

# Case Report from Audit Firm Inspection Results

(In Program Year 2019)

July 2019

**Certified Public Accountants and Auditing Oversight Board**



## **Introduction**

Since its inception in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAFOB) has been conducting inspections of Japanese audit firms from the viewpoint of securing the public interest and protecting investors with the aim of ensuring and improving the quality of auditing in Japan.

The CPAFOB compiled examples of deficiencies identified in its inspections as the “List of Examples of Issues on Audit Quality Control Identified through Inspections” in February 2008 (renamed the “Case Report from Audit Firm Inspection Results” in 2012), and has since issued revised editions every year.

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

This Case Report has been updated to add the latest actual cases of inspections and redesigned to make the background to deficiencies more easily understood, following previous years' editions in terms of its basic structure.

We plan to present details of the content of the Report and organize information exchanges by conducting briefings at regional chapters of the Japanese Institute of Certified Public Accountants (JICPA) and lectures at the Japan Audit & Supervisory Board Members Association.

In addition, we have published information about the inspection system and the situation at audit firms in the form of the “Monitoring Report in 2019.” Please also refer to this report.

Please submit any comments or requests regarding this Case Report to the dedicated e-mail address below.  
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## **Responses Expected of Audit Firms**

### **1. Ensuring the Reliability of Audits**

In recent years the powers of audit and supervisory board members, audit and supervisory boards, audit committee members, and audit committees (below, “corporate auditors etc.”) have been strengthened and a corporate governance code has been introduced. Developments such as these have led to corporate governance environments being reinforced, but incidents of fraud continue to occur both in Japan and overseas. The number of listed companies that have provided timely disclosure of inappropriate accounting has also been increasing. Given these circumstances, a considerable number of them are likely to have issues pointed out to them by auditors. To further ensure the reliability of audits, it is therefore necessary for each audit firm to continue to verify its individual audit engagements and system of quality control with reference to the deficiencies and their causes described in this Case Report.

In doing so, audit firms should pay attention not only to whether their engagements and systems comply with the standards formally, but also whether they strive to ensure and improve the quality of their audits. In effect, such as whether they exercise appropriate professional skepticism that could identify fraudulent accounting, and whether they constantly focus on the business risks of the audited companies upon evaluating audit risks.

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

### **2. Organized Responses**

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

With regard to the management of audit firms, the “Principles for Effective Management of Audit Firms” (The Audit Firm Governance Code) was issued in March 2017. In light of the fact that some audit firms, particularly large-sized audit firms, are already establishing a governance environment for ensuring and improving audit quality, the CPAAOB will continue examining whether or not the governance environment established and/or strengthened by each audit firm based on the Code is effective.

### **3. Preparation of Appropriate Audit Documentation**

We should bear in mind that if any audit document has not been prepared properly for an important audit

matter, this is not simply a deficiency of documentation, but in most cases, it implies that the necessary audit procedures have not been implemented. It is therefore vital to enhance the ability of each audit team to prepare appropriate audit documentation through education/training. It is also important for senior staff to provide day-to-day guidance to partners and assistants to engagement partners with regard to frontline supervision of audits, the review of audit documentation and engagement quality control reviews, periodic inspection, etc. of audit firms.

#### 4. Responding to Issues According to Size

There is wide variation in the sizes of audit firms, with some having just a few personnel while others have headcounts that run into the thousands. There are also differences in operations management environments. Because of these factors, it is important to continuously inspect whether the quality control environment established by the audit firm is appropriate in view of the size of the firm and the operations management environment.

The following characteristics have been identified as problems relating to the size of the audit firm, so each audit firm should refer to them and take appropriate action based on their size.

##### [Large-sized audit firms]

We can see that large-sized audit firms are working in an organized manner on improvements toward higher quality, such as rebuilding their governance environments through, for example, the utilization of knowledge of outside third parties, strengthening of collaboration between different levels within the firm (management, quality control division, business divisions, engagement teams), and appropriate human resource development and personnel management and evaluation.

On the other hand, at large-sized audit firms, since their organizations are extremely large, issues such as the lack of frequent communication among divisions and between the head office and regional offices and difficulty in ensuring the penetration of the firm's measures across all divisions and offices have still been pointed out. As a means of addressing this, a trend that has been seen recently is to shift the maintenance and improvement of quality control to business units, which are closer to the audit frontline. While such initiatives are likely to be effective to some extent, attention needs to be given to ensuring that the quality control department accurately and continuously finds out about the characteristics of the engagements handled by each business unit so as to ensure the effectiveness of the measures instituted by business units.

##### [Second-tier audit firms]

Regarding second-tier audit firms, some of them have been moving to establish structures that allow for organized action with regard to the firm's quality control, but their headquarters organization remains weak. Furthermore, the quality control environment is sometimes inadequate as a result of a limited numbers of quality control personnel and insufficient awareness concerning quality control among the CEO and PICOQC. Another problem is that at firms that are expanding the range of operations they perform, the

establishment of an audit performance environment has not kept pace with, for example, the undertaking of new audit contracts. Furthermore, business administration at second-tier audit firms is characterized by low levels of involvement by partners in the business of the firm, heavy reliance on part-time employees in the performance of audit engagements, and inadequate post-merger management integration.

In addition, with second-tier audit firms needing to improve their ability to conduct audits for large listed companies, they are beset by problems such as inadequate handling of international operations, including the building of relationships with overseas partners.

[Small and medium-sized audit firms]

At small and medium-sized audit firms, many CEOs and PICOQCs still do not understand the importance of quality controls and are failing to make proactive efforts. In addition, they lack the resources for developing systems of quality control. Because of this, while they are addressing deficiencies identified in external inspections, this action is often superficial, being based on treating the symptoms rather than tackling the causes. Some audit firms are also not making an effort on a day-to-day basis to improve audit quality and followed the previous audit procedures on the grounds that no major problem had occurred in the past.

There are also some small and medium-sized audit firms that place priority on expanding the range of services they offer, and have therefore accepted audit engagements without performing adequate risk assessments of listed companies that carry a high degree of audit risk and without having taken appropriate steps to address risks.

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

The relationship between the directors/company auditors of a business audited company and an independent auditor are being streamlined through the recent revision of the Companies Act and related regulations such as the Corporate Governance Code. Meanwhile, incidents such as fraudulent accounting by listed companies and accounting issues related to overseas group companies continue to be seen.

Management is responsible for the preparation of financial statements and the design of internal controls. Furthermore, from the perspective of investor protection and securing the reliability of the capital market, directors and company auditors are strongly expected to appropriately evaluate and select independent auditors, who provide assurance as to the accuracy of financial statements, as well as to fulfill their responsibilities in order to ensure proper audits, such as by allowing adequate auditing time to ensure high quality audits and by fully collaborating with the independent auditors.

It is also important for market participants such as shareholders of audited companies that the directors and company auditors of audited companies appropriately evaluate and select independent auditors, and that companies' proper financial information is disclosed on a continuous basis by securing proper auditing.

In view of such matters, this Case Report describes examples of deficiencies identified in the CPAAOB's inspections, which include recent accounting fraud cases, in the most easily comprehensible manner possible from the perspective of providing directors and company auditors etc. in listed companies, as well as investors with reference materials. Furthermore, this Report describes excellent cases of improvement efforts by audit firms. Thus, we hope that this Report will be used as a reference for the appropriate evaluation of independent auditors.

## **Important Points for Users of this Case Report**

### **1. Regarding Cases Included in the Report**

- (1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, that does not mean that the CPAAOB puts less importance on cases that were not included in the Case Report.
- (2) The cases included in the Report may have had facts omitted or changed to the extent that does not affect the purport of the case.
- (3) The number of cases pointed out on the following pages reflects neither the proportion of the number of deficiencies by the size of the audit firms, nor the ratio of the number of deficiencies by the inspection items.
- (4) Deficiencies that were not included in the Case Report may include matters that should be noted by the audit firms and engagement teams, or may include the points to be expected in terms of appropriate audit procedures.
- (5) In cases where there are multiple criteria for identifying the deficiencies, the principal provision is quoted.

### **2. Main Characteristics of the 2019 Edition**

- (1) “I. Operations Management Environment (Root Cause Analysis)” (title in previous program year’s edition: “I. Root Cause Analysis”) adds examples of issues with the operations management environment in response to the Governance Code for Audit Firms.
- (2) In “II. Quality Control Environment,” (title in previous program year’s edition: “II. Quality Control”) expanded examples of issues with the quality control environment with regard to the conclusion of new audit contracts, the hiring of professional personnel, the supervision of assistants to engagement partners, etc.
- (3) In “III. Individual Audit Engagements,” descriptions of deficiencies and points to note have been included in sections such as “4. Group Audit” and “6. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits” to reflect the fact that accounting fraud at listed companies and accounting issues at overseas group companies continues to attract public attention.
- (4) The following is a comparison of numbers of cases of deficiencies in this Case Report with the previous program year’s case report.



	PY 2018	No. of cases removed	No. of new cases added	PY 2019
II. No. of cases of deficiencies with quality control environment	66	14	21	73
III. No. of cases of deficiencies with individual audit engagements	116	37	44	123

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(Definitions of terms)

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

Act	Certified Public Accountants Act
FIEA	Financial Instruments and Exchange Act
Audit firm	An audit firm, a partnership, and an individual firm
Large-sized audit firm	<p>An Audit firm that has more than approximately 100 domestic listed audited companies and whose full-time staff performing actual audit duties total at least 1,000.</p> <p>In this case report, they specifically refer to KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst &amp; Young ShinNihon LLC, and PricewaterhouseCoopers Aarata LLC.</p>
Second-tier audit firm	<p>An audit firm whose business scale is second only to large-sized audit firms.</p> <p>In this case report, this will refer to five audit firms: Gyosei &amp; Co., BDO Sanyu &amp; Co., Grant Thornton Taiyo LLC, Crowe Toyo &amp; Co., and PricewaterhouseCoopers Kyoto.</p>
Small and medium-sized audit firm	An Audit firm other than large-sized and second-tier audit firms
CPAAOB	Certified Public Accountants and Auditing Oversight Board
JICPA	Japanese Institute of Certified Public Accountants
Quality control (QC) review	Quality control review performed by the JICPA under Article 46-9-2 of the Certified Public Accountants Act and Article 122 of the JICPA Rules
Audit Firm Governance Code	Refers to the Principles for Effective Management of Audit Firms, published by the FSA in March 2017
Audit team	Persons engaged in the provision of audit services, and comprises an engagement partner and assistants to the engagement partner
Engagement partner	The person responsible for conducting the audit, who is a CPA with responsibility for the audit services and their provision as well as the audit report issued
Assistants to engagement partner	Members of an audit team other than the engagement partner



# I . Operations Management Environment (Root Cause Analysis)





## **1. Operations Management Environment and Root Cause Analysis**

### **(1) Necessity of Root Cause Analysis**

With regard to audit firms that the CPAAOB conducted inspections of, it has been recognized that when a deficiency was detected in a review conducted by the JICPA in accordance with Article 46-9-2 of the Certified Public Accountants Act and Article 122 of the JICPA Rules (below, “QC review”) or periodic inspection, quite a few audit firms only took cosmetic improvement measures, without fully identifying the cause.

Deficiencies identified in inspections are discovered within the scope of investigations. It is likely that the audit firms have other undiscovered deficiencies arising from the same root causes. Moreover, even if measures are implemented to address the direct causes of the deficiencies, they will only be effective temporarily, and similar deficiencies will occur again. Therefore, improvement measures developed only to cope with the direct causes, without any root cause analysis, would not be effective or sufficient for improving the quality control system of the entire firms, and would not lead to fundamental improvement; therefore, the quality of the audits by the audit firms would not be improved.

On the contrary, taking symptom-treating perfunctory measures such as simply adding checklist items in response to individual deficiencies, for example, would lead to an increase in unnecessary and ineffective workload for professional staff to respond to the checklist and often prevent them from implementing an effective and efficient audit engagements.

Thus, audit firms shall understand the importance of root cause analysis of deficiencies in order to substantively improve quality control.

When performing root cause analysis, it is important to accurately identify what are assumed to be the direct causes. The direct causes of deficiencies do not only reside the knowledge, attitudes, or experience of those who carried out the acts. It is therefore essential to identify them after obtaining an adequate understanding of factors such as the a situation with the audit team and the business conditions of the audited company, and to then analyze the root causes in view of the direct causes.

In recent years, with regard to deficiencies at large audit firms relating to individual audit engagements identified through external inspections and periodic investigations, the firms not only identify and communicate the inadequacies in audit procedures and audit evidence, but also incorporate action to analyze their root causes into their quality control environment.

For example, the quality control department etc. acts voluntarily to conduct interviews with and questionnaire surveys of the audit team in which the deficiency was identified in order to find out the details of the direct causes of the deficiency, after which it analyzes whether these direct causes were the result of the firm’s operations management environment or quality control environment, and then reflects its findings in the improvements to be made.

## **(2)Effectiveness of Operations Management Environment and Root Cause Analysis**

Many of the issues pointed out as the root cause of deficiencies are related to the business management (governance) environments and the service management environment, for example, the policy of top management, the headquarters' environment of monitoring audit field work, the culture of quality control and governance of the audit firm. Therefore, each audit firm should pay special attention to the effectiveness of the business management (governance) environments and the service management environment such as the governance of the audit firm, which could be a root cause, without being caught by the direct cause of individual deficiencies.

The following are examples of issues with the business management (governance) environment and the operations management environment. They were identified during the CPAAOB's inspections by analyzing direct causes of deficiencies and investigating root causes.

### **[Large-sized audit firms]**

#### **[Case 1]**

Multiple deficiencies, some of which were significant, with some individual audit engagements subject to investigation were identified at an audit firm.

The direct causes of these deficiencies included the fact that in an audit area etc. in which the engagement partner was convinced that there were no problems with accounting treatment at an audited company as a result of data obtained from the company and consultations conducted with them in advance, the engagement partner did not demonstrate professional skepticism, and therefore instructions, supervision, and review of the audit frontline were inadequate. Not only that, but assistants to engagement partner did not possess the level of understanding required under audit standards.

In light of this situation, we conducted further investigations into the causes, and discovered that although the audit firm had been stepping up its hiring of professional personnel, such as by recruiting people mid-career, in order to cope with an increase in audit engagements, and that this was leading to an improvement in quality control on the audit frontline, there were problems with the quality control environment in that efforts to ensure and improve audit quality were not being instituted rapidly enough. For example, the skill level of audit teams as a whole had not been raised to an adequate degree.

#### **[Case 2]**

Multiple significant deficiencies with some individual audit engagements subject to investigation were identified at an audit firm. These concerned, for example, the failure to establish and implement in-depth audit procedures relating to fraud risk.

The direct causes of these deficiencies included the fact that engagement partners had not been adequately providing appropriate guidance and supervision concerning risks relating to audit engagements. Furthermore, due to inadequate internal/external cooperation by the audit division, it

failed to sufficiently identify this situation with engagement teams and changes in the circumstances of audited companies, which led to inadequate support being provided in the case of high-risk audit engagements.

In light of this situation, we conducted further investigations into the causes, and discovered that division managers were designated as being responsible for quality control, and that the scope of control of the managers of large divisions was too broad. Against this backdrop, there was deemed to be a problem with the operations control environment and the quality control environment, whereby it was difficult to respond flexibly to each audit engagement.

### **[Second-tier audit firms]**

#### **[Case 1]**

A significant deficiency with the quality control environment pertaining to the conclusion of new audit contracts was identified at an audit firm.

The direct cause of this significant deficiency with the quality control environment was that the head of quality control did not amend the rules on the conclusion and renewal of contracts despite knowing that they were incompatible with the actual situation.

In light of this situation, we conducted further investigations into the causes, and discovered issues with the operations management environment and the quality control environment, whereby there was scant awareness of the need to perform appropriate risk assessment procedures. Specifically, the executives, including the CEO, while knowing that the rules pertaining to the conclusion of new audit contracts were incompatible with the actual situation, tolerated them on the grounds that no major problems with business administration had occurred in the past.

#### **[Case 2]**

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

The direct causes of such deficiencies were that partners followed the previous audit procedures and were not reviewing the audit documentation effectively because they believed that no major problems with audit engagements had occurred in the past.

As a result of further analysis of the cause in view of such circumstances, an issue with was identified with the operations management environment. Specifically, despite the fact that the firm had undergone repeated mergers, the headquarters organization remained vulnerable, the regional offices that had been established by separate entities were permitted to administer business in their own ways, resulting in hardly any personnel interaction taking place.

## **[Small and medium-sized audit firms]**

### **[Case 1]**

Wide-ranging deficiencies in the quality control environment were identified at an audit firm, while numerous significant deficiencies were also discovered with individual audit engagements subject to investigation.

The direct causes of these deficiencies included the fact that the representative of the audit firm lacked awareness of the need to establish a quality control environment for the entire audit firm, the fact that the PICOQC did not adequately understand the role they were expected to fulfill and lacked awareness of their personal responsibility to maintain and improve quality control within the audit firm as a whole, and the fact that engagement partners felt that it was okay to just follow the previous audit procedures. In light of this situation, we conducted further investigations into the causes, and discovered issues with the operations management environment. Specifically, we found that the firm had been established as a result of the merger of multiple individual firms, and that two of the previous audit departments were still operating independently in terms of both finances and personnel. This led to remnants of an organizational culture in which each of the audit departments within the audit firm placed priority on their own operations. However, the CEO, who was the person ultimately responsible for quality control for the audit firm as a whole, did not set forth a central policy aimed at integrating quality control, and did not demonstrate sufficient leadership in establish an effective headquarters organization.

### **[Case 2]**

A significant deficiency in the quality control environment pertaining to the conclusion of new audit contracts was identified at an audit firm, while wide-ranging and numerous significant deficiencies were also discovered with multiple audit engagements subject to investigation.

The direct causes of the significant deficiency in the quality control environment included the fact that specific execution procedures and approval procedures for the conclusion of new audit contracts had not been codified. Meanwhile, the direct causes of the deficiencies with individual audit engagements included the fact that the engagement team including engagement partners was lacking understanding and knowledge on the auditing standards and audit procedures for addressing identified audit risks had not been established or implemented and the fact that materials etc. supplied by audited companies had not been examined from a critical point of view, for example, indicating a lack of professional skepticism.

As a result of further analysis of the cause in view of such circumstances, issues with the operations management environment were identified, whereby the PICOQC's involvement in quality control was inadequate, and they failed to demonstrate leadership in the establishment of the quality control environment. Specifically, even though the audit firm had concluded audit contracts with a high level of audit risk in recent years, the CEO did not believe that companies audited by the firm included ones with a high level of audit risk. As a result, they lacked the volition to perform appropriate risk

assessments of current and new audited companies in response to the expansion of the audit firm and its risks.

As the above cases show, an analysis of the causes of deficiencies revealed that they stem from issues with the audit firm's business management (governance) environment or operations management environment, so to address the causes of these deficiencies, it is important to improve these environments. Although audit firms, and large-sized audit firms in particular, are currently working to establish and strengthen their organizational administration in accordance with the Audit Firm Governance Code, they ought to give adequate attention to ensuring their effectiveness and endeavoring to contribute to ensuring and improving audit quality.

## **2. Specific Examples of Root Causes**

The following are specific examples of issues with the business management (governance) environment and operations management environment that were identified during inspections and described in "1. Operations Management Environment and Root Cause Analysis."

To address deficiencies, it will be necessary for audit firms to refer to these examples as they work on tackling fundamental issues that affect the firm as a whole, such as problems relating to its operations management environment, in order to ensure and improve audit quality.

### **[Large-sized audit firms]**

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

Since large-sized audit firms have several thousands of employees, they usually have multiple divisions, consisting of several hundreds of staff managed by a division manager, etc. So, we can see their characteristics that they have multiple offices, including some regional offices.

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

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

that this has proved somewhat effective. As a result, divisions etc. are playing a greater role in voluntarily improving quality and propagating an improvement-oriented mindset among engagement team members. However, the management and quality control departments etc. are prioritizing the autonomy of each division with regard to initiatives for improving audit quality, and just leaving such initiatives in the hands of the divisions. There are cases where problems such as an insufficient understanding of the actual situation of each division and an insufficient verification of whether the improvement measures are being appropriately carried out are occurring. As a result, the management and quality control departments etc. need to find out properly about the action being taken in each division and pay attention to how effective it is.

The following are specific examples of root causes at large-sized audit firms identified so far by the CPAAOB:

- Although firms are determining important audit areas at each level of the organization and formulating and implementing improvement measures in a prioritized and focused way, there was inadequate recognition of the need for departments in charge of quality control to find out whether measures to improve quality in audit were being implemented effectively. As a result, confirmation by departments in charge of quality control of the type of monitoring of audit engagements being performed by audit divisions was inadequate.
- Although the number of professional personnel is increasing as a result of firms stepping up recruitment, including of mid-career personnel, to cope with business expansion, the overall skill level of audit teams has not been improved sufficiently, and efforts to ensure and improve quality on the audit frontline are not being made to an adequate degree. (With regard to this example, also refer to [Large-sized audit firms] [Case 1] on p. 16)
- Although division managers are supposed to be responsible for quality control within their respective divisions, the scope of control of the managers of large divisions was too broad. As a result, structures for gauging the situation on the audit frontline and ensuring internal and external cooperation have not been adequately developed. Because of this, information from engagement quality control (EQC) reviewers outside the division and information from engagement partners inside the division are not being sufficiently utilized by audit divisions, and as a consequence, flexible support based on changes in the circumstances of audited companies is not being adequately provided. (With regard to this example, also refer to [Large-sized audit firms] [Case 2] on p. 16)

### **[Second-tier audit firms]**

Looking at second-tier audit firms, we find that while the firms are indeed moving forward with the establishment of quality control environments, the establishment of headquarters organizations has, on the whole, been insufficient. Furthermore, top management's awareness of quality control is not keeping

pace with the expansion in their firms operations. On the other hand, the firms differ in terms of how they were established, their operations management environments, and their size, so the root causes of problems differ from firm to firm.

As a result, each firm needs to move quickly to make effective improvements after analyzing causes in ways that adequately reflect trends with their own operations, their operations management environments, and so on.

The following are specific examples of root causes identified so far by the CPAAOB:

- With audit engagements expanding as a result of factors such as mergers and the undertaking of audit engagements for high-risk companies, executives, including the CEO, have scant awareness of the need to perform appropriate risk assessment procedures. For example, while knowing that the rules pertaining to the conclusion of new audit contracts were incompatible with the actual situation, they tolerated them on the grounds that no major problems with business administration had occurred in the past. (With regard to this example, also refer to [Second-tier audit firms] [Case 1] on p. 17)
- Operations are performed independently at each regional office. Specifically, matters such as the mobilization of engagement teams, the determination of partners' remuneration, periodic inspections, and engagement quality control reviews are determined and implemented under an independent operations management environment. Furthermore, partners and employees at the different regional offices hardly ever come into contact with each other. Given this situation, the CEO recognizes the need for integrated business administration within the firm, and is taking steps to achieve this, such as strengthening headquarters functions. However, because the role of headquarters is not clearly prescribed in organizational rules etc., and there are no full-timers assigned to headquarters, the functions of headquarters are not being adequately performed, so the steps being taken are inadequate to ensure integrated business administration. (With regard to this example, also refer to [Second-tier audit firms] [Case 2] on p. 17)
- The audit firm had many partners who had a high percentage of concurrent work, and depended on a large number of part-time employees for its audit engagements. Although it was pointed out in the previous CPAAOB's inspections that such a business structure made it difficult for the management philosophy to be instilled and for the CEO, etc., to enforce governance, the firm has still not been able to make fundamental improvements to its business structure. Therefore, the development of effective governance is insufficient to thoroughly enforce quality control across the entire firm.
- The PICOQC was busy dealing with the firm's merger, and had not adequately ensured that audit teams would make use of audit tools in accordance with audit standards, and was not sufficiently investigating whether improvements aimed at addressing issues that had been pointed out were being implemented. Because these circumstances, inadequate action was being taken to improve quality within audit teams that were not following audit procedures at the level required under audit standards.

- Even though audit operations are expanding as a result, for example, of the firm accepting engagements from high-risk audited companies, the CEO and the PICOQC believe that by adjusting the schedules of partners it will be possible to cope with the expansion without expanding the current audit teams. However, partners with poor ratings for quality control in numerous engagements are having to be relied on, and yet despite this, the quality-control capabilities of these partners are not being increased. Such circumstances exemplify the fact that insufficient efforts are being made to adapt to the organization's operational expansion.

### **[Small and medium-sized audit firms]**

Small and medium-sized audit firms come in various sizes and forms, and levels of establishment and implementation of quality control structures also differ from firm to firm. However, their organizations are relatively small, and they all face the difficulty of providing audit teams with organized assistance in areas such as quality control. A key characteristic of them, therefore, is that business administration and levels of quality control depend to a large degree on the abilities of individuals that belong to the audit firm, including the CEO, and the relationship between the personnel and the firm.

Because of this, low awareness of and involvement in quality control by the CEO often affect the quality control climate throughout the audit firm, so it is important for the CEO to demonstrate leadership in quality control.

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

- Cases relating to inadequate awareness of quality control among CEOs and PICOQCs
- Cases resulting from the background to the establishment of the audit firm or changes in the management environment within the audit firm due to mergers etc.

#### **(1) Cases relating to inadequate awareness of quality control among CEOs and PICOQCs**

- The number of audit engagements is increasing year by year, and the firm has recently undertaken engagements from high-risk listed companies. However, only a small number of partners comprise the full-time professional staff, and partners and assistants to engagement partners also include part-time employees. Because of this, partners focus only on their own audit engagements, and are not getting sufficiently involved in quality control.
- The audit firm has not established an environment for performing organized audits commensurate with audit risks. For example, it had not secured enough human resources to perform proper audits.
- The CEO and the PICOQC lack an adequate understanding of recent environmental changes affecting auditing and accounting and levels of quality required under current audit standards. Furthermore, an environment for the ongoing provision of education and training has not been established.



- The PICOQC is replaced every two years, but the current PICOQC believes that his main role is to continue conducting periodic inspections, as his/her predecessor did. He/she therefore lacks awareness of the need to proactively get involved in quality control as a whole. Because of this, he/she is not properly fulfilling his/her role of managing quality control. For example, he/she is not providing adequate instructions to staff involved in quality control. Furthermore, even though the CEO has been aware of this situation with quality control, he/she has not attempted to establish a more effective quality control environment.
- The CEO and engagement partners relied on the assertions of audited companies based on their audit experience, and were not sensitive to fraudulent risks. In particular, certain engagement partners relied on the assertions of a high audit risk audited company and did not perform audit procedures with professional skepticism. They did not understand current accounting and audit standards either.
- The CEO did not appropriately evaluate the quality of individual audit engagements or the professional skills of professional staff, even though the most recent quality control review had identified material deficiencies. He had partners with insufficient understanding and knowledge of the quality levels required under current audit standards serve as engagement partners or EQC reviewers of listed companies for many years, and had not established an effective quality control system.
- The CEO and PICOQC assumed that there would be no significant quality control issues as long as they avoided audit failures by fully addressing matters that the engagement team deemed significant in audit engagements. Furthermore, they responded to deficiencies identified in the quality control review by taking improvement measures merely as a formality without fully analyzing the cause, on the grounds that material deficiencies had not been identified in the past quality control reviews.
- As a partners' meeting has ultimate responsibility for the quality control system in an audit firm, each partner should be aware of the responsibility as a member of this meeting, in order to design and operate the quality control system of the audit firm. However, partners, including the CEO, were not aware of their responsibility regarding the operation of the firm. And therefore, the partners' meeting did not function well.
- Partners lacked experience in quality control operations of an audit firm or in forming audit opinions of listed companies prior to the establishment of the firm. They also had insufficient understanding and knowledge of the quality level required under audit standards. In addition, with regard to quality control of the audit firm and audits of listed companies, they lacked an attitude of seeking to improve audit quality and professional skills since they assumed that they could fully deal with issues based on their experience.
- Partners, including the CEO, have not carried out self-improvement on audits although audit levels required under audit standards have changed, and do not understand the levels required under current audit standards. In addition, they are not fully aware of the necessity of continuously reviewing the quality control environment according to quality levels required under current quality control standards.

(2) Cases resulting from the background to the establishment of the audit firm or changes in the management environment within the audit firm due to mergers etc.

- The audit firm comprises two audit departments, and each department's audit engagements, finances, and personnel are controlled independently by the representative partner (head) of the audit department. The representative partner of each audit department is typically appointed by the previous representative partner, and an organizational climate exists in which priority is placed on the independence of each audit department. The audit firm has designated the CEO as the person with the ultimate responsibility in quality control, but the CEO has not set forth a central policy aimed at integrating quality control, and has not demonstrated sufficient leadership in establishing an effective headquarters organization. (With regard to this example, also refer to [Small and medium-sized audit firms] [Case 1] on p. 18)
- The audit firm has increased its audit engagements, including ones involving listed companies, and risks relating to audit engagements are increasing. However, as the PICOQC, the CEO is not demonstrating leadership in establishing a quality control environment. For example, they lack the volition to perform appropriate risk assessments of current and new audited companies. (With regard to this example, also refer to [Small and medium-sized audit firms] [Case 2] on p. 18)
- The CEO believes that no significant audit-related issues have occurred in the past, and therefore sees little need to establish an integrated operations management environment for ensuring that audits are conducted in a systematic fashion. Furthermore, even though the most recent quality control review resulted in a qualified opinion, he/she has not demonstrated leadership in improving quality control. For example, he/she has not given instructions to the PICOQC to make improvements based on an adequate understanding of the causes of deficiencies.
- The audit firm was incorporated through the merger of multiple individual firms, so quality control for audit engagements was left to the partners themselves. And because each partner was responsible for the profitability, staffing, etc. of their own audit engagements, there remained an organizational climate in which they would not interfere with the work of other partners. So the operations management environment was not integrated.
- Because the firm was established by multiple CPAs operating individual firms for the purpose of conducting audit engagements, each partner's possesses a strong attitude that they are running their own firm, and despite the environment changing, they are averse to change, and refuse to proactively review their past quality control methods and audit procedures. Because of reasons such as these, the volition to ensure and improve the audit quality of the firm is inadequate.

### **3. Response to the Audit Firm Governance Code**

<Expected response>

The Audit Firm Governance Code, which was published in March 2017, was formulated with the

organizational administration of large-sized audit firms, which have numbers of personnel and handle the audits of listed companies etc., in mind. In response to the Governance Code, large-sized audit firms are required to establish effective management bodies and administer their operations in an organized manner in order to improve audit quality. Furthermore, there are no obstacles to the Audit Firm Governance Code also being adopted voluntarily by audit firms other than large-sized audit firms, and each audit firm must respond voluntarily in light of its own characteristics etc.

#### <Responses based on size>

As of July 1, 2019, all large-sized audit firms and second-tier audit firms as well as eight comparatively large small and medium-sized audit firms had announced adoption.

Regarding the five principles of the Audit Firm Governance Code, application of them by firms based on size is as follows: Large-sized audit firms and second-tier audit firms have declared that they will apply all the principles. However, many second-tier audit firms have not made statements concerning involvement by third parties with independence (below, “independent third parties”) to perform supervision/evaluation functions within their organizational environments (Principle 3). Furthermore, compared with those from large-sized audit firms, external explanations concerning organizational structures and quality control structures for ensuring transparency (Principle 5) tend to be simplified. In addition, few small and medium-sized audit firms, despite having adopted the Audit Firm Governance Code, are applying all of the principles, with supervision/evaluation functions within organizational environments (Principle 3) and ensuring transparency (Principle 5) often being dropped.

#### <Responses to supervision/evaluation functions within organizational environments (Principle 3)>

Large-sized audit firms are pressing ahead with adding independent third parties as outside members of existing supervision/evaluation bodies, establishing independent bodies such as public-interest committees to monitor the organizational administration of the audit firm from a public-interest point of view, and so on. With these initiatives, it is important that third parties are provided with the information they need concerning important decisions and business administration at the audit firm, and that opinions are sought from the independent third parties whenever necessary.

For these reasons, some firms are moving to provide necessary information to independent third parties by allowing independent third parties to attend meetings of management bodies, including those of group firms, or establishing secretariats to assist the independent third parties. Furthermore, some are providing opportunities for independent third parties to periodically exchange opinions with the CEO etc. There are also cases of firms taking action to enhance effectiveness increasing the proportion of members of committees etc. who are independent third parties.

In addition, second-tier audit firms have appointed independent third parties as members of bodies for supervising/evaluating business execution bodies, yet some of them have not clarified how these independent third parties are appointed period of their role and the powers that they have been given.



## II . Quality Control Environment



## **Implementation of Quality Control Operation**

### **Outline**

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC environment are appropriate to the size and characteristics of the firm. Responses to requirements for QC systems under the audit standards vary between large-sized audit firms with several thousand members, and small and medium-sized audit firms. Furthermore, many deficiencies identified in the past reflect the size and characteristics of each audit firm, and the background to the deficiency as well.

Therefore, in “II. Quality Control Environment”, examples of deficiencies identified in the CPAAOB inspections are categorized into “Large-sized audit firms” and “Small and Medium-sized Audit Firms,” and introduced basically according to the provisions of “Quality Control for Audit Firms” (Quality Control Standards Committee Statement No. 1).

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

### **Analysis of deficiencies that occurred**

Regardless of the size of an audit firm, the purpose of establishing a QC system is to reasonably ensure the quality of audit engagements handled by the organization.

However, some audit firms developed a QC system only as a formality. In such cases, the QC system developed by the audit firm often does not work as expected and results in deficiencies, due to such causes as the failure to appropriately operate the system and to organically link the system to the improvement of individual audit engagements.

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still many deficiencies in individual audit engagements. Therefore, it can be assumed that there are deficiencies in the operation of the QC system. Specifically, operation-related deficiencies have been identified in areas such as reviews of audit documentation and periodic inspections. Furthermore, deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past were improved merely as a formality without uncovering their fundamental causes, which has led to continued identification of same deficiencies in other individual audit engagements. From such cases, it may be deemed that efforts to improve operations related to quality control are insufficient.

For example, there are cases where measures that were developed to improve the deficiencies have not fully permeated the divisions and engagement teams, which have resulted in failure to achieve the expected effects and in continued identification of the deficiencies in the division or engagement team.

At second-tier audit firms and small and medium-sized audit firms, deficiencies continue to be identified in a broad range of areas in terms of both the design and operation of the quality control system. In addition, as at large-sized audit firms, there were cases where deficiencies that had been identified in the past by the CPAAOB inspections and quality control reviews were not appropriately improved in individual audit engagement inspections. Many such cases were deemed attributable to the quality control system. The above resulted from the facts that the CEO and the PICOQC did not understand quality control operations, and that the design and quality control system were not conducted or used appropriately. In addition, there were cases where sufficient resources were not applied to the establishment of a quality control system that directly affects the audit quality.

A cause that is unique to second-tier audit firms is the failure of quality control system functions to suit the expansion of the size of the corporation through merger or acceptance of new audit engagements. For example, although persons in charge of each function of the quality control system including EQC reviews and education/training were appointed, they could not identify and correct the deficiencies that are inherent in terms of quality control and individual audit engagement, because there was no one responsible for the quality of audit.

#### **(Observed effective efforts)**

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

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

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

#### **Expected response**

Based on the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish such a system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual audit engagements. Specifically, the CEO and PICOQC of audit firms should understand the purpose and importance of the quality control system, and take the initiative in ensuring that each professional in a firm understands that the primary purpose of the QC system is to spread measures to improve the quality of audit throughout the entire organization, and monitors its effects at all times.

The content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of professionals at the firm, the characteristics of



management, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC environment according to the size and characteristics of their firm and appropriately maintain the system by reviewing it as needed.

### **[Large-sized Audit Firms]**

#### **1. Initiatives to Improve Performance**

##### **Points of focus**

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

Specifically, the CPAAOB checks the status of cause analysis of the deficiencies identified in the past and the status of measures to improve operations, such as measures based on the status of analysis, as well as the effectiveness of the firm's improvement efforts by verifying individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB seeks to identify the operational and structural issues that might be the cause of such insufficiency, and inspects the effectiveness of the remediation measures carried out by the firm.

##### **Outline of inspection results**

At large-sized audit firms, remediation measures for deficiencies identified in the CPAAOB inspections and QC reviews may be planned under the initiative of the QC division at the headquarters, and disseminate them to engagement teams through training and notifications, after which each engagement team then responds through the revision of audit procedures based on the risks of each audited company. However, the CPAAOB inspection has revealed that organized improvement measures are not sufficient at different levels within the firm, such as departments and partners. Specifically, there were cases where improvements were not permeated at firms whose departments and regional offices had no personnel exchange with other departments, resulting in static human resources.

##### **Expected response**

Large-sized audit firms employ several thousands of staff members and have multiple offices, including those outside major cities. Therefore, they usually have multiple departments, each consisting of several hundreds of staff members and managed by a department manager or equivalent. In order to disseminate improvement measures planned at the headquarters to the entire organization as a response toward improvement and achieve sufficient effects, the entire firm should respond to any deficiency together with division managers, based on the understanding of the entire firm in quality control, instead of

response only by limited divisions, such as the QC division. Thus, the expected effects can be achieved. The CEO in particular should take the initiative in encouraging all members, especially the engagement partners, who are in a position to lead the engagement teams, to improve operations, so that the intent of the improvement permeates the entire organization. Thereupon, the PICOQC is required to plan and implement the timely and appropriate measures under the instructions of the CEO, while division managers are not required to only improve operations but to provide appropriate instructions and urge professional staff under their management to make appropriate responses.

Furthermore, the CEO and PICOQC should together with division managers or equivalent, establish an effective system to monitor improvement and take appropriate actions to promptly resolve any issues that were identified in the inspection.

In carrying out measures to improve operations at large-sized audit firms, you have to pay close attention so that the measures do not become a formality, such as by avoiding giving uniform instructions for improving deficiencies throughout the entire firm. For this purpose, it is necessary to carry out moderated and effective measures, such as by fully analyzing the tendency and cause of the identified deficiencies to identify the target areas for performance improvement (for example, certain departments and subordinate offices, audit items such as accounting estimates and response to fraud, and IPO-related audits), and focusing on effective improvement measures that suit the target areas.

### **Case 1: Information sharing and cooperation within the firm**

In response to the results of past external inspections, the audit firm is promoting consultations with engagement teams based on cooperation between audit divisions, quality control divisions, etc. with the aim of maintaining and improving quality control throughout the firm.

However, because of cooperation between divisions within the firm was inadequate, when considering making changes to the composition of an engagement team involved in a high-risk audit engagement, the division in charge failed to communicate adequately with the engagement partner, who had been assigned from another division, and therefore failed to grasp this engagement partner's situation, such as how many audit engagements he/she was involved with, whether he/she had a heavy workload, etc. Although other divisions were aware of heavily loaded information about this engagement partner, it was not being shared with other divisions.

Furthermore, the audit divisions and quality control divisions were not sharing information with each other about material changes in audit engagements, the audit divisions were unaware of increased risk of audit engagements, and therefore did not consider the needs of additional supports for these audit engagements.

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

### **Case 2: Verification of improvement**

The audit firm changes its engagement partners engaged in audit engagements with many

deficiencies identified in the CPAAOB inspections, in order to limit the number of audited companies they are in charge of. However, an engagement partner that was subject to the limitation of the number of audited companies in charge was retained due to reasons such as handover, with a partner to be newly engaged in the engagement supplementing the roles of the above engagement partner.

However, the new engagement partner was held up by a temporary project of another engagement and could not be involved in the above engaged as initially planned. Therefore, the engagement team has not been able to fully respond to the accounting issues of the audited company.

Furthermore, although the new engagement partner initially reported to the division manager of the audit firm about accounting issues and the temporary project of another engagement, he/she did not make subsequent reports on an ongoing basis.

Moreover, the division manager failed to respond to the situation where full involvement of the new engagement partner cannot be expected by, for example, assigning more employees to the engagement team.

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

### **Case 3: Gathering of audit risk information**

Quality control division is encouraging improvements to be made in responses to risks by sending a questionnaire concerning audit risks pertaining to audited companies to audit teams, and is gathering information on audit risks with individual audit engagements. It is also providing audit teams with instructions as necessary based on the information it has gathered.

However, the environment is such that the same information is gathered from audit teams regardless of the degree of audit risk. Information that reflects risk levels is not being collected.

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

#### **《Points to note》**

**When taking measures to improve operations by changing team members, attention must be paid to check whether the personnel change has yielded the expected effects.**

**In addition to the above, even though the initiative of improvement was not effective, the QC division and other departments did not carry out monitoring or other actions and not verify the improvement status for each engagement team. Then, it can be said that the CPAAOB inspection was made before appropriate improvement guidance could be provided. This led to the identification of cases of an “unimproved” situation. It is important to enhance the system of quality controls such as EQC reviews and periodic inspections. In addition, audit divisions close to field site could design and exercise their own expeditions monitoring system is thinkable.**

## **2. Operation of the Quality Control System**

### **Points of focus**

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

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

Change of auditors at listed companies has been increasing in recent years. In undertaking new audit engagements of large companies such as listed companies, it is necessary to fully examine the time needed for auditing, the human resources such as professional staff and the level of audit fees in order to reasonably ensure the quality of audit.

Therefore, the CPAAOB inspections not only evaluate anticipated risks from the conclusion and renewal of audit contracts (below, “engagement undertaking risk”) but also verify whether the time for auditing and human resources as well as the level of audit fees are fully examined to ascertain whether the quality of audit is reasonably ensured.

### **Outline of inspection results**

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

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

### **(Observed effective efforts)**

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

The QC partners in the audit division confirm the views of the EQC reviewer concerning audit risks

with audit engagements identified during the term by engagement partners, and inform quality control review headquarters of areas deemed to be high risk. Furthermore, quality control review headquarters examines audit teams' responses to risks, and demands that audit teams undergo headquarters quality control reviews as necessary. Because this system is implemented twice a year on a continuous basis, quality control review headquarters is able to act swiftly in responding to listed-company audit engagements in high-risk areas.

### **Expected response**

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

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

The CEO and PICOQC should then establish environment where the engagement partners conducting reviews and EQC reviewers can appropriately carry out their operations.

Specifically, audit firms should assign appropriate engagement partners and EQC reviewers, considering each partner's awareness of required audit quality, abilities in QC and audit risk based on the audited company's corporate environment. In addition, if a deficiency in audit improvement caused by an engagement partner has been detected, for example, the audit firm should re-evaluate the ability in QC of the engagement partner and appropriately allocate resources based on the ability and provide re-training to engagement partners.

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

The CEO and engagement teams, including engagement partners, should endeavor to appropriately conduct audit engagements by fully understanding the benefits and limitations of a system such as the above.

### **Case 1: Review of audit documentation and supervision of audit engagements**

- ▶ Engagement partners, in advance discussions with an audit company with regard to areas in which it was deemed that there were no problems with the action being taken by the audited company, did not give instructions to assistants to engagement partners concerning specific audit procedures, and did not perform an appropriate review of audit documentation.

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

- ▶ Engagement partners assumed that partners and assistants to engagement partners had sufficient auditing experience and skills in areas other than important audit areas, and that the degree of the risks of misstatement was relatively low. Therefore, they did not give sufficient directions to assistants to engagement partners appropriately to perform audit procedures and did not conduct sufficient reviews or supervision to ascertain whether the audit procedures performed by partners and assistants to engagement partners sufficiently met the audit levels required by the audit standards.

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

- ▶ At the time they planned audits, engagement partners lacked awareness of the need to consider effective audit procedures each term in the light of the situation in audited companies. Because of this, they did not give effective instructions to partners and assistants to engagement partners concerning the design of audit procedures correspond to the risk of material misstatements. Furthermore, at the completion of audits, they did not perform in-depth reviews for the purpose of ascertaining whether sufficient appropriate audit evidence had been obtained.

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

#### **《Points to Note》**

**In a limited time frame, such as year-end audits, it is required to appropriately plan the content, timing and scope of the review of audit documentation for engagement partners or equivalent to conduct appropriate reviews and direct engagement teams through reviews. It is also required to give specific directions and supervision to partners and assistants to engagement partners.**

### **Case 2: Securing effective review**

- ▶ The EQC reviewer assumed, through daily communication with the engagement team, that the audit procedures performed by the engagement team were sufficient and appropriate.

Therefore, the EQC reviewer did not conduct sufficient reviews of audit documentation

concerning important audit judgments made by engagement teams and their conclusion, by ascertaining whether the engagement teams' explanations for important audit areas, such as audit procedures for significant risks, were supported by sufficient appropriate audit evidence. (Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

- ▶ EQC reviewers did not conduct adequate engagement quality control reviews from an objective standpoint. For example, EQC reviewers mainly checked the information presented in audit summary memos prepared by engagement teams, and omitting reviews of important items in management letters or in financial statements. Furthermore, they lacked awareness of the need for skepticism in engagement quality control reviews. For example, they did not adequately examine the content of audit documentation, instead relying on oral explanations from the engagement teams. Moreover, because they were pressed for time to perform important engagement quality control reviews, they did not conduct appropriate engagement quality control reviews in other areas.

As a result, they not only failed to identify deficiencies in accounting estimates and audit procedures for fraud risks, but also overlooked the fact that the content of management letters was inconsistent with the audit results.

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

### **Case 3: Effectiveness of periodic inspections**

- ▶ Although reviewers for periodic inspections confirmed the existence of audit documentation using a checklist, they lacked awareness of the need to conduct in-depth reviews concerning the adequacy of further audit procedures performed by engagement teams. Because of this, deficiencies concerning accounting estimates and related-party transactions were not discovered. (Quality Control Standards Committee Statement No. 1, paragraphs 47)
- ▶ The engagement team performed additional audit procedures as corrective measures against the deficiency identified in the cyclic inspection. The QC department did not sufficiently monitor the audit documentation to ascertain whether the judgments made by the engagement team for these additional audit procedures were supported by sufficient appropriate audit evidence, since it did not understand the need to critically evaluate important judgments made by the engagement team.

(Quality Control Standards Committee Statement No. 1, paragraphs 50 and 51)

### **《Points to Note》**

**It should be noted that EQC reviews and periodic inspections are required to evaluate the content of the engagement teams explanations objectively based on documents, through examination of audit**

**documentation.**

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



## [Second-tier Audit Firms and Small and Medium-sized Audit Firms]

### **1. Operations**

#### **(1) Improvement Initiatives**

##### **Points of Focus**

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

##### **Outline of inspection results**

As shown in the case example section below, in some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and in more than one deficiency, no improvement measures were made or the improvement was insufficient.

Possible causes of the identified deficiencies include the following:

- The PICOQC merely carried out measures as a formality, such as simply disseminating information on the deficiencies through training and only instructing to respond to the items included in the checklist for improvement related to identified deficiencies, without considering why the matter was identified as a deficiency in the QC review;
- The audit firm lacked the attitude of seeking improvement in all audit engagements; and
- The audit firm had not established environment to effectively monitor the improvement of deficiencies.

Furthermore, engagement partners that review the audit documentation, the EQC reviewer and the person in charge of periodic inspection or the equivalent did not fully understand the purpose of their functions and completed their work by reviewing audit documentation and implementing checklists merely as a formality. They also relied on the engagement practitioners for the development of knowledge required for audit engagement. The audit firm did not proactively seek to maintain and improve the aptitude of professional staff or develop their capabilities. Therefore, professional staff including partners often did not fully understand the matters required under the audit standards and standards of audit of the Auditing Standards Committee Statement or equivalent. All of this led to the inability to detect the same or similar deficiencies that were inherent in individual audit engagements, and thus to make any improvement.

**(Observed effective efforts)**

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

- The CEO directly ascertained the improvement of deficiencies in all audit engagements;
- A system that enables an early detection of audit issues was established, such as the implementation of a preliminary EQR review system; and
- The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team.

**Expected response**

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

**Case 1: Establishment and implementation of specific procedures for improvement**

- ▶ With the aim of addressing deficiencies identified in the QC review, the PICOQC of an audit firm reported the recommendations for improvement in the QC review at the partners' meeting, and instructed engagement partners to communicate them to each engagement team. The PICOQC also prepared a checklist of recommendations, and used it in order to have engagement partners conduct self-inspections. Furthermore, EQC reviewers confirm that these self-inspections were performed.

However, since the instructions and recommendations checklist were limited to items and accounts which were directly identified, they did not constitute improvement measures based on adequate analysis of causes.

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

- ▶ The audit firm had not prescribed in its quality control regulations the role of the quality control committee in connection with responding to global reviews. As a result, the PICOQC did not believe it to be their personal responsibility to respond to issues pointed out in global reviews, and therefore did not consider what course of action to take.  
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)
- ▶ With regard to issues highlighted in quality control reviews, the audit firm analyzes them, identifies their causes, and formulates improvement plans.  
However, among the causes identified, the PICOQC formulated improvement plans with respect to some of them only.  
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

### **Case 2: Communication of specific policies and procedures for improvement**

There were cases where the specific policies and procedures for improvement were not fully communicated within the organization. For example, in the checklist designed for periodic inspection, the PICOQC included deficiencies identified in the QC review and improvement plans for them. However, the PICOQC did not explain to other members in the firm the reasons of the deficiencies and the purpose of the improvement plans. For part-time employees, only a postal mail describing the deficiencies was sent.  
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)

### **Case 3: Verification of improvement**

- ▶ Ahead of a merger, the audit firm with the aim of finding out about the audit quality control system employed by the audit firm it was to merge with, held meetings with the PIOCQC at the audit firm it was to merge with, examined the results of its inspections by the CPAAOB, and so on.  
However, the PICOQC, while aware that the audit firm that was the object of the merger had had numerous deficiencies point out during CPAAOB inspections etc., did not adequately assess whether the quality level of the firm was acceptable. For example, they did not specifically identify and analyze the nature and causes of the deficiencies.  
(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16)
- ▶ The audit firm prepared a checklist of recommended improvements to be made in response to issues pointed out in quality control reviews etc., had engagement partners perform self-inspections using the checklist, and had the quality control division confirm that the self-inspections were being performed.  
However, the confirmation performed by the quality control division only involved determining whether engagement partners had conducted checks, and did not adequately confirm whether the

improvements made by audit teams were appropriate.

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

**《Points to Note》**

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

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

### **(1) Establishment/Implementation of Internal Rules**

#### **Points of focus**

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

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

#### **Outline of inspection results**

In the establishment and implementation of internal rules, as shown in the case example section below, some firms did not establish internal rules related to organizational structure, independence, the provision of non-audit services, etc.. Some other firms did not follow internal rules related to contract management.

Some of the reasons for such deficiencies were that the members of the audit firms did not understand the laws and standards that are applied to audit firms, that the audit firms adopted the template of the “Audit Quality Control Regulations” that are provided by the Japanese Institute of Certified Public Accountants (below, “JICPA”) as their internal rules without customizing them to their actual operation, and that they believed that did not need to be revised as no problems had occurred in the past.

#### **Expected response**

Audit firms need to reconfirm that their internal rules are in compliance with the applicable laws and standards and are adequate considering the actual operational conditions of the firms. Based on this reconfirmation, they should perform sufficient examination and review as to whether their operations are performed in accordance with the internal rules. They also need to establish service management

environment concerning the appropriate establishment, dissemination, and implementation of internal rules, for example, by establishing a workflow in accordance with the actual conditions of the individual firm.

#### **Case 1: Establishment of internal rules related to independence**

The PICOQC of an audit firm stipulated in the firm's internal rules that even if fees received from a single client accounted for 15% of the firm's total revenues for two consecutive years, if it fell to less than 15% in the third year, the firm could avoid the application of the Safeguard. This rule did not correctly reflect the "Guideline for Independence."

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

#### **Case 2: Establishment of articles of incorporation and organizational rules**

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

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

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

#### **Case 3: Implementation of internal rules**

Although the CEO and PICOQC stipulated in the "Contract Management Regulations" that the conclusion of a contract shall be notified to all partners and an inquiry of the contract details be requested when entering into a non-audit service contract with a client, neither notification nor inquiry was carried out when the majority of the non-audit service contracts were concluded.

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

#### **《Points to Note》**

**The number of identified deficiencies in establishing rules, such as the non-existence thereof, has decreased due to the enhancement of templates provided by the JICPA or equivalent. However, since the templates were used without being customized to the audit firm's actual operation, and the internal rules did not suit the actual situation of the firm, the rules were not actually followed at some firms. Therefore, it is vital to**

check periodically whether or not there are any discrepancies between the internal rules developed by the audit firm and the actual status of operation.

In addition to cases described here, deficiencies in the operation of the Partners' Meeting have been identified, such as the compensation of professionals being decided by the CEO instead of the partners' meeting, although the internal rules on quality control stipulate that the compensation of professionals be decided at the partners' meeting.

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

### **Points of focus**

A variety of restrictions and obligations, etc., are imposed on certified public accountants and audit firms by the Certified Public Accountants Act (below, "the Act") and other laws, regulations, and professional standards, from the perspective of ensuring appropriate operations. The CPAAOB, therefore, inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the service management environment to ensure such compliance.

### **Outline of inspection results**

From the perspective of compliance with laws, regulations and professional standards, some audit firms had deficiencies related to legal compliance, including a lack of internal rules regarding the non-competing obligation by partners, lack of partners' qualifications required for operational control, and a discrepancy between matters described in the articles of incorporation as the purpose of the audit firm and the firm's actual operation. In particular, multiple deficiencies were identified in the satisfaction of partners' qualifications required for operational control.

Causes of the deficiencies include: the PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not appoint practitioners to take charge of the confirmation of regulatory compliance of each task that requires such confirmation, and did not establish a clear and concrete workflow for confirmation.

### **Expected response**

An audit firm should establish appropriate operation control structure to ensure compliance with laws, regulations, and professional standards by identifying those operations where it is required to check the status of compliance with laws, regulations, and professional standards, and by assigning persons to be responsible for the identification work.

## **Case 1: Non-compete obligation by partners**

The audit firm did not have internal rules that set forth procedures to check that each partner's

individual firms did not compete with the business of the audit firm and detailed procedures to approve such competing transactions.

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

#### **Case 2: Satisfaction of requirements for partner**

An audit firm did not satisfy the requirement that the majority of partners have been engaged in audit certification services for three years or more after being registered as certified CPAs. Despite this situation, the CEO did not take necessary improvement measures. Moreover, in the business report, the firm incorrectly included three partners who had less than three years of audit certification experience in the number of those with at least three years of experience after being registered as CPAs.

(the Act, Article 34-13, paragraph 1, Article 34-16, paragraph 2; the Ordinance, Article 25, Article 38, paragraphs 1 and 2; Quality Control Standards Committee Statement No. 1, paragraph 28)

#### **Case 3: The objective described in the audit firm's articles of incorporation and implemented operations**

Although this audit firm limited the firm's objective described in its articles of incorporation to the audit or attestation services for financial documents (operation described in Article 2, paragraph 1 of the Act), it provided the service of preparation of comfort letters, which was the service of compiling financial documents, examining or planning financial matters, or being consulted on financial matters (operation described in Article 2, paragraph 2 of the Act). Thus, the actual scope of operations did not comply with the articles of incorporation.

(Article 34-5 of the Act)

#### **《Points to Note》**

**Other deficiencies have been identified such as the failure to submit a notification of changes to the articles of incorporation by the submission due date and failure to approve conflict-of-interest transactions.**

### **(3) Information Security**

#### **Points of focus**

Professional staff, in the course of their daily duties, often carries paper documents and personal computers that contain or store confidential information of audited companies. They also use e-mail to communicate with the contact persons of the audited companies. Audit firms also store electronic audit documentation and electronic data before compilation in servers installed in and outside their offices. Therefore, audit firms are required to establish and operate information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, the CPAAOB inspects audit firms for the status of establishment of



information security systems, from the following perspectives:

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

### **Outline of inspection results**

As shown in the case example section below, some audit firms did not appropriately carry out any measures to prevent information leakage as specified in their internal information security rules, while others did not establish internal rules to properly control the use of Internet server services for the firm's operation.

Causes of the identified deficiencies:

- The information security manager or equivalent established internal information security rules only as a formality, leaving the application of the rules to professional staff (including part-time staff) who use computers and other information devices;
- The information security manager or equivalent did not implement any measures to keep track of the operational status of the internal information security rules at their audit firms, placing too much reliance on such professional staff being compliant with the internal rules;
- The information security manager or equivalent did not establish internal rules appropriate for the information devices actually used in the firm; and
- Because priority was placed on executing tests of internal controls and substantive procedures, personal information related to audit procedures was not anonymized.

### **Expected response**

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

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

### **Case 1: Establishment and operation of internal information security rules**

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

- A security policy to prevent information leakage was in place. However, no policy or procedures for action to take in the event of information leakage were established;
- Stored data were not classified according to their crisis level; no backup or encrypted data were created for stored data; no ID codes or passwords were assigned to professional staff to protect critical electronic data from unauthorized access; and
- The firm required all members to submit a “security policy compliance report,” but some members failed to submit this report.

(Article 27 of the Act; Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16; JICPA IT Committee Practical Guideline No. 4, III 1, IV 2, and 5)

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

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

(Article 27 of the Act; Quality Control Standards Committee Statement No. 1, paragraphs 15 and 16; JICPA IT Committee Practical Guideline No. 4, IV 2, 5, and V 2)

### **Case 3: Security in using Internet servers for operations**

An audit firm uses an Internet server service provided by a leading Internet service provider. The firm has not established internal security rules for the use of an Internet server service for the firm’s operations. Because of the lack of such internal rules, when the firm performed regular assessment of the service provider, the firm did not check whether the service provider took measures to prevent unauthorized access, whether the service provider used subcontractors for providing services, or other security-related matters of the service provider.

(JICPA Code of Ethics, Article 6, paragraphs 1 and 3; JICPA IT Committee Practical Guideline, No.4, IV2 and 3)

### **Case 4: Handling of personal information**

As part of its security policies, the audit firm has formulated an information management policy and provides internal training to point the keys of personal information handling.

However, the audit firm was not ensuring compliance with the information management policy it

had established in the areas of testing internal controls and substantive procedures relating to the personnel expenses. For example, payroll information such as names and salaries and pay slips were stored without anonymization in audit documentation.

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

#### 《Points to Note》

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

#### (4) Prevention of Insider Trading

##### **Points of focus**

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

In addition, not only will the CPA involved in insider trading be held liable, but also such involvement can seriously damage trust in the audit firm to which the CPA belongs. Each audit firm is therefore required to constantly take effective measures to prevent any of its members from participating in insider trading.

In consideration of the above, the CPAAOB inspects audit firms regarding the status of establishment and operation of an anti-insider trading system, from the following perspectives:

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

##### **Outline of inspection results**

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

Causes of identified deficiencies:

- The anti-insider trading manager or equivalent did not comprehensively understand the anti-insider trading measures to be performed under the internal rules;

- The anti-insider trading manager or equivalent did not confirm whether members were actually compliant with the anti-insider trading rules, having too much confidence that members were appropriately observing the relevant rules.

### **Expected response**

Audit firms should understand that negative effects of insider trading on capital markets are generally known and take even more effective measures to prevent such trading.

Specifically, audit firms should take necessary responses such as carefully studying “Q&A Concerning Insider Trading” issued by the JICPA (September 2, 2008) and other relevant documents, re-examining the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and considering whether the strengthening of systems to prevent insider trading is required.

### **Case 1: Implementing training to prevent insider trading**

The PICOQC and the partner in charge of training of an audit firm only carried out training to prevent insider trading once in the past. Although regulations concerning insider trading were subsequently revised, after which new partners joined or new audit assistants were hired, no training to prevent insider trading nor surveys of the status of participation in training to prevent insider trading were conducted.

(Article 26 of the Act; Quality Control Standards Committee Statement No. 1, paragraph 15 and 19)

### **Case 2: Submission of written pledges regarding anti-insider trading**

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

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

### **《Points to Note》**

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

- The “Rules for Preventing Insider Trading” prohibit transactions involving specified securities etc. of business partners, and the “Code of Conduct and Ethics” prohibit excessive entertainment and gifts, but that is all. No comprehensive rules have been established.
- Although it is specified in the “Rules for Preventing Insider Trading” that a list of audited companies to which services are provided shall be distributed to members in order to provide a warning about insider trading, the anti-insider trading manager did not distribute a list of audited companies to

**which services are provided; and**

- **Although members were instructed to submit written pledges to not buy/sell regulated securities issued by the audited companies to which services are provided, in accordance with the “Rules for Preventing Insider Trading,” written pledges from certain members who should submit the pledges have not been obtained, because the status of submission has not been confirmed.**

### **3. Professional Ethics and Independence**

#### **Points of Focus**

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

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

- ▶ Whether the audit firm obtains, at least once a year, a confirmation letter concerning compliance with policies and procedures for the maintenance of independence from all persons required to maintain independence; and whether appropriate verification procedures are used according to the classifications of such applicable persons;
- ▶ Whether the audit firm performs the independence confirmation procedures set forth in its internal rules before acceptance and continuance of audit engagements, and when issuing the auditor's report, appropriately confirms that there was no change in the status of independence;
- ▶ Whether the audit firm carries out independence confirmation procedures after providing those subject thereto with the latest correct information on the subsidiaries, etc., of the audited company;
- ▶ Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as no dependence on a single income source, employment restrictions, and restrictions on gift-giving and entertainment, and whether the audit firm instructs the professional staff to follow these policies and procedures; and whether the professional staff follow the policies and procedures for the observance of professional ethics stipulated in the internal rules of the firm; and
- ▶ Whether the audit firm establishes and implements policies and procedures related to engagements associated with long periods of time to ensure compliance with the legal requirement of rotation.

#### **Outline of inspection results**

As shown in the case example section below, there were identified deficiencies, such as not properly implementing the independence confirmation procedures specified in their internal rules or otherwise, and even if the procedures were implemented, the implementation was not comprehensive.

Causes of the deficiencies include: the PICOQC or the equivalent did not establish specific procedures (including but not limited to how to gather the latest information on consolidated subsidiaries, etc., of the audited company) and period of independence confirmation, and did not appoint a practitioner in charge thereof, and the management of the implementation status was left entirely to certain staff in

charge.

**Expected response**

Audit firms need to establish environment as soon as possible to implement comprehensive procedures to confirm their independence in a timely and sufficient manner in order to ensure the reliability of audits, since many deficiencies are still identified in matters concerning professional ethics and independence.

**Case 1: Independence confirmation procedures for professional staff**

Engagement partners had insufficient understanding of the firm's quality control rules, and apart from audit team members involved in important operations, they mistakenly believed that it was unnecessary to confirm independence. As a result, independence confirmation procedures were not performed with respect to multiple assistants to engagement partners.

(Quality Control Standards Committee Statement No. 1, paragraph 20; Auditing Standards Committee Statement No. 220, paragraph 10))

**Case 2: Confirmation procedures for accepting new engagements**

The policy and procedures for retaining independence that were established by the audit firm required that a written confirmation of the auditor's independence, or equivalent, be obtained from all professionals of the audit firm before conclusion of a new audit contract. However, the PICOQC obtained the written confirmations only from the engagement partners and audit assistants who were to engage in the new engagements, and did not obtain them from other partners or professionals.

(Quality Control Standards Committee Statement No. 1, paragraph 23)

**Case 3: Incomplete list of audited companies**

Partly due to the fact that the PICOQC did not take measures to centrally collect the most recent information about audited companies, etc., and reflect such information in the "List of Audited companies" distributed at the time of annual independence confirmation, some audited companies were omitted from the "List of Audited companies" distributed at the time of the independence confirmation procedures.

(Quality Control Standards Committee Statement No. 1, paragraphs 20, 21, and 23)

**Case 4: Environment for obtaining information about group firms**

With regard to non-assurance engagements for audited companies performed by a tax accounting firm which is a member of the audit firm's group, the audit firm had not established an environment for comprehensively assessing the identified situations and relationships that could harm independence. As a result, when the tax accounting firm concluded new contracts with audited

companies, failure to perform required verification and approval procedures were not discovered or prevented in advance.

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

**Case 5: Calculation of dependence on income from a single audited company**

The CEO and the PICOQC incorrectly interpreted the provisions in the JICPA Guideline for Independence and other independence-related rules. When calculating the percentage of compensation received from one single audited company to judge the necessity of the Safeguard, revenues which should not have been included were included in the total revenues of the firm (denominator), such as the revenues of a real estate lease business operated by a company at which a partner of the firm served as a representative director and the revenues of a tax accounting firm that were not attributable to a partner who worked concurrently for the tax accounting firm.

(Guideline for Independence, paragraphs 220 and 222; Guideline for Interpreting Professional Ethics Q13)

**Case 6: Length of engagement by engagement partners**

The PICOQC assigned a back-office employee to prepare the document used for determining the rotation of engagement partners. The PICOQC also assumed that each partner checked the lengths of his/her individual audit engagements. The PICOQC did not check the accuracy of the document prepared by the back-office employee. As a result, the PICOQC could not detect that the document prepared for engagement rotation contained incorrect lengths of audit engagements of some engagement partners.

(Quality Control Standards Committee Statement No. 1, paragraphs 20 and 24)



#### **4. Acceptance and Continuance of Engagements**

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

###### **Points of focus**

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

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

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

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

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

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

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

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

### **Outline of inspection results**

The acceptance and continuance of audit engagements should be an essential issue in an audit firm's managerial judgment. In reality, as shown in the case example section below, deficiencies were identified in internal procedures relating to the acceptance and continuance of audit engagements. For example, information on an audited company obtained by the partner who would take charge of the engagement for the audited company was not shared with the approvers of the acceptance/continuance of engagements (such as the Partners' Meeting). Thus, they did not perform an appropriate risk assessment. In another case, insufficient consideration was given to whether the audit firm possessed the audit resources required to accept an engagement.

Causes for the deficiencies:

- The prospective engagement partner prioritized quick acceptance and quick commencement of the engagement rather than performing careful risk assessment and taking timely and appropriate actions for any identified problems;
- The prospective engagement partner did not have sufficient experience to make appropriate decisions regarding management fraud, audit of internal control, accounting estimates or other matters. Therefore, the engagement partner failed to properly identify and assess risks related to accepting the engagement based on facts found in a preliminary audit or information provided by the predecessor auditor; and
- When discussing a proposed engagement, the partners did not recognize how important it was to assess the risk associated with the proposed engagement based on information gathered by the predecessor auditor, and other partners were reluctant to express critical opinions as to whether or not the engagement should be accepted.

### **(Observed effective efforts)**

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

Since the company from which the acceptance of engagement was being considered was a high-risk company where sales fraud had been identified in the previous fiscal year, it was necessary in risk evaluation upon acceptance to carefully determine the status of internal control relating to prevention of fraud. Under such circumstances, the prospective engagement partner not only obtained information from internal personnel such as the management, but also gathered detailed and objective information

in order to corroborate the assertions of the management, such as by interviewing external experts who were directly involved in the fraud prevention measures of the company, in order to fully understand the internal systems and progress related to the actual establishment of internal control.

### **Expected response**

Decisions on the acceptance and continuance of audit engagements are essential matters in an audit firm's management. Fully recognizing this, audit firms need to re-examine what policies and procedures for acceptance and continuance of audit engagements are established and how they are operated. Regarding the risk assessment at the time of acceptance or continuance of an engagement, re-examination should be made about the policy and procedures as well as their implementation and operating effectiveness, from the viewpoints such as whether the decision of acceptance was made by identifying engagement acceptance risks based on collected information, and considering measures to manage such risks.

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

### **Case 1: Approval in Partners' Meeting**

Whether an audit engagement could be accepted or not was to be decided at the Partners' Meeting. However, the information materials to be presented to the Partners' Meeting were selected only by the prospective engagement partner at his or her sole discretion. As a result, the acceptance of engagements was decided and approved without communicating to the Partners' Meeting information necessary and sufficient for making the right decision.

(Quality Control Standards Committee Statement No. 1, paragraph 25)

### **Case 2: Risk assessment procedures when concluding a new audit contract**

- ▶ The prospective new audited company is in a state that may cast significant doubt on the audited company's ability to continue as a going concern, such as recording net loss and negative operating cash flows for several years. Nevertheless, the audited company did not disclose the footnote information regarding a going concern assumption on the grounds of financial support from its president.

Under such circumstances, the prospective engagement partner obtained from the predecessor auditor a copy of a financial support letter by the president upon the acceptance of the engagement. However, the engagement partner did not fully perform risk assessment procedures, such as verifying the feasibility of the financial support described in the letter by checking the financial status of the president.

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

- The “Policies and Procedures for the Conclusion of New Contracts” established by the audit firm had just been copied from Quality Control Standards Committee Statement No. 1 (Quality Control at Audit Firms) and Auditing Standards Committee Statement No. 220 (Quality Control at Audit Firms), with specific procedures not having been established.

Furthermore, the prospective engagement partner did not take appropriate action. For example, they did not identify the fact that the accounting of the audited company was mainly performed by a single individual, which constituted a vulnerability in the accounting system, as an engagement acceptance risk. Moreover, even though they identified the fact that the company they were considering accepting the engagement from had committed fraud in the past, they accepted the appointment before the process of considering what to do had been completed.

(Quality Control Standards Committee Statement No. 1, paragraphs 14, 25, 26, and F26-2; Auditing Standards Committee Statement No. 220, paragraphs 11, and F11-2)

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

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

#### 《Points to Note》

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

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

### **Case 3: Risk assessment procedures when accepting a revision audit engagement**

The acceptance of a revision audit engagement covering multiple terms was just prior to the deadline for the audit report, so it was difficult to borrow audit documentation from the predecessor auditor to assess the adequacy of the audit procedures performed by the predecessor auditor and to carry out additional audit procedures. Despite this, the audit time and human resources required for the acceptance of this engagement had not been sufficiently analyzed.

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

#### **《Points to Note》**

In recent years, there have been several cases of listed companies submitting revised reports such as annual securities reports as a result of the discovery of inappropriate accounting treatment, and as is the case with normal audits of financial statements, with revision audits it is also essential to perform appropriate quality control from deciding whether to conclude the contract to the submission of the auditor's report. If it is expected that financial statements covering multiple terms will need to be revised, it is possible that it will take more time for the auditor to obtain sufficient appropriate audit evidence than is the case with normal audit engagements. Audit firms must therefore pay attention to the fact that it is highly likely that it will be impossible to complete the audit in accordance with the initial timetable.

### **Case 4: Risk assessment procedures when continuing an engagement**

Although the audited company carried out several transactions, which the engagement team should carefully examine the business rationality of, such as subscription to a third-party allocation of shares by a company that is unrelated to the audited company's business and conducting significant transactions with related parties, the engagement partner did not perform assessment of contract risk in light of these events.

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

#### **《Points to Note》**

In addition to the above, some firms did not examine the integrity of the top management of audited companies from the perspective of responses to indications of inappropriate restrictions to the extent of audit and significant internal control deficiencies over financial reporting, although they had identified that information necessary for audits was not provided by the top management and that there were material weaknesses concerning company-level controls and process-level controls.

Audit firms must pay attention, not only when accepting a new engagement but also when continuing an existing contract, to whether the acceptance of engagements is decided after identifying engagement acceptance risks and considering actions for the risks based on information that was obtained.

### **Case 5: Availability of human resources**

Upon acceptance of a new engagement, the CEO did not consider whether there was environment including sufficient time and human resources, in order to carry out procedures for high risk engagement.

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

### **(2) Communications between Predecessor and Successor Auditors**

#### **Points of focus**

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

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

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

Whether the predecessor auditor responds honestly and clearly to inquiries made by the prospective auditor. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant material misstatements in the financial statements that affected or could affect the auditor's opinion, whether the predecessor auditor provides such information to the successor auditor;

- ▶ Whether the prospective auditor makes inquiries required under the audit standards to the predecessor auditor, including the reason for the replacement of the audit firm, and the status of measures against fraud risks, to determine whether or not to accept the engagement;
- ▶ Whether the prospective auditor and the predecessor auditor respectively create and store detailed records of the processes performed for the handover of the engagement;
- ▶ Whether the audit firm confirms that the handover is properly conducted, by having the engagement team report the status of the communication to an appropriate department or a person who does not belong to the engagement team; and
- ▶ Whether in cases where the conclusion of audit contract has been canceled or an existing contract has been terminated in response to illegal conduct, the predecessor auditor, pursuant to a request from the prospective auditor, provides the prospective auditor with all facts and information

concerning confirmed and suspected illegal conduct that the predecessor auditor deems that the prospective auditor needs to know prior to determining whether an audit contract can be concluded.

### **Outline of inspection results**

As shown in the case examples below, deficiencies were observed in some audit firms regarding communication with the predecessor auditor, including failure to make appropriate inquiries.

Causes of the deficiencies include: the partner who would take charge of the engagement prioritized quick acceptance and quick commencement of the audit engagement rather than performing careful risk assessment, solving any identified problems or performing procedures required by the audit firm in an adequate and timely fashion.

### **Expected response**

The predecessor auditor needs to understand that it is essential to provide information relating to the audit risks of the audited company, etc., obtained in the course of performing audit engagements to the prospective auditor in a sufficient and accurate manner.

In addition, the prospective auditor needs to establish a system in which the information relating to audit risks of the audited company, etc., obtained from the predecessor auditor in the process of communications between auditors, etc., which should be properly documented and fully used in the audit.

Similarly, when an engagement is handed over within the same audit firm, information related to audit risks needs to be properly conveyed. In particular, important audit-related matters such as fraud risk, should be fully and clearly communicated from the predecessor engagement team to the successor engagement team.

### **Case: Inquiries, etc., to the predecessor auditor**

The prospective engagement partner accepted a new audit engagement for a fund from the predecessor auditor of this audited company.

The person in charge of the fund had run a similar fund in the past, and the prospective engagement partner had accepted an audit engagement from them at that time. Furthermore, when inquiries were made during the handover of the similar fund, important matters were not conveyed by the predecessor auditor.

Because of this, the prospective engagement partner assumed that no additional inquiries were necessary, and therefore did not make inquiries to the predecessor auditor of this audited company.

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9)

### **《Points to Note》**

**In addition to the above, some firms did not carry out examinations in accordance with the engagement**

rules established by the audit firm before the due date when being handed over audit contracts, due to the significant increase in new engagements following an expansion of operations.

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



## **5. Recruitment, Education and Training; Evaluation and Assignment**

### **(1) Recruitment, Education and Training**

#### **Points of focus**

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

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

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

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

#### **Outline of inspection results**

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

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

Causes of the deficiencies included a lack of awareness of the need to establish an education and training system for the firm as a whole. There were cases, for example, of the PICOQC or equivalent entirely entrusted the training of professional staff, including providing engagement-related knowledge, to the engagement partner(s) who provided direction and supervision in the field work.

Several audit firms thought it was sufficient to rely on the voluntary efforts of part-time professional staff to improve their capabilities, and thus lacked awareness of the need to ensure and improve audit quality by ensuring that the audit firm as a whole maintained an appropriate level of knowledge, etc., of audit engagements.

**Expected response**

Audit firms, when recruiting personnel, need to make appropriate estimates of the number of personnel they require in light of factors such as the current workload, the number of new audit engagements expected to be accepted, and the number of staff expected to leave the firm in the future.

Furthermore, when providing education and training for personnel, audit firms must maintain and improve the competence and capabilities of their audit teams (including part-time and unqualified audit team members). The efforts may include accurately understanding in which areas the professional staff do not have sufficient knowledge, and developing and implementing education/training programs based on this understanding as well as fully taking into account the knowledge, experience and current competence and capabilities of the individual professional staff. It is also important to enhance the effectiveness of education and training through reviews of audit documentation, etc., so that the advice and awareness obtained during training programs can be put into practice in audit field work.

**Case 1: Recruitment of staff**

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

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

**Case 2: Effectiveness of training**

- ▶ Training conducted by the division in charge of quality control involves nothing more than showing a DVD of issues that have been identified, and does not reflect the causes of issues identified during quality control reviews or problems discovered through reviews by engagement partners and engagement quality control reviews conducted by the division in charge of engagement quality control reviews.

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

- ▶ The PICOQC provided training within the firm once a month mainly for their members. However, the PICOQC did not conduct internal training for special knowledge, such as the auditing of financial institutions or give sufficient instructions to participate in outside training. As a result, education/training environment that would enable auditing for the risks of the audited companies was not established.

(Quality Control Standards Committee Statement No. 1, paragraph 28)

### **Case 3: Education and training of part-time members**

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

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

#### **《Points to Note》**

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

- **Audit firms did not provide professional staff with opportunities to maintain and improve the knowledge, competence/capabilities. They only monitored the achievement status of practitioners' CPE (continuing professional education) enrollment obligations, and did not develop an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced;**
- **Audit firms did not continuously conduct education and training to improve the audit quality control capabilities for engagement partners. It resulted in many deficiencies identified in certain individual audit engagements; and**
- **Audit firms did not follow up on personnel who had been absent from training sessions.**

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

### **(2) Evaluation, Compensation, and Promotion**

#### **Points of focus**

Audit firms are expected to design appropriate policies and procedures for compensation, performance evaluation, and promotion of personnel that places a high priority on audit quality. The CPAAOB inspects the conditions of establishment and implementation of procedures for the evaluation, compensation, and promotion of professional staff, from the following perspectives:

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

**Outline of inspection results**

Audit firms did not evaluate audit team members based on competence and capabilities as professional , particularly those of quality control, and compliance with professional ethics.

The above deficiency resulted from evaluation and compensation for professional staff being determined based on the subjective evaluation of them by the CEO. In some audit firms, an evaluator of partners assumed that there was no significant difference in the quality of the audit performance between the partners.

**Expected response**

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

In addition, audit firms should properly evaluate professionals improving and maintaining their competence and capabilities as well as complying with professional ethics, and appropriately reflect the results of the evaluation in compensation, promotion, and composition of engagement teams, in order to fully reward such efforts.

**Case 1: Policies and procedures for evaluating professional staff**

The audit firm has established guidelines as a procedure for evaluating partners and reflecting their evaluations in their compensation, and prescribes that compensation be determined following discussions with the representative partner based on comments from evaluators and the results of personnel evaluations.

However, the person in charge of engagement quality control review and the PICOQC did not perform evaluations of each partner in the area of quality control, and therefore contributions to improving quality control were not taken into account.

Furthermore, while the guidelines prescribe that discussions with the representative partner should take place for the purpose of determining the compensation of each partner based on their evaluations, it was not made clear what should actually be discussed, and discussions did not even occur.

(Quality Control Standards Committee Statement No. 1, paragraphs 17, 28, A20, and A24)

**Case 2: Evaluation of part-time employees**

Evaluation of part-time employees engaged in audits was conducted in the same way as for full-time employees. However, the audit firm was concerned that part-time employees would leave the firm if their evaluation was severe, leading to difficulties in audit engagements. As a result, the audit firm did not fully reflect the results of personnel evaluation in the promotion/demotion and

composition of engagement teams.

(Quality Control Standards Committee Statement No. 1, paragraphs 15 and 17)

#### 《Points to Note》

**In addition to the above cases, although audit firms identified engagement partners with insufficient quality control capabilities in their evaluation, the firm did not sufficiently monitor audit engagements in which these partners were involved.**

**Evaluation, compensation, and promotion directly reflect management policies of a representative of firms and have a large impact on the culture of the audit firm. It is necessary to develop and operate appropriate policies and procedures with full consideration of the importance of matters.**

### (3) Assignment

#### **Points of focus**

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

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

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

#### **Outline of inspection results**

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

- The audit firm failed to appropriately conduct risk assessment for audited companies, or compose an engagement team based on risk assessment;
- The audit firm gave priority to acquiring new audit engagements without due consideration to the professional staff's competence/capabilities and experience, or the performance capability of the

audit firm as a whole; and

- The audit firm did not correctly understand the QC competence of engagement partners and how much time they could spend on audit engagements.

### **Expected response**

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

### **Case 1: Assignment of engagement partner**

- ▶ The CEO assigned a partner, who was busy with his/her own private practice and who could not spend enough time on the audit engagement, as an engagement partner, although he knows the partner's situation.

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

- ▶ With regard to the assignment of engagement partners, the rules of the audit firm specify that the Partners' Meeting must confirm that they possess the aptitude and competence to perform their duties as engagement partners. However, the person in charge of appointment believed that just observing the day-to-day work performance of partners was sufficient to constitute the assessment required for the assignment of engagement partners. As a result, he/she did not perform an assessment to confirm whether engagement partners had the aptitude and competence required when submitting a proposed rotation plan for engagement partners to the Partners' Meeting.

(Quality Control Standards Committee Statement No. 1, paragraphs 28 and 29)

- ▶ When appointing engagement partners, the CEO of the audit firm is supposed to take into account not only restrictions on the number of years of involvement, but also factors such as the level of difficulty of the results of audit engagement and quality-related personnel evaluations. However, even though factors such as the size of business and degree of internationalization of companies audited by each audit division and the periods of engagement of each partner differed, the CEO appointed engagement partners for each audit division, which had been independent audit firms prior to the merger, and did not consider audit risk for the firm as a whole and whether enough time could be secured to complete engagements.

(Quality Control Standards Committee Statement No. 1, paragraphs 17, 30, A26, and A27)

**Case 2: Composition of engagement team**

- ▶ Engagement partners, when assigning audit assistants to each engagement team, did not consider whether the persons assigned had sufficient knowledge and experience necessary to perform audit engagements in accordance with the professional standards and applicable laws and regulations.

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

- ▶ The PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office but relied on the regional office for audit responses, including composition of engagement teams. This led to insufficient monitoring by the audit division in head office for the composition of engagement teams at the regional office, such as failing to instruct improvement.

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

## **6. Audit Documentation**

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

#### **Points of focus**

Audit documentation provides evidence to show that an auditor has obtained the basis for issuing an auditor's report and that the auditor has conducted the audit in accordance with the auditing standards generally accepted in Japan. Thus, the audit documentation serves as evidence to directly and specifically demonstrate the audit procedures performed by the auditor.

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

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

- ▶ Whether the audit firm has prescribed the information and techniques required for audits and informed audit teams of them;
- ▶ Whether engagement partners, during the process of conducting an audit, properly supervise the audit engagement by monitoring the progress of the audit engagement, finding out about important matters, etc. through the review of audit documentation and discussions with engagement teams;
- ▶ Whether professional staff prepare audit documentation in such a way to sufficiently describe the types of audit procedures performed in accordance with the auditing standards generally accepted in Japan, the nature, the timing and scope of audit procedures, the grounds for judgments, the conclusions reached, and other information;
- ▶ Whether more experienced members of the audit team appropriately review the audit documentation prepared by less experienced members; and
- ▶ Whether the engagement partner reviews the audit documentation and has discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

#### **Outline of inspection results**

Deficiencies in lack of audit documentation, which means that engagement teams did not perform appropriate audit procedures, were identified in many audit firms. In the preparation of audit documentation and supervision/review by superiors, audit procedures performed by engagement teams and the basis for auditor's conclusion were not documented. Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were



sufficiently and appropriately documented, deficiencies in audit documentation were identified.

Causes for the identified deficiencies were as follows:

- The professional staff did not fully understand the important role of the audit documentation when performing quality control related services in the audit firm and providing explanation of audits to others;
- Engagement partners did not consider the need to supervise assistants to engagement partners or review audit documentation and left the audit procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team of the audited company issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation; and
- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and obtained oral explanation or equivalent from the assistants to the engagement partner.

#### **Expected response**

Some firms did not prepare audit documentation so that the audit procedures performed for individual audit engagements could be clearly identified. There were also many cases where the processes to reach an important conclusion could not be understood from the audit documentation. The firms in which these deficiencies were found should strictly instruct the professional staff to follow the following processes:

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

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

#### **Case 1: Preparation of audit documentation**

The engagement partner believed that experienced auditors would be able to adequately

understand what had been examined by providing serial numbers for documents filed and check marks indicating whether procedures had been followed. Because of this, with regard to audit documentation relating to the evaluation of internal control, even though documents obtained from the audited company had been filed, there was no appropriate description of audit procedures performed with respect to the documents. Furthermore, with regard to audit documentation concerning the use of real-estate appraisal documents, the documentation contained conclusions related to the audit procedures but did not contain appropriate descriptions of the purpose of the examination, records of the processes used to reach the conclusions, and what items were examined.

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

### **Case 2: Review of audit documentation**

- ▶ Although engagement partners reviewed audit working papers to verify whether there were any accounting issues, they did not fully ascertain through their reviews whether appropriate audit procedures were performed for the risks identified, or whether sufficient appropriate audit evidences were obtained for items of accounting estimates, since they lacked awareness of the need to ensure the sufficient appropriate audit evidences obtained and the sufficiency of documentation at the working papers.

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

- ▶ Engagement partners did not verify that an understanding of procedures required under current audit standards and an understanding of the recent business situation at audited companies had been reflected in audit plans. Their verification of the adequacy of audit evidence and engagement documentation was also insufficient. Furthermore, because partners and professional staff who work with engagement partners had experience of audit work at large-sized audit firms and had spent many years working on current audit engagements, and because there was low awareness of the need for partners to check the engagement documentation produced by other partners, a critical stance was lacking. As a result, reviews of audit documentation were inadequate. For example, audit procedures to appropriately deal with risks were not performed and sufficient appropriate audit evidence was not obtained.

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

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

The engagement partner believed that because the part-time staff that performed procedures had audit experience at a large-sized audit firm, they must have carried out the required procedures, and even though audit procedures covering accounts such as sales, which are important audit

items, had been assigned to the part-time staff, the engagement partner overlooked the fact that the part-time staff had failed to perform certain substantive procedures with respect to sales. In this way, the engagement partner did not give adequate instructions and provide adequate supervision to assistants to the engagement partner.

(Quality Control Standards Committee Statement No. 1, paragraphs 31 and A30)

#### **《Points to Note》**

**Engagement partners should understand that they are required to appropriately assess audit procedures that were performed through review of audit documentation, concerning the relevance of audit procedures performed by assistants to engagement partners, and whether the conclusion that was reached was supported by sufficient appropriate audit evidence.**

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

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

### **Points of focus**

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

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

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

mentioned above.

### **Outline of inspection results**

In the control of audit documentation, audit firms had not established specific procedures for the completion of audit files and the retention of audit documentation. Some firms registered audit documents as the final assembly despite the fact that they had not completed important audit procedures, while some firms did not control audit documentation in a register. Cases of identified deficiencies include the following: lack of awareness in the control of audit documentation, as well as the lack of the professional staff understanding of the importance of audit documentation when carrying out quality control related services at the audit firm and when explaining audits to others.

### **Expected response**

Audit firms need to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.

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

### **Case: Final assembly of the audit file**

- ▶ The PICOQC did not monitor if the assembly of the audit documentation for annual audits and quarterly reviews were completed within the due period determined by the audit firm.  
(Quality Control Standards Committee Statement No. 1, paragraph 44)
  
- ▶ Because audit teams were not adequately aware that all audit documentation needed to be stored in files, they did not allow enough days in their schedules for the final assembly of audit documentation, and communication concerning the assembly of audit documentation was also insufficient. Furthermore, the quality control division had not standardized procedures for the final assembly of audit documentation, and had not prepared prescribed forms etc. Because of this, final assembly of audit documentation was not performed. For example, details of tasks performed were just left saved on the PCs of audit team members.  
(Quality Control Standards Committee Statement No. 1, paragraph 44; Auditing Standards Committee Statement No. 230, paragraph 13)

**《Points to Note》**

**In addition to the above cases, audit firms did not establish specific procedures, the person in charge, and other related matters regarding the final assembly of audit files, while other firms only controlled the name of the audited company, fiscal year and the total number of audit files, and did not keep track of what sort of audit files containing audit documentation existed.**

## **7. Engagement Quality Control Review**

### **Points of focus**

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

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

- ▶ Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer, and whether they maintain objectivity and independence;
- ▶ Whether the EQC reviewer reviews at an appropriate time for the planning of an audit, significant audit judgments, and expressions of audit opinion;
- ▶ Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and reviews the appropriateness of financial statements and the draft of audit report, etc.; and
- ▶ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient appropriate audit evidence, by reviewing the audit documentation.

### **Outline of inspection results**

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

Causes of the identified deficiencies include the following issues:

- Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;
- In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review because the EQC reviewer had to give priority to the audit engagements he/she was in charge of;
- Despite the fact that the firm did not have a sufficient number of partners and members having

sufficient knowledge and experience to perform the review, the PICOQC did not examine whether persons qualified as an EQC reviewer have been recruited or developed;

- Although the EQC reviewer paid attention to responding to deficiencies identified in the CPAAOB inspections and QC reviews, he/she merely examined the same matters as the deficiencies and did not review the situation of responses to similar matters;
- As the engagement team did not pass on to the EQC reviewer (including in cases entrusted to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the description of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters; and
- The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit documentation.

#### **(Observed effective efforts)**

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

Besides the normal opinion engagement quality control review, the audit firm carried out preliminary engagement quality control reviews concerning important accounting estimates, such as the recoverability of deferred tax assets, at an early stage during the end-of-term audit, when plenty of time was available. As a result, engagement quality control reviews were not performed when staff were busy with formulating an opinion. This meant that they could take their time and conduct an in-depth engagement quality control review.

#### **Expected response**

When reviewing the audit planning, the EQC reviewer needs to review the risk assessment procedure performed by the engagement team and further audit procedures planned by the engagement team from objective standpoints, by taking into account not only the business activities and changes of business performance of the audited company, but also the business risk related to the business objectives and strategies of the audited company.

In addition, when reviewing the forming of the audit opinion, the EQC reviewer needs to undertake a review through not only discussing significant matters for forming the audit opinion with the engagement partner but also reviewing the audit documentation related to significant judgment to confirm that the conclusions made by the engagement team were supported by sufficient appropriate audit evidence. Especially at small and medium-sized audit firms, partners who also fulfilled the role of EQC reviewer were usually quite busy because the firms were operated by a small number of partners. Consequently, there were some cases in which those firms found it difficult to undertake reviews appropriately. Therefore, audit firms are required to take action to enhance and strengthen their EQCR environment after reaffirming the importance of the EQCR of audit engagements.

### **Case 1: Eligibility of the EQC reviewer**

Partners who did not have sufficient reviewing capability were appointed as EQC reviewers, since the CEO and PICOQC did not take any measures to improve the capability of EQC reviewers other than training and did not inspect their eligibility.

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

### **Case 2: Securing effective review**

- ▶ Reviews of audit engagements were conducted under a council system of all representative partners at the review committee held once a month. Reviews were carried out verbally based on the submitted review documentation, and were completed without examining audit working papers related to material judgments on significant risks. Accounting issues were mainly discussed at the committee and they did not sufficiently discuss whether sufficient appropriate audit evidence was obtained.

(Quality Control Standards Committee Statement No. 1, paragraphs 34, 36, and 37; Auditing Standards Committee Statement No. 220, paragraphs 18–20)

- ▶ The EQC reviewer, when conducting preliminary engagement quality control reviews aimed at addressing fraud risk, reviews whether there were any suspected material misstatements resulting from fraud.

However, based on his/her impressions from meeting with management of the audited company at other times, he/she believed that management was not involved in fraud, and accepted that opinion of the engagement team while being unable to point out that the fraudulent investigation report submitted at the time of the engagement quality control review contained statements casting doubt on the explanations provided by management.

(Quality Control Standards Committee Statement No. 1, paragraphs 36, 37, FA40-2, and A41; Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

- ▶ The audit firm had not established an effective environment for quality control reviews. For example, the firm had the bulk of EQC reviews performed by specific EQC reviewers, so some EQC reviewers became pressed for time in conducting their EQC reviews, and they did not confirm that sufficient and appropriate audit evidence had been obtained relating to important judgements made by audit teams.

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

### **Case 3: Follow-up of findings identified in the EQC review**

With regard to material findings identified in the review, the EQC reviewer only received explanations from the engagement team about additional procedures and the final audit judgments



made by the engagement team after the review, but did not verify the appropriateness and sufficiency of such additional procedures by inspection of the audit documentation. Thus, the audit firm did not perform effective EQC reviews.

(Quality Control Standards Committee Statement No. 1, paragraphs 41, 42, and 43)

**《Points to Note》**

**It must be noted that even when an audit firm entrusted an external CPA to perform EQC reviews, the external CPA is expected to produce the same response as when a person within the audit firm is appointed as the EQC reviewer.**

**The EQC reviewer must pay attention to the fact that he/she is required to objectively evaluate the contents of the explanations by the engagement team with records and by carrying out examinations through audit documentation.**

**In particular, where EQC reviewer at the headquarters reviews audit engagements performed by a regional office through a video conference, necessary audit working papers have to be submitted to the EQC reviewer in advance.**

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

### **Points of focus**

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

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

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

- ▶ Whether the audit firm assigns as the person responsible for the monitoring of the system of quality control a person with sufficient and appropriate experience for the role, and vests the assigned person with sufficient authority;
- ▶ Whether the audit firm appropriately grasps the status related to the establishment of a quality control system and has an inspection environment in place to identify quality control problems closely; and
- ▶ Whether the audit firm evaluates the impact of deficiencies identified in the process of ongoing monitoring, and takes appropriate improvement measures in accordance with the results of such evaluation.

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

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

measures taken were appropriate; and

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

Statements of objection and doubt are investigated from the following perspectives:

- ▶ Whether an appropriate system for a statements of objection and doubt has been established;
- ▶ Whether statements of objection and doubt that have been received are properly investigated; and
- ▶ Whether appropriate corrective action is taken in response to the results of investigations of statements of objection and doubt.

### **Outline of inspection results**

As shown in the case example section below, there are cases where practitioners responsible for ongoing monitoring and periodic inspection (including external practitioners) merely performed reviews with checklists, etc., and the PICOQC did not provide practitioners with instructions prior to the inspection or did not conduct monitoring of them after the inspection. There are also many QC system operational deficiencies where the audit firm was not able to appropriately identify deficiencies in individual audit engagements through periodic inspections.

The primary causes of these deficiencies include the lack of appropriate understanding of QC system monitoring at the audit firm, as well as the failure to ensure sufficient time and resources as a result.

### **Expected response**

Audit firms are required to establish and maintain a system in which the primary function of monitoring the system of QC (i.e., voluntarily identifying, understanding, and correcting problems) can be fully exercised. Specifically, audit firms should fully keep in mind that they need to carefully select individual audit engagements and identify inspection items by taking into account the economic environment, the business condition of the audited company, and results of the last CPAAOB inspection and QC review; and they also need to have qualified periodic inspection practitioners perform inspections in addition to formal inspections conducted according to the checklist and to establish environment to confirm the adequacy of the improvement measures taken for deficiencies found by the inspection.

Furthermore, a system for ensuring that statements of objection and doubt are received in a timely fashion and that investigations are conducted as necessary needs to be established and implemented. For example, a system for receiving reports from whistleblowers both inside and outside the audit firm could be established.

### **Case 1: Effectiveness of ongoing monitoring**

- ▶ The PICOQC only operated an annual ongoing monitoring by using the checklist indicated as the JICPA's template as a formality. The PICOQC did not perform an effective ongoing monitoring, such as confirming related internal rules and documents.

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

- ▶ The person in charge of ongoing monitoring entrusted all inspections to an office staff member and did not give to the office staff members specific instructions about ongoing monitoring. The checklist used by the office staff member for ongoing monitoring only indicated conclusions. The person in charge of ongoing monitoring did not check what procedures were taken by the office staff member for the ongoing monitoring. Thus, the firm's ongoing monitoring did not work effectively.

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

## **Case 2: Effectiveness of periodic inspections**

- ▶ The person in charge of periodic inspections performed inspections without an adequate understanding of the levels required under current audit standards. Furthermore, the CEO neglected to establish a structure for ensuring the effectiveness of periodic inspections. For example, he/she did not secure appropriate personnel and time for inspections based on the scale and importance of the targeted inspection. As a result, insufficient time was spent on the inspection even though the audit engagement was large.

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

- ▶ The person in charge of periodic inspections lacked skepticism when inspecting audit procedures performed by engagement teams. As a result, adequate inspections from the point of view of determining whether engagement teams had performed sufficient audit procedures for making judgments were not performed. Because of this, only superficial deficiencies such as a lack of audit documentation were identified. Furthermore, the PICOQC and the partner in charge of periodic inspections believed that there would be no problems with audit quality control as long as periodic inspections were performed before the start of the year-end audit for the following fiscal year. As a result, they performed periodic inspections immediately before the year-end audit and measures to address deficiencies discovered during the periodic inspections could not be included in the audit plan for the following fiscal year.

(Quality Control Standards Committee Statement No. 1, paragraphs 47, 48, 49, and 50)

- ▶ The partner in charge of periodic inspections merely provided inspection assistants with checklists for conducting periodic inspections, failing to inform them of specific points to focus on, for example. Furthermore, despite the fact the deficiencies detected were almost all related to documentation, and that no deficiencies concerning, for example, the adequacy and appropriateness of audit procedures, were identified, the PICOQC did not evaluate the effectiveness of the periodic inspections.

(Quality Control Standards Committee Statement No. 1, paragraphs 47 and 48)

- The PICOQC just post a list of deficiencies detected during periodic inspections and the improvement measures required on a noticeboard in the office, so these matters were not communicated adequately. Furthermore, the descriptions of the required improvement measures only covered the procedures that needed to be followed to address the identified deficiencies. They were not based on the causes of the deficiencies.

Furthermore, confirmation of the status of improvements was limited to operations subject to periodic inspections, and the status of improvements with operations not subject to periodic inspections was therefore not confirmed.

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

### **Case 3: Statements of objection and doubt**

Even though the representative partners were receiving information about fraud at audited companies via a hotline, they did not inform the PICOQC of the information they had obtained. Furthermore, even though the “Audit Quality Management Rules” stated that engagement partners in charge of audited companies should report how they investigated information received from inside and outside the firm to the division in charge of quality control in writing, they did not make such reports.

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

### **《Points to Note》**

**In addition to the above, there were deficiencies in the selection of inspection, such as the audit engagements of certain engagement partners not being subject to periodic inspection, as well as deficiencies such as failure to inform the necessary departments of significant problems relating to quality control that had been identified during EQC reviews.**

**It should be noted that even when an external CPA was appointed as the person in charge of periodic inspections, the external CPA expected the same response as when a person within the audit firm is appointed as the person in charge of periodic inspections.**

**It is important to analyze the deficiencies identified in a QC review, and re-evaluate whether periodic inspections were effectively performed to ascertain whether the identified deficiencies could have been prevented or noted beforehand.**

## **9. Cooperation with Company Auditors**

### **(1) Cooperation between Independent Auditors and Company Auditors**

#### **Points of focus**

Independent auditors and company auditors are obligated to ensure the appropriateness of financial statements under the Companies Act and applicable laws. To perform this obligation, it is important that they cooperate by sharing information identified during audits at an appropriate time, as well as by actively exchanging information and opinions, where, for example, company auditors should evaluate the status of QC of audits undertaken by accounting auditors.

In consideration of the importance of cooperation between accounting auditors and company auditors as mentioned above, the CPAAOB inspects the status of such cooperation.

#### **Outline of inspection results**

The necessity of cooperation between independent auditors and company auditors has been recognized in general. Regular communications between them are conducted, though the depth of cooperation varied.

It is our understanding that audit firms report results of the CPAAOB inspection and QC review to company auditors in writing as determined on a timely manner. On the other hand, as shown in the case example section below, there were some cases where communication was inadequate, and some cases where audit firms received notification of the results of a special review from the JICPA, but they did not communicate the results of the special review with company auditors, since there were no particular identified deficiencies.

#### **Expected response**

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

Audit firms and company auditors of the audited company should improve the effectiveness of the audit by sharing audit-related information with each other, including development of the audit plan and implementation of audit procedures, the progress of the audit at each stage of forming the auditors’ opinions, and the conditions of the audited company discovered in the course the audit. They should also actively promote cooperation with each other through exchange of opinions on audit quality issues based on the results of the CPAAOB inspection and the QC review. It is believed that this cooperation will contribute to securing and enhancing audit quality, and in turn improve and strengthen the corporate governance of the audited company.

Furthermore, revisions to auditing standards made in 2018 have made it a requirement to include key

audit matters (below, “KAM”) in audit reports. KAM are determined from among matters discussed with corporate auditors etc., and this development means that the importance of cooperation with corporate auditors has increased. So with this importance of cooperation with corporate auditors in mind, it is essential to engage in proper communication.

Audit firms must also establish a system to support engagement teams so as to promote appropriate communication between the engagement teams and company auditors of the audited company.

It should be noted that the Auditing Standards Committee Statement No. 260 “Communication with Company auditors,” revised in May 2015, stipulates that when performing an audit of an audited company, the audit firm should keep close communication with company auditors in the audited company regarding particularly important matters, and specifies matters that should be communicated to company auditors, including the content and method of communication to company auditors concerning the results of the QC review or the CPAAOB inspection as part of explanations made by the accounting auditor regarding the establishment and operation of a quality control system. An understanding of this standard is therefore essential (Notes 1 and 2).

(Note 1) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is necessary if the disclosure is made to those charged with the governance or equivalent of the audited company and the disclosed information is “whether or not there were deficiencies in the establishment or operation of the quality control system of the audit firm and the outline of such deficiencies” or “whether or not there were deficiencies related to the engagement for the audited company and the outline of such deficiencies.”

(Please refer to “III. Handling of Inspection Results” in the “Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board” published by the CPAAOB in April 2015.)

(Note 2) In principle, any disclosure, including whether or not the audit firm received the CPAAOB’s inspection, is not permitted during the inspection.

### **Case: Cooperation with company auditors**

- ▶ When communicating the results of a QC review, the prospective engagement partner for a new audit engagement did so by preparing communication material for the board of company auditors by amending cases from the past when an unqualified conclusion had been obtained. As a result, the prospective engagement partner only informed the board of company auditors of the fact that a qualified conclusion had been issued and the titles of each item subject to qualification. Therefore, sufficient information concerning the design and operation of the system of quality control was not conveyed in writing. For example, whether improvement recommendations had been made and the response of the audit firm was not communicated.

(Auditing Standards Committee Statement No. 260, paragraphs 16 and A31)

- ▶ Although an engagement partner identified risks of material misstatement due to fraud when formulating the audit plan, in light of the situation with the conduct of the audit during the term, they deemed that there was no risk of material misstatement due to fraud, and altered the audit plan.

However, the engagement partner was not adequately aware of the importance of properly informing corporate auditors etc. of the risks of material misstatement due to fraud that they had identified, and provided them with details of the risk assessment before the alteration of the audit plan.

(Auditing Standards Committee Statement No. 260, paragraphs 13, 20, and 22)

## **(2) Response to Detection of Fraud/ Non-Compliance**

### **Points of focus**

In the event of discovering any fact that may affect ensuring the appropriateness of financial statements of the audited company, the auditor must notify company auditors thereof so as to encourage the audited company to implement voluntary corrective action (see Article 193-3 of the Financial Instruments and Exchange Act, below “FIEA”). In light of the important role played by such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

### **Outline of inspection results**

#### **(Observed effective efforts)**

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

When regulations regarding responses to detected facts such as legal violations were introduced under FIEA, some audit firms ensured all partners understood them by, for example, showing to partners and employees cases of how to notify those charged with the governance of the audited company in the case of the detection of facts such as an illegal act.

In addition, there were cases where the audit firm notified the audited company under Article 193-3 of FIEA of a matter deemed to affect the appropriateness of its financial statements, and the notification led to the audited company’s correction of its quarterly report and strengthening of its organizational structure aiming at implementing appropriate disclosure.

### **Expected response**

It should be kept in mind that in the event of identifying any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by requiring audited companies to make corrections, including reviewing whether to give notice under Article 193-3 of FIEA.



Furthermore, it is necessary for audit firms to develop a system to support engagement teams so that the engagement teams' responses to consultation can be carried out appropriately.



### 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," explains those deficiencies with a composition similar to the Auditing Standards Committee Statements.

However, this part also contains separate items that introduce fraud in financial statement audits, for which cautious responses are required under the Fraud Risk Response Standard and to which attention is paid due to recent accounting fraud scandals. In addition, accounting estimates, in which many deficiencies are continuously identified, are separately introduced.

Furthermore, audits of internal control over financial reporting, in which different audit standards are applied from those applied for audits of financial statements, are introduced in a separate item, including contents of the use of internal audits (Auditing Standards Committee Statement No. 610).

Each item describes the Points of Focus in inspection, etc., along with examples of identified deficiencies, and Points to Note in performing audit procedures are appended for reference.

### **Analysis of deficiencies**

Deficiencies identified in individual audit engagements result from lack of requirements of audit standards or standards of the Auditing Standards Committee Statement ("requirement(s)").

Causes of the deficiencies include various factors that are remotely due to engagement teams and the environment surrounding audited companies. However, in recent cases the following three causes were found relatively frequently:

- Insufficient consideration for relevance 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 audit standards and the Auditing Standards Committee Statement.

(1) Cases of deficiency due to insufficient consideration for relevance of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence

(Reference case) Extent of test of details—Case where the sufficiency and appropriateness of audit evidence were not evaluated

The engagement team evaluated that there was a risk of material misstatement due to fraud for the occurrence of sales in a significant component, and identified revenue recognition as a significant risk. During the period, the team performed a dual-purpose test for operation evaluation procedures of internal controls concerning the sales process and substantive procedures, and tested them with internal vouchers of shipment. Apart from the above procedures, the team tested dozens of items with the vouchers for the three months prior to the balance sheet date.

However, the engagement team did not evaluate whether the audit evidences obtained from the audit procedures were sufficient and appropriate for the risk of material misstatement due to fraud. (Auditing Standards Committee Statement No. 240, paragraphs 29 and F32-3)

As the above example shows, there are many cases where it is not clear whether sufficient appropriate audit evidences were obtained from audit procedures performed by engagement teams. These deficiencies resulted from the fact that engagement teams did not sufficiently consider audit procedures and audit evidence at the following two stages:

- Risk assessment at the audit planning stage

Auditors did not appropriately plan the responses to audit risk at the assertion level, since risk assessment by the auditors was insufficient in itself.

Furthermore, there were many cases where sufficient appropriate audit evidences were not obtained since the responses to audit risks considered at a detailed audit plan were not appropriate to the identified risks, although the risks were appropriately identified.

- Evaluation of obtained audit evidences

Auditor have to conclude whether sufficient appropriate audit evidences have been obtained. If not, he/she needs to perform additional audit procedures. Auditors shall ascertain whether sufficient appropriate audit evidences have been obtained through reviews of working papers, there are cases where such obtained audit evidences were not sufficiently evaluated.

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

When performing audit procedures, it is required under audit standards to develop and perform procedures in response to the identified audit risks based on risk assessment. The nature, timing and extent of specific procedures responding to audit risks are determined based on the professional judgment of the engagement team, in light of the situation of the audited company. In particular, it is required that procedures in response to assessed risks at the assertion level are formulated in a detailed audit plan.

(2) Cases of deficiency due to the lack of a professional skepticism that an auditor should have

(Reference case) Audit of accounting estimates—Case where the audit firm only understood accounting estimates argued by the audited company but did not perform audit procedures that should have been performed in response to the argument.

The audited company accounts for deferred tax assets, excluding the future deductible amount that is collected over a period of more than five years based on profit plans that assume that the profit before income taxes' budget for the next fiscal year continues for the next five years.

However, the engagement team did not consider the feasibility of management's assumption that the same amount of profit before income taxes would be generated from the second year until the fifth year, despite comparing the profit plan with the amount in the budget that was submitted to the Board of Directors when considering the collectability of deferred tax assets. (Auditing Standards Committee Statement No. 540, paragraph 12)

In this case, a deficiency in audit procedures was identified since the argument of management, such as the feasibility of the business plan that was used in accounting estimates, was not evaluated objectively and procedures to verify the rationality of the argument were not performed, even though the engagement team understood the management's assumption and the accounting treatment, due to a lack of professional skepticism. Similarly, at some audit firms there were cases where sufficient and appropriate audit evidence was not obtained since a material misstatement risk was overlooked due to the lack of professional skepticism.

Apart from the above cases, there were cases where, although journal entry tests were performed as responses to audit risk related to management override, and certain journal entries were selected, auditors did not note irregular items in the selected journal entries and did not verify their adequacy. Auditors need to 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) Cases of deficiency due to insufficient knowledge of the requirements

#### (Reference case) Substantive analytical procedures—Case of failure to respond to requirements

The engagement team mentioned that they performed substantive analytical procedures for account balances over performance materiality including sales, cost of sales, and selling, general and administrative expenses. However, the team did not set the acceptable level of difference between expectation and actual amounts, and thus did not satisfy the requirements of substantive analytical procedures. (Auditing Standards Committee Statement No. 520, paragraph 4)

In the above cases, the following requirements, which are required when adopting substantive analytical procedures, were not met. Therefore, a deficiency of failure to perform substantive procedures was identified.

- Develop the expectation of booked amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- Determine the acceptable level for differences of booked amounts from expectation without further investigation.

When performing audit procedures, if the engagement team does not fully understand the requirements, and requirements are not satisfied in the audit procedures performed, the purpose of audit cannot be achieved

with the performed procedures and it results in a deficiency at audit procedures.

In addition to substantive analytic procedures described as an example, there tend to be many deficiencies due to the non-performance of requirements in areas such as those below:

- Confirmation procedures (Auditing Standards Committee Statement No. 505);
- Development and implementation of audit sampling (Auditing Standards Committee Statement No. 530);
- Management bias in accounting estimates (Auditing Standards Committee Statement No. 540, paragraph 20);
- Audit procedures for transactions with related parties (Auditing Standards Committee Statement No. 550);
- Audit procedures on group audits (Auditing Standards Committee Statement No. 600);
- Using the work of internal auditors (Auditing Standards Committee Statement No. 610); and
- Using the work of an auditor's expert (Auditing Standards Committee Statement No. 620).

### **Expected response**

Engagement teams are required to exert professional skepticism in all audit aspects, as well as to update and expand the required knowledge such as audit standards. Upon this, it is necessary to respond to individual audit engagements from the perspective of whether sufficient audit plans are developed for misstatement risks, and whether the audit procedures planned are performed according to the requirements of standards of audit, such as the Auditing Standards Committee Statement, in order to reasonably reduce audit risk to a 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 environment that monitors each engagement team's understanding of improvement measures, as well as the operation status of improvement measures by each engagement team. Upon the improvement of audit engagements, the use of existing systems including periodic inspections and QC reviews is also effective, instead of additional new QC systems. Each audit firm is required to try effective and efficient improvement for audit quality in a way that suits the feature of each firm.

Regardless of the size of the audit firm, some deficiencies in individual audit engagements are caused by



engagement partners with an insufficient understanding of the concept of the risk-based approach. In this case, it is necessary to note that appropriate responses as an audit firm are required, such as re-education of partners and appropriate assignment.

According to the Auditing Standards Committee 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 appropriate understanding of the deficiencies so that it can explain the deficiencies that were identified in the inspection to the audited company.

Once again, it is necessary for not only the engagement teams of the individual audit engagements 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 during their own audit engagements and examine/review such deficiencies in a timely manner.

## **1. 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 Committee 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 Committee 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**

There were many cases in assessing risks and responding to assessed risks where the engagement team did not appropriately develop and perform procedures responding to assessed risks because the engagement team did not carry out an appropriate assessment of risks.

For example, there were cases where a deficiency was identified in the nature, timing, and extent of year-end substantive procedures due to inappropriate revision of the audit plan when the business environment or performance of the audited company was deteriorated during the term, or a misstatement was identified in conjunction with the performance of the audit. There were also cases where a deficiency was identified in the tests of controls and substantive procedures since the engagement team did not plan appropriate audit procedures in response to assessed risks.

Moreover, there were still engagement partners and assistants to engagement partner who did not fully understand the concept of a risk-based approach. Therefore, 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 examine the adequacy of the assessed risks and procedures in the audit plan developed by using audit tools.

In addition, at audited companies with many related party transactions of various types, there were cases where notes on financial statements for significant related party transactions were omitted since no particular risk was identified, although the risk must be carefully assessed from the perspective of completeness of related party transactions.

### **Expected response**

Professional staff should note that they must pay due attention and exercise professional skepticism in fully understanding the audited company and its environment as well as assessing risk through such understanding, and carefully identify and assess audit risks, referring to this Case Report and the Audit Proposals issued by the JICPA. 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 personnel allocation of engagement teams.

## **(1) Audit planning**

### **Case 1: Detailed audit planning**

The engagement team did not establish a detailed audit plan for accounts receivable related to the collectability of credits and allowance for doubtful accounts, although they identified the collectability of credits owned by the audited company's subsidiary as a significant risk.

(Auditing Standards Committee Statement No. 300, paragraph 8)

### **《Points to Note》**

**As deficiencies in audit planning, there were cases where the engagement team only followed audit procedures in the past as a formality and did not appropriately develop a detailed audit plan such as the**

nature of audit procedures that should be performed by engagement team members.

The engagement team shall carefully consider the timing and extent of audit procedures responsive to the assessed risks of material misstatement, as well as the nature of audit procedures, regarding whether the developed audit procedures correspond to the assessed risks and whether sufficient appropriate audit evidence has been obtained from those audit procedures.

In addition, an appropriate audit plan enables the following matters to be achieved. Therefore, it is important to consider these matters at the planning stage.

- Appropriate attention to significant areas of audit;
- Identification and solution of potential issues in a timely manner;
- Conduct of an effective and efficient audit work through appropriate management of audit engagements;
- Selection of engagement team members with appropriate competence and suitability to address risks, and allocation of the appropriate assignment to those team members;
- Appropriate instructions to and supervision of team members, and reviews of working papers; and
- Cooperation with component auditors and experts as necessary.

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

In the audit plan developed at the beginning of the fiscal year, the engagement team designed and performed substantive procedures for each material class of transactions, account balance, and disclosure, based on figures from the financial statements for the previous fiscal year.

However, the engagement team did not consider the necessity to revise the audit plan, such as re-assessment of materiality, although there were changes in the business environment and worsening of the business performance of the audited company during the fiscal year.

(Auditing Standards Committee Statement No. 300, paragraph 9)

#### **《Points to Note》**

In addition to the examples of identified deficiencies mentioned above, there was a case where an engagement team did not consider whether their audit plan should be revised including risk assessment and materiality when events, which the engagement team did not expect, occurred, such as changes in business activities due to the reorganization of the audited company, the occurrence of fraud cases, significant overdue receivables and slow-moving inventories. If an engagement team obtains information, which significantly differs from original information used at the planning stage, the team should consider whether the plan should be revised.

### **(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**

The audited company operates multiple businesses including online retailing. The engagement team identified a risk of material misstatement in existence and completeness assertions for sales by all the audited company's 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 Committee Statement No. 315, paragraph 25; No. 330, paragraph 17)

#### **《Points to Note》**

**Besides the above example, there were cases where the engagement team did not understand the internal controls even though the audited company was engaged in significant businesses besides its main business. Fraudulent financial reporting may generate in businesses other than the main business. It is essential to take into account differences in terms of the types of transactions and related internal controls between businesses when identifying and assessing the risk of material misstatements at the assertion level.**

**There were also cases where businesses and distribution channels at the group level were not understood as part of group audits even though businesses of individual significant components were understood.**

**In addition to the above, the engagement team did not examine the risk of material misstatement by business process. As a result, differences in the types of transactions recorded in the same account may lead to differences in effective audit procedures or the nature of audit evidence. However, there were cases where the risk of material misstatement by types of transactions was not identified and assessed.**

#### **Case 2: Identifying and assessing the risks of material misstatement**

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

However, the engagement team identified fraud risks in sales and software, but did not consider not to identify risks of misstatement in assertions concerning completeness and cut-offs of expenses, even though the engagement team predicted that the audited company would fraudulently overstate its profits,.

(Auditing Standards Committee Statement No. 315, paragraph 25)

#### **Case 3: Identifying and assessing significant transactions with consolidated subsidiaries**

The audited company received a sales order from its consolidated subsidiary for the construction of a power plant to be used by the subsidiary for its power generation business. With regard to the transaction, its sales and costs were recorded in the same amount on the audited company's non-consolidated financial statements. Although professional staff documented that the audited

company was involved in the power plant construction as an agent of the construction contract, the engagement team did not examine the reasonableness of recording the sales on a gross basis instead of a net basis.

In addition, sales for the transaction were subject to notes on related parties in the financial statements, which stated that the transactions terms “are determined negotiations on the price based on market condition.” However, the engagement team did not examine the adequacy of this statement, although the construction contract had unusual transaction terms, which the same amount of the construction costs incurred at the audited company was charged to the consolidated subsidiary that was the contractee.

(Auditing Standards Committee Statement No. 550, paragraphs 23 and 24)

#### **《Points to Note》**

**The engagement team shall note that they need to identify and assess the risks of material misstatement through an understanding of the audited company and its environment, considering unusual significant transactions, related party transactions and matters dependent on management’s judgments.**

**Furthermore, through an understanding of the audited company and its environment, the engagement team shall ensure that it assesses whether the audited company’s accounting policies are appropriate for its business, comply with the applied financial reporting framework, and are consistent with accounting policies that are adopted in the industry to which the audited company belongs. Moreover, with regard to accounting policies for inventory assets, it needs to consider the rationale for employing different accounting policies when, for example, valuing the products of domestic consolidated subsidiaries and overseas consolidated subsidiaries.**

#### **Case 4: 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 Committee Statement No. 315, paragraph 28)

#### **《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.**

### **(3) The auditor's responses to assessed risks**

#### **Case 1: Audit procedures for risks of material misstatements**

- ▶ The engagement team identified material misstatement risks with respect to prepaid expenses as well as salaries and allowances, and deemed that such risks were low. Furthermore, with regard to prepaid expenses, it performed a comparative analysis with the figures for the previous term, while with regard to salaries and allowances, it analyzed the causes of increases in the amounts booked, personnel expenses per employee, etc.

However, the engagement team did not perform substantive procedures, instead only performing analytical procedures such as comparing accounts for the previous term.

(Auditing Standards Committee Statement No. 330, paragraph 17)

- ▶ The engagement team designed and implemented an audit sampling method, using the population of the last month's sales in order to verify the accounts receivable balance at the year-end.

However, 14 of the 18 samples selected by the engagement team had been settled prior to the year-end, which were not included in the accounts receivable balance at the year-end. As a result, the engagement team did not design its audit procedures to obtain sufficient appropriate audit evidence with regard to the existence of accounts receivable at the year-end.

(Auditing Standards Committee Statement No. 330, paragraphs 5 and 17; No. 500, paragraph 5)

#### **《Points to Note》**

**When planning audit procedures responsive to assessed risk, auditors shall plan audit procedures to obtain sufficient appropriate audit evidences corresponding to the material misstatement risks at the assessed assertion level, considering the nature of related class of transactions, account balance and disclosure, and the relevant internal controls.**

**In particular, auditors shall note that they are required to obtain audit evidences, which are more competent or appropriate, for risks of material misstatement due to fraud, than in cases where no risk of fraud is identified for the assertion.**

**Engagement teams shall also note that they need to plan and perform substantive procedures for a significant class of transactions, account balance and disclosure regardless of the assessment of material misstatement risks, because they may not identify all risks of material misstatement and there are inherent limitations of an audit including management override on internal controls.**

#### **Case 2: Adequacy of presentation and disclosure**

- ▶ With regard to asset retirement obligations (ARO) for solar power generation equipment, the audited company did not book the ARO on the balance sheet or even mention it in a note on the ground that use of the equipment was conditional on the extension of the term of the land

lease agreement and therefore the end of the term could not be determined, meaning that the ARO could not be reliably estimated.

However, the engagement team did not examine the materiality of the ARO in order to determine whether a note was required.

(Auditing Standards Committee Statement No. 330, paragraph 23; ASBJ Statement No. 18, paragraph 16)

- The audited company applied International Financial Reporting Standards (IFRS) when preparing its consolidated financial statements. IAS 7 (Statement of Cash Flows) stipulates that interest received, dividends received, interest paid and dividends paid must be disclosed separately, but the audited company did not present amounts for interest received and dividends received separately in its consolidated statement of cash flows, instead presenting only a total figure.

However, the audit team did not assess the reasonableness of the audited company not recognizing the amounts of interest received and dividends received separately and instead presenting the total figure.

(Auditing Standards Committee Statement No. 330, paragraph 23)

#### 《Points to Note》

**Other than the above, deficiencies in audit procedures for presentation and disclosure included a case where the engagement team did not examine whether this fair value calculation method was actually based on real-estate appraisal standards even though the notes to leased property disclosed that an amount calculated by the audited company in accordance with real-estate appraisal standards was the fair value, a case where the engagement team did not examine the reasonableness of the presentation category of asset retirement expenses stemming from asset retirement obligations, and a case where the engagement team did not notice an error in the presentation on a cash flow statement.**

**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 used an external warehouse to manage its inventories, including shipment and acceptance as the Service Organization.

Under such circumstances, the engagement team did not understand how the audited company



used the operations of the warehouse, which is the service organization. Moreover, in understanding internal controls relevant to audit, the engagement team did not assess the design of the audited company's internal controls relevant to the services provided by the warehouse and the application of the controls to the service.

(Auditing Standards Committee Statement No. 402, paragraphs 8, 9, and 10)

#### **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 auditor's 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 inspected 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 Committee Statement No. 402, paragraph 16)

#### **《Points to Note》**

**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 1: Examination of identified misstatements during the audit**

During an audit engagement for a financial institution, the engagement team identified the overstatement of accrued revenue for the previous year was recognized in the current year, and treated it as an uncorrected misstatement.

However, the engagement team did not consider how the misstatement affected the internal control audit. Further engagement team did not consider whether it was necessary to describe the

misstatement in the written representation as an “uncorrected misstatement identified in the current fiscal year that could affect earnings for past fiscal years.”

(Auditing Standards Committee Statement No. 450, paragraphs 4, 5, 13, and A4)

### **Case 2: Evaluating the effect of uncorrected misstatements**

The audited company included a prior year’s uncorrected misstatement in non-operating expenses and did not restate its financial statements. The engagement team did not examine the reasonableness of the above accounting since the amount of the prior-year uncorrected misstatement was less than materiality and the team lacked awareness of the need to carefully examine treatments in audits. Therefore, the team did not examine the adequacy of recognizing the uncorrected misstatement as profit or loss of the current year. In addition, they did not ask the audited company to state the uncorrected misstatements in a summary of unadjusted misstatement, which was attached to the written representation.

(Auditing Standards Committee Statement No. 450, paragraphs 10 and 13; ASBJ Statement No. 24, paragraphs 21 and 35)

### **《Points to Note》**

**There were numerous cases where auditors did not examine the results of evaluating 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 for the current term, (2) uncorrected misstatements included in comparative information, or (3) 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: Development of an audit plan for the use of IT systems**

- ▶ The engagement team only inquired if there were significant changes from the previous year in its understanding of the general structure of IT use in mission-critical systems for sales and

purchase operations, and did not perform procedures for understanding the stability of information systems, the overview of IT infrastructure and the degree of IT use, etc.

Moreover, the engagement team did not consider whether they should use an IT specialist although there was no one on the team who had sufficient knowledge of IT.

(Auditing Standards Committee Statement No. 315, paragraphs 17 and 20; IT Committee Practical Guideline No. 6, paragraph 4)

- The 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 examined 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 examine 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 Committee Statement No. 315, paragraph 20; Audit and Assurance Practice Committee Report No. 82, paragraph 144)

#### **《Points to Note》**

**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.**

## **2. 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 responses 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 sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to keep sampling risk at a tolerably low level;
- When testing items selected by specific sampling, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining part of the population; 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 the risks of material misstatement due to fraud” and (3) “Response to assessed the risks of material misstatement due to fraud” in “6. The Auditor’s Responsibilities Relating to Fraud in Financial Statement 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 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 response to audit risk, 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 “1. Risk Assessment and Response to Assessed Risks” in Chapter III).

In many other cases, the engagement team appropriately performed risk assessment and designed audit procedures to respond to the assessed risk but the engagement partners neither gave specific directions nor exercised specific supervision. Assistants to engagement partners 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, gain 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 (sufficiency of audit evidence)**

- ▶ The engagement team recognized sales as a significant risk, and compared each transaction with evidence in order to investigate the existence of sales.

However, the engagement team only made comparisons with internal evidence, such as copies of invoices issued by the audited company, and did not assess the reliability of this evidence as proof.

(Auditing Standards Committee Statement No. 500, paragraph 6)

- ▶ As for the occurrence and accuracy of sales with credit cards, the engagement team performed confirmation procedures for several of the balances of accounts receivable as of the balance sheet date, and vouched all unconfirmed accounts to the reports that the audited company obtained from credit card companies.

Audit evidences of the credit sales obtained from the confirmation procedures were for the

sales in the latter half of the year-end month. However, the engagement team did not consider the necessity of additional substantive procedures for the credit sales related to the period between the beginning of year and the first half of the year-end month, which is not subject to examination.

(Auditing Standards Committee Statement No. 500, paragraph 9)

#### **《Points to Note》**

**As in the above example cases of a deficiency, there were cases where the insufficient audit evidence for responding to the risks identified was obtained. For example, even though significant risks had been identified, audit procedures were completed after only using audit evidence that was easy to obtain, such as internal evidence from the audited company. There were also cases where tests of effectiveness of internal controls and substantive procedures were performed only for part of the period subject to audit, as well as cases where substantive procedures were not planned and performed for selling, general, and administrative expenses identified as a risk of material misstatement.**

**When performing tests of effectiveness of internal controls and substantive procedures, auditors are required to determine the period that should be subject to audit procedures in consideration of account balances and assertions. In audit procedures for the occurrence and accuracy related to items in the statement of income, in particular, auditors should note that the items audited over the entire period are subject to the procedures, in general. Furthermore, auditors should note that periods that should be subject to tests of effectiveness of internal controls for financial statement audits differ from period for audit of internal control over financial reporting, in the case where there was a change in internal control activities during the period.**

**In addition, generally, inquiries without other procedures neither proves that there is no risks of material misstatement at the assertion level, nor obtains 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 responsive 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 responsive to audit risk.**

**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 one case, the engagement team performed multiple audit procedures, yet the quantitative or qualitative appropriateness of audit evidences was not verified through the planned audit procedures. As a result, it was considered that the team did not obtain sufficient audit evidence to reduce the overall audit risk to a low level.**

**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.**

## **Case 2: Sufficient appropriate audit evidence—appropriateness of audit evidence**

- ▶ As audit procedures for completeness of liabilities related to purchase and selling, general and administrative expenses (excluding personnel expenses and depreciation), the engagement team vouched with records at bank accounts related to payments made in the period between the following day of the balance sheet date and 10 days later with supporting documents. However, although the cutoff date of payments of liabilities at the audited company was usually at month-end and they were paid at the following month-end, the engagement team did not plan and perform audit procedures for obtaining sufficient appropriate audit evidence on the completeness of liabilities. They needed to examine expanding the period of deposit payment records subject to verification, and verifying whether there were any invoices received on and after the date of the financial statements that should have been recorded as liabilities. (Auditing Standards Committee Statement No. 500, paragraph 5)

- ▶ In verifying the accuracy of inventory, the engagement team observed a physical inventory as part of its substantive audit procedures. The engagement team verified the accuracy of the closing balance recorded in the inventory listings through tracing the quantity confirmed at the physical inventory to that on the inventory listings. However, the engagement team did not perform audit procedures to obtain sufficient appropriate audit evidence to verify the accuracy of the unit prices of the closing balance. (Auditing Standards Committee Statement No. 330, paragraph 17; No. 500, paragraph 8)

- ▶ With regard to sales by significant components, the engagement team claimed to have identified significant risks and to have performed tests of detail, which constitute substantive procedures, at the same time as performing procedures to assess implementation of internal controls (dual-purpose test). However, as procedures to assess implementation of internal controls, the engagement team just stated in the audit documentation that it had checked whether approvals had been given and the consistency of different types of evidence. Information on amounts investigated was not included, and substantive procedures had not been performed. (Auditing Standards Committee Statement No. 330, paragraph 17; No. 500, paragraph 6)

### **《Points to Note》**

**The engagement team needs to evaluate the reliability and relevance of audit evidence when planning and executing audit procedures.**

**As the above examples show, when a test of operating effectiveness of internal controls was also used as a substantive procedure (dual-purpose test), the engagement team did not consider the effectiveness of such**



test as a substantive procedure. When planning and performing tests of effectiveness of controls and substantive procedures, engagement teams have to consider whether procedures to obtain sufficient appropriate audit evidences, which achieve the relevant audit objectives, are planned and performed.

### **Case 3: Work of management's experts**

The audited company acquired shares in A Co. through a share exchange using the shares of the audited company, and made it a consolidated subsidiary. When calculating the exchange ratio for the share exchange, the audited company employed the results of services provided by an expert. The engagement team obtained the results of the services provided by the expert that were used by management from the audited company, and used them to investigate the share exchange ratio. However, the engagement team failed to examine the competence, capabilities and objectivity of the expert used by management.

(Auditing Standards Committee Statement No. 500, paragraph 7)

### **《Points to Note》**

**When using the work of the management's experts (including pension actuary, real estate appraiser, etc.), the auditor needs to evaluate the competence, capabilities and objectivity of such experts, and understand the expert's work, paying attention to evaluating the adequacy of the expert's work used as audit evidence in light of related assertions.**

### **Case 4: Reliability of information prepared by audited companies**

- ▶ The audited company determined whether impairment losses needed to be booked on goodwill based on its profit plan.

The engagement team used this profit plan to investigate the reasonableness of the audited company's judgement concerning the recoverable amount of goodwill.

However, the engagement team overlooked the fact that the recoverable amount of goodwill had been overstated as a result of applying the incorrect exchange rate in the profit plan, and did not properly assess whether the information prepared by the audited company was sufficiently accurate and detailed in view of the auditors' purposes.

(Auditing Standards Committee Statement No. 500, paragraph 8)

- ▶ In the verification of consolidated journal entries related to the elimination of unrealized profit on inventories, the engagement team checked the inventory quantities and profit ratio with information prepared by each division of the audited company.

However, the engagement team did not obtain audit evidence on the accuracy and completeness of the information, and did not assess the reliability thereof.

(Auditing Standards Committee Statement No. 500, paragraph 8)

- ▶ In examination of the valuation of inventories, the engagement team used the information prepared by the audited company (details of sales transactions for identifying inventories whose profitability had declined).

However, the engagement team did not examine the completeness of the sales transactions, and did not evaluate whether the information was sufficiently reliable for the auditor's purposes, while the engagement team investigated the accuracy of the information.

(Auditing Standards Committee Statement No. 500, paragraph 8)

- ▶ The engagement team examined to select the site observations, assess whether to recognize the construction loss provision, and investigate incomplete transfers from construction-in-progress expenditures to completed-construction costs, using the P/L data by construction projects prepared by the audited company.

However, the engagement team did not evaluate whether the P/L data by construction projects and the construction-in-progress expenditures were appropriately aggregated, although the engagement team verified the reliability of the data through verifying that the total annual completed-construction amounts and completed-construction costs for all construction projects was consistent with the general ledger.

(Auditing Standards Committee Statement No. 500, paragraph 8)

#### **《Points to Note》**

**As shown in the above case, it is essential to verify whether the data obtained from an audited company was consistent with the financial statements, such as verifying the completeness of the data population, when extracting samples from data obtained from an audited company.**

**Further, as part of the audit of accounting estimates, numerous cases were observed in which the information prepared by an audited company was used as an audit evidence without its accuracy and completeness being verified. When using the information obtained from an audited company as an audit evidence, the engagement team should thoroughly examine the reliability of such information, including the information produced by information systems.**

#### **Case 5: Timing of substantive procedures (procedures for remaining period)**

- ▶ When verifying the balances of loans and deposits at an audited financial institution, the engagement team performed a dual-purpose test of both substantive procedures and operating effectiveness of controls to verify transactions during the term until February. However, the team only performed the analytical procedures for its risk assessment, but did not plan and perform the substantive procedures to verify the remaining period.

(Auditing Standards Committee Statement No. 330, paragraphs 17 and 21)

- ▶ The audited company was in the retail business, and from the middle to the end of the

closing month, it performed a physical inventory at several dozen stores.

The engagement team selected two stores and observed the inventories being taken, and planned and performed roll-forward procedures from the date of the physical inventory up to the date of the financial statements.

However, the engagement team failed to obtain sufficient appropriate audit evidence to verify the balance of inventory on the date of the financial statements since the engagement team's audit procedures included the following deficiencies:

- a) The engagement team only identified the changes in inventory from the date of the physical inventory to the date of the financial statements for the stores observed, and did not perform its substantive procedures for the transactions that led to the changes.
- b) Any audit procedures were not planned or performed for the stores not observed.

(Auditing Standards Committee Statement No. 330, paragraph 21; No. 500, paragraph 5; No. 501, paragraph 4)

#### **《Points to Note》**

**It should be kept in mind that in the case where substantive procedures were performed as of a cut-off date set before the balance-sheet date, additional substantive procedures should be performed for the period from a cut-off date to the balance sheet date to reasonably support the use of audit conclusions of the substantive procedures to cover the remaining period.**

## **(2) External Confirmation**

### **Case 1: Reliability of responses to confirmation request**

As part of its confirmation procedures, the engagement team requested a balance confirmation from a confirming party, and received a response by fax. And in the case of the balance confirmation from another confirming party, it only obtained a PDF of the confirmation via the audited company.

However, the engagement team did not assess the reliability of the response, even though it had not obtained the original confirmation document, and did not perform procedures to obtain additional audit evidence.

(Auditing Standards Committee Statement No. 505, paragraphs 9 and 15)

#### **《Points to Note》**

**External confirmation procedures generally provide strong audit evidence to auditors. However, if auditors have suspicion of the reliability of the replies, 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. In the case of confirmation with the attorney, 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.

**Note:** On February 19 and 2018, Auditing Standards Committee Statement No. 73, "Practical Guidelines on the Assessment of Structures for Managing Risks Associated with Litigation and Confirmation with Attorneys" were revised to Auditing and Assurance Committee Practical Guidelines No. 73, "Practical Guidelines on Inquiry Letters to Advising Attorneys Concerning Litigation," and have been applied to audits for the accounting years starting on or after April 1, 2018.

### **Case 2: Alternative audit procedures**

In confirming the outstanding balances of accounts receivable as of the balance sheet date, the engagement team conducted alternative procedures for confirmations not replied 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 threshold, which should have been confirmed.

(Auditing Standards Committee Statement No. 505, paragraph 11)

### **《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**

- ▶ The engagement team performed balance confirmation procedures as part of its substantive procedures for receivables, and if there was an exception in relation to confirmation, it performed an investigation with respect to the amount of the difference.

However, performing a balance confirmation for an important business partner, the engagement team discovered that the amount in the response from the business partner included a large difference in an item called "money retained" (the amount of the other party's obligation was excessively high). However, the team did not identify what "money retained" referred to, and excluded it from its investigations. It therefore did not obtain sufficient appropriate audit evidence with respect to the difference.

(Auditing Standards Committee Statement No. 505, paragraph 13)

- ▶ With regard to land and buildings, the audited company included a note concerning pledged assets on the grounds that a revolving mortgage had been established when the money was borrowed from financial institutions.

With respect to the fixed tangible assets for which the revolving mortgage had been established, the engagement team compared the description of the assets on the collateral statement with the engagement documentation for the previous year's audit, compared the amount with that in the fixed-asset ledger, perused examination records, minutes from meetings of the directors, and the approval circulars at the time the loan was taken out in order to investigate changes in the collateral.

However, when the engagement team asked the three financial institutions that had provided the revolving mortgage to confirm the balance, two of them responded that there was no collateral property, while the other did not make a clear statement as to whether there was collateral property. Despite this, the team did not consider the need for additional procedures such as make inquiries with the financial institutions or resending the balance confirmation requests.

(Auditing Standards Committee Statement No. 505, paragraphs 13 and 15)

- ▶ As a substantive procedure for receivables, the engagement team performs balance confirmations, and if there are differences in the balance confirmations collected, it asks the audited company to analyze them, and then investigates the details of the differences. As part of the confirmation procedures performed by the engagement team, differences were confirmed (overstatements of the audited company's claims), and the engagement team compared some of these confirmed differences with a subsidiary ledger, which was a statement of receivables prepared by the audited company, in order to confirm whether the differences actually existed.

However, the subsidiary ledger is no more than accounting information, so the figures will obviously match, so the engagement team did not obtain sufficient appropriate audit evidence for the confirmed differences.

(Auditing Standards Committee Statement No. 505, paragraphs 13 and 15)

### 《Points to Note》

**Exceptions arising from replies to external confirmation might indicate misstatements in financial statements or potential misstatements. Based on this, the engagement team should investigate the differences 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.**

### **(3) Substantive analytical procedures**

#### **Case 1: Identified deficiencies in substantive analytical procedures**

- ▶ The engagement team performed substantive analytical procedure for sales, estimating auditor's expectation for sales by dividing the cost of sales for the current term by the cost rate for the previous term.

However, with costs predicted to have decreased as a result of an increase in capacity utilization during the current term, the team did not consider whether it was appropriate to use the previous term's cost rate to make the expectation. Furthermore, the expectation for sales was computed by aggregating the sales for two divisions even though the cost rate for each division was different, but the team did not consider whether it was appropriate to make the expectations through aggregation.

(Auditing Standards Committee Statement No. 520, paragraph 4)

- ▶ In the substantive analytical procedures for sales rebates of the audited company, the engagement team assumed that there was no significant fluctuation in the ratio of rebates to sales, and made rebates expectation by multiplying current year's sales by the rebate ratio during the previous period.

However, although the rebate contracts differed between customers and sales to each customer fluctuated every year, the engagement team did not examine the appropriateness of the above expectation by obtaining specific supporting information such as review of revisions to the rebate contracts by each customer.

(Auditing Standards Committee Statement No. 520, paragraph 4)

#### **《Points to Note》**

**There continue to be cases where the engagement team selected substantive analytical procedures as substantive procedures, but, for example, only performed annual comparisons that did not meet the requirements of substantive analytical procedures.**

**It should be noted that in some cases, substantive analytical procedures met requirements stipulated in the audit standards, but examinations as to the reliability of the data and the accuracy of the expected value, which were necessary to reduce the audit risk to a minimum acceptable level, were not performed. For example, the engagement team used the actual previous period results and financial forecast as expectations without a rational reason when performing such procedures. The engagement team should consider the nature and relevance of information sufficiently, and that any difference of recorded amounts from expectation may turn out to be a material misstatement.**

#### **Case 2: Investigation of results of substantive analytical procedures**

In substantive analytical procedures for personnel expenses (salary, miscellaneous wages,

allocated labor expenses), the engagement team identified that a difference between the amounts recorded in manufactured costs and the expectation of the auditor exceeded the acceptable difference.

However, they simply assumed that the difference resulted from internal assistance provided from the sales and control division to the manufacturing division to respond to unpredicted sales orders without obtaining sufficient appropriate audit evidences relating to the difference, such as documents to support the assumption that the internal assistance actually occurred.

(Auditing Standards Committee Statement No. 520, paragraph 6)

#### **《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**

- ▶ The engagement team identified sales and cost of sales of a subsidiary that closed its books in September, which was a significant component of the audited company, as material misstatement risks. As procedures for responding to these risks, the team compared evidence. Specifically, for sales, it compared shipping records with goods receipts etc. for May-September, while for cost of sales, it compared shipping records with delivery notes etc. for May-July.

However, the team did not consider the need to extract samples from the entire period subject to the audit.

(Auditing Standards Committee Statement No. 500, paragraph 5; No. 530, paragraph 5)

- ▶ As a test of detail for cost of sales, the engagement team randomly selected at least two samples from each month, and compared them with delivery notes.

However, when making the comparisons, the team did not consider whether at least two samples from each month was sufficient as a test of detail.

(Auditing Standards Committee Statement No. 500, paragraph 5; No. 530 paragraphs 5 and 6)

- ▶ With the audit firm having no internal rules of audit sampling, the engagement team selected

25 or more samples in the test of details for account items (sales, accounts receivable, etc.) that are highly related to the business objectives of the audited company in the audit of internal control over financial reporting, and a few number of samples for other account items. However, the engagement team did not consider whether these numbers of samples could provide a reasonable basis for conclusion about the entire population.  
(Auditing Standards Committee Statement No. 500, paragraph 5; No. 530, paragraphs 5 and 6)

#### **《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: Testing some selected items in a population**

With regard to dividend income, SG&A expenses, etc., which had been identified as important transaction types, the engagement team performed substantive procedures for those transactions performed during the term that exceeded a certain amount.

However, even though the remaining components for the above-mentioned substantive procedures of the population all exceeded performance materiality, the engagement team did not consider whether additional substantive procedures needed to be performed.

(Auditing Standards Committee Statement No. 500, paragraphs 9 and A55)

#### **《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**

The audited company identified the scope of related parties based on a group relational diagram, aggregated the total amounts of transactions and receivables/payables with respect to each related party, and considered whether they needed to be disclosed.

However, when performing its audit procedures, the engagement team overlooked the fact that the audited company had not aggregated transactions between consolidated subsidiaries and related parties, and did not obtain sufficient audit evidence with respect to the completeness of notes concerning related party transactions.

(Auditing Standards Committee Statement No. 550, paragraph 24)

### **《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 Committee Statement No. 240, also see “6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits.”

### **Case 2: Identification and assessment of the risks of material misstatement associated with related party transactions**

The audited company makes short-term loans to A Co., its top shareholder. 100% of the voting rights in A Co. are held by B Co., which is controlled by the representative director and chairman

of the audited company, and thus constitutes a related party of audited company.

However, with regard to the loans by the audited company, the engagement team did not adequately consider the transaction terms and their consistency with the management's explanations or the business rationale for the transactions.

(Auditing Standards Committee Statement No. 550, paragraphs 10, 12, 17, and 22)

#### **《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: Identification of any events or conditions that may cast significant doubt on the audited company's ability to continue as a going concern**

Despite severe business conditions that resulted in continuing operating losses and negative operating cash flow, and difficulties in financing as evidenced by multiple financial institutions' refusal to provide loans, the audited company mentioned that neither an event nor a condition which might cast significant doubt on the going concern assumption had occurred, maintaining that these losses had arisen from restructuring business operations.

However, the engagement team did not examine the reasonableness of the audited company's argument.

(Auditing Standards Committee Statement No. 570, paragraphs 9 and 11)

#### **《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.**

**Besides the above, in one case, the engagement team did not examine the audited company's financing plan**

specifically for the feasibility of financing. In other cases, the engagement team did not sufficiently examine, on a consolidated basis, factors having a significant impact on the going concern assumption, including subsidiaries' additional financing needs. The engagement team needs to evaluate the audited company's financial position comprehensively based on specific audit evidence and the effectiveness and feasibility of the measures taken by management in relation to the assessment of the assumption of the audited company's ability to continue as a going concern.

## **(7) Other**

### **Case 1: Subsequent events**

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 Committee Statement No. 560, paragraph 7)

### **《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:

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

### **Case 2: Forming the audit opinion (assessment of misstatements)**

The engagement team identified an uncorrected misstatement relating to the failure to book impairment losses on goodwill.

However, even though the uncorrected misstatement exceeded the threshold for materiality in nonconsolidated financial statements, the engagement team did not consider its impact on the audit opinion.

(Audit Standards Committee Statement No. 700, paragraph 9)

### **Case 3: Consolidated adjusting entries**

The engagement team identified risks of material misstatements in accounting treatment for capital consolidation. However, the accounting procedures performed by the engagement team had the

following deficiencies, and the team did not assess whether the audit evidence it obtained was adequate and appropriate for the risk of material misstatements.

- a) With regard to the journal entries of amortization of goodwill, the engagement team only reviewed documents prepared by the audited company, and did not perform substantive procedures.
- b) With regard to the journal entries of the equity method of accounting, the engagement team only made comparisons with the previous term, and did not perform substantive procedures with respect to the booked amounts.
- c) With regard to the journal entries of market value valuation, the engagement team compared the total journalized amount of deferred tax assets/liabilities with the figure for the previous term, and discovered that it had decreased significantly. Yet despite this, it concluded that “nothing unusual was found with journal entries,” and did not consider whether additional procedures were necessary.

(Auditing Standards Committee Statement No. 330, paragraphs 6, 17, and 25; No. 500, paragraph 10)

#### **《Points to Note》**

**As can be seen from the case above, there was a case where the engagement team, in its examination of consolidated adjusting entries, only made comparisons with the previous term and reviewed documents prepared by the audited company, and did not perform substantive procedures.**

**In addition to the above, there were also cases where the engagement team lacked an understanding of the company and its environment at the group level, which is essential for assessing risk relating to consolidated financial statements, and even though complex intra-group transactions had occurred, the team did not examine completeness concerning the elimination of unrealized profit. When auditing consolidated financial statements, engagement teams need to realize that they must have a proper understanding of the corporate group, including assessments of capital relationships, effective control, and levels of influence.**

**For information on typical cases related to consolidated financial statements, also see “4. Group Audit.”**

### **3. 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 Committee Statement No. 540, paragraph 14 in addition to the planned audit procedure.

#### **Outline of inspection results**

In auditing accounting estimates, there were still many cases where the engagement team only understood management's assumptions and accounting approaches but due to the lack of professional skepticism, did not objectively evaluate management's arguments regarding the appropriateness of inventory assessment rules and achievability of its business plan that the audited company's accounting estimates were based upon, thereby failing to examine the reasonableness of the management's arguments adequately.

Further, required audit procedures were often not performed, due to the lack of understanding of requirements under Auditing Standards Committee Statement No. 540.

#### **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.

## **(1) Matters common to auditing accounting estimates**

### **Case 1: Reasonableness of management's assumptions**

- ▶ The audited company operates an online retailing business, and issues two types of reward point to promote sales. Each type of point differs greatly in terms of period of validity, usage rate, and end-of-term balance, but the amount of the audited company's provision for reward points was calculated by multiplying the usage rate by the total balance of the two types of point. The engagement team deemed that it was reasonable for the audited company to bundle the two types of point together when calculating the usage rate. However, the team did not find out the reason why points used could not be categorized by type or the reason why expired points were treated differently depending on the time they expired, and did not adequately consider the reasonableness of the management's assumptions. Furthermore, the engagement team did not obtain audit evidence concerning the accuracy and completeness of computer-system data obtained from the audited company, and did not verify whether this data was sufficiently reliable as grounds for the calculation of the provision for reward points.

(Auditing Standards Committee Statement No. 500, paragraph 8; No. 540, paragraph 12)

- ▶ The audited company recorded the entire book value of end-of-term inventory that was not expected to be sold or used within one year as a valuation loss. When determining whether inventory was expected to be sold or used within one year, the audited company assumed that "the proportion sold or used during the next year would be the same as it was during the current year." The engagement team identified the valuation of inventory assets as a significant risk, and based on the circumstances of the business and budget figures for the following year, which it had obtained through discussions with the management, the team determined that it was reasonable to expect there to be no change in the situation with sales and usage. However, even though there were products for which sales and usage of inventory assets varied from year to year, the engagement team did not consider matters from the standpoint of whether the assumption was reasonable.

(Auditing Standards Committee Statement No. 540, paragraph 14)

### **《Points to Note》**

**Other than the provision for reward points and assessment of inventory assets 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.**

Particularly, when a significant risk is identified in accounting estimates, the engagement team must evaluate the following.

- (1) 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;
- (2) The reasonableness of management's material assumptions; and
- (3) 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.

- The audited company used the next year's budget to assess both the recoverability of deferred tax assets and the impairment of long-lived assets. The audited company did not account for any deferred tax assets because of the uncertainty of the budget, while they considered it unnecessary to recognize the impairment loss of long-lived assets as the budget was likely to be certain. Therefore, the management's judgment on accounting estimates was inconsistent. However, in examining accounting estimates, the engagement team did not verify the reasonableness of applying inconsistent assumptions to project business performance for an identical period.

(Auditing Standards Committee Statement No. 500, paragraph 10; No. 540, paragraphs 12 and 20)

#### 《Points to Note》

Other than the examples above, there were cases where the engagement team did not sufficiently consider the inconsistency in management's assumptions among accounts. For example, although the audited company accounted for impairment loss on its subsidiary's shares in individual financial statements, the equivalent goodwill recognized in its consolidated financial statements was not written off. The engagement team should comprehensively evaluate the consistency of events they understood.

#### Case 2: Review of the method of accounting estimates

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 Committee Statement No. 540, paragraphs 7 and 14)

#### **《Points to Note》**

**The engagement team needs to verify the method of the management's accounting estimates by evaluating whether the management's method for measurement is appropriate under certain circumstances and whether the management's assumptions are reasonable under the applicable accounting standards. Further, when reviewing the management's methods for accounting estimates, the engagement team should consider the following:**

- **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**

- ▶ With regard to provisions for handling product complaints, the engagement team chose to compare the accounting estimate, which had been booked as a product warranty provision in the previous year, with the actual amount for one of many cases subject to provisions, on the grounds that the same calculation method was used.

However, the team only investigated one case, and did not examine whether it was possible to identify and assess risks of material misstatement relating to accounting estimates in the current year just by investigating one case.

(Auditing Standards Committee Statement No. 540, paragraph 8)

- ▶ Although the real value of shares in a subsidiary held by the audited company had fallen by more than 50%, the audited company did not book an impairment loss on the shares, but instead booked a provision for investment losses. However, the real value of the shares in



the subsidiary had dropped by over 50% continuously since past years, and the subsidiary had suffered a net loss in the previous year.

Against this backdrop, in the previous year the engagement team examined specific possibilities for a recovery in the real value of the shares in the subsidiary based on future plans etc., but did not do so in the current year. It also allowed the provision for investment losses to be booked without considering whether it would be necessary to book an impairment loss on the shares pursuant to accounting standards etc. for financial instruments. Furthermore, the engagement team did not retrospectively consider the management's assumptions and judgements concerning the valuation of shares in subsidiaries, including provisions for investment losses.

(Auditing Standards Committee Statement No. 540, paragraphs 8, 11, and 12; Accounting System Committee Statement No. 14, paragraph 92)

#### **《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.**

#### **Case 4: Evaluation of reasonableness of business plan**

- ▶ The real value of shares in a subsidiary held by the audited company declined by more than 50% from the acquisition cost during the current term, but the audited company deemed that it was unnecessary to book a valuation loss or provision with respect to the shares.

The engagement team discovered that the business plan for the subsidiary prepared during the current term contained the forecast that the real value of the shares in the subsidiary would recover to the acquisition cost within four years. The team then obtained internal materials corroborating the claims made in the subsidiary's business plan from the audited company, and confirmed that the value of sales presented in the subsidiary's business plan was consistent with the internal materials from the audited company.

However, with the subsidiary's business plan projecting a substantial increase in profits, the engagement team did not adequately consider the reasonableness of the assumptions employed by the management, such as the assumptions on which the business plan was based, the impacts of specific measures, and its consistency with the audited company's business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12)

- ▶ With regard to a fixed asset that was showing signs of having impaired, the audited company deemed that recognition of an impairment loss was unnecessary as the total amount of pre-discounted cash flow projected in the five-year business plan was higher than the book value of the fixed assets. The engagement team also determined that this judgment was reasonable. However, with regard to the business plan, which forecast that operating profit would rise at a pace of 1.7 times a year, the engagement team just accepted the audited company's explanation that the target for the first year was feasible and that sales would increase as the market was growing. They therefore deemed that the projections in the business plan for the second and subsequent years were reasonable, and did not consider the feasibility of achieving the targets set forth in the business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12)

#### **《Points to Note》**

**In examining accounting estimates, including the valuation of investments and loans for affiliated companies, impairment of long-lived assets and recoverability of deferred tax assets, the engagement team often evaluates the reasonableness and other aspects of the business plan prepared by management.**

**However, in many cases, the engagement team evaluated the plan qualitatively only through interviews with management without verification of the details of the business plan with supporting evidence. As such, the engagement team did not sufficiently or appropriately examine the reasonableness of the business plan from a critical standpoint as professionals. The engagement team should carefully consider the business plan by examining the consistency between the plan and the business environment as understood by the engagement team, comparing it with past actual results, verifying specific measures that form the basis of figures contained in the plan such as increasing revenues and reducing costs, and examining their feasibility.**

## **(2) Evaluation of shares of affiliate companies**

### **Case: Examination of net asset value and recoverability**

In valuing the shares of a non-performing subsidiary, the engagement team did not examine the reasonableness of the audited company's decision not to realize impairment on the shares, despite the fact that the audited company assumed that the value of the shares would recover to approximately 50% of the book value in five years based on the subsidiary's business plan.

(Auditing Standards Committee Statement No. 540, paragraph 12)

### **《Points to Note》**

When the net asset value of shares of the audited company's affiliate company for which the market value is extremely difficult to estimate declines by more than 50% from the acquisition cost, the audited company is required to consider that the net asset value deteriorated substantially and recognize an appropriate amount of impairment loss. This treatment should also apply to the valuation of shares of affiliate companies shortly after establishment or acquisition, and the net asset value of the shares should be carefully considered in analyzing the difference between an affiliate company's performance and its business plan.

### **(3) Valuation of receivables**

#### **Case 1: Review of recognition and measurement**

In its verification procedures for the valuation of loans to and receivables from a consolidated subsidiary whose liabilities were in excess of assets, the engagement team took into account unrealized gains on land owned by the consolidated subsidiary, and deemed that booking a provision for bad debts was unnecessary. However, it did not adequately consider the feasibility of selling the land, which was at the center of the assessment of recoverability.

(Auditing Standards Committee Statement No. 540, paragraph 12)

### **《Points to Note》**

Besides the above, there were also cases where the engagement team did not consider the reasonableness of the amount of an asset that was expected to be subject to seizure that the audited company claimed could be recovered. If during the valuation of receivables, an asset is expected to be subject to seizure, it is not enough to just identify the asset concerned. It is also necessary to adequately consider the feasibility of seizure and the amount expected to be recovered from the disposal of the asset.

Additionally, if it is difficult to obtain data that helps judge the debtor's ability to pay, there is a simplified method of valuing receivables with default possibility by, for example, provisioning 50% of the balance net of the estimate disposal value of the collateral. As for individually material receivables with default possibility, it is necessary to obtain sufficient data to the extent possible and to sufficiently examine whether the receivables are appropriately estimated at the time of valuation.

#### **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 Committee Statement No. 540, paragraph 14)

- In its self-assessment, an audited financial institution accepted that although C Co. had low net assets at the end of the term, if the assets of the owner-manager were taken into account, its solvency was adequate. It also predicted that it would earn sufficient profits in the future based on the business plan, and had no doubts about the collectability of the debt. It therefore categorized the company as a "normal borrower."

After examining the company's financial condition and business plan, the engagement team deemed that the debtor category was appropriate.

However, the engagement team noticed that C Co.'s inventory balance had been large in relation to its annual sales for at least the past five years, and that if it became clear that it was saddled with unsellable inventory, it would have negative equity. Despite this, the engagement team did not obtain additional audit evidence.

(Auditing Standards Committee Statement No. 540, paragraph 12)

### 《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.**

### Case 3: Accuracy of loan loss ratio

In the examination of loan loss ratio, the engagement team did not take into account the accuracy or completeness of the beginning loan balance or the amount of loss for a calculation period

prepared by the financial institution that is a cooperative financial institution.  
(Auditing Standards Committee Statement No. 540, paragraph 12)

**《Points to Note》**

**Other than the example mentioned above, when auditing allowance for doubtful accounts, it is important to perform procedures to verify the sufficiency of allowance, considering any material changes in the creditworthiness of borrowers for the period from the balance sheet date to the date of the auditor's report.**

**(4) Inventory valuation**

**Case: Examination of method of making accounting estimates and information produced by the entity**

In its valuation of inventory, the accounting policy of the audited company, which produces parts, is to employ the cost method based on the retail method. In the case of product inventory, the end-of-term balance was calculated by multiplying the price reduction rate by the total sale prices of the end-of-term inventory, while in the case of work in process, it was calculated by multiplying the percentage completed and the price reduction rate by the total sale prices of the end-of-term inventory.

The engagement team performed recalculations for end-of-term inventory valuation data obtained from the audited company, and deemed that the audited company's valuation of inventory was reasonable. However, the engagement team did not evaluate the accuracy and completeness of basic data such as total sale prices and total manufacturing costs, which were used to prepare the data. Furthermore, the engagement team did not consider the reasonableness of using percentage completed for work in process or whether it was acceptable to use the same figure for percentage completed for all the inventory in a factory

(Auditing Standards Committee Statement No. 500, paragraph 8; No. 540, paragraphs 12 and 14)

**《Points to Note》**

**In addition to the examples above, there were some cases where the engagement team did not sufficiently examine the reasonableness of the methodology used by the audited company for inventory valuation loss calculation or the reliability of the data prepared by the audited company for valuation loss calculation.**

**Also, audited companies have inventories with special characteristics, such as property 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: Review of cash-generating units**

Even though the audited company, which is in the clothing retail business, decides whether to open

or close stores based on the profitability of each store, it does not group its long-lived assets in units of stores. Instead, it groups them in brand units, which are larger.

However, the engagement team did not consider whether stores constituted the smallest unit that generates cash flow or whether the cash flow generated by each store is mutually dependent on other stores, and it did not obtain sufficient appropriate audit evidence concerning the reasonableness of grouping.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

### 《Points to Note》

**Other than the case above, there were some cases where the engagement team overlooked the fact that the audited company's cash-generation unit deviated from the actual situation and where the engagement team did not consider the appropriateness of the grouping of corporate assets. In addition, in some cases where it was considered that long-lived assets were no longer impaired due to the change in cash-generating units, the engagement team did not appropriately examine the appropriateness of the change with professional skepticism from the perspective of whether they indicated signs of fraud.**

**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

- ▶ The audited company was in the restaurant business, and had a certain criteria to identify indications whether long-lived assets may be impaired. The criteria were that the restaurant had been opened for at least two years, and the profits or cash flow generated from operating activities had been continuously negative. However, it had not criteria to identify indications of impairment of restaurants that had been open for less than two years (below, “new restaurants”).

The engagement team deemed that there were no problems with these criteria, after taking into account the nature of the business, namely that it normally takes new restaurants two or three years to start turning a profit. Furthermore, the engagement team reviewed minutes from meetings of the board of directors and checked the documents the sales performance of restaurants that had opened in the current year, and considered whether there had been any items about closing restaurants. In this way, the engagement team evaluated monitoring situation at the audited company and examined whether there were any indications of impairment at new restaurants.

However, even though some restaurants were actually closing in the second or third year after opening, the engagement team did not examine whether the negative profits or cash flow from the operating activities of new restaurants at the end of the term were far lower than the

negative amounts anticipated in the business plan.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 11)

- A Co., a consolidated subsidiary of the audited company, has booked an operating loss, meaning that A Co.'s operating performance was far worse than had been projected in the business plan formulated at the time of A Co.'s establishment. However, the engagement team deemed that the judgement of the audited company, namely that A Co. had only just been established and that there were therefore no indications of impairment of long-lived assets, was reasonable.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

#### 《Points to Note》

**Other than the examples above, there was a case where the engagement team agreed to the audited company's argument that its deteriorated performance was unusual and temporary, without analysis of the cause. There was also a case where even though the market prices of land had dropped significantly, the engagement team did not judge that there were indications of impairment on the grounds that an impairment loss had already been booked in the past. Furthermore, there was a case where the audited company, in its calculation of earnings from operating activities, had not appropriately allocated head-office expenses to each asset and cash-generating unit. In light of these deficiencies, engagement teams need to carefully consider 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.**

#### **Case 3: Review of recognition and measurement of impairment**

The audited company deemed that the profitability of machinery and equipment at a factory owned by a consolidated subsidiary had declined, and booked an impairment loss on the machinery and equipment by writing its value down to its fair value which was based on an appraisal by an expert, prior to deduction of projected disposition expenses.

However, the engagement team did not consider the reasonableness of not deducting disposition expenses from the fair value used to measure the impairment loss on the machinery and equipment.

(Auditing Standards Committee Statement No. 540, paragraph 12)

### 《Points to Note》

Other than the example above, there was a case where the audited company, in its projections of future cash flow, determined the period of projections for future cash flow without taking into account the remaining economic life of key assets within each cash-generating unit.

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 assertion 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 and impairment 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.

In addition, despite an accounting standard stipulating that a relatively large amount out of acquisition costs allocated as goodwill may indicate the possibility of goodwill impairment in the year of acquisition, the engagement team determined that there was no indication of impairment based on the operating profit generated by the acquired subsidiary on an unconsolidated basis without taking into account the goodwill amortization. As such, the engagement team failed to examine whether to take impairment loss in line with the accounting standard.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12; ASBJ Guidance No. 10, paragraph 77)

### 《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.

Furthermore, as can be seen from the above example, if the amounts allocated to goodwill and intangible



**assets other than goodwill are relatively high, this could be deemed an indication of impairment even in the year of the business combination. For this reason, if a large amount of goodwill has been booked, the engagement team needs to also give adequate consideration to whether there are indications of impairment in the year in which the goodwill arose.**

#### **Case 2: Indications of goodwill impairment**

The engagement team acknowledged substantial changes in the business environment surrounding the audited company's consolidated subsidiary for which goodwill was recorded, such as the resignation of the president of the subsidiary at the acquisition and substantial underachievement of the subsidiary's earnings against the business plan. However, the engagement team did not adequately examine whether these circumstances should have been treated as indications of impairment.

(Auditing Standards Committee Statement No. 540, paragraphs 12 and 17)

### **(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 Committee Statement No. 540, paragraphs 7 and 11)

- ▶ When considering categories under ASBJ Guidance No. 26 "Implementation Guidance on Recoverability of Deferred Tax Assets" for domestic consolidated subsidiaries, the engagement team deemed that the basic data prepared by the audited company was reasonable.

However, with regard to domestic consolidated subsidiaries that had been deemed to be Category 2 by the audited company, the team investigated the reasonableness of the classification for some of the subsidiaries, but in the case of other companies, it did not consider the reasonableness of the classification, and did not even consider whether more detailed investigation was required.

(Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

#### **《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**

Based on ASBJ Guidance No. 26 “Implementation Guidance on Recoverability of Deferred Tax Assets,” the audited company and its subsidiary deemed that the companies were Category 3, and predicted that a pretax profit would be booked from the following term onwards. However, because the estimate for total future taxable income was negative, it did not book deferred tax assets for either of the companies.

Regarding the estimate for the total future taxable income of both companies, the engagement team acquired an understanding of the companies and their environment with respect to the decision not to book deferred tax assets, and as a result of performing an investigation based on the business plans for the two companies and the scheduling of end-of-term temporary differences that would be added/subtracted in the future, the team concluded that the judgement of the audited company and its subsidiary was reasonable.

However, the engagement team did not quantitatively examine the level of future taxable income before adjustment for temporary differences etc., which needed to be considered when determining recoverability of deferred tax assets.

(Auditing Standards Committee Statement No. 540, paragraphs 11 and 12)

#### **《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. In this regard, see the points to keep in mind provided in “Case 1: Reasonableness of management’s assumptions” and “Case 4: Evaluation of reasonableness of business plan” in “(1) Matters common to auditing accounting estimates.”

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**

For the valuation loss on shares of a subsidiary recorded in the past, the audited company estimated the timing of the reversal of the temporary difference, and concluded that the deferred tax asset associated with the valuation loss was recoverable. The engagement team identified the recoverability of deferred tax assets as a significant risk.

However, the engagement team, in considering the recoverability of deferred tax assets, only ascertained the management’s intention to sell the shares through discussions and a management representation letter, failing to examine the feasibility of the intended sale based on the fact that the audited company had not executed sales for a long time.

(Auditing Standards Committee Statement No. 540, paragraph 14)

### **《Points to Note》**

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.

Furthermore, a case was also seen where, in examining the tax effect on consolidated retained earnings, the engagement team did not adequately investigate the audited company’s policy that “subsidiaries do not generally pay dividends.”

## **(8) Retirement benefit obligations**

### **Case: Reliability of basic data**

The audited company outsourced the calculation of retirement benefit obligations to a pension actuary, an external expert, and booked allowance for retirement benefits based on the calculation

result prepared by the actuary.

In examining the allowance for retirement benefits, the engagement team used as audit evidence the calculation results of the pension actuary that the management used.

However, the engagement team did not examine the accuracy and completeness of data of base salary, etc., of employees, which form the basis of the retirement benefit obligations calculation and which was prepared by the audited company to the pension actuary.

(Auditing Standards Committee Statement No. 540, paragraph 12)

#### **《Points to Note》**

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

**In addition, although actuarial assumptions such as the discount rate could influence the calculation results for retirement benefit obligations greatly, there were some cases where the engagement team failed to examine the reasonableness of actuarial assumptions. The engagement team should be aware of the importance of examining the appropriateness of the actuarial assumptions made by the audited company.**

### **(9) Asset retirement obligations**

#### **Case 1: Methods of accounting estimates and review of previous period accounting estimates**

The audited company multiplied an estimated price that it had employed in the past by the area of the property concerned to calculate the asset retirement obligations for stores. However, when estimating the asset retirement obligation for a new store that had opened in the previous year, the audited company used the amount of the written estimate obtained from a construction company to book the asset retirement obligation for the store because the amount of this written estimate was higher than the amount calculated using the previous method. Furthermore, the actual amount of expenditure associated with the closure of store in the previous year exceeded the asset retirement obligation that had been booked, resulting in a performance difference being incurred as an expense.

In response, the engagement team was told by the audited company that the reasons for the fact that the construction estimate for the new store and the expenditures associated with the store closure are different from the estimated amounts calculated by the previous method were that the building had a different structure and that a condition to clear the site of the old store had not been taken into account. The engagement team agreed on these explanations and deemed there to be no problem with the previous calculation method.

However, the engagement team did not give adequate consideration to the point that the circumstances of the just only two stores, a new store and a closed store, described above were unusual, and that the previous calculation method was appropriate for other stores.

(Auditing Standards Committee Statement No. 540, paragraphs 7 and 8)

## **Case 2: Appropriateness when reasonable estimates cannot be obtained**

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 the performance of restoration obligations. In the case of profitable stores and the company's head office, on the other hand, it does not book asset retirement obligations on the grounds that it is difficult to reasonably estimate the timing of the performance of 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 small. Furthermore, the engagement team did not obtain sufficient appropriate audit evidence concerning the reasonableness of the audited company's claim that in the case of profitable stores and the head office, it was difficult to reasonably estimate the timing of the performance of restoration obligations.

(Auditing Standards Committee Statement No. 330, paragraph 20; No. 540, paragraphs 11 and 12)

### **《Points to Note》**

**Even though the amount of asset retirement obligations cannot be fixed due to the lack of clarity in timing and methods, asset retirement obligations should be recognized if information is available to reasonably estimate the timing and probability regarding the fulfillment of asset retirement obligations. Since cases where asset retirement obligations cannot be reasonably estimated are limited to cases where the amount cannot be reasonably estimated even though all evidence available as of the account closing date is taken into consideration and the best estimation is made, the engagement team should keep in mind that it should examine the reasonableness of the management's assertions including the possibility of obtaining information useful to estimate asset retirement obligations when the audited company asserts that asset retirement obligations cannot be reasonably estimated.**

#### **4. Group Audit**

##### **Points of focus**

Recent fraud cases identified at domestic and overseas 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 identifying significant components in group audits, in one case, the group engagement team did not perform sufficient risk assessment by considering the qualitative aspect. In another case, the group engagement team did not sufficiently communicate with component auditors, or review the sufficiency of identification of significant risks related to group financial statements and audit procedures relevant to such risks.

##### **(Observed effective efforts)**

The following is an example of an effective effort aimed at ensuring and improving group audit quality. A dedicated section was established within the audit business department to support and monitor engagement teams that conducted global group audits. Specifically, the dedicated section gathered information through questionnaire surveys of the engagement teams and interviews with group auditors 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 a problem occurred in a component other

than a significant component, resulting in revision of the financial statements.

The audit business department prepared, in cooperation with the advisory department, a checklist that summarized the key points in controlling overseas affiliate companies. The checklist enables the improvement of the financial reporting environment and risk control environment of new overseas affiliate companies of the audited company.

### **Expected response**

In group audit, there were many cases where the engagement team excessively relied on the audit results of component auditors without adequately evaluating it. When auditing the audited company's financial statements and group financial statements, the auditor should evaluate the work of others, always keeping in mind that the ultimate responsibility to issue an appropriate audit report is on the group auditors that issue opinions of all the financial statements.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the scope and timing 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 according to the applicable financial reporting framework. Therefore, the group engagement team needs to develop an appropriate audit plan and perform audit procedures, and needs to evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for opinion regarding group financial statements.

Particularly, when a significant component exists in overseas countries, the group engagement team is required to grasp the status of material overseas audited companies, and identify 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 accounting 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. Additionally, in the case where the overseas component auditors are arranged in a multi-layered and complex structure, especially when involving an overseas 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 overseas component auditors, evaluation of reports prepared by the overseas component auditors, and understanding of the audited company's management control over new affiliate companies added through acquisition, etc.

### **Case 1: Significant components**

- ▶ When selecting significant components of individual financial importance within the group,

the group engagement team determined that components where any one of total assets, retained earnings, sales, or pretax profit accounted for more than 15% of the simple total for all consolidated companies would be regarded as components of individual financial importance. However, because the team did not take into account figures after the elimination of intragroup transactions, it did not adequately consider whether components generating around 25% of consolidated sales constituted significant components of individual financial importance.

(Auditing Standards Committee Statement No. 600, paragraphs 8, 16, and A5)

- ▶ Regarding a component not selected as a significant component, the group engagement team did not consider its importance from a qualitative perspective, even though it had been in the red for a prolonged period, possessed fixed assets in excess of the materiality threshold for group audit, and consideration needed to be given to the risk of impairment losses on fixed assets.

(Auditing Standards Committee Statement No. 600, paragraphs 8, 16, and A5)

- ▶ The group engagement team did not assess the risk of material misstatements in the group financial statements by taking into account the qualitative materiality of fixed assets owned by foreign manufacturing subsidiaries and sales transactions by a sales subsidiary.

(Auditing Standards Committee Statement No. 600, paragraph 17)

#### 《Points to Note》

**When determining significant components, the engagement team should consider the audited corporate group's characteristics and circumstances including qualitative materiality such as potential significant risks in the group financial statements, on top of the financial materiality of individual units.**

#### Case 2: Materiality

The group engagement team set the materiality for significant components at the same level as, not lower than, the materiality for the group financial statements as a whole.

(Auditing Standards Committee Statement No. 600, paragraph 20)

#### 《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 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 examine the adequacy of component materiality to perform appropriate audit procedures to response audit risks for each**



component.

### **Case 3: Deciding audit tasks regarding the financial information of components**

- ▶ Regarding procedures for responding to the significant risk regarding overseas subsidiaries of the audited company, the group engagement team made a request to the auditors of components in the form of an instruction letter, and received reports from them.  
However, in its instructions to the auditors of components, the group engagement team gave instructions not for audit procedures, but instead for agreed-upon procedures, and did not perform audit procedures for significant risks or obtain sufficient appropriate audit evidence.  
(Auditing Standards Committee Statement No. 600, paragraphs 17, 25, and 26)
- ▶ Regarding the financial information of components of individual financial significance to the group, the group engagement team failed to perform audit procedures based on the materiality of individual components. For example, the group engagement team did not perform substantive procedures on major accounts such as revenues,  
(Auditing Standards Committee Statement No. 600, paragraph 25)

#### **《Points to Note》**

**The group engagement team should consider whether audit tasks have been planned for both significant components and other components appropriately.**

### **Case 4: Involvement in tasks undertaken by component auditors**

The group engagement team identified the existence and cut-offs of sales as risks for material misstatements due to fraudulent group financial statements, and planned to address these risks by performing substantive procedures for unshipped sales involving direct transactions.

On the other hand, the auditor of an overseas subsidiary, which was a significant component, performed substantive procedures for sales by extracting and comparing with evidence transactions that exceeded performance materiality and transactions with new customers in the last month of the quarter. This auditor also conducted cut-off tests around the date of the financial statements.

However, the group engagement team did not adequately assess whether the audit procedures performed by the component auditor were appropriate for the purpose of addressing significant risk, including whether the audit procedures had been based on risk assessments for each sales channel and transaction type in the audited company's group.

(Auditing Standards Committee Statement No. 600, paragraphs 30 and 42)

#### **《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 further audit procedures.

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 further audit procedures planned by the component auditors.

#### **Case 5: Communication with component auditors**

- ▶ The group engagement team sent audit instructions to significant component auditors and received related deliverables. However, the following deficiencies were identified in the audit procedures performed by the group engagement team:
  - a) The group engagement team identified significant risks relating to fraudulent group financial statements at the component (the risk of management override of internal controls and risks relating to sales), but did not inform the component auditor. As a result, audit procedures for addressing significant risks relating to fraudulent group financial statements were not followed.
  - b) The group engagement team asked for confirmation of the component auditor's independence, but did not inform the component auditor of the scope of independence to maintain.

(Auditing Standards Committee Statement No. 600, paragraphs 29 and 39)

- ▶ During the process of understanding the audited company's business environment, the group engagement team became aware that an overseas subsidiary that was significant component was operating the same type of construction business as the audited company. However, even though the group engagement team identified a fraud risk concerning percentage of completion method at the audited company, it did no more than inform the component auditor that this was a significant risk due to the risk of fraud in revenue recognition. It did not specifically inform the component auditor of the fraud risk concerning percentage of completion method.

(Auditing Standards Committee Statement No. 600, paragraph 39)

#### **《Points to Note》**

**Group engagement teams must inform component auditors of significant risks relating to group financial statements that would affect the work of the component auditor. Furthermore, group engagement teams must ask 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 pointed out in the examples above, there were cases where the group auditor did not properly inform the component auditor of risks. There were also cases where even though the component auditor

reported significant risks to the group engagement team, the group engagement team did not adequately evaluate these risks. Furthermore, there were cases where the timing of obtaining information such as the audit plan from the component auditor is late. Group engagement teams therefore need to have effective two-way communication with component auditors.

#### **Case 6: Evaluation of audit results communicated from component auditors**

- ▶ The group engagement team sent audit instructions to significant component auditors and received responses.

However, with regard to uncorrected misstatements that were reported in the responses by the component auditor, the group engagement team had not decided whether it was necessary to review the related audit documentation prepared by the component auditor, and did not request the component auditor to include the misstatement in the summary of uncorrected misstatements to be attached to the management representation letter. Furthermore, the group engagement team did not examine whether an internal control deficiency reported by the component auditor should be a material weakness, or whether it should be reported to the group's management.

(Auditing Standards Committee Statement No. 265, paragraph 7; No. 450, paragraph 13; No. 600, paragraphs 41 and 45)

- ▶ The group engagement team sent audit instructions to the auditor of an overseas subsidiary, which was a significant component, and obtained a related deliverable.

However, even though the group engagement team had received a report from the component auditor concerning "the absence of the accounting manager," related to a significant risk, it did not verify whether this matter should be treated as a deficiency in internal control. The group engagement team also did not decide whether it was necessary to review the relevant sections of the component auditor's audit documentation.

(Auditing Standards Committee Statement No. 600, paragraph 41)

- ▶ The group engagement team sent audit instructions to significant component auditors and received related deliverables. However, the following deficiencies were identified in the audit procedures performed by the group engagement team:

- a) With regard to incomplete procedures described at the section of the report received from the component auditor, the report stated that five bank balance confirmation letters had not been collected, and the group engagement team understood this. However, the group engagement team did not assess the impact of these incomplete procedures on the audit of the group financial statements, and did not consider whether additional procedures were necessary.
- b) The group engagement team was informed by the component auditor that eight deficiencies

were identified in an assessment of IT controls performed as part of its audit of internal controls. However, with regard to four deficiencies in internal control informed as described above, the group engagement team did not assess the impact on the audit of the group financial statements based on concrete evidence, and did not consider whether additional procedures were necessary.

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 42)

#### **Case 7: Sufficiency and appropriateness of audit evidence obtained**

The group engagement team identified the risk of management override of internal controls as a significant risk in relation to the group financial statements, and requested the auditor of the relevant significant component to perform audit procedures relating to journal entry tests.

However, the group engagement team did not evaluate as to whether the component auditor had obtained sufficient appropriate audit evidence.

(Auditing Standards Committee Statement No. 600, paragraph 43)

#### **《Points to Note》**

**As pointed out in the examples above, there were a number of cases where the group engagement team simply obtained information from the component auditors on the results of their audit procedures and did not evaluate regarding the sufficiency and appropriateness of audit evidence obtained for significant risks. If a group engagement team deems that the work performed by a component auditor is inadequate, it must decide what kind of additional procedures it should perform and which of the component auditor or the group engagement team should perform these additional procedures.**

**Of note, 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.**

#### **Case 8: Consolidation process (accounting policies)**

The audited company prepared its consolidated financial statements based on IFRS (International Financial Reporting Standards). Furthermore, the audited company's overseas components followed local accounting standards when preparing their own financial statements. The audited company then included certain accounts in its consolidated financial statements without adjusting their accounting treatment to IFRS. The group engagement team found out from the component auditors that different accounting treatment was required under the local accounting standards and IFRS regarding these accounts.

However, the group engagement team did not adequately consider the need to adjust the accounting treatment based on accounting standards employed by the components to accounting treatment based on IFRS, which was employed for the consolidated financial statements.

(Auditing Standards Committee Statement No. 600, paragraph 34)

## **5. 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**

There was a case 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**

In using the work of others, there were many cases where the engagement team excessively relied on the work of others and did not adequately evaluate it. When auditing financial statements, the engagement team is required to evaluate the operations of others, always keeping in mind that the ultimate responsibility for the audit opinions of the whole financial statements is on the group auditors. When using expert services, the auditor should determine the necessity of use, assess the qualifications, competency and objectivity of the experts, and evaluate the appropriateness of the experts' work for 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 audit evidence conforming to the audit purpose.

### **Case 1: Agreement with auditor's experts**

With regard to some real estate 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 Committee Statements No. 620, paragraph 10)

### **Case 2: Evaluation of adequacy of experts used by the auditor**

The engagement team identified the valuation of real estate inventory for sale as a fraud risk, and

requested an expert to perform an assessment of it.

However, the engagement team did not examine the adequacy of the expert's work even though the expert did not use the methodology specified by the engagement team.

(Auditing Standards Committee Statement No. 620, paragraphs 11 and 12)

**《Points to Note》**

**Before using experts' work, the engagement team needs to avoid relying entirely on their work, and to determine the scope of work to be used through consultation with the experts, assess their qualification, competency and objectivity, and evaluate the appropriateness of the experts' work for audit purposes.**

**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 "2. Audit Evidence."**

## **6. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits**

### **Points of focus**

Users of financial statements are increasingly paying more attention to fraud that may result in material misstatement on financial statements. Considering this, the CPAAOB inspects the auditor's response to fraud risks in financial statement audit 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 a material misstatement due to fraud; and places emphasis on where and how material misstatement due to fraud may exist, including how fraud is committed, without assuming reliability and integrity of the audited company's management, directors, and company auditors;
- ▶ Whether the engagement team evaluates whether the information obtained from other risk assessment procedures and related activities indicates that one or more fraud risk factors are present and takes them into account in identifying and assessing the risks of material misstatement due to fraud at two levels: the financial statement level and the assertion level;
- ▶ 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 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 failures in audit procedures related to fraud risks in the financial statement audit such as: the engagement team overlooked indications of possible frauds although the risk of material misstatement due to fraud could have been identified in the planning and conducting stages of audit; and the engagement team determined the misstatement to be an error without skeptical consideration, although there was a suspected fraud involving the management.

We have also observed cases such as: the engagement team failed to assess risks of material misstatement due to fraud in view of changes at the audited company; the engagement team did not consider the risks of material misstatements due to fraud other than in revenue recognition; the engagement team did not sufficiently perform audit procedures to respond to the assessed risks although the team identified risks of material misstatement due to fraud in revenue recognition; the engagement team performed only perfunctory procedures for risks related to management override; the engagement team did not carefully assess fraud risks therein although the team identified related party transactions and unusual transactions.

### **(Observed effective efforts)**

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

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 expected 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 risks of material misstatement due to fraud.

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

Therefore, when planning, 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 might be used for fraud, obtain information through interviews with managers and other employees, and carefully examine whether such information indicates the existence of fraud risk factors, through discussions within the engagement team.

Furthermore, auditors should consider identified fraud risk factors and identify and evaluate risks of material misstatement at two levels: the level of financial statements as a whole, and the assertion level.



In responding to risks of material misstatement due to fraud that they evaluated, auditors should always keep in mind that there is a possibility that material misstatement due to fraud could occur, and draw up general responses to the risks of material misstatement due to fraud at the level of the entire financial statement and at the assertion level.

In implementing procedures to cope with the risks of material misstatement due to fraud, auditors should keep in mind that they are required to obtain audit evidence, which is more relevant or reliable, or greater in quantity, for assertions related to the identified risk of fraud than for other assertions for which no risk of fraud is identified.

If auditors identify any circumstances that indicate the possibilities of a material misstatement due to fraud during the course of audit, they should make inquiries of and ask for explanation from the management and should perform additional audit procedures to determine whether suspected material misstatement due to fraud exists. If auditors identify the suspected material misstatement due to fraud in such case that the management explanations are not considered reasonable, it is necessary to note that they should modify their risk assessment and planned procedures responding to audit risks, and conduct audit procedures that are specifically responsive to the types of possible fraud.

#### **(1) Discussions by the engagement team, risk assessment procedures, and related activities**

##### **Case 1: Understanding of fraud cases in an audited company and the industry to which such audited company belongs**

The engagement team identified that a different form of transactions such as sale on consignment and sale as purchasing agent existed in the sales transactions of the audited company, which is in the wholesale business, and also identified business practices such as sales based on change of title of inventory.

However, the engagement team did not assess fraud risk factors based on this understanding of such business activities of the audited company and industry practices.  
(Auditing Standards Committee Statement No. 240, paragraphs 11 and 25)

##### **《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.**

**Besides the above example, there were also deficiencies resulting from a lack of adequate consideration. For example, an engagement team identified fraud risk at an audited company, but due to a poor understanding**

of the company and its environment, it overlooked other methods that could be used to commit fraud besides the ones it had identified.

#### **Case 2: Discussion within the engagement team**

The engagement team did not discuss where risks of material misstatement by type of fraud existed on the financial statements, including the possibility of fraud that may occur in a relationship with a related party or in a transaction with a related party, and also did not share such information within the team.

(Auditing Standards Committee Statement No. 240, paragraph 14)

#### **《Points to Note》**

Other than the examples of deficiencies mentioned above, the engagement team only carried out discussions within the team routinely. The team often did not hold substantial discussions including the examination of possible risks in relation to the audited company in reference to published fraud cases. There were also some cases where the engagement team only directed fraud-related inquiries to the management or communicated with the management and company auditors routinely, and the information obtained was not reflected in the risk assessment.

### **(2) Identifying and assessing the risks of material misstatement due to fraud**

#### **Case: Identifying and assessing fraud risks in revenue recognition**

- ▶ The engagement team was aware that the audited company was involved in various types of transactions, and that revenue recognition policy differed for each of them.

However, the engagement team identified fraud risk in connection with revenue recognition at the assertion level for the audited company as a whole, but did not properly identify and assess specific fraud risks based on the form of revenue and transaction.

(Auditing Standards Committee Statement No. 240, paragraph 25)

- ▶ Regarding fraud risk in connection with revenue recognition at the audited company, which is in the food and beverage service business, the engagement team did not identify the fraud risk relating to revenue recognition for the restaurant business, which accounts for more than 95% of consolidated sales. Instead, the team limited fraud risk to revenue recognition for another business operated by a consolidated subsidiary (less than 5% of consolidated sales). However, the engagement team did not consider the reason why it had decided not to identify revenue recognition for the restaurant business as a fraud risk.

(Auditing Standards Committee Statement No. 240, paragraphs 25 and 46)

#### **《Points to Note》**

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. In particular, when the audited company operates multiple businesses within its consolidated group, it is necessary to identify and assess fraud risks for each type of revenue and transaction.

Note that cases were seen where it was concluded, with respect to the presumption that there was fraud risk in revenue recognition, and without adequate investigation, that the circumstances were not such that presumption could be easily applied to revenue recognition. However, if revenue recognition is not to be identified as a fraud risk, it is necessary that adequate consideration be given and that the reasons for rebutting fraud risk be presented in the audit documentation.

The engagement team shall keep in mind that it needs to identify and assess the risks of material misstatement due to fraud at two levels—at the level of the financial statements as a whole and at the assertion level—after sufficiently examining risks related to management override according to information and judgment the team has obtained.

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

#### **Case 1: Journal entries test**

- ▶ The engagement team performed journal entry tests as one of the audit procedures for addressing the risk of management override, but it did not conduct reasonable examinations for the following:
  - a) The selection of journal entries for irregular accounts was stated as one of the criteria for the selection of journal entries, but no specific definition of “irregular” was determined, so the selection criteria were unclear.
  - b) There were several selection criteria, but results concerning some of them were not recorded.
  - c) With regard to the selected journal entries, the engagement team did no more than determine that there were no problems with the details of the journal entries, and did not consider the need to perform tests of detail.

(Auditing Standards Committee Statement No. 240, paragraph 31)

- ▶ In its journal entry tests, the engagement team selected journal entries above a certain monetary amount (performance materiality amount) that contained specific keywords such as “CEO” and then deemed that there were no relevant journal entries.

However, the engagement team did not consider whether this procedure for discovering material misstatements due to fraud, which covered journal entries above the specific amount, was appropriate. Furthermore, it used only typical keywords as selection criteria, and did not assess the characteristics of inappropriate or atypical journal entries based on an understanding of the business environment in which the audited company was operating and the process the

audited company used to make and revise journal entries. It also did not consider whether this approach was adequate to address the risk of management override.

(Auditing Standards Committee Statement No. 240, paragraph 31)

#### **《Points to Note》**

**Other than the example mentioned above, there were many cases where suspicion arose over the exercise of professional skepticism. In one case, the engagement team did not perform procedures to address fraud risk with respect to journal entries selected for fraud risk on the grounds that these journal entries were deemed not to be problematic based on the team's understanding of the details of the journal entries. In another case, the engagement team only performed journal entry testing routinely without fully taking fraud risks into consideration with respect to procedures to respond to audit risks related to management override.**

**The engagement team shall keep in mind that it needs to formulate 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 operated 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 2: Business rationality of significant transactions**

- ▶ The audited company transferred outsourcing costs to a third party, which were recorded as expenses during an interim period, to loan to the third party at year end because it was subsequently determined that the costs would be borne by the third party. However, although the engagement team identified the transactions as unusual transactions, the engagement team did not examine whether or not such transactions had business rationality.

(Auditing Standards Committee Statement No. 240, paragraph 31)

- ▶ When selling machinery, a subsidiary of the audited company retained the book value of the asset on the balance sheet as an inventory and recorded revenue at the amount of the sales price, where the book value of the asset should normally be accounted for as “gain or loss on sale of fixed assets.”

However, in examining the appropriateness of the accounting treatment, the engagement team did not examine whether the transaction was a significant transaction that was outside the audited company's normal course of business or of an unusual nature, considering the auditor's understanding of the audited company or its environment and information obtained during the audit.

(Auditing Standards Committee Statement No. 240, paragraph 31; No. 315, paragraph 10)

- ▶ The audited company sells office supplies, and employs the shipping basis as the standard for revenue recognition, yet for some transactions, it booked sales of goods that had not yet been shipped as an industry-specific business practice.

With respect to the withheld inventory corresponding to the unshipped sales, the engagement team recognized that the contract terms were unclear, and that this was simply a case of storage that was unavoidable given the relationship with the customers. It also recognized that in the case of some customers, the period of storage was long.

However, the engagement team just accepted the explanation of the audited company that these transactions had been ongoing for some time and that payment was being received under similar terms to general sales transactions involving shipping. The team did not investigate, from the standpoint of addressing risk, whether the transactions were based on economically reasonable demands from the buyers. Furthermore, the team did not adequately consider whether factors such as responsibility for storage charges and shipping charges satisfied the requirements for booking sales.

(Auditing Standards Committee Statement No. 240, paragraph 31)

#### **《Points to Note》**

**Significant transactions falling outside the audited company's ordinary transaction process or which can be deemed unusual may have been carried out to conduct fraudulent financial reporting or to conceal misappropriation of assets, indications include the following:**

- **The form of such transactions appears extremely complex (e.g., transactions involve multiple audited companies within a consolidated group or multiple unrelated third parties);**
- **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 audited 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 under audit.**

**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 examine 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 3: Response to fraud risks in revenue recognition**

- ▶ With regard to revenue recognition, the engagement team identified material misstatements due to fraud as a risk. Based on its understanding of the audited company's environment, it anticipated fraud risk scenarios for specific methods of fraud, and formulated an audit plan to address these scenarios. Specifically, the engagement team envisaged such scenarios as the company having related parties make payments to the company for sales, booking fictitious sales, and then refunding the money and reversing the sales the following fiscal year. However, the engagement team did not adequately formulate or follow substantive procedures for directly addressing fraud risk. For example, the team did not conduct tests of detail focused on transactions with related parties. Compared to situations where fraud risk had not been identified, the engagement team did not obtain more appropriate or more convincing audit evidence.

(Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraphs 5 and 20)

- ▶ The engagement team identified the appropriateness of cut-offs for merchandise sales as a fraud risk, and witnessed inventory taking and performed cut-off tests for sales transactions as procedures for addressing this risk.

However, the engagement team only selected two business sites for attendance inventory taking. These were the site with the highest monetary materiality and one other site, which was selected after taking into account factors such as sites that had been visited by auditors in past years and regional bias. As a result, the considerations were inadequate as further audit procedures for addressing fraud risk.

(Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraph 5)

- ▶ Depending on the type of construction project, the audited company booked sales based on either the completed-contract method or the percentage-of-completion method. With regard to the completed-contract method, the engagement team identified the "risk of reallocation of costs between projects as a means of understating cost of sales" as a fraud risk, and to identify fraudulent reallocations of cost of sales at the time of the end-of-term audit, the team followed analytical procedures for balances of work in progress, after which it deemed that there were no accounts that required detailed investigation. However, the analytical procedures performed by the engagement team involved the application of a uniform cost rate,

even though the cost rates differed from project to project. Moreover, the team did not take into account the characteristics of the timing of the incurrence of project costs (e.g. the fact that few costs are incurred in the design phase of the first half of a project). As a result, the procedures lacked sufficient precision to identify material misstatements due to fraud.

Furthermore, with regard to the percentage-of-completion method, the engagement team identified the “risk of manipulation of rates of progress to meet budget targets as a means of overstating sales” as a fraud risk, and formulated an audit plan to investigate important construction projects using substantive procedures. However, the engagement team did not perform substantive procedures with respect to contracting costs, which were the main component of cost of sales, which provided the basis for the calculation of rates of progress. However, the team did not obtain sufficient appropriate audit evidence for addressing fraud risk. (Auditing Standards Committee Statement No. 240, paragraph 29)

- The engagement team identified a very strong incentive at the audited company to expand its revenue and profits since the company was in the rapid growth stage. Under these circumstances, the team identified a fraud risk where sales transactions with unclear underlying economic rationale might occur. The team also identified more than one unusual sales transaction in the audited company’s rapid increased sales.

However, the engagement team did not examine the appropriateness of the selling price of raw material reselling transactions of the above sales transactions, as well as the reasonableness of recording bill and hold sales. In addition, the team did not examine the reasonableness of changes in collection terms regarding sale transactions of merchandise. Moreover, they did not assess whether the above transactions implied a possibility that they were carried out for fraudulent financial reporting purposes.

(Auditing Standards Committee Statement No. 240, paragraphs 29 and 31; No. 330, paragraph 20)

- Bill and hold sales, which were prohibited by the audited company’s internal rules, were identified at the audited company through direct whistleblowing to the engagement team. The audited company insisted that the sales transactions in question were realized by the year-end since the merchandise subject to the sales had already been shipped by the year-end.

Against this argument, the engagement team conducted a short notice inspection of the storage site on the day following the year-end, in order to examine the audited company’s argument that the deposited inventory was shipped by year-end, and confirmed that the inventory was removed and no physical items remained.

However, the engagement team did not perform for fraud risks that were necessary for this matter, such as tests based on evidence including shipment slips, if the merchandise was delivered to the customer, and ascertaining whether similar sales existed, since they determined

that their procedures above were sufficient as tests of the fact of shipment.

(Auditing Standards Committee Statement No. 240, paragraph F35-2)

- ▶ With regard to the cause of exceptions noted in responses to confirmation request for accounts receivable from sales transactions to a leasing company, the engagement team received a reply from the leasing company stating that the cause of the exception was that no account payable would be recorded until the start date of the related lease agreement with the end users, which would be more than a year later than the date of leasing company's receipt.

However, the engagement team did not examine reasonableness of the occurrence and cut-off assertions of the sales transactions, including the rationale of the transactions and the contract conditions pertaining to them.

(Auditing Standards Committee Statement No. 240, paragraph 22)

- ▶ The engagement team identified, for the entire revenue of the audited company, the risk of fictitious revenues recognition as a risk of material misstatement due to fraud.

The engagement team checked domestic transactions against copies of invoices and settlement notes, while checking export transactions against invoices.

However, the documents were prepared by the audited company, and the engagement team did not obtain audit evidence that was more relevant or reliable for the risk of whole fictitious revenue recognition.

(Auditing Standards Committee Statement No. 240, paragraph 29; No. 330, paragraphs 5 and 20)

#### 《Points to Note》

**As with the examples of identified deficiencies mentioned above, there were deficiencies in procedures for risk assessment and procedures for responding to the assessed risk in relation to revenue recognition:**

- **In one case, the engagement team did not sufficiently perform risk assessment on revenue recognition with an understanding of the audited company's business and its business environment, including its type of business and the characteristics of its sales transactions. The team therefore did not plan appropriate audit procedures; and**
- **In another case, the engagement team identified risks of material misstatement due to fraud in revenue recognition but did not specifically identify the kinds of risk that existed in each assertion.**

**The team, therefore, did not plan appropriate audit procedures and respond to audit risk.**

**In addition, there were cases where the engagement team only routinely verified books against vouchers, overlooking an abnormal profit ratio and agreement details inconsistent with the realities. There was also a case where the engagement team, in its investigation of estimated total cost using the percentage-of-completion method, did no more than make inquiries of management and make comparisons with internal materials prepared by the audited company.**



For revenue recognition, Auditing Standards Committee 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 responses to audit risks.

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

- ▶ In examining a loan that may be relevant to a related party, the engagement team directly confirmed with the original borrower and assessed 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 Committee Statement No. 240, paragraphs F11- 2 and 31; No. 550, paragraph 22)

- ▶ During 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 Committee Statement No. 240, paragraphs F11- 2, 32-2, and F35-2)

#### **《Points to Note》**

According to Auditing Standards Committee 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 situations that imply material misstatement due to fraud**

It was discovered that the audited company recognized revenue for a product, the payment for which had been made in advance but which had not been delivered to the customer. The engagement team interviewed the audited company's executive officer and obtained the following background to such accounting:

- a) An e-mail urging employees to achieve their monthly sales targets was sent to all employees from the representative director & president; and
- b) The specific instruction to record advance payments as revenue was notified to all stores by the manager in charge of stores in an e-mail sent.

However, the engagement team determined the misstatement as due to an error without fully evaluating whether a circumstance that indicated the possible material misstatement due to fraud, and did not perform examinations to comply with the Standard to Address Risks of Fraud in an Audit.

(Standard to Address Risks of Fraud in an Audit No. 1, paragraphs 1–4; its Appendix 2, paragraphs 3 and 4; Auditing Standards Committee Statement No. 240, paragraph F11-2)

##### **《Points to Note》**

In the case above, the auditors did not exercise the professional skepticism that is assume expected of them even though there were strong indications of material misstatement due to fraud.

Other than the examples mentioned above, there were other cases where professional skepticism was not exercised. For example, even though the engagement team determined the booking of sales to be a circumstance that indicated a possible material misstatement due to fraud, the team did not investigate the inconsistencies between this circumstance and the explanations given by the management.

Auditors need to exercise professional skepticism and evaluate the audit evidence they have obtained to ensure that they do not overlook indications of material misstatement due to fraud. Furthermore, if the engagement team identifies indications of a material misstatement due to fraud, the team needs to perform additional audit procedures while exercising professional skepticism and making inquiries of and asking for explanation from the management in order to determine whether there are suspected material misstatement due to fraud.

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

The engagement team had received a report from the directors of the audited company about the fact that an employee of a consolidated subsidiary of the audited company had misappropriated

assets. The team received an explanation of the circumstances of this fraud, revised the audit plan, and performed additional audit procedures.

However, the engagement team did not adequately consider the results of the audited company's investigations, and did not obtain a complete picture of the impact of the fraud on the financial statements. Furthermore, the team did not adequately consider the impact of the fraud on the audit of internal controls or the need to correct information on the financial statements.

(Auditing Standards Committee Statement No. 240, paragraph F35-2)

#### **《Points to Note》**

**As in the examples of identified deficiencies mentioned above, 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 responses to audit risks, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient examination 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 uncovering fraud matters relating to that responsibility, inform the appropriate layer of management of such matters in a timely fashion. 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 type, timing, and scope of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems.**

## **7. Audit of Internal Control over Financial Reporting**

### **Points of focus**

Auditors should express audit opinions based on evidence obtained by themselves as auditors, such as whether the internal control report assessed by the management was prepared to appropriately present the results of the assessment of internal control effectiveness in accordance with generally accepted internal control assessment standards.

Under these circumstances, the CPAAOB inspects audit firms regarding auditing internal control 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 transaction cycles 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 control of the audited company;
- ▶ Whether, in the course of an internal control audit, the engagement team reports the deficiencies detected by the auditors to the appropriate person at an opportune time 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 corrects it, and examines progress made in correcting the deficiencies at an opportune time; and
- ▶ Whether the engagement team examines the potential impact on the financial reporting by the misstatements found during the course of the financial statement 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’ ability and independence, the adequacy of samples, assessment scheme 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**

Auditors should sufficiently understand the design, the operation, and the assessment methodologies of the internal control so as to integrate internal control auditing and financial statement auditing considering materiality for effective and efficient audits.

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

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 methodologies of internal control assessment, and the assessment of the significance of internal control deficiencies. They should not perform procedures uniformly and routinely without sufficient examination.

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**

The audited company (a labor-intensive consulting firm) considered sales, accounts receivable, and inventories as 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 personnel expenses, which were 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 and Assurance Practice Committee Statement No. 82, paragraphs 98 and 100)

### **《Points to Note》**

**“Important 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 important 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, important 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**

The engagement team identified the risk of appropriate evaluation of the shares of affiliate companies as a significant risk. However, the engagement team did not examine whether there was a rational reason for the exclusion of business processes associated with the significant risk from the scope of internal control assessment.

(Auditing and Assurance Practice Committee Statement No. 82, paragraph 112)

### **《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 they are requested 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 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, in accordance with the degree of impact on financial reporting.

If some processes are included in business processes involved in the preparation of accounts that are substantially related to the company's business objectives for significant business locations or units, but are excluded from 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) Evaluation of Assessment of Internal Control**

### **Case 1: Sampling**

- In 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 Committee Statement No. 500, paragraph 9; Auditing and Assurance Practice Committee Statement No. 82, paragraphs 153 and 154)

- ▶ In assessing the operation of internal controls over operational 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 examine whether the management's sample selection method has provided a reasonable basis for conclusion about the entire 12-month population.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 153 and 158)

## **Case 2: Assessment of design and operation of internal control**

- ▶ As part of its sales management process, the audited company performed master registration and processed orders received, shipments, cash collection, receivables settlement, etc. through their core computer system, which was interfaced with the accounting system once a month to allow the accounting of sales, accounts receivable, etc. to be performed.

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

(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))

- ▶ With regard to internal controls relating to sales, the engagement team believed, based on audits in past years, that it had understood the internal controls for reflecting automatic journal entries in the accounting system based on transaction information entered into the sales management system.

However, even though the team was aware that the relevant internal control program had been changed, it did not consider the impact of the change on the audit for the current year.

(Audit Standards Committee Statement No. 315, paragraph 8; IT Committee Practical Guideline No. 6, paragraph 6)

## **《Points to Note》**

Other than the examples mentioned above, in some internal control evaluation, some engagement teams documented as audit evidence only the results of control activities, such as a signature on a document. With a sufficient understanding of Auditing Standards Committee Statement No. 230 ("Audit Documentation"), a team needs to document significant facts identified in the course of performing procedures and professional judgments, as well as the results of the procedures, in a manner that enables experienced auditors without involvement in the audit to understand the situation. Meanwhile, in evaluating internal control assessment, an engagement team also needs to pay attention to changes in the audited company's business activities and earnings structure, regardless of audit experience in the past years.

Furthermore, in implementing a test of detail and tests of controls for the same transaction as a dual-purpose test, the engagement team needs to pay attention to whether it can take procedures that are suited to both purposes of the test, especially whether audit evidence obtained is appropriate for the assertion of account and internal control to be assessed.

It should also be noted that evaluation of the design and operating effectiveness of the financial reporting process must be carefully performed, since the process is one of the most important business processes concerning the reliability of financial reporting but its frequency is lower than other operational processes that are related to daily transactions.

### **Case 3: Timing of assessment procedures**

- ▶ The engagement team planned to perform the financial statements audit and the internal controls audit in an integrated fashion, but with regard to company-level internal controls and business-process internal controls relating to financial reporting process not relating to the preparation of the securities report (financial statements) , the team had not completed its assessment of the design and operation of these internal controls on the date of the Companies Act audit report.

(Auditing Standards Committee Statement No. 300, paragraph 8; No. 330, paragraphs 5, 6, 10, and 25; Auditing and Assurance Practice Committee Statement No. 82, paragraph 27)

- ▶ In developing its plan for responding to financial statements audit risk, the engagement team planned to rely on the related effective internal controls. However, the team did not complete its evaluation on the design and operating effectiveness of IT general controls and IT application controls by the date of the auditor's report for the Companies Act.

(Auditing Standards Committee Statement No. 300, paragraph 8; No. 330, paragraphs 5, 6, 10, and 25; Auditing and Assurance Practice Committee Statement No. 82, paragraph 27)

### **《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 prior to performing important 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.

Furthermore, there was a case where the engagement team performed tests of internal controls during the term, and with regard to the period after that, performed roll-forward procedures after the date of the financial statements. However, the roll-forward procedures were not completed by the date of the auditor's report for the Companies Act.



#### **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))

#### **《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) Evaluation of Deficiencies**

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

- ▶ The audited company reported multiple deficiencies with company-level internal controls, financial reporting process, business processes, IT general controls, and IT application controls. However, the engagement team did not consider whether taken together, these multiple deficiencies, some of which had been corrected during the term, constituted a material weakness.

(Auditing Standards Committee Statement No. 330, paragraph 16; Auditing and Assurance Practice Committee Statement No. 82, paragraph 205)

- ▶ 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 Committee Statement No. 315, paragraph 30; IT Committee Practical Guideline No. 6, paragraph 53)

### **Case 2: Determination of material weaknesses**

Regarding the results of internal control assessment by management, the engagement team obtained a list of matters to be remedied that was prepared by management, and understood that management assessed that there was no material weaknesses although there were deficiencies as of the year-end.

However, the engagement team did not examine the appropriateness of the results of assessment by the management concerning such control deficiencies.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 210 and 211)

### **Case 3: Assessment of internal control over misstatement**

The engagement team detected an overstatement of sales and cost of sales of the same amount and the audited company did not revise the financial statements since it did not have an impact on net profits. However, the engagement team did not examine whether the misstatement mentioned above was caused by internal control deficiency, nor did they consider the impact on the internal control assessments in the financial statement audit or confirm whether the audited company treated the matter as a deficiency in the management's assessment of the internal control reporting system.

(Auditing and Assurance Practice Committee Statement No. 82, paragraphs 43 and 44)

### **《Points to Note》**

**Deficiencies in the 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 compensating control; 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 possibility of material misstatement. The team needs to pay attention to the fact that it is required to carefully judge if the deficiency found falls under material weaknesses.**

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

## **(4) Use of Management Assessment**

### **Case: Extent of using the work of internal auditors**

The engagement team partially employed audit results from internal auditors concerning the audited

company's IT general controls for its accounting system and construction system, which were core systems (controls relating to program and data access controls, program modification, 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 auditors' objectives.

(Auditing Standards Committee Statement No. 610, paragraphs 11 and 19)

**《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. However, on such occasions, it is necessary to examine if the independence and professional skills 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.**

**In this case, the engagement team should keep in mind that it is necessary to examine the degree of risk corresponding to the internal control where the engagement team plans to use the work performed by the audited company's internal auditors, the nature and materiality of the internal control, the operations of internal control, the degree of judgment necessary for assessing operations, and the quality of the work performed by the internal auditors.**



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