

Provisional Translation

Case Report from Audit Firm Inspection Results

(Program Year 2024)

July 2024

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 audit quality 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 (Case Report)), 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 Case 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 accounting auditors, investors and other market participants.

This Case Report has been updated to add the latest cases of inspections and redesigned to make the background to audit deficiencies identifies via inspections as understandable as possible, following previous years' editions in terms of its basic structure.

We plan to present the details of the Case Report and organize dialogue with relevant organizations, such as briefings at regional chapters of the Japanese Institute of Certified Public Accountants (JICPA) and lectures at the Japan Audit & Supervisory Board Members Association and other.

In addition, we have published information about the inspection system and the situation at audit firms in the form of the “2024 Monitoring Report”. Please also refer to this report.


In order to further ensure the reliability of audits, audit firms should review individual audit engagements and quality control systems in reference to examples of deficiencies and causes of the deficiencies described in this Case Report. In particular, small and medium-sized audit firms should make effective use of the Case Report in training programs, for example, in order to voluntarily improve audit quality.

Please submit any comments or requests regarding this Case Report to the dedicated e-mail address below.
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Important Points for Users of this Case Report

1. Regarding Cases Included in the Case Report

- (1) Although this Case Report is a compilation of relatively new cases of deficiencies that were identified in the inspections, it does not mean that the CPAAOB puts less importance on cases that were not included in the Case Report.
- (2) The CPAAOB inspections classify audit deficiencies as either significant deficiencies or deficiencies, but this Case Report will draw no distinction between the two, listing those deficiencies that comport to the purposes of this Case Report.
- (3) The cases included in the Case Report may have had facts omitted or changed to the extent that does not affect the purport of the case.
- (4) The number of cases pointed out on the following pages reflects neither the proportion of the number of deficiencies by the size of audit firms, nor the ratio of the number of deficiencies by the inspection items.
- (5) Deficiencies that were not included in the Case Report may be included in matters that should have been noted by audit firms and engagement teams, or may be included in the points to be expected in terms of appropriate audit procedures.
- (6) In cases where there are multiple criteria for identifying the deficiencies, the principal provision is quoted.
- (7) New example cases and observed effective efforts adopted in the 2022 edition of the Case Report are preceded by the mark.
- (8) Cases where deficiencies have been identified since previous fiscal years or cases where deficiencies have been identified at multiple audit firms are preceded by the mark at the beginning of the sentences.

**FREQUENT**

2. Main Characteristics of the 2024 Edition

- (1) "I. Operations Management System (Root Cause Analysis)" expands on case studies of root cause analysis and root cause from recent inspections in light of the importance of root cause analysis.
- (2) "II. Quality Control System" and "III. Individual Audit Engagements" provide extensive coverage of the latest inspection cases, as well as examples of effective efforts at small and medium-sized audit firms that contribute to improvement.
- (3) Notes on newly applied revised Code of Ethics and unapplied new standards (such as Auditing Standards Statement No. 600 and Auditing Standards for Internal Controls over Financial Reporting Statement No. 1) are provided as columns.

- (4) The charts have been enhanced to assist in understanding the content described in the "Required Actions" and "Points to Note."
- (5) The CPAAOB has prepared a "summary of Outline of inspection results" and a "summary of Required Actions" for this Case Report, which have been published together with this Case Report.

(Definitions of terms)

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

Act	Certified Public Accountants 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 & Young ShinNihon LLC, and PricewaterhouseCoopers Japan LLC.</p>
Mid-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 refers to four audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC and Crowe Toyo & Co..</p>
Small and medium-sized audit firm	An Audit firm other than large-sized and Mid-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 77 of the JICPA Rules
Audit team	Persons engaged in the provision of audit services, and comprises (an) engagement partner(s) and assistants to the engagement partner(s)
Engagement partner	The person responsible for conducting audits, 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

(List of Standards, etc. for Published Cases)

Audit standards, practical guidelines, etc. related to the cases presented in this Case Report are as follows:
The auditing standards and practical guidelines described below are, in principle, the standards effective as of the end of June 2024. If the standards corresponding to individual cases were not yet revised, they are stated as such.

Furthermore, the provisions prior to the 2022 revision are cited in Quality Control Standards Statement No. 1, and the provisions prior to the 2023 revision are cited in Auditing Standards Statement No. 600.

Quality Control Standards Statement No. 1 "Quality Control at Audit Firms"

Quality Control Standards Statement No. 1 Practical Guidelines No. 1 "Guidelines for Information Security in Certified Public Accountant Services"

Auditing Standards Statement 220 (Quality Control in Audit Engagements)

Auditing Standards Statement 230 (Audit Documentation)

Auditing Standards Statement 240 "Fraud in the Audit of Financial Statements"

Auditing Standards Statement 260 Communication with Audit & Supervisory Board Members

Auditing Standards Statement 265 (Communication on Deficiencies in Internal Controls)

Auditing Standards Statement 300 (Audit Plan)

Auditing Standards Statement 315 (Identification and Assessment of the Risks of Material Misstatement)

Auditing Standards Statement 320 (Materiality in the Planning and Conduct of Audits)

Auditing Standards Statement 330 ("Auditors' Procedures for Addressing Assessed Risks")

Auditing Standards Statement 402 ("Audit Considerations for Outsourcing Companies")

Auditing Standards Statement No. 450 "Evaluation of Misstatements Identified during the Audit Process"

Auditing Standards Statement 500 (Audit Evidence)

Auditing Standards Statement 501 (Audit Evidence for Specific Items)

Auditing Standards Statement 505 "Confirmation"

Auditing Standards Statement No. 520 (Analytical Procedures)

Auditing Standards Statement 530 ("Audit Sampling")

Auditing Standards Statement 540 (Auditing of Accounting Estimates)

Auditing Standards Statement 550 "Related Parties"

Auditing Standards Statement No. 560 "Subsequent events"

Auditing Standards Statement 570 ("Going Concern")

Auditing Standards Statement 600 (Group Audit)

Auditing Standards Statement 610 (Use of the Work of Internal Auditors)

Auditing Standards Statement 620 (Use of the Work of Experts)

Auditing Standards Statement 701 (Reporting of Significant Audit Considerations in Audit Reports of Independent Auditors)

Auditing Standards Statement 900 (Changes in Auditors)

Auditing Standards for Internal Controls over Financial Reporting Statement No. 1 (Audit of Internal Control over Financial Reporting)

Audit and Assurance Standards Board Practical Guidance No. 5, "Practical Guidance on Information Security in Certified Public Accountant Services"

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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 (hereinafter referred to as "company auditors, etc.") have been strengthened, corporate governance codes are introduced, and these developments have helped enhance corporate governance environments. However, incidents of fraud continue to occur both in Japan and overseas and a number of listed companies have announced inappropriate accounting practices and other misconduct through the timely disclosure procedure.

Under these circumstances, efforts have been continuously made to improve the quality of audits and ensure their reliability. For example, audit standards concerning "Key Audit Considerations (KAM)" and "Other Content" in audit reports have been revised, the Quality Control Standards on Audits have been revised to introduce a quality control system based on a risk-based approach, and ethical rules have been revised to strengthen independence concerning remuneration, etc. For accounting auditors of listed companies, mid-tier audit firms and small and medium-sized audit firms are continuing to replace large-sized audit firms. Mid-tier audit firms and small and medium-sized audit firms are playing a greater role as auditors of listed companies, and are urgently required to improve audit quality. It is therefore necessary for each audit firm to continue to verify its individual audit engagements and quality control systems with reference to the deficiencies and their causes described in this Case Report.

In doing so, audit firms should be mindful of striving in practice to ensure and improve the quality of their audits, considering not only whether individual audit engagements and quality control system formally comply with audit standards but also whether they are applying appropriate professional skepticism to identify fraudulent accounting and whether they are focusing at all times on audited companies' business risks to assess and address risk of material misstatement.

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

This Case Report also includes examples of "observed effective efforts" by audit firms that might serve as guides for improvement, and we ask that you find these informative.

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 quality control systems should not only be an issue for the CEO and PICOQC, but rather a firm 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 audit quality.

With regard to the organizational operation of audit firms, in light of the "Principles for the Organizational Operation of Audit Firms" (Audit Firm Governance Code) (formulated in March 2017), large-sized audit firms and others are working to further establish and strengthen governance environments to ensure and improve audit quality. Amid this situation, the Audit Firm Governance Code was revised in March 2023 to require effective disciplines suited to the size and characteristics of audit firms. The CPAAOB will continue to verify whether the governance environments established and strengthened by each audit firm are effective.

3. Accurately Discerning Deficiencies and Analyzing Causes

One prerequisite for appropriately analyzing root causes is accurately identifying back ground of deficiencies and precisely discerning their essential causes. If these essential causes cannot be precisely discerned, then the root causes cannot be suitably analyzed and the measures responding to root cause will also be unsuitable. For example, we should bear in mind that when appropriate audit work papers on significant matters during the audit has not been prepared, the issue in the vast majority of cases is not simply a lack of documentation but a failure to perform the audit procedures to obtain sufficient and appropriate audit evidence. If the prepared audit documentation does not satisfy the requirements stipulated in Auditing Standards Statement No. 230, paragraph 7, it is necessary to carefully discern whether this is due to the necessary audit procedures not having been implemented without playing it down as simply an issue of documentation. If the necessary audit procedures have not been carried out, the reasons for this must be further analyzed and efforts must be made to improve. To ensure that necessary audit procedures are implemented, the skills of the engagement team must be enhanced through classroom education/training and superiors need to commit to providing guidance on a day-to-day basis to the members of engagement team through supervising the audit practices, reviewing audit work papers, performing engagement quality reviews and conducting periodic inspection, etc.

4. Responding to Issues According to Firm 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 system. Because of these factors, it is important to continuously check whether the quality control system established by the audit firm is appropriate in view of the size of the firm and the operations management system.

The following characteristics have been identified as issues 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 for ensuring 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, audit divisions, engagement teams), and appropriate human resource development and personnel management and evaluation.

On the other hand, due to the large size of the organization, communication among layers of official positions and between departments is not always smooth, and it remains difficult to disseminate organizational measures throughout to all departments and offices. As one of such measures, in recent years there has been a trends to establish a quality control system not only at the head office but also at business units closer to the audit frontline. Such efforts are considered to be effective to some extent, but it is necessary to ensure that the head office quality control unit accurately and continuously identifies the characteristics of operations in each business unit and ensures the effectiveness of efforts in each business unit.

[Mid-tier audit firms]

Mid-tier audit firms have been improving their organizational structures for ensuring systematic actions with regard to quality system, but their headquarter organizations are still weaker than large-sized audit firms. In addition, the quality control system of some firms is inadequate as a result of limited manpower assigned to quality control and also insufficient awareness of CEOs and PICOQCs concerning quality control. Another issue is that at firms expanding their operations, the competency and capability are not enough to serve new audit contracts in a timely manner. In addition, business administration at each firm is characterized by the reliance on a large number of part-time professional staff and audit support staff for audit engagements and by quality control issues at certain district offices.

Moreover, while Mid-tier audit firms are required to improve their ability to perform audits for large-sized listed companies, they have problems in that they have yet to sufficiently develop a system for securing human resources and offering organizational support to engagement team or a system for international services, such as for effectively utilizing their overseas business alliance.

[Small and medium-sized audit firms]

As a result of lack of awareness of the importance of quality control among the CEOs and PICOQCs, small and medium-sized audit firms fail to proactively address matters of quality control. In addition, they lack the resources for developing quality control systems. Because of these, while they are addressing deficiencies identified in external inspections in their efforts for improving audit quality, this remedial action is often superficial, being based on treating the symptoms rather than tackling the root causes. Some audit firms are also not making an effort on a day-to-day basis to improve audit quality and only followed the previous audit procedures on the grounds that no major issue had occurred in the past.

Some small and medium-sized audit firms prioritize expanding their operations and have concluded new contracts in the belief that risks of new audit contracts (hereinafter, "contract risks," including risks for renewing contracts) had been appropriately assessed even though due consideration had not been given to fraud risks of listed companies with high audit risk. As a result, instances of inadequate and inappropriate risk assessment procedure and further audit procedures in audit services are found.

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

The relationship between directors/company auditors of audited companies and accounting auditors is being developed under the Companies Act and related regulations such as the Corporate Governance Code. On the other hand, among listed companies, for example, accounting fraud at overseas group companies continues to be seen.

Management is responsible for preparation of financial statements and the design and operation of internal controls. Furthermore, from the perspective of investor protection and securing reliability of the capital market, directors and company auditors are strongly expected to appropriately evaluate and select accounting auditors, who provide assurance as to fairness 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 accounting auditors.

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

In particular, effective from the fiscal year ended March 31, 2021, "key audit matters" (hereinafter referred to as "KAM") are required to disclose in order to improve transparency of audits conducted by accounting auditors and increase information value of audit reports. More effective audits are expected to further enhance collaboration and communication between accounting auditors and company auditors, etc. as well as discussions with management, leading to more effective audits. In addition, the Audit Firm Governance Code, which was revised in March 2023, stipulates that audited companies, shareholders, and other capital market participants are expected to actively exchange views with accounting auditors on measures to improve the quality of accounting audits, and utilize the useful information obtained from such exchanges to improve organizational management.

In light of this, this Case Report describes a wide range of examples of deficiencies identified in the CPAAOB's inspections in an easy-to-understand manner as much as possible from the viewpoint of providing directors and company auditors, etc. of listed companies, etc. and investors, etc. with reference information on audits. This Case Report also describes observed effective cases of improvement efforts by audit firms. We thus hope that this Case Report would be helpful as a reference for the appropriate evaluation of accounting auditors.

I. Operations Management System (Root Cause Analysis)

1. Operations Management System and Root Cause Analysis

(1) Necessity of Root Cause Analysis

It is noted that a number of audit firms do not conduct root cause analysis for deficiencies identified in the quality control review or the CPAAOB inspection.

As the scope of the quality control review and the CPAAOB inspection are highly limited, it is likely that, in addition to identified deficiencies, there remain undetected deficiencies with same root causes. If improvement measures are taken without root cause analysis, the effects will be temporary and similar deficiencies are likely to recur. In such cases, improvement in the quality control system will be ineffective and/or insufficient, thus will not lead to fundamental improvement of the audit quality as a whole.

On the contrary, perfunctory improvement measures would only increase ineffective and unnecessary tasks for audit frontline, which hinder effective and efficient audit. Audit firms should recognize the importance of root cause analysis to realize substantial improvements of audit quality.

In recent years, large-sized audit firms have started root cause analysis of identified deficiencies as part of their quality control system, in addition to just informing them.

For example, the quality control division performs thorough analysis of direct causes of deficiencies by interviews or questionnaires with the audit team, and then considers what kinds of root causes exist in the operations management system or the quality control system for better improvement measure.

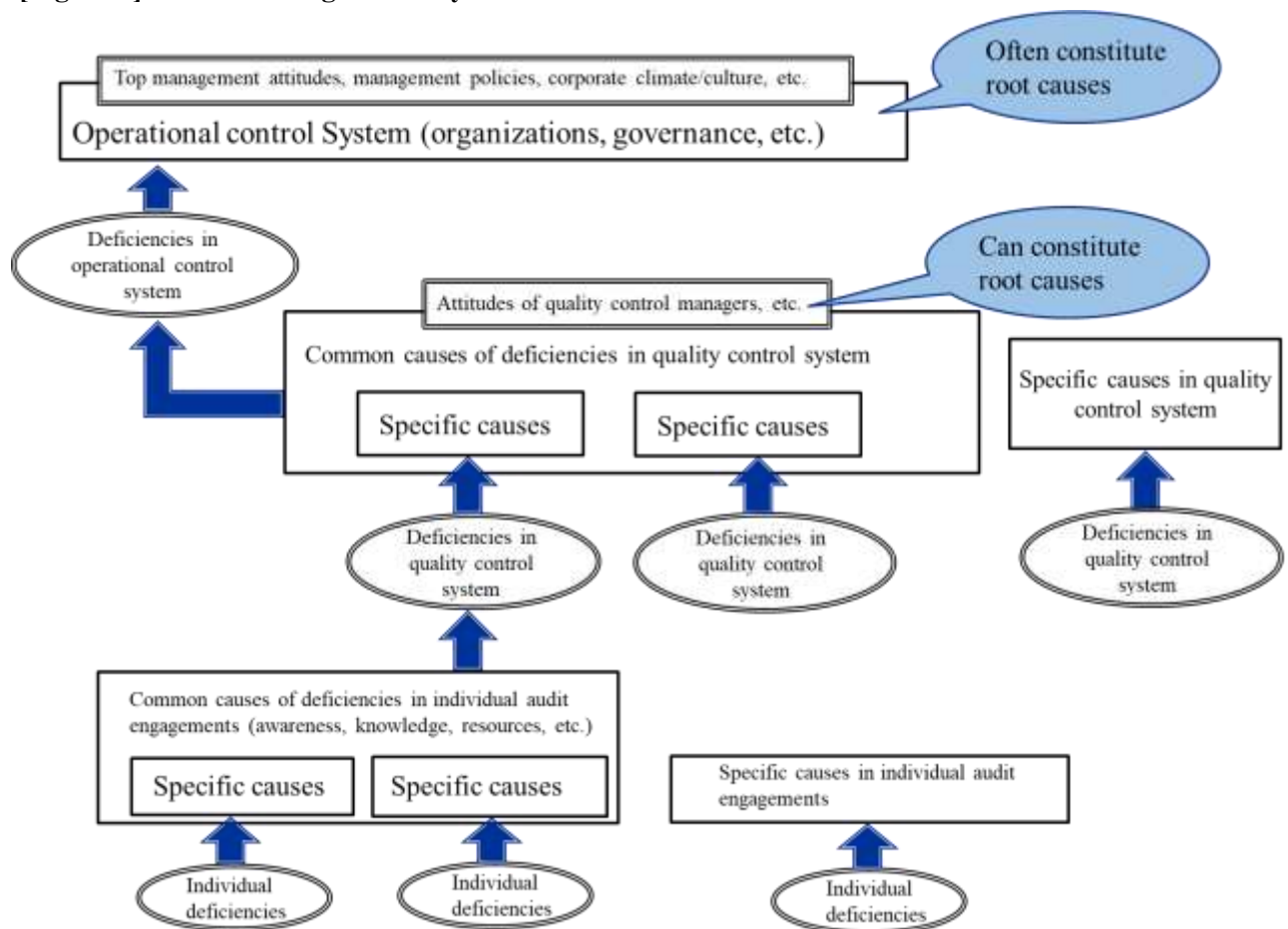
(2) Root Cause Analysis

In root cause analysis, it is important to accurately identify the direct causes of deficiencies as a first step. In direct cause analysis, it is necessary not only to consider the knowledge, awareness, and experience of individual assistants to engagement partner, but also to consider other aspects of the audit, such as situation of the audit teams and the audited companies. .

Direct causes can be divided into "specific causes," which is unique to individual deficiencies, and "common causes" which is common to multiple deficiencies. Further analysis of common causes often leads to root causes of deficiencies.

In the past inspections, the root causes were frequently related to “tone at the top”, “business strategy”, or “corporate culture” in the operations management system. Accordingly, it is especially necessary to pay attention to the effectiveness of the operations management system. In addition, the root causes sometimes exist in the quality control system (i.e. attitudes of PICOQC) (see [Figure 1]).

[Figure 1]Reference image: Identify deficiencies and root causes



The followings are examples of root cause analysis by CPAAOB.

[Large-sized audit firms]

[Case 1]



At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

One of the direct causes is a lack of critical mindset in the audit team to confirm consistency among audit evidences, when auditing the revenue recognition policy or the significant accounting estimates. The common causes of deficiencies in the quality control system were as follows: the quality control headquarters has not implemented sufficient measures for the audit teams to have critical mindset, and the EQC reviewer or the periodic inspection reviewer does not sufficiently perform critical review against the audit team's procedures. Further investigations into the root causes have revealed that the top management has believed that, by the introduction and implementation of audit quality improvement measures, every engagement team would proactively address all accounting and audit issues to obtain sufficient appropriate audit evidence. Furthermore, the top management has believed that a risk-based appointment of EQC reviewers and the measures to secure sufficient preparation period for internal periodic review would raise awareness of the reviewers to conduct in-depth reviews.

[Case 2]

At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies are as follows: the audit teams do not sufficiently perform critical review against management's assertions concerning the timeliness of accounting treatment for accounting estimates; and the audit teams do not recognize the need to reconsider if sufficient audit procedures are performed to the areas where the risk of material misstatement is deemed relatively low. Furthermore, there were common causes for deficiencies in the quality control system as follows: the quality control headquarters does not give clear instructions to the audit divisions regarding the width and the depth of audit procedures to be performed, and the quality control headquarters does not sufficiently collaborate with the audit divisions to check the effectiveness of quality improvement measures.

Further considerations into the root cause have revealed that the top management does not sufficiently recognize the need to monitor the close collaboration between the quality control division and the audit divisions to realize the effect of improvement measures.

[Case 3]



At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies are as follows: the audit teams do not pay sufficient attention

to reconsider the risk assessment of audited companies according to changes in the corporate environment, especially for audit areas where the risk of material misstatements are deemed relatively low. Also, the audit teams do not pay sufficient attention to consider if appropriate audit procedures have been performed responding to the identified audit risks. Furthermore, the common cause of the deficiencies in the quality control system is that the quality control headquarters does not give sufficient instruction for the audit divisions to ensure if appropriate risk assessments and audit procedures are performed. Further investigations into the root cause has revealed that the top management has believed that, only by implementation of audit quality improvement measures, the audit teams would perform appropriate risk assessments and audit procedures. Also, the top management does not sufficiently recognize the need to check the execution status of the measures in the audit frontline.

[Mid-tier audit firms]

[Case 1]

At the audit firm, multiple deficiencies, including significant ones, are identified with regard to some audit engagements subject to inspection.

The direct causes of these deficiencies include a tendency to follow the previous year's audit procedures and a lack of professional skepticism to challenge management assertions. Also, a common cause of the deficiencies in the quality control system is that the PICOQC has not recognized the resource shortage in the quality control division as the main reason of the deficiencies being undetected and/or unremedied.

Further analysis of the root cause has revealed that the CEO does not recognize the need to check the adequacy and effectiveness of the quality control system by himself. For example, the CEO has failed to grasp that the top management does not recognize the resource shortage under the business expansion, and the CEO has believed that the enhancement of the headquarters function and the improvement of the quality control system would be realized only by leaving them to the division heads.

Another root cause is that the CEO and other executives do not pay sufficient attention to monitoring the penetration and the effectiveness of quality control measures in the audit frontline, in spite of the insufficient commitment of the engagement partners to their duties and the insufficient audit quality improvements in the audit teams.

[Case 2]



At the audit firm, a wide range of deficiencies, including significant ones, are deficiencies, identified in all audit engagements subject to inspection.

The direct causes of these deficiencies are that the engagement teams do not sufficiently understand the audit standards and the level of procedures required under the current audit standards, and that

they do not sufficiently understand the significant assumptions used by the audited company when auditing accounting estimates. They also do not critically examine the management's assertions about the significant assumptions, thus failing to exercise professional skepticism. The common causes of deficiencies are as follows; the quality control headquarters has believed that, only by communication of the quality control policies, procedures and measures through training, etc, the audit team would deal with them appropriately, and the quality control headquarters does not pay sufficient attention to monitoring the penetration and effectiveness of them for better ones. Another common cause is that each partner does not have proper critical attitude when conducting audit working paper review, engagement quality control review, and internal periodic inspection and does not appropriately fulfill the responsibility as audit partner. Further investigation into the root cause has revealed the followings: the CEO and other executives do not have sufficient compliance mindset to the professional ethics and the internal rules, and do not pay sufficient attention to fostering a quality-first culture and to building an effective operations management system; they are so focused on the early realization of full-time engagement of the partners and staffs that they have lacked sufficient attention to improvement of the firm's audit quality, despite that they have been aware of constant shortage of the resources and the skills; and furthermore, the CEO and other partners do not accurately grasp the situations that the professional staffs, including themselves, do not understand the audit standards and the level of procedures required under the current audit standards, and do not have critical attitude toward management assertions when auditing accounting estimates.

[Case 3]

At the audit firm, multiple deficiencies are identified in all audit engagements subject to inspection; especially a number of deficiencies, including significant ones, are identified at a particular regional office.

Those deficiencies in the audit engagements have common causes; the engagement partners and staffs do not have sufficient understanding of the level of audit procedures required under the current audit standards, do not keep professional skepticism for response to fraud risk and audit in accounting estimates, and do not pay sufficient attention to reconsidering risk assessment and audit procedure every year. In addition, the deficiencies at a particular regional office have a common cause that the lead engagement partner put such an excessive reliance on the other engagement partner, a main person performing the audit procedures, that he does not pay proper attention to his work.

The common cause in the quality control system is the PICOQC has not recognized the need to cooperation between the quality control division and audit divisions under the belief that the audit division should lead the improvement measures. The common cause for a particular regional office is the top management has believed that appropriate audit team would be organized at the regional office only by assigning appropriate audit partner, so that he does not provide any additional support

to the regional office.

Further investigations into the root causes have revealed that the CEO does not like to demonstrate a strong leadership in planning and implementing audit quality improvement measures for prompt improvements, rather values autonomy of the quality control division and the audit divisions. In addition, the top management does not recognize the necessity of strong collaboration between the quality control division and the audit divisions by valuing autonomy in those divisions. Furthermore, despite the concern about the audit quality at a regional office, the top management has not recognized a need to proactively support the regional office because they have a belief that the regional office is able to make improvements on their own.

[Small and medium-sized audit firms]

[Case 1]

Deficiencies are identified in the quality control system at this audit firm, and a number of deficiencies, including significant ones, are also identified in the audit engagements subject to inspection.

The common causes of the deficiencies in the audit engagements are as follows: audit teams does not sufficiently understand the level of procedures required under the current audit standards, such as assessment and response to fraud risks and audit of accounting estimates; audit partners put such an excessive reliance on assistants to engagement partner that they do not perform in-depth review of the audit documentation. The common causes of the deficiencies in the quality control system are as follows: the CEO and the PICOQC do not perform a root cause analysis of deficiencies identified in the quality control reviews and daily monitoring activities (including periodic inspections) in order to prevent similar deficiencies from recurring; and they do not recognize the situation that the assistants to engagement partner do not have sufficient understanding of the level of procedures required under the current audit standards.

Further investigations into the root cause has revealed that the CEO and the PICOQC have a belief that their audit quality is sufficient as they did not receive any significant deficiencies in the past quality control reviews, resulting they does not pay sufficient attention to the improvement of their audit quality. In addition, they have not demonstrated leadership to improve audit quality due to their belief that audit quality would be improved only by establishment of quality control system.

[Case 2]



At the audit firm, a wide range of deficiencies, including significant ones, are identified in the audit engagements subject to inspection. The common causes of the deficiencies in the audit engagements are as follows; the engagement team does not have sufficient understanding of the accounting standards, the audit standards, and the level of procedures required by the audit standards; and the engagement team lacks professional skepticism and does not critically test the management

assumptions when auditing accounting estimates. The common causes of deficiencies in the quality control system are as follows: the CEO and other partners do not share a mindset to ensure appropriate audit quality through in-depth reviews of audit procedures each other and do not foster an appropriate firm culture; in addition, the CEO and the PICOQC do not recognize the needs to check the penetration and effectiveness of the improvement measures for deficiencies and actually do not execute such checks. Further investigation into the root causes has revealed that the CEO is not willing to take a leadership for more effective and systematic operations management system and quality control system to ensure appropriate audit quality. Furthermore, the CEO and the PICOQC have believed that the firm's audit quality has been at an appropriate level because the audit partners have extensive audit experience and the professional staffs came from large-sized audit firms, and they do not accurately understand the level of the firm's audit quality.

[Case 3]

Although the audit firm is small, it has two audit divisions since its foundation. Each division independently manages its audit engagements, financial affairs, and personnel affairs, which has created a firm culture that values independence of each division. Furthermore, only engagement partners work on a full-time basis, while all professional staffs work on a part-time basis.

Under these circumstances, at the audit firm, multiple deficiencies, including significant ones, are identified in the quality control system. In addition, a number of deficiencies, including significant ones, are identified in the audit engagements subject to inspection.

The deficiencies in the audit engagements have common causes as follows; the engagement partners and the staffs do not sufficiently understand the level of audit procedures required by the audit standards and do not keep professional skepticism such as critical mindset to challenge management assertions; and part-time staffs do not have a sense of belonging to the firm and do not pay sufficient attention to maintain and improve the audit quality. The common causes in the quality control system are as follows; the CEO and the PICOQC do not sufficiently understand how to perform root cause analysis to prevent the deficiencies from recurring, and placed so much reliance on audit team members that have sufficient capabilities based on their past audit experiences.

Further analysis of root causes has revealed that the CEO and the PICOQC are not aware that all audit team members, including themselves, do not sufficiently understand the audit standards and the levels of quality control system and the audit procedures required by the standards. In addition, the CEO and the PICOQC have believed that the firm's current operations management system is appropriate, since no significant deficiencies were detected in the past quality control reviews, etc. As a result, they do not recognize the need to transform the firm's operations management system, such as integration of the two divisions and/or employment of more full-time staffs.

As shown in the above cases, the root causes of deficiencies are often in the operations management system or the quality control system, and eliminating these root causes is necessary in order to remediate the

deficiencies.

Audit firms, large-sized ones in particular, are currently making efforts to establish and strengthen organizational operations in accordance with the Audit Firm Governance Code. They should give due consideration to the effectiveness of those efforts so that the efforts can contribute to ensuring and improving audit quality.

(3) Specific Examples of Root Causes

The following are specific examples of root causes identified in inspections, including those mentioned in 1. (2) Root Cause Analysis.

It is necessary to work on substantial resolution of root causes, such as problems with the operations management system of the audit firm.

[Large-sized audit firms]

Large-sized audit firms often have issues in the operation of quality control system. Since large-sized audit firms have thousands of employees, they often run its business by multiple divisions which have hundreds of people each, including local offices. Under such circumstances, in order to improve the level of quality control throughout the entire organization, it is necessary not only to set up a formality of quality control system, but also to ensure penetration of quality improvement measures through every audit team by strong management leadership and collaboration with audit frontline. In recent years, large-sized audit firms have started to establish a quality control system not only at headquarters level but also with the audit frontline in order to make quality improvement efforts sustainable, therefore the importance of audit frontline for the audit quality improvement has been increasing. However, in efforts to improve audit quality, there are cases where the firm's management have left the efforts to audit frontline to value autonomy of audit frontline, or cases where communication between the firm's management and the audit frontline has been insufficient. As a result, there are such issues that the actual situation of audit frontline has not been sufficiently understood, or the improvement measures have not been sufficiently monitored. Therefore, the firm's management, including the quality control division, needs to sufficiently check the penetration and effectiveness of improvement measures with appropriate understanding of the audit frontline.

The followings are specific examples of root causes of deficiencies at large-sized audit firms identified by the CPAAOB's inspections:



- The top management has believed that, by the introduction and implementation of audit quality improvement measures, every engagement team would proactively address all accounting and audit issues to obtain sufficient appropriate audit evidence. Furthermore, the top management has believed that a risk-based appointment of EQC reviewers and the measures to secure sufficient

preparation period for internal periodic review would raise awareness of the reviewers to conduct in-depth reviews. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 9)

- The top management does not sufficiently recognize the need to monitor the close collaboration between the quality control division and the audit divisions to realize the effect of improvement measures. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 9).



- The top management has believed that, only by implementation of audit quality improvement measures, the audit teams would perform appropriate risk assessments and audit procedures. Also, the top management does not sufficiently recognize the need to check the execution status of the measures in the audit frontline. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 9).



- The top management has believed that audit responses for areas other than significant risk areas would be improved only by notifications.
- The top management and the quality control headquarters have believed that all engagement partners and team members have a full understanding of the purpose and the importance of the CPA registration system, and have believed that they appropriately handle CPA information, such as headcount or audit hours, when preparing the public documents.

[Mid-tier audit firms]

It is recognized that mid-tier audit firms are making efforts to improve the quality control system, however, it is also recognized that enhancement of the headquarters function is insufficient. Furthermore, there are situations where top managements' awareness of the quality control has not caught up with the firms' growth, where firms are heavily dependent on part-time staffs and non-CPA assistants in the execution of audit engagements, and where a particular regional office has an audit quality issue. The root causes of deficiencies are different from firm to firm due to the difference in operations management systems, size of operations, and its history.

Accordingly, each firm needs to conduct substantial root cause analysis for effective improvement of the audit quality.

The followings are specific examples of root causes of deficiencies at Mid-tier audit firms identified by the CPAAOB's inspections:

- The CEO does not recognize the need to check the adequacy and effectiveness of the quality control system by himself. For example, the CEO has failed to grasp that the top management does not recognize the resource shortage under the business expansion, and the CEO has believed that the enhancement of the headquarters function and the improvement of the quality control system

would be realized only by leaving them to the division heads. Another root cause is that the CEO and other executives do not pay sufficient attention to monitoring the penetration and the effectiveness of quality control measures in the audit frontline, in spite of the insufficient commitment of the engagement partners to their duties and the insufficient audit quality improvements in the audit teams. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 10)



- The CEO and other executives do not have sufficient compliance mindset to the professional ethics and the internal rules, and do not pay sufficient attention to fostering a quality-first culture and to building an effective operations management system. In addition, they are so focused on the early realization of full-time engagement of the partners and staffs that they have lacked sufficient attention to improvement of the firm's audit quality, despite that they have been aware of constant shortage of the resources and the skills. Furthermore, the CEO and other partners do not accurately grasp the situations that the professional staffs, including themselves, do not understand the of audit standards and the level of procedures required under the current audit standards, and do not have critical attitude toward management assertions when auditing accounting estimates. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.10)
 - The CEO does not like to demonstrate a strong leadership in planning and implementing audit quality improvement measures for prompt improvements, rather values autonomy of the quality control division and the audit divisions. In addition, the top management does not recognize the necessity of strong collaboration between the quality control division and the audit divisions by valuing autonomy in those divisions. Furthermore, despite the concern about the audit quality at a regional office, the top management has not recognized a need to proactively support the regional office because they have a belief that the regional office is able to make improvements on their own. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.11)
 - The members of the Management Committee have believed that the resource issues (human, time) were resolved by measures such as reconsidering staff assignment, monitoring the ratio of audit partner hour to the total, and increasing the headcount of audit assistants.
- A starburst-shaped icon with the word "NEW" inside.
- The top management, including the CEO, has lacked awareness of taking initiative in making sincere efforts to maintain and improve audit quality, and does not demonstrate leadership for an appropriate level of audit quality in the firm. In addition, because no significant quality control issues were noted as a result of improvement measures taken in response to the deficiencies identified in the external inspections, the top management has believed that their insufficient understanding of audit standards has already been resolved and their audit quality has been improved to an appropriate level. As a result, the top management has not yet accurately grasped, the level of audit quality at the firm as a whole.

[Small and medium-sized audit firms]

Small and medium-sized audit firms are different in size and history, and the level of quality control systems differ from firm to firm. However, all of them have relatively small organizations, and it is difficult to provide audit teams with organizational support. The level of operation management and quality control is often affected by the abilities of the CEO and other individuals and their relationship. It is important that the CEO demonstrates leadership in quality control because there are many cases in which the low level of awareness and involvement of the CEO in quality control affects the quality control culture of the firm. It should also be noted that in the event of a significant change in the business environment, such as a merger, the CEO should demonstrate full leadership to appropriately update the quality control system in line with the change. The followings are the specific examples of root causes at small and medium-sized audit firms identified in the CPAAOB inspections. In recent inspections, "the CEO's insufficient demonstration of leadership toward quality improvement" and/or "failure to accurately grasp the level of audit quality at the firm" have often been identified as root cause.

- The CEO and the PICOQC have a belief that their audit quality is sufficient as they did not receive any significant deficiencies in the past quality control reviews, resulting they does not pay sufficient attention to the improvement of their audit quality. In addition, they have not demonstrated leadership to improve audit quality due to their belief that audit quality would be improved only by establishment of quality control system. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The CEO is not willing to take a leadership for more effective and systematic operations management system and quality control system to ensure appropriate audit quality. Furthermore, the CEO and the PICOQC have believed that the firm's audit quality has been at an appropriate level because the audit partners have extensive audit experience and the professional staffs came from large-sized audit firms, and they do not accurately understand the level of the firm's audit quality. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.12)
- Although the audit firm is small, it has two audit divisions since its foundation. Each division independently manages its audit engagements, financial affairs, and personnel affairs, which has created a firm culture that values independence of each division. Furthermore, only engagement partners work on a full-time basis, while all professional staffs work on a part-time basis. Under these circumstances, the CEO and the PICOQC are not aware that all audit team members, including themselves, do not sufficiently understand the audit standards and the levels of quality control system and the audit procedures required by the standards. In addition, the CEO and the PICOQC have believed that the firm's current operations management system is appropriate, since no significant deficiencies were detected in the past quality control reviews, etc. As a result, they do not recognize the need to transform the firm's operations management system, such as



integration of the two divisions and/or employment of more full-time staffs. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.13)

- Each partner, including the CEO, does not have critical mindset to other partners' audit quality, and does not pay attention to the improvement of the firm's audit quality. In addition, each partner, including the CEO, is expanding a wide range of non-audit services through affiliated companies, which has made them to lower the priority of the audit quality.
- The CEO and the PICOQC does not demonstrate leadership to maintenance and improvement of the audit quality. In addition, they are not aware that professional staffs, including themselves, have lacked an understanding of current audit standards and/or the level of quality control and audit procedures required by the standards.
- The CEO has failed to create a firm culture to put priority on the professional ethics, so that the partners and the staffs have extremely lacked the attention to the importance of keeping professional integrity and credibility. In addition, the CEO and the PICOQC have believed that the understanding of the level of procedures required by the current audit standards has been wide spread throughout the firm as a result of the recruitment of CPAs who have extensive work experience at large-sized audit firms and the execution of sufficient in-house trainings training.
- The audit firm is working on the operational improvements responding to the Business Improvement Order (improvement of operations management system) by the FSA and the several improvement recommendations by the quality control reviews.

Under this situation, the aforementioned order or the recommendations have not been recognized as the fundamental issue at the firm, because each partner of the firm has been engaged in large volume of non-audit service as their own private business, resulting lower attention to the audit quality at the firm. Moreover, the CEO and the PICOQC have lacked the attention to make the quality control system more effective, and have not demonstrated the leadership for better audit quality. Furthermore, each partner at the firm has not been aware of the need to monitor the quality of other audit engagements one another, which is a lack of responsibility as an audit partner. Thus, the firm does not foster a good corporate culture, in which each partner actively interact one another for better audit quality, and has not prepared for conducting organized audits.

- The audit firm merged with the other firm recently. The CEO has not recognized the importance of integration of the management structures with regard to personnel evaluations, compensation, engagement team assignments, and others. Furthermore, the partners at the firm have continued specific audit engagements for many years and have lost professional skepticism in assessing audit risks in light of the latest corporate environment.
- The CEO thinks that important management issues should be discussed among limited members such as the CEO, the PICOQC, and the EQC reviewers; and does not think it necessary to share those issues with all partners. As such, the CEO has not fostered a collaborative firm culture for better audit quality, and thus has not prepared for conducting organized audits in the firm.



- The audit firm comprises a small number of partners and staffs who have no work experience at other audit firms, and has not changed its management style since its foundation. For many years, a limited number of listed companies has been main audit clients for the firm, and as a result, total fee received from those main clients to the firm (fee dependency) is high.
Under the circumstance, the CEO, who is also a PICOQC, has placed top priority on keeping the relationships with the main clients and has believed that there was no issue with the audit quality and the firm's management style. In addition, the CEO/PICOQC has not recognized the need to keep attention to the necessary qualifications as certified public accountants, such as audit quality, professional ethics and independence. He has also not been aware of the need to have organized operations management system and quality control systems. Moreover, as a result of the firm management run only by the CEO/PICOQC for a long time, other partners have not been aware of the need to fulfill their responsibilities.
- When evaluating partners, the CEO has placed more importance on quantitative factors such as the number of audit engagement in charge, the number of new audit engagement, etc; on the other hand, the CEO has placed less importance on audit quality aspects. In this way, the CEO has not paid sufficient attention to the design and operation of quality control system that places more importance on the audit quality.
- The president and the PICOQC have not sufficiently recognized the lack of understanding for the purpose of the current audit standards and the level of quality control and audit procedures required under the standards. Also, the president and the PICOQC have believed that their partners have sufficient audit capabilities due to their rich experience in the past, so that they put excessive reliance on them.
- The president and the PICOQC have not been aware of the need to establish an organized quality control system because they have believed that there are no problems in the current firm operations. Furthermore, they have not recognized that there is a lack of understanding for the purpose of the current audit standards and/or the level of quality control and audit procedures required under the standards.
- The CEO has the highest priority on issuing an unqualified audit opinion in time, so that he has not exercised the professional due care, and has not paid sufficient attention to fulfill the role and responsibility as an audit firm, which is entrusted by the society. Other engagement partners, including the PICOQC, is going along with the CEO and do not keep other engagement partners' quality in check.
- The audit firm is established by partners who were colleagues at a large-sized audit firm. As the audit firm comprises a small number of partners, the CEO and the PICOQC have believed that they understand the partners' abilities each other and they are demonstrating their abilities. In addition, since no significant deficiencies have been pointed out in the past quality control reviews, the CEO and the PICOQC have believed that the firm has minimum level of quality control system

in place according to the size. Accordingly, they have not sufficiently recognized the need to develop an organized quality control system.

2. Response to the Audit Firm Governance Code

Based on the economic and social situation surrounding the accounting audits, the Act for Partial Amendment of the Certified Public Accountants Act and the Financial Instruments and Exchange Act were enacted and promulgated in May 2022, and the related government orders were promulgated in January 2023 and came into effect in April 2023. The Act introduced a registration system of audit firms that engage in audits of listed companies in order to ensure the reliability of accounting audits and to contribute to further demonstration and improvement of the CPA's ability. As a result, audit firms that engage in audits of listed companies are obliged to establish a system to conduct its operations in accordance with the Audit Firm Governance Code and a system to realize an enhanced information disclosure.

The Audit Firm Governance Code was established in 2017. Based on the above laws and regulations, the Expert Review Committee on the Audit Firm Governance Code held discussions and revised the Audit Firm Governance Code in March 2023 to require effective disciplines suited to the size and the nature of audit firms. The purpose of the revision was to: (i) make small and medium-sized audit firms that engage in audits of listed companies to easily adopt the code; and (ii) enhance disclosure regarding the globalization of audit firms and others.

The Audit Firm Governance Code has been developed for organized business operation by audit firms that engage in audits of listed companies, but it does not exclude voluntary adoption by other audit firms. On this basis, each audit firm is required to determine if the Audit Firm Governance Code should be implemented for effective organizational management at their own discretion based on its size and characteristics.

For more information such as the adoption status by audit firm size, please refer to the "2024 Monitoring Report".

3. Responses to the Revision of Quality Control Standards

The Business Accounting Council of Japan published an opinion letter on the revision of quality control standards for audits ("Quality Control Standards") (November 16, 2021). The opinion letter included the introduction of a quality management system (a management method in which audit firms: (i) set quality objectives; (ii) identify and assess quality risks that hinder the achievement of quality objectives; (iii) define and implement policies or procedures to address the assessed quality risks; and (iv) make remediations based on root cause analysis if there are deficiencies), according to the revisions of international quality control standards such as "International Quality Management Standard 1" (Quality Management at Audit Firms - ISQM1), "International Quality Management Standard 2" (ISQM2), and

"Quality Control for Financial Statement Audits" (ISA220). The revised Quality Control Standards are required to be implemented from the audits of financial statements for fiscal years starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years starting on or after July 1, 2024).

The JICPA published Quality Control Standards Statement No. 1, Practical Guidance No. 3 (Q & A on Quality Control at Audit Firms and Audit Engagements, and Reviews of Audit Engagements) (February 16, 2023) and Quality Control Standards Statement No. 1, Practical Guidance No. 4 (Tools for Quality Control at Audit Firms) (last amended on January 17, 2024) for applying the revised quality control standards.

For more information about responses by the size of audit firms, please refer to the "2024 Monitoring Report".

II. Quality Control System

Implementation of Quality Control Operation

Outline

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the QC system are appropriate to the size and characteristics of the firm.

Responses to requirements for QC systems under the audit standards vary from large-sized audit firms with several thousand members to relatively small-sized audit firms. Furthermore, many deficiencies identified thus far reflect the size and characteristics of each audit firm, and the background to the deficiency as well. Therefore, in “II. Quality Control System”, examples of deficiencies identified in the CPAAOB inspections are categorized into “Large-sized audit firms” and “Mid-tier, and small and medium-sized audit firms”.

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.

(Revision of Quality Control Standards Concerning Audits and Revision of Ethics Rules)

The revised Quality Control Standards will be applied to audits of financial statements for fiscal years or accounting periods starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years or accounting periods starting on or after July 1, 2024). The Ethics Rules, which were revised in July 2022, came into effect on April 1, 2023. This Case Report presents deficiencies in accordance with the provisions of Quality Control Standards Report No. 1 (Quality Control at Audit Firms). However, cases of deficiencies based on the revised Quality Control Standards Report and the revised Ethics Rules have not been identified. Therefore, it should be noted that the provisions on the basis of deficiencies presented in this Program Year are all pre-revision provisions.

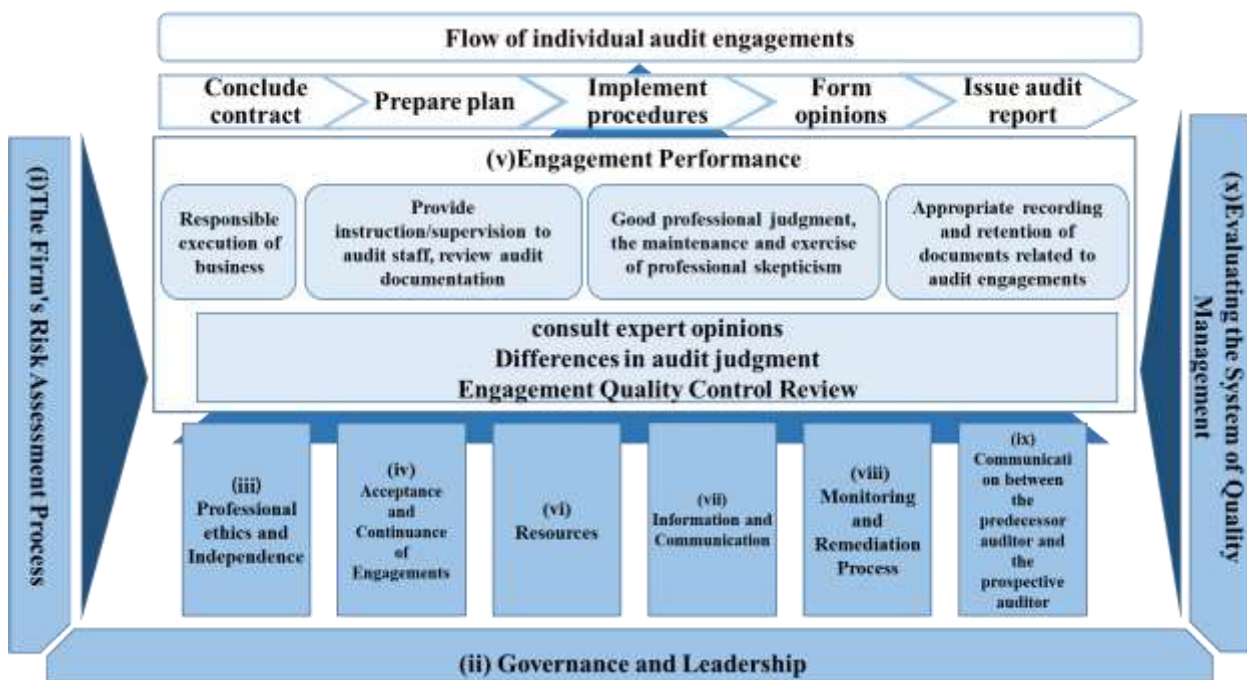
Relationship between quality control system and individual audit engagements

Regardless of the size of an audit firm, the purpose of establishing and operating a quality control system is to reasonably ensure the quality of audit engagements as an organization. The quality control system required is stipulated in the "Quality Control Standards for Audits" and the "Quality Control Standards Report," etc., and it has a significant impact on the quality of individual audit engagements through the establishment and operation of a quality control system. Some audit firms have established a quality control system only as a formality. In such cases, the system does not operate as expected, and thus does not function effectively in improving the quality of individual audit engagements.

The revised quality control standards define quality control system as follows: (i) The Firm's Risk Assessment Process, (ii) Governance and Leadership, (iii) Professional Ethics and Independence, (iv) Acceptance and Continuance of Engagements, (v) Engagement Performance, (vi) Resources, (vii) Information and Communication, (viii) Monitoring and Remediation Process, (ix) Communication between the predecessor auditor and the prospective auditor. The QC system of an audit firm must be evaluated at

least once a year by setting a record date, and conclude whether the quality control system provides the audit firm with reasonable assurance that the objectives of the system are achieved ((x) Evaluating the System of Quality Management). (i) In order to enable audit firms to conduct quality control on their own initiative, audit firms are required to set quality objectives for each component of their quality control system, identify and assess quality risks that could hinder the achievement of the quality objectives, and define and implement policies or procedures to address the assessed quality risks. (ii) Governance and Leadership establish the environment underlying an audit firm's quality control system and have a significant impact on all other components of the quality control system of an audit firm. It should be noted that (ii) Governance and Leadership must also be included in the evaluation of (i) The Firm's Risk Assessment Process and (x) Evaluating the System of Quality Management. (v) Engagement Performance includes elements that have a direct impact on the quality of individual audit engagements, such as the direction and supervision of assistants by engagement partners, review of audit documentation, and review of audit engagements. The quality of individual audit engagements can be reasonably ensured when the aforementioned quality control system functions comprehensively and effectively in accordance with the scale and characteristics of each audit firm (see [Figure 2]).

[Figure 2] Reference Image: Relationship between Quality Control System and Individual Audit Engagements



Analysis of deficiencies that occurred

At large-sized audit firms, although deficiencies related to the design of a QC system have seldom been identified in recent years, there are still many deficiencies in individual audit engagements. Therefore, it can be assumed that there are deficiencies in the operation of the QC system. Specifically, operation-related deficiencies have been identified in areas such as reviews of audit work papers, engagement quality control reviews and periodic inspections.

Furthermore, with regard to deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past, adequate verification was not conducted as to whether improvement measures had taken hold and how effective they were. As a result, the same or similar deficiencies have been identified in other individual audit engagements. In such cases, it may be deemed that efforts to improve quality control operations are insufficient.

For example, the objectives of measures designed to improve deficiencies were not fully understood by divisions and engagement teams, etc., and were not sufficiently permeated. As a result, the expected effects of improvement measures were not achieved, and similar deficiencies continued to be identified in individual audit engagements.

At Mid-tier audit firms and small and medium-sized audit firms, deficiencies have been identified in a broad range of areas in terms of both the establishment and implementation of the quality control system. In addition, same as at large-sized audit firms, inspections of individual audit engagements found cases where deficiencies, which had been identified in the past by the CPAAOB inspections and quality control reviews, etc., were not appropriately remediated. In many of those cases, the deficiencies were deemed to be attributable to the quality control system. Specifically, there were many cases where the CEO and the PICOQC did not have sufficient awareness and knowledge of quality control operations and did not appropriately develop and operate a quality control system. There were also many cases where the CEO and the PICOQC did not have sufficient understanding of the depth and methods of cause analysis required to prevent the occurrence of similar deficiencies identified in quality control reviews, etc.

Specifically, although persons responsible for each function of the quality control system, such as EQC reviews and education / training, had been appointed, there were cases in which the deficiencies inherent in quality control and individual audit engagements had not been identified and corrected on their own due to insufficient human resources allocated to each office at the headquarters.

(Observed effective efforts)

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

In the area of quality control operations, a council has been established to identify the issues to be considered and integrate the administration of regional offices. This council comprises members of the quality control division at the headquarters as well as members from across the entire audit firm, including partners, managers, and senior staff involved in quality control at regional offices. Furthermore, the results of its

consideration are shared with the board and partners meetings at regional offices to ensure that there is no variation in the responses over the regional offices.

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

Expected response

Based on the adequate awareness of the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish and implement such system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the QC system can effectively work in individual audit engagements. Specifically, the CEO and PICOQC of audit firms should aware the purpose and importance of the quality control system, take the initiative in ensuring that whole personnel in a firm understand the primary purpose of the QC system, disseminate measures to improve the quality of audit throughout the entire organization, and verify their effects at all times. In this regard, it should be noted that the revised QC standards also state that it is important for the CEO to have an awareness of organizationally ensuring audit quality and to demonstrate leadership toward the establishment of a quality control system.

Note that the content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of personnel at the firm, the characteristics of the management of organization, and whether the firm belongs to a global network. In light of this, the CEO and PICOQC of audit firms should establish appropriate QC system according to the size and characteristics of their firm and appropriately maintain the system by revising it as needed.

(Reference)

Main provisions serving as the basis grounds for deficiencies identified in quality control operation and relevant points to be noted are as follows.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
1. Initiatives to Improve Operation	Quality Control Standards Statement No. 1 paragraphs 15, 16, 31	<ul style="list-style-type: none"> ➤ For deficiencies identified in inspections, etc., has formulated and implemented specific improvement measures based on the root causes. ➤ Whether the proposed improvement measures have been disseminated throughout the organization. ➤ Whether the effects of the improvement measures have been verified.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
2.Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards	Quality Control Standards Statement No. 1 paragraphs 15, 16, 17, 18	<ul style="list-style-type: none"> ➤ Whether the audit firm has developed an organizational culture that ensures compliance with laws, regulations, and professional standards as well as internal rules. ➤ Whether the audit firm periodically checks whether there are any discrepancies between the internal rules it developed and their actual implementation. ➤ Whether the audit firm has developed a control system for appropriately recording and managing the CPA qualifications and actual working hours of partners and employees. ➤ Whether the audit firm has established security rules necessary for the use of Internet server services in the course of business, and whether it has considered security measures.
3. Professional Ethics and Independence	Quality Control Standards Statement No. 1 paragraphs 20, 21, 23, 24	<ul style="list-style-type: none"> ➤ Whether the audit firm obtains confirmation letters concerning independence from all target persons at least once a year. ➤ Whether the audit firm conducts independence confirmation procedures when accepting or continuing audit engagements. ➤ Whether the audit firm has developed and implemented a control system for updating, in a timely and accurate manner, the list of regulated companies, which is necessary for the procedures to confirm.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		<ul style="list-style-type: none"> ➤ Whether the audit firm has established a policy and specific procedures concerning compliance with professional ethics, such as dependence on remuneration, restrictions on employment, confidentiality, and gift-giving and entertainment, and informed them to professional staff. ➤ Whether the audit firm has established policies and procedures to comply with the rotation system for engagement partners, etc.
4. Acceptance and Continuance of Engagements	<p>Quality Control Standards Statement No. 1 paragraphs 25, 26</p> <p>Auditing Standards Statement No. 900 Paragraphs 9, 13</p>	<ul style="list-style-type: none"> ➤ Whether specific procedures for evaluating contract risks have been established, and whether approval by the audit firm is made in a timely and appropriate manner. ➤ Whether the identified engagement risks have been appropriately reflected in the audit plans for individual audit engagements. ➤ Whether the audit firm examines whether it has sufficient human resources to implement newly accepted engagements. ➤ Whether the predecessor auditor provides information including information and circumstances relating to material misstatements in the financial statements in good faith and clearly in response to inquiries from the prospective auditor. ➤ Whether the prospective auditor makes inquiries of the predecessor auditor on matters required under auditing standards in order to determine whether or not to

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		accept the engagement.
5. Recruitment, Education and Training; Evaluation and Assignment	Quality Control Standards Statement No. 1 paragraphs 28, F28-2, 29, 30	<ul style="list-style-type: none"> ➤ Whether the audit firm continually provides education and training aimed at improving its audit quality control capabilities, and provides follow-up to personnel who have not completed the mandatory training. ➤ Whether the audit firm has established policies and procedures to fairly evaluate the competence (especially competence related to quality control) of professional staff and their compliance with professional ethics with regard to evaluation, remuneration and promotion, and whether these policies and procedures are properly implemented. ➤ Whether the engagement team sufficiently evaluates the time, work experience, and capabilities, etc. that professional staff, including engagement partners, can secure to perform their duties when forming the engagement team;
6. Audit Documentation	Quality Control Standards Statement No. 1 paragraphs 31, 44 Auditing Standards Statement No. 220 Paragraphs 14, 15, 16	<ul style="list-style-type: none"> ➤ Whether the engagement partner reviews the audit documentation and holds discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the conclusions and audit opinion. ➤ Whether the audit firm has appropriately developed policies and procedures for the final assembly of the audit file, and ensures that the final assembly of the audit file is completed by the deadline.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		<ul style="list-style-type: none"> ➤ Whether the audit firm has adequate policies and procedures in place to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.
7. Engagement Quality Control Review	Quality Control Standards Statement No. 1 paragraphs 36, 37, 38	<ul style="list-style-type: none"> ➤ Whether a person with the necessary experience and skills, etc. and who maintains objectivity and independence has been appointed as the EQC reviewer. ➤ Whether the EQC reviewer examines, based on the audit documentation, whether the evaluation of independence, the necessity of consultation with experts and the conclusion reached, and the significant judgments made by the engagement team are supported by sufficient appropriate audit evidence.
8. Monitoring the Firm's Quality Control System	Quality Control Standards Statement No. 1 paragraph 47, 48, 49, 50	<ul style="list-style-type: none"> ➤ Whether the audit firm appropriately grasps the status of establishment and implementation operation of the quality control system, and has established an inspection system to identify deficiencies. ➤ Whether the audit firm has had the person in charge of periodic inspection conduct an in-depth inspection of whether the audit evidence is sufficient and appropriate, by making inquiries of the professional staff and inspecting the audit documentation. ➤ Whether the audit firm evaluates the impact of deficiencies identified through ongoing monitoring and periodic inspections, instructs the relevant manager (s) to implement corrective

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		measures, and checks the appropriateness of the measures.
9. Cooperation with Company Auditors	Auditing Standards Statement No. 260 Paragraphs 13, 14, 15, 16, 22	<ul style="list-style-type: none"> ➤ Whether the engagement team clearly communicates with the company auditors, etc. about the auditor's responsibilities related to the audit, an overview of the scope and timing of the planned audit including the nature and the reasons of identified significant risks. ➤ Whether the engagement team provides audited companies with appropriate written explanations about the results of the CPAAOB inspections and quality control reviews. ➤ Whether important audit findings are communicated to company auditors in a timely manner.

[Large-sized Audit Firms]

1. Efforts to Improve Operation

Points of focus

At large-sized audit firms, although a quality control environment has been developed as a formality, there may be some deficiencies in its operation. Therefore, the CPAAOB inspects, in a focused manner, whether effective, rather than a formality, efforts are being made to improve operations in response to deficiencies identified in the previous CPAAOB inspection and quality control review.

Specifically, the CPAAOB verifies the effectiveness of the firm's improvement efforts by checking the status of cause analysis of the deficiencies identified in the past and the status of the implementation of remediation based on it, and by examining individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB examines the effectiveness of the remediation measures carried out by the firm through the process such as examining problems on the operation management system that are supposed to be the cause of issues.

Outline of inspection results

At large-sized audit firms, improvement measures for deficiencies identified in the CPAAOB inspections and quality control reviews are often drafted under the initiative of the quality control division etc. at the headquarters, and after being made known to each engagement team through training and notifications, each engagement team takes action, such as reviewing actual audit procedures according to the risks of each audited company. In addition, in order to further disseminate improvement measures, there is a tendency to establish a quality control environment not only at the headquarters but also at divisions closer to the audit frontline.

However, the CPAAOB inspection identified that organizational improvement measures were not necessarily sufficient at different levels within the firm, including divisions and partners. For example, cases in which cooperation between the head office and divisions was inadequate or in which efforts to make operational improvements had not sufficiently taken hold at divisions and regional offices where staff assignment is not flexible due to a lack of exchange of personnel with other divisions, etc. Furthermore, cases in which there were lacks of organizational support from the head office and audit service divisions concerning the response to the important audit areas where no significant change had occurred, were identified.

Expected response

Large-sized audit firms employ several thousand employees and have multiple offices, including regional ones. As a result, they usually have multiple divisions with several hundred employees. It is therefore important that measures taken at the headquarters are instilled throughout the entire organization as a means of improving operations. In order to achieve this, it is important to increase the

understanding of quality control operations at the firm as a whole and to take action at the firm as a whole, including division managers, rather than having only limited departments, such as the quality control department, take action. In particular, the CEO needs to take the initiative in encouraging all members, especially engagement partners who are in a position to lead each engagement team, to make operational improvements so that the purpose of operational improvements reaches the entire organization. In addition, the PICOQC needs to plan and implement timely and appropriate measures under the direction of the CEO, and division managers need not only to make operational improvements themselves, but also to provide appropriate instructions and encourage professional staff under their umbrella to take appropriate actions.

Furthermore, the CEOs and PICOQCs, together with department heads, etc., should establish an effective system to monitor improvement and promptly take appropriate remedial actions in case a problem related to the status of dissemination or effectiveness of improvement measures has been recognized as a result of verification.

In carrying out measures to improve operations at large-sized audit firms, close attention should be paid so that the measures are not superficial, such as giving uniform instructions for remediating deficiencies throughout the entire firms. For this purpose, it is important to carry out moderated and effective measures, such as fully analyzing the tendency and causes of the identified deficiencies to specify the target areas for operational improvement (for example, certain departments and subordinate offices, audit items such as accounting estimates and response to fraud, and IPO-related audits), and focusing on effective improvement measures that suit such target areas.

Case 1: Verification of the status of improvement

- ① In order to improve the deficiencies identified in the previous CPAAOB inspection, the audit firm implemented measures such as familiarization training for partners and professional staff. In addition, through training for monitoring personnel, the audit firm worked to ensure thorough monitoring by communicating points to be noted for each of the major items subject to monitoring. However, the quality control headquarters did not fully explain the information related to audit risks identified when selecting audit engagements to be monitored to some of the persons in charge of monitoring, and did not examine in detail the reports from some of the persons in charge of monitoring. As a result, **the situation where the engagement team did not appropriately performed audit procedures was not adequately identified during the monitoring process.**

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



- ② The audit firm conducted audit monitoring of significant audit areas, mainly accounting estimates, as one of the improvement measures against deficiencies identified in external inspections. However, the department in charge of these measures **did not adequately confirm whether the procedures to respond to audit risks, which had been planned at the time of audit planning through audit monitoring, had been implemented without fail,** and the effectiveness of audit

monitoring was not ensured in some audit engagements.

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

Case 2: Collection of audit risk information

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

However, in effect, **such collection is conducted as collecting same information throughout all audit engagements regardless of the degree of audit risk. Consequently, information corresponding to risks is not being collected.**

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

2. Operation of the Quality Control System

Points of focus

At large-sized audit firms, although deficiencies in the design of a QC system have seldom been identified in recent years, deficiencies continue to be identified in individual audit engagements. The CPAAOB believes that the cause of these deficiencies lies in the operational aspects of the quality control system, although the form (organization and procedures) has been developed.

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

In recent years, the number of auditor changes at listed companies and the number of newly listed domestic companies have remained at high levels. In concluding new audit contracts with large companies, including listed ones, and new audit contracts pursuant to Article 193-2-1 of the Financial Instruments and Exchange Act, sufficient consideration should be given to the time for auditing, audit teams' human resources, the level of audit fees, etc., in order to rationally ensure audit quality.

Therefore, the CPAAOB inspects noting that whether audit firms sufficiently consider the time for auditing ,manpower and the level of audit fees with the viewpoint that verifies reasonableness of the evaluation of risks from the conclusion and renewal of audit contracts (below, "engagement undertaking risk") as well as the audit quality .

Outline of inspection results

In terms of the operation of QC systems, the CPAAOB has identified many deficiencies in areas such as reviews of audit work papers, EQC reviews and periodic inspections. Specifically, there were many cases where the engagement partner etc. conducting reviews, the EQC reviewer, and the person in charge of periodic inspections did not fully understand the changes in the environment surrounding the audited company and the audited company's circumstances, or the audit procedures performed by the engagement team, and therefore did not identify any deficiencies in individual audit engagements.

Causes of these deficiencies include: a disparity in awareness of audit quality and abilities related to quality control among partners, such as engagement partners and EQC reviewers; the QC department not being able to fully grasp the disparity; as a result, appropriate engagement partners and EQC reviewers were not assigned; and engagement teams not proactively taking action to ensure audit quality, such as not consulting the head office for expert opinions in a timely manner.

(Observed effective efforts)

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

The QC partners in the audit division confirm the views of the EQC reviewers concerning risks of material misstatement with audit engagements identified during the course of audit by engagement

partners, and inform quality control review headquarters of areas deemed to be high risk. Furthermore, quality control review headquarters examines audit teams' responses to risks, and demands that audit teams undergo headquarters quality control reviews as necessary. Because this process is performed twice a year on a continuous basis, quality control review headquarters is able to act promptly in addressing high-risk areas in listed-company audit engagements.

Expected response

Engagement partners need to be aware that they are responsible for directing, supervising, and guiding engagement team members so that they can perform audit engagements sufficiently and appropriately, taking into account the abilities and experience of engagement team members, and to be proactively involved from the audit planning stage through the formation of audit opinions. Specifically, engagement partners need to accurately understand the progress of audits and important matters through appropriate direction and supervision of assistants to engagement partners in the audit process, conduct in-depth reviews of audit documentation, and confirm that sufficient appropriate audit evidence is obtained prior to expressing audit opinions.

Furthermore, the EQC reviewer needs to spend sufficient time to examine whether audit engagements are sufficiently and appropriately performed, such as by objectively evaluating audit procedures and audit evidence included in audit documentation for important matters and confirming that there are no problems with the process of forming audit opinions.

To this end, the CEO and the PICOQC need to establish an environment in which engagement partners conducting reviews and EQC reviewers can appropriately perform engagements.

Specifically, engagement partners should assign appropriate engagement partners and EQC reviewers, etc. based on an understanding of each partner's awareness of audit quality, abilities in quality control, and audit risks based on the audited company's corporate environment. For example, if deficiencies in the implementation of operational improvements attributable to engagement partners are detected, the audit firm as a whole should re-evaluate the abilities of engagement partners in quality control, appropriately allocate engagement partners based on abilities, and provide re-education to engagement partners.

Furthermore, large-sized audit firms utilize content such as electronic audit documentation that describes audit procedures and checklists used in EQC reviews and periodic inspections in order to conduct audits and related services effectively and efficiently. In addition, they have established a consultation function and a deliberation system in which difficult audit issues are discussed and advice / solutions are provided at the head office. Such systems are useful for achieving a certain level of audit quality throughout the firm, but they also reduce the awareness of engagement teams to proactively consider audit quality.

Engagement teams, including the CEO and engagement partners, need to make efforts to establish and operate a quality control system based on a full understanding of the benefits and limitations of such systems as described above.

Case 1: Supervision of audit engagements and review of audit work papers



- ① The engagement partner believed that, since there had been no significant changes in the circumstances of the audited company, it would be sufficient to carry out audit procedures similar to those of the previous fiscal year, or that appropriate procedures had been carried out by assistants to the engagement partner with sufficient experience. As a result, **the engagement partner did not give appropriate instructions to the assistants to the engagement partner regarding the audit procedures to be performed when disclosing financial statements, etc. and examining compliance with accounting standards, etc. for accounting treatment from previous fiscal years, and did not sufficiently review related audit documentation regarding the audit procedures performed by the assistants to the engagement partner.**

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

- ② In an audit area where the engagement partners deemed the risk to be relatively low, based on their understanding of the company and business environment and their past audit experience, and in an audit area where the engagement partners were convinced from prior discussions, etc. with the audited company that there were no accounting issues, they thought that they should only confirm the correspondence between their assumption and the conclusion written in the audit work paper. Also, **they trusted their assistants to engagement partner excessively. Because of these issues, the engagement partners did not provide appropriate instructions/supervision and did not conduct reviews appropriately.**

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

《Points to Note》

To suitably perform audit engagements within a limited time frame such as that for year-end audits, engagement partners are required to provide concrete instructions to the assistants to engagement partner and supervise their performance appropriately.

The content, timing and scope of the audit work papers to be reviewed should also be suitably planned so that engagement partners, etc., appropriately review the audit work papers.

Case 2: Ensuring effective EQC review



- ① The EQC reviewer was convinced that the engagement team had appropriately developed the audit plan based on a sufficient understanding of the audited company's business, and **lacked awareness of critically examining the audit plan developed by the engagement team from an objective standpoint.**

As a result, EQC reviewers failed to point out deficiencies concerning procedures related to response to fraud risks in their reviews.

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

- ② **The quality control headquarters did not re-examine the eligibility of the EQC reviewer according to the risks of audit engagements in which material risk information was newly identified in the middle of the fiscal year.**

(Quality Control Standards Statement No. 1, Paragraph 38)

Case 3: Effectiveness of periodic inspections



- ① The personnel in charge of periodic inspections were **not aware of the need to include areas with a relatively high risk of material misstatements in the scope of inspection**, taking into account the areas the engagement team identified as priority audit items when determining the scope of inspection. In addition, the personnel were **not aware of the need to perform a critical inspection** of the engagement team's judgment on the items included in the scope of inspection and the audit procedures performed. As a result, the personnel in charge of periodic inspections were not able to identify any deficiencies related to the examination of accounting treatment associated with the application of the accounting standard for revenue recognition or the audit of accounting estimates. (Quality Control Standards Statement No. 1, paragraph 47)

- ② **Although** persons in charge for periodic inspections **confirmed the existence of audit work papers corresponding to a checklist, they lacked awareness of the need to conduct in-depth reviews concerning the adequacy of further audit procedures performed by engagement teams**. Because of this, they failed to conduct effective inspections. For example, deficiencies concerning accounting estimates and related-party transactions were not discovered. (Quality Control Standards Statement No. 1, paragraph 47)

《Points to Note》

With regard to EQC reviews and periodic inspections, it should be noted that, as with reviews, it is necessary to objectively evaluate whether the explanations provided by the engagement team are supported by sufficient appropriate audit evidence, not only through oral communication but also through examination of audit documentation.

In addition, audit firms that position global reviews as the center of periodic inspections should check whether the global reviews exhaustively carry out inspections that correspond to the requirements under Japanese audit standards, and whether it is necessary to take any supplementary measures if there is a concern that they are not carrying out such inspections.

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

- ① **The audit firm submitted to some audited companies audit contracts, audit plan statements, and audit results statements containing misstatements describing that persons who were not registered as CPAs engaged in audits of the audited companies were not registered as CPAs were not registered as CPAs were not registered as CPAs as CPAs.** In addition, **the audit firm submitted an audit summary to the Director-General of the competent Local Finance Bureau containing an excessive number of CPAs or engagement hours.**

Furthermore, the audit firm provided incorrect information to an audited company concerning the number of CPAs that should be included in the "Composition of assistants to engagement partners" column of the securities report, and as a result, **the audited company overstated the number of CPAs in the securities report.**

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)



- ② We have issued business cards indicating that they are CPAs to persons who have passed the final test but have not yet been registered as CPAs or who have not passed the final test.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 48 of the Certified Public Accountants Act).

Case 5: Omission of registration of audited company information (large companies, etc.)



The audit firm's internal rules stipulate that audit and attestation services pertaining to entities with high social impact (hereinafter referred to as "PIEs") and entities equivalent to PIEs need to undergo additional EQC reviews. Furthermore, with regard to whether an audited company falls under a large company, etc., the audit firm manages this matter through a database that contains registration information of large companies, etc. and financial information of the audited company, including capital and total liabilities. The audit firm instructs each engagement team to enter and update this database at regular intervals every year. However, with regard to audit services pertaining to an unlisted audited company that is a 100% subsidiary of a listed audited company, the engagement partner overlooked the fact that the audited company was not registered as a large company, etc. in the database even though the audited company met the requirements for a large company, etc. In addition, the engagement partner did not undergo additional EQC reviews prescribed in the internal rules. In addition, the audit firm did not take sufficient measures necessary to prevent errors in data input into the database and the failure to register the audited company as a large company, etc., and failed to detect the failure to register the audited company as a large company, etc., in a timely manner.

(Quality Control Standards Statement No. 1, Paragraphs 15 and 34; Auditing Standards Statement No. 220, Paragraph 7).

《Points to Note》

Whether or not an audited company falls under a PIE has wide-ranging effects, such as having an impact on the maximum period of involvement of the partners in charge of audit engagements, etc. and on the scope of communication with company auditors, etc. Therefore, audit firms need to establish a control environment that prevents errors.

Case 6: Communication with company auditors, etc.

- ① A component auditor of an audited company who belongs to the same network as the audit firm provided audit and non-audit services to the component of the audited company.

However, the assistants to engagement partner lacked understanding of the audit standards, while engagement partners did not sufficiently review the summary report of the audit results submitted to the Audit & Supervisory Board. As a result, information on fees related to those services was not provided in writing to the audited company's Audit & Supervisory Board Members.

(Auditing Standards Statement No. 260, Paragraph 15 and 18)



- ② After issuing the Companies Act audit report, the engagement team explained the audit results of the Companies Act audits to the company auditors, etc. of the audited company.) The team explained the content of the draft of the management confirmation letter concerning the Companies Act audits. The team also explained the audit results again before issuing the Financial Instruments and Exchange Act audit report. b) The team explained the information on the fees paid to the audited company group for audit and non-audit services. However, the engagement team did not communicate with the company auditors, etc. regarding a) and b) above at the right time before issuing the Companies Act audit report.

(Auditing Standards Statement 260 Paragraph 14, 15 and 20)

《Points to Note》

Please refer to the Auditing Standards (Auditing Standards Report 260, etc.), which specifically describe matters required to be communicated with company auditors, etc. It should be noted that such communication needs to be conducted at a timely timing before the issuance of the audit report, and that if the audited company is a PIE, the scope of such communication will expand.

Case 7: Information Management



The audit firm has prescribed in its internal rules, etc. the appropriate handling of personal information, including that of customers and employees of business partner companies. These internal rules, etc. prescribe that personal information obtained from audited companies should be deleted, blacked out, or otherwise handled when preparing audit documentation, except in cases where personal identification is required. However, most of the individual audit engagements

subject to inspection by the CPAAOB involve audit documentation for which no measures, such as deletion or blackening, have been taken with respect to personally identifiable information. As a result, the audit firm has not been thorough in handling personal information protection.

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

[Mid-tier Audit Firms and Small and Medium-sized Audit Firms]

1. Efforts to Improve Operation

Points of focus

CPAAOB performs inspections based on QC review reports, in principle. CPAAOB inspections focuses on improvements of deficiencies identified in previous CPAAOB inspection or QC review. Specifically, CPAAOB ascertains cause analysis of deficiencies identified before as well as measures to improve operations, such as measure based on the cause analysis, and also ascertains 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, CPAAOB seeks to identify the operations management system issues that might be the cause of such insufficiency.

Outline of inspection results

As shown in the case example section below, at some audit firms, initiatives to improve the deficiencies identified in the QC review were not fully implemented, and over multiple deficiencies, improvement measures were not implemented or insufficient.

Possible causes of the above deem to be as follows:

Although PICOQC or equivalent recognized the need to analyze the underlying causes for the items noted in the recommendations for improvements, he went no further than analyzing the direct specific causes, and did not sufficiently understand the necessity of, or the analysis methods for, analyzing the root causes to be found in the quality control and operations management systems;

The audit firm lacked the attitude of seeking improvement throughout all audit engagements;

The audit firm had not established system to effectively monitor the improvement of deficiencies; and

The divisions had insufficient manpower to implement improvement measures correspond to the size of the audit firm.

Furthermore, there were many cases found which engagement partners responsible for reviewing audit documentation, EQC reviewers, and persons in charge of periodic inspections completed their work by superficially reviewing audit documentation and filling out checklists as a matter of formality because they did not sufficiently understand the purpose of their own roles. In addition, the audit firm left acquisition of knowledge related to audit to the discretion of audit team members themselves instead of proactively maintaining and improving the aptitude and capabilities of the staff. Therefore, engagement teams did not sufficiently understand the level of procedures required under audit standards such as the Audit Standards Statement. As a result, there were many cases found which the same or similar deficiencies in individual audit engagements were not found, or operational improvements by the audit firm were not made sufficiently.

(Observed effective efforts)

NEW

The followings are Examples of effective efforts:

Establishment of a cross-organizational project for audit quality improvement led by CEO.

CEO directly ascertained the improvement of deficiencies in all audit engagements;

Partners of quality control department monitor audit documentation before expressing audit opinion.

A system that enables an early detection of audit issues was established, such as the implementation of a preliminary EQC review system;

The identified deficiencies were understood and the improvement measures were disseminated through discussions in each engagement team; and

A system under which an expert committee was set up for each discussion point, the members (inclusive of assistants to engagement partners) analyzed causes and discussed improvement measures, and conclusion was a provided to the firm's quality control division, was constructed.

Expected response

Audit firms must fully understand to what range and nature a deficiency should be improved, considering the reason why it was identified as a problem in CPAAOB inspection or QC review. Based on these understandings, audit firms should develop and implement appropriate improvement measures for identified deficiencies. In this regard, it is important for CEO to take a leadership, and at the stage of formulating improvement measures, not only make formal improvements to deficiencies but also analyze root causes of the deficiencies and then formulate effective improvement measures to resolve the causes. At the implementation stage of the improvement measures, it is important to make the entire organization understand correctly details of the improvement measures. It is also necessary to check whether the same or similar deficiencies exist not only in the individual audit engagements where the deficiencies were identified, but also in other individual audit engagements, and to fully verify whether the improvement measures formulated by the audit firm are appropriately implemented, in order to improve the overall audit engagements conducted by the audit firm.

Case 1: Establishment and implementation of specific procedures for improvement

- ①The audit firm attributed the deficiencies identified in the quality control review to a) insufficient understanding of audit standards, b) insufficient understanding of the level required by audit standards, and c) lack of professional skepticism.

However, the audit firm **did not perform an analysis of the root causes** of a) to c).

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

- ②With regard to the root causes of the deficiencies identified in the CPAAOB inspection, the audit firm recognized engagement partners' insufficient involvement in audit work and implemented improvement measures in which engagement partners take the initiative in identifying and assessing audit risks. Moreover, the quality control division checked through periodic inspection how much

the improvement measures had taken hold. In addition, the CEO continuously communicated the importance of engagement partners' involvement through communication with staff members.

However, **due to a shortage of the manpower at the quality control division** necessary for continuing those improvement measures and ensuring that they take hold, **corrective actions taken in relation to the deficiencies identified were insufficient**. Moreover, **as engagement partners placed excessive trust in the formats of audit documentation revised in response to quality control reviews, awareness about the need for engagement partners' involvement in audit work did not sufficiently improve**.

(Quality Control Standards Statement No. 1, paragraphs 31, A30, and A31; Auditing Standards Statement No. 220, paragraphs 14, 15, and 16)

Case 2: Dissemination of specific policies and procedures for improvement

The PICOQC fails to disseminate specific policies and procedures for improvement thoroughly. For example, the PICOQC included deficiencies identified in the QC review and improvement plans in the checklist designed for periodic inspection. However, the PICOQC **did not explain to other members in the firm the reasons of the deficiencies and the purpose of the improvement plans**. **For part-time professional staff, only a postal mail describing the deficiencies was sent**.

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

Case 3: Verification of improvement

- ① Ahead of a merger, the audit firm with the aim of finding out about the audit quality control system employed by the audit firm to be merged with, held meetings with the PIOCQC of that firm, reviewed the results of inspections by the CPAAOB, and so on.

However, while the PICOQC was aware that the audit firm to be merged with had had numerous deficiencies pointed out during CPAAOB inspections etc., he/she **did not adequately assess whether the quality level of the firm was acceptable**. For example, he/she did not specifically understand and analyze the nature and causes of the deficiencies.

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



- ② The audit firm communicate points to attention of performing audit, which are based on deficiencies identified in external inspections, with the firm's personnel by training. The firm also prepared "Table for Identifying Deficiencies" that listed the deficiencies and had engagement partners perform self-check, and had EQC reviewers confirm results of the self-check. However, the engagement partners and the EQC **reviewer only confirmed items of self-check listed in the "Table for Identifying Deficiencies" as a formality, and did not perform in-depth reviews of deficiencies**.

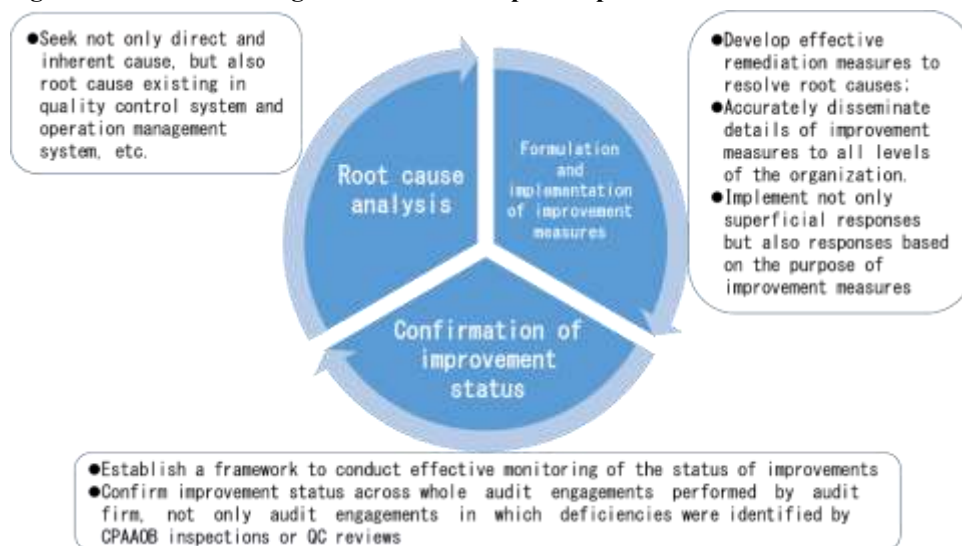
Furthermore, the audit firm performed these self-check only for audit engagements of specific fiscal year-ends, and **did not perform self-check for audit engagements of the other fiscal year-ends**.

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

《Points to Note》

The above are examples of audit firms, which deficiencies identical or similar to the deficiencies identified in past CPAAOB inspections and QC reviews, were identified. This resulted from the implementation of formal improvement measures, such as simply communicating the deficiencies for improvement and using improvement checklists, without identifying the root causes of the deficiencies and resolving or improving them. Therefore, the PICOQC should keep in mind that it is necessary not only to communicate details of identified deficiencies to engagement teams, but also to consider specific instructions for improvement of audit procedures. In the case of using improvement checklists, PICOQC and engagement partners should monitor a status of the improvement in light of the meaning of the deficiencies and the scope of procedures to be improved based on the meaning. (Refer to [Figure 3])

[Figure 3] Reference image: Initiatives to improve operations



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

(1) Establishment/Implementation of Internal Rules

Points of focus

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

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

Outline of inspection results

Regarding the a design and operation of internal rules, as shown in the case example section below, there were deficiencies not only in the operation of internal rules but also in designs of them.

As for the causes of these deficiencies, there were cases in which there was a lack of sufficient understanding of the laws, regulations and standards applicable to audit firms and cases in which audit firms adopted the template of quality control rules ("Audit Quality Management Rules") provided by the JICPA without making any modification according to the audit firm's actual circumstances. There were also cases in which audit firms assumed that it was unnecessary to revise the rules because no problem had occurred in the past.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

The audit firm promoted understanding of the relationship between the audit manual and the Auditing Standards Statement by noting the requirements indicated in relevant statements with respect to each provision of the audit manual. Using such audit manual, the audit firm provides education on the level of audit responses required by the audit standards.

Expected response

Audit firm should re-examine whether their internal rules comply with laws, regulations, and professional standards and are appropriate for their size and actual situation, and review and revise internal rules as necessary. Audit firm should also establish an operations management system for appropriate design, dissemination, and operation of internal rules, such as by establishing a workflow that is appropriate for the actual situation.

Case 1: Establishment of internal rules (Establishment of articles of incorporation and organizational rules)

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

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

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

Case 2: Establishment of internal rules (Partners' meeting)

The audit firm has a partners' meeting consisting of all partners to make decisions on important matters relating to management and operations.

However, the audit firm did not have a system in place for appropriate operation of the partners' meeting. For example, **the audit firm did not specifically stipulate in writing the matters to be resolved by the partners' meeting and the method of resolution, and it did not keep a record of the process of deliberation and content of resolutions on matters though it asserted that such matters had been resolved by the partners' meeting.**

(Article 34-13 of the Certified Public Accountants Act)

Case 3: Dissemination of internal rules



An audit firm stipulated in its quality control regulations that "When these regulations are newly adopted or renewed, PICOQC shall document policies and procedures concerning quality control in these regulations, etc., distribute these regulations to personnel, and explain the content of these regulations, the purpose to be achieved, and the point that each individual is responsible for quality." However, the audit firm **only kept various regulations, including quality control regulations, in**

a cabinet within their office, and PICOQC did not distribute the quality control regulations, etc., to personnel. Furthermore, PICOQC did not fully inform personnel of the content and objectives to be achieved, etc., when new personnel were employed or quality control regulations, etc., were newly established or revised.

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

Case 4: Operation of internal rules (retirement age rules)



An audit firm set the retirement age for partners at 65 in its retirement age regulations, but the audit firm permitted its partners who had passed the retirement age to attend partners' meetings and keep their partner registration without adopting a resolution to extend the retirement age, so that the audit firm did not treat these partners in accordance with the regulations.

(Quality Control Standards Statement No. 1, paragraph 15)

Case 5: Operation of internal rules (seeking expert opinions)

However, the audit firm did not establish specific procedures for obtaining expert opinions. For example, the audit firm did not establish specific reporting procedures when the engagement team identified matters on which an expert opinion should be sought, and did not identify a person with appropriate expert knowledge and experience in or outside the firm.

(Quality Control Standards Statement No. 1, paragraph 33, F33-2)

《Points to Note》

As the templates provided by JICPA and other bodies have been enhanced, the number of deficiencies in the design of rules, such as the absence of rules, has been decreasing. However, there are some operational problems where the templates are used without any modification, and the rules are not in accordance with the actual situation of the audit firm, and the rules are not actually functioning. Therefore, it is vital to check periodically whether or not there are any discrepancies between the internal rules developed by the audit firm and the actual status of implementation.

In addition to the above, the following deficiencies were identified:

- There is no contact channel for information related to fraud risk received from outside, and no specific system has been established to respond to information related to fraud risk from outside.
- The firm had failed to put in place a system for tallying and managing working hours of professional staff, which serve as the basis for developing audit plans.
- Regarding audit strategy to obtain audit evidence by conducting substantive procedure without conducting test of internal controls, the audit manual did not set out any guidelines on the requirements, nature, timing and extent of such substantive procedure.
- When concluding contracts for non-audit services, procedures prescribed in internal rules (notification to and proceedings of all personnel) were not performed.

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

Points of focus

A variety of restrictions and obligations, etc., are imposed on certified public accountants and audit firms by the Act and other laws, regulations, and professional standards, from the perspective of ensuring appropriate operations. CPAAOB, therefore, inspects the status of compliance with applicable laws, regulations, and professional standards, and the status of the establishment and implementation of the operation management system to ensure such compliance.

Outline of inspection results

From the perspective of compliance with laws, regulations, and professional standards, there were deficiencies in the rules for non-competition among partners, as well as in the rotation of key personnel in charge of audit engagements, inappropriate responses to inspections, and false statements regarding CPA qualifications.

Causes of the deficiencies listed above include: PICOQC or equivalent did not fully understand the applicable laws, regulations and professional standards or did not clearly and concretely stipulate practitioners and workflow regarding the tasks that necessitate verifying the status of compliance with laws, regulations and professional standards.

Expected response

An audit firm should be aware of their duties and responsibilities of certified public accountants at all times and should foster an organizational culture under which laws, regulations, and professional standards are observed. Moreover, an audit firm should establish an appropriate operations management system to ensure compliance with laws, regulations, and professional standards by identifying operations which necessitate checking the status of compliance with laws, regulations, and professional standards, and by assigning persons to be responsible for those operations.

Case 1: Prohibition on competitive work by partners

A certain partner affiliated with the audit firm had continued to provide services (audit services) that fall within the scope of the firm's engagements at his/her own audit office since before becoming a partner of the firm in violation of the Act, which prohibits engagement in competitive work by partners. In addition, the audit firm overlooked the fact that this partner was violating the Act.

(Article 34-14, paragraph 2 of the Act; Quality Control Standards Statement No. 1, paragraph 19)

Case 2: Rotation of major engagement team members

With regard to long-period involvement in audit work, the audit firm's quality control rules require that senior engagement team members (engagement partners, EQC reviewers, and other

engagement team members responsible for making important decisions and judgments related to important matters of audit engagement) be replaced at intervals of seven years with regard to audit engagements for "large companies, etc." as defined under the Act and at intervals of 10 years with regard to audit engagements related to companies other than "large companies, etc."

However, the CEO, who concurrently serves as the PICOQC, did not sufficiently understand laws and regulations related to independence. As a result, **when partners performing audit engagements for large companies, etc. as assistants to engagement partners were involved in the audit work for equivalent or a longer period of time than engagement partners, the CEO/PICOQC did not consider whether such partners were other engagement team members responsible for making important decisions and judgments related to important matters of audit engagement.** Moreover, some engagement partners were violating the firm's policy concerning long-term involvement in audit engagements for companies other than large companies, etc. that was prescribed by the internal rules by continuing to be involved for more than 10 years. (The Act, Article 24-3; Ordinance for Enforcement of the Certified Public Accountants Act, Article 9, paragraph 3; Guideline for Independence, Section 1, paragraph 139; Quality Control Standards Statement No. 1, paragraph 24)

Case 3: Inappropriate response to inspection

The audit firm submitted the inspection-related documentation to inspectors as if it had been prepared in a timely manner even though some partners and staff members had prepared some documents relating to quality management system after cut-off date of inspection or they had prepared some audit documents relating to individual audit engagement and inserted into the audit final file which had been completed and assembled before.

(The Act, Articles 26, 28-3, and 34-14-3)

Case 4: Responding to QC reviews



PICOQC of this audit firm made statements to partners and employees **that could be interpreted as encouraging or permitting the addition, correction and update** of audit documentation relating to audit engagements subject to JICPA QC reviews during the period between the audit report date and the completion of the assembly of the final engagement files.

(Quality Control Standards Statement No. 1, paragraph 17, A4).

Case 5: Inputting working hours of professional staff

Professional staff at the audit firm input working hours into the attendance management system. However, at this audit firm, there were numerous cases in which the working hours of professional staff, including those on statutory holidays, were not input into the attendance management system. In addition, there were numerous cases in which the number of working hours listed in the audit summary was insufficient and in which working hours on statutory holidays were input as working

hours on working days. Despite these cases, corrective measures were not taken to ensure the accuracy of input working hours for all professional staff, and the working hours of professional staff were not appropriately managed.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7; Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

Case 6: Misstatements concerning qualifications as a certified public accountant in materials submitted outside the firm

The audit firm submitted to some audited companies audit plan statements containing misstatement that an employees engaged in an audit of the audited company who were not registered as a CPAs was qualified as a CPAs.

In addition, the audit firm issued business cards to persons who had not yet been registered as CPAs, stating that they were CPAs.

(Quality Control Standards Statement No. 1, Paragraph 15; Auditing Standards Statement No. 220, Paragraph 7)

《Points to Note》

In addition to the above cases, the following deficiencies have been identified.

- The requirement that the majority of partners have been engaged in audit and attestation services for three (3) years or more after being registered as a certified public accountant has not been met.
- Internal rules did not establish procedures for identifying whether or not services that compete with audit firms are being conducted, or specific approval procedures related to competitive work.
- There is a discrepancy between the purpose of the audit firm stated in the Articles of Incorporation and the actual content of the audit firm's business.
- Notification concerning an amendment to the Articles of Incorporation has not been submitted by the statutory submission deadline.
- Transactions involving conflicts of interest are not approved.
- The audit firm did not calculate and manage the actual work hours of partners and employees, and did not establish a system for appropriately preparing audit summaries.
- Approval procedures for contracts for services outsourced by affiliates of the audit firm were not carried out.

(3) Information Security

Points of focus

Firm personnel routinely obtain confidential information of audited companies, etc., and carry around personal computers on which such information is stored. They also use e-mail to communicate with a person in charge at audited companies, etc., and store electronic audit documentation and electronic data before preparation of documentation at audit firms and on external servers. Therefore, audit firms are required to establish and implement information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, CPAAOB inspects audit firms for the status of establishment and implementation of information security systems, from the following perspectives:

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

Outline of inspection results

As shown in the case example section below, the deficiencies identified included: a failure to appropriately implement measures to prevent information leakage; a failure to establish internal rules on the use of internet server services for operation; a failure to appropriately apply rules on information security to part-time staff; and a failure to appropriately anonymize personal information described in audit documentation.

Causes of the identified deficiencies:

The information security manager or equivalent established internal information security rules only as a formality, leaving the application of the rules to professional staff (including part-time professional staff) who use computers and other information devices;

The information security manager or equivalent did not implement any measures to keep track of the operational status of the internal information security rules at their audit firms, being too confident in professional staff's compliance with the internal rules;

The person responsible for information management do not properly understand their own professional responsibilities, and do not establish rules suited to the actual use of information devices at the audit firm;

Forgetting to anonymize personal information.

As managers responsible for information management did not sufficiently understand or were not sufficiently aware of the importance of information security, they were not aware of the need to appropriately develop information security systems.

(Observed effective efforts)

The following are examples of observed effective efforts made by audit firms.

To reduce the risk of information leakage due to the loss of personal computers, the audit firm introduced a virtual desktop interface (VDI) using thin client terminals and used an external cloud storage service for exchange of data with audited companies (through the method of creating individual dedicated sites accessible only by engagement team members and audited companies within the storage account). When the external cloud storage service was introduced, the audit firm identified risks associated with its introduction and implemented its own new management measures as necessary with regard to risks not addressed by the external service provider.

Expected response

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

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

Case 1: Establishment and implementation of internal information security rules

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

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

- The audit firm did not inform all partners and other staff of various rules, including the basic policy for information security. The audit firm did not provide periodic education/training concerning information security, either.

(Article 27 of the Act; Quality Control Standards Statement No. 1 (Before amendment in July 2023), paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 III-1, IV-2, and 5)

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

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

(Article 27 of the Act; Quality Control Standards Statement No. 1 (Before amendment in July 2023), paragraphs 15 and 16; Quality Control Standards Statement No. 1 Practical Guidelines No. 1 IV-2, IV-5, and V-2)

Case 3: Handling of personal information

FREQUENT

In its Manual for Preparing Audit Documentation, the audit firm stipulated the following: a) In principle, vouchers containing personal information should not be stored as audit documentation; b) Measures should be taken to make it impossible to identify individuals when such vouchers are stored as audit documentation.

However, in audit documentation of multiple audit engagements at the audit firm, information that enables the identification of specific individuals, such as names, masking was not masked or other measures were not taken. **Therefore, internal rules on the protection of personal information are not being appropriately implemented.**

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

《Points to Note》

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

In addition, there is a case in which an Internet server service provided by a major Internet-related company was being used as a file server in the absence of rules setting out necessary security measures for job-related use of the Internet server service in operations. It should be noted that the status of security measures should be examined when periodically evaluating service providers.

(4) Prevention of Insider Trading

Points of focus

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

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

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

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

Outline of inspection results

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

Causes of identified deficiencies:

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

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

Expected response

Audit firms should understand that the general public awareness of negative effects of insider trading on capital markets is increasing and take even more effective measures to prevent such trading.

Specifically, audit firms should take necessary responses sufficiently referring to “Q&A Concerning Insider Trading” issued by the JICPA (September 2, 2008) and other relevant documents, re-examine the status of establishment and implementation of the rules for preventing insider trading, and consider whether the strengthening of systems to prevent insider trading is required.

Case: Submission of written pledges regarding anti-insider trading

The PICOQC requires the submission of a written pledge to comply with the “Rules for Preventing Insider Trading,” which prohibits all members from buying/selling regulated securities issued by the audited companies to which services are provided. However, the written pledge was **only required to be submitted at the time of hiring**, and besides, any anti-insider trading measures such as monitoring all members for trading of regulated securities were not carried out subsequently. (Article 26 of the Act; Quality Control Standards Statement No. 1, paragraph 19)

《Points to Note》

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

- **The audit firm has not established internal rules comprehensively, only prohibiting transactions involving specified securities etc. of parties to which services are provided in The “Rules for Preventing Insider Trading” and prohibiting excessive entertainment and gifts in the “Code of Conduct and Ethics”;**
- **Although it is specified in the “Rules for Preventing Insider Trading” that a list of companies to which services are provided shall be distributed to members in order to provide a warning about insider trading, the anti-insider trading manager did not distribute such list of audited companies to which services are provided; and**
- **Although members were instructed to submit written pledges to not buy/sell regulated securities issued by companies to which services are provided, in accordance with the “Rules for Preventing Insider Trading,” written pledges from certain members who should submit the pledges have not been obtained, because the status of submission has not been confirmed.**

3. Professional Ethics and Independence

Points of focus

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

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

- ▶ Whether the audit firm obtains, at least once a year, a confirmation letter concerning compliance with policies and procedures for the maintenance of independence from all persons required to maintain independence; and whether appropriate verification procedures are performed according to the classifications of such applicable persons;
- ▶ Whether the audit firm performs the independence confirmation procedures set forth in its internal rules before acceptance and continuance of audit engagements, and when issuing the auditor's report, appropriately confirms that there was no change in the status of independence;
- ▶ Whether the audit firm has designed and operated a control environment for updating, in a timely and accurate manner, the list of companies subject to regulations on independence, which is necessary for determining whether or not a party subject to the regulations complies with the provisions on independence when carrying out independence confirmation procedures;
- ▶ Whether the audit firm establishes and communicates policies and specific procedures to ensure the observance of professional ethics, such as fee dependency, employment restrictions, duty of confidentiality and restrictions on gift-giving and entertainment, and whether the audit firm instructs the professional staff to follow these policies and procedures; and whether the professional staff follow the policies and procedures for the observance of professional ethics stipulated in the internal rules of the firm; and
- ▶ Whether the audit firm establishes and implements policies and procedures related to engagements associated with long periods of time to ensure compliance with the legal requirement of rotation.

Outline of inspection results

As shown in the case example section below, some engagement teams merely performed a formality review of the independence confirmation procedures prescribed in internal rules, etc., and easily concluded that there were no problems with independence. Some engagement teams also did not perform independence confirmation procedures comprehensively. In addition, some engagement teams did not update their internal rules in accordance with amendments to laws and regulations concerning

independence.

As for the causes of the deficiencies, in some cases, PICOQC, etc. did not determine specific procedures for confirming independence (include procedures for updating the list of independent regulated entities) and the specific period of implementation or appoint the person in charge of the confirmation procedure.

Expected response

Audit firms continue to have deficiencies in matters related to professional ethics and independence. Therefore, in order to ensure the reliability of audits, it is necessary to establish an appropriate operations management environment by complying with the basic principles of the "Code of Ethics" published by JICPA and applying the conceptual framework approach. In addition, it is necessary to carefully consider the actual situation when identifying, evaluating, and addressing factors that hinder independence. (Refer to [Figure 4])

[Figure 4] Conceptual framework approach



Case 1: Confirmation of independence in collegial review



As an independence confirmation procedure in a council review, the audit firm verbally confirmed the independence of prospective review committee members, and if no problem was found with their independence, the audit firm recorded in the "Confirmation of Independence" column of the "Review Request Form" that the independence confirmation procedure had been completed. However, the audit firm **did not perform independence confirmation procedures for some prospective review committee members**.

(Quality Control Standards Statement No. 1, paragraphs 20 and 38)

Case 2: Confirmation of independence when accepting new audit engagements

The audit firm performs procedures to confirm the independence of members who conduct a preliminary investigation of new audit engagement before conducting the preliminary investigation, and performs procedures to confirm the independence of other members of the engagement team before commencing audit engagements.

However, **with regard to confirmation of independence, the audit firm did not establish internal rules setting out specific procedures such as who should be subject to the checks and when they should be implemented**, so for some audit engagements, **procedures to confirm independence before conducting a preliminary investigation or before starting audit**

engagements were not performed.

(Quality Control Standards Statement No. 1, paragraph 20)

Case 3: Inadequate preparation of a list of regulated companies

When performing the procedure for confirming independence to a partners and other staff, the audit firm prepared a list of companies subject to regulation on independence and then appended this list to the independence checklist. However, the audit firm **neglected to include multiple companies subject to regulation on this list, as the firm had not checked the comprehensiveness of such list.** Furthermore, when performing the procedure for confirming independence, even though the responses obtained from partners and other staff contained oversights in the checks, the firm failed to adequately ascertain the reasons for this and thus failed to sufficiently confirm the status of compliance with rules regarding independence.

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

Case 4: System for obtaining information about group firms

The audit firm performed non-audit services (financial due diligence, etc.) entrusted to it by affiliated companies, etc. These services were outsourced by affiliated companies, etc.

However, **with regard to the acceptance of non-audit engagements by the audit firm, the audit firm did not establish policies and procedures for maintaining independence,** and did not establish specific procedures for: a) examination of whether concurrent provision of non-audit services constituted prohibited work, etc. (i.e., whether there was a capital relationship between the client of the non-audit services and the audited company, the nature of the non-audit services, etc.); b) examination of safeguards to be applied when providing non-audit services; c) approval by the engagement partner and PICOQC.

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

Case 5: Calculation of fee dependency

The fees received from a specific audited company accounted for more than 15% of the audit firm's total fees for two consecutive years, so the audit firm as a safeguard requested a CPA who was not a member of the audit firm to conduct a review after expressing the audit opinion. The audit fees from the audited company and the total audit fees from that company's consolidated subsidiaries were included in the numerator when calculating the degree of fee dependency from the audited company.

However, **the audit firm had not established standards for determining "cases in which fees account for a certain percentage" and "cases in which the fees significantly exceed 15%" in its Interpretive Guidance for Professional Ethics, and had not considered whether these cases applied to the audited company. The audit firm had also not made judgements of related companies, etc., in keeping with the Interpretive Guidance for Professional Ethics, and had**

not considered whether there were any related companies, etc., that should be taken into consideration when calculating the degree of fee dependency.

(Guideline for Independence, Section 1, paragraphs 27, 220 and 222; Interpretive Guidance for Professional Ethics Q1 and Q13)

Case 6: Involvement period of engagement partners

After being involved as an engagement partner, CEO attended meetings to report audit results to representative directors etc. of some audited companies during periods when he / she was no longer involved as an engagement partner due to the number of years he / she had been continuously involved.

However, despite being aware of this fact, **the person in charge of independence did not examine whether CEO's attendance at the meeting to report audit results had a direct impact on the results of audit engagements or other matters from the perspective of independence.**

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

Case 7: Employment with client



With regard to the existence and materiality of factors hindering the independence of a former partner in charge of the audit engagements for an audited company and was scheduled to assume office as an officer of the audited company, the audit firm only checked whether audited financial statements had been issued for the period from the day on which the former partner resigned as an engagement partner in the audit engagement to the day on which he / she assumed office as an officer of the audited company. **It did not conduct an examination in light of whether the audit firm provided economic benefits, etc. to the former partner, whether the audit firm owed debts to the former partner, or whether the former partner had been involved in the professional services of the audit firm.**

(Guideline for Independence, Section 1, paragraph 135 and 139)

Case 8: Payment of commission for referral to assurance services

The audit firm paid to staff members a set percentage of the assurance service contract sum as an allowance by way of commission for referral to assurance services when the referral resulted in the conclusion of a contract. The firm also outsourced new customer cultivation and referral services to an external business partner and paid them commission for referral to assurance services. However, **the payment of such commission violates the Code of Ethics prohibiting payment of commission referral to assurance services.**

(Code of Ethics, Article 23)

《Points to Note》

In addition to the above, examples of deficiencies in professional ethics and independence include

the following:

- **The firm included, in the denominator for calculating the fee dependency, the fees received by partners engaged in concurrent business from companies serving as part-time directors, but it did not consider whether it was appropriate to include such fees in the denominator as income for the audit firm.**
- **The firm had neither set out policies and procedures regarding the long-term involvement of engagement team members, nor prescribed standards for those subject to periodic rotation or when safeguards are required to defuse the situation that may create threats to independence.**

Safeguards regarding Fee Dependency

If fees received from clients for specific audit engagements account for a large proportion of the total income of the audit firm, etc. expressing an audit opinion (hereinafter referred to as "fee dependency"), concern about losing fees from such clients for audits and other engagements affects the level of self-interest of the auditor, which is a disincentive to independence (threats), and creates undue pressure; therefore, safeguards need to be considered and implemented to reduce the threats to an acceptable level .

<Calculation of fee dependency >

The calculation of fee dependency is described in Q. 410 - 5-4 of Practical Guidance No. 1 of the Code of Ethics, Q & A on Ethical Conduct (Practical Guidance), as follows; please refer to that guidance for further details.

The total fees from an audit client and its related entities;

Total fees of the audit firm, etc.

< Safeguards for audit engagements as Public Interested Entities >

When providing audit services to a client which is Public Interested Entity (PIE) (*), the audit firm shall apply the following safeguards (if it is determined that they can be safeguards) regarding fee dependency.

- When for each of two consecutive years fee dependency from the client represent or is likely to represent more than 15%: A review, which is similar to engagement quality review, performed by a professional accountant who is not a member of the firm expressing the opinion on the financial statements, prior to the audit opinion being issued on the second year's financial statements.
- When the circumstances described above continue for five consecutive years: The audit firm shall cease to be the auditor after the audit opinion for the fifth year is issued.

It should be noted that the amended Code of Ethics revises the rules on safeguards for fee dependency, and as a result, a review (periodic inspections or JICPA QC reviews) after expressing audit opinion is no longer accepted as safeguards for audit engagements as PIE.

(*)Public Interest Entity (PIE) is defined as "Large company etc." under the Certified Public Accountants Act and are additional entities treated as PIE by an audit firm.

4. Acceptance and Continuance of Engagements

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

Points of focus

In order to reasonably ensure audit quality, in principle, audit firms need to carefully assess engagement risks by collecting information regarding the integrity, etc., of the audited company involved from a wide range of sources, prior to the acceptance or continuance of engagements. If an audit firm evaluates the risks insufficiently in the process of risk assessment regarding the conditions of audited companies, or if an audit firm make a judgment as to whether the acceptance and continuance of audit engagements should be accepted, etc., 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, audit firms need to pay attention to the following points, for example, when accepting or continuing audit engagements:

- ▶ Whether there are engagement risks, including questions regarding the integrity of the top management of the audited company (note that interviewing top management is an effective way of assessing their integrity);
- ▶ Whether it is possible for the audit firm to allocate the necessary and appropriate personnel and time, and to perform audit procedures according to engagement risks;
- ▶ Whether the audit firm retains professional staff having sufficient knowledge, experience, capabilities and competence required to deal with the specified engagement risks appropriately; and
- ▶ Whether or not audit firms comply with the relevant Rules on Professional Ethics and Independence.

In particular, when examining the integrity of the management of an audited company, it is necessary to obtain information that is considered to be necessary in each situation, and if problems are identified, it is necessary to carefully examine whether or not to accept or continue the audit engagement, and to document the conclusion appropriately.

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

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

- ▶ Whether specific procedures for assessing engagement risks have been established, and whether

engagement risks have been appropriately assessed;

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

Outline of inspection results

The acceptance and continuance of audit engagements are core management decisions at audit firms. However, as shown in the case example section below, when accepting and continuing audit engagements, risk information such as the integrity of the audited company involved, which was obtained by the prospective engagement partner through a preliminary investigation and handover of audit engagements, was not shared among persons authorized to approve the acceptance or continuance of engagements (partners' meetings, etc.). As a result, appropriate risk assessment was not performed. In addition, insufficient consideration was given to the audit resources required to conclude engagements. Other deficiencies included a failure to conduct appropriate risk assessment despite having identified situations in which there was significant doubt about the going concern assumptions or the business rationale of transactions was in doubt.

Causes for the deficiencies:

The prospective engagement partners gave greater priority to quickly concluding audit contracts and quickly getting started on the engagement than to carrying out careful risk assessments and resolving issues in a timely and appropriate manner;

The prospective engagement partner did not have sufficient experience to make appropriate judgments regarding management fraud, internal control audits, accounting estimates, etc. As a result, engagement risk assessment based on facts identified through the preliminary investigation and handover of audit engagements, etc. was not performed appropriately.

When discussing with partners whether or not to accept an audit engagement, the audit firm did not understand the importance of conducting a risk assessment based on information etc. obtained from the predecessor auditor, and partners other than the prospective engagement partner did not critically consider audit engagements obtained by other partners.

(Observed effective efforts)

The following are examples of an effective effort observed in an audit firm.

Since the company from which the acceptance of engagement was being considered was a high-risk company where sales fraud had been identified in the previous fiscal year, it was necessary in risk evaluation of the engagement acceptance to carefully determine the status of internal control relating to

prevention of fraud. Under such circumstances, the prospective engagement partner not only obtained information from internal personnel such as the management, but also gathered detailed and objective information in order to corroborate the management's insists, such as by interviewing external experts who were directly involved in the fraud prevention measures of the company, in order to fully understand the internal systems and progress related to the actual establishment of internal control.

In order to develop an environment in which companies intending to list can receive appropriate audits, the Company has established a dedicated department within the headquarters organization. This dedicated department has functions of providing consultation services to companies intending to list, ensuring audit quality by supporting engagement teams, and planning and conducting training to develop human resources who will be responsible for audits of companies preparing to be listed.

Expected response

Audit firms should pay sufficient attention to the fact that acceptance and continuance of audit engagements are core management decisions at audit firms. It is necessary to determine whether to accept or reject an audit engagement after identifying engagement risks and considering measures to address them as an audit firm, based on information obtained through a preliminary investigation or handover of audit engagements, such as the integrity of the audited company and risk information on the audited company.

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.

In addition, the number of new contracts for audits equivalent to the provisions of Article 193 - (2), Paragraph 1 of the Financial Instruments and Exchange Act for listed preparatory companies has increased to a considerable extent, and there are many listed preparatory companies that face challenges in internal controls and internal control environments. Therefore, when concluding new audit contracts with listed preparatory companies, it is necessary to carefully consider whether or not audits of appropriate quality can be conducted, while paying attention to the following points.

Carefully evaluate the integrity of audited companies' management.

Consider whether or not it is possible to conduct audits suited to audited companies' contract risks by securing the necessary and appropriate amount of audit manpower and time.

Secure audit team members possessing the knowledge, experience and capabilities, necessary for conducting audits, including knowledge of initial listing related operations.

Furthermore, from the viewpoint of constructing a framework that can continuously provide audit services to listed companies, it will be necessary to train human resources who will be responsible for initial listing related operations, and accumulate and consolidate related knowledge and know-how.

Case 1: Risk assessment procedures when accepting new audit engagements

①The prospective engagement partner had assessed the contract risk as high after ascertaining that in previous audits, the submission of audit reports had been delayed due to vulnerabilities in the audited company's management systems relating to accounting, etc. After that, inquiring with the predecessor auditor and confirming that there were no problems with the integrity of key management of the company, the prospective engagement partner submitted the matter to partners meeting to discuss the advisability of acceptance of a new audit engagement.

However, the prospective engagement partner had not had a meeting with key management of the company and the partners meeting failed to adequately assess the integrity of key management of the company, it approved the new contract with the audited company based solely on the outcome of the inquiry made to the predecessor auditor.

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

②The prospective engagement partner underwent a review related to the conclusion of a new audit contract based on the audit firm's rules when he/she concluded a new audit contract.

However, **although a new audited company conducted business acquisition transactions which required careful consideration of business rationale, the prospective engagement partner did not sufficiently consider the business rationale of those transactions or the integrity of the management**. The partner in charge of the EQC review was not aware of the need to conduct an in-depth review of the conclusion of a new audit contract and therefore overlooked the above situation and approved the audit contract.

(Quality Control Standards Statement No. 1, paragraphs 25, 26, and F26-2)

③Despite planning to rely on the audit results from the auditor of an foreign significant component, the prospective engagement partner requested the PICOQC to approve the engagement on the grounds that no issues with group audits had been identified, even though the independence of the component auditor had not been confirmed. Furthermore, even though materials attached to the request to approve the engagement stated that the auditor of the foreign significant component was scheduled to be changed, the PICQCC approved the engagement without checking whether the prospective engagement partner had confirmed the independence of the incoming auditor.

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

《Points to Note》

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

It should be kept in mind that when an audit firm merges with another audit firm, the audit firm needs to

perform necessary procedures such as accepting audit engagements need to be completed and appropriate risk assessment procedures.

It should be remembered that the methods for obtaining information on the integrity of the client must be examined with reference to the following from Quality Control Standards Statement No. 1(After revision), paragraph A69.

- In the case of existing engagements, where applicable, information from current or past work or inquiries to other professional personnel who have undertaken other work for the engagement;
- In the case of a new client, inquiries to a person who is currently providing or has provided in the past accounting and audit-related services as a professional expert to the client in accordance with the provisions on professional ethics.
- Discussions with third parties, such as financial institutions, legal experts, and other companies in the same industry in which they are involved;
- Background checks using relevant databases (which may also fall under intellectual resources); in some cases, audit firms may use service providers to carry out background checks.

Case 2: Risk assessment procedures at the time of renewal of audit contracts

The engagement team became aware of significant matters, including significant deficiency in internal controls, note about going concern assumption, and doubt about the business rationale of the transaction with a major shareholder. The engagement team assess the transactions of dubious rationality with the major shareholder as the circumstances that indicated the risk of material misstatement due to fraud.

However, when renewing the audit contract with the audited company, **the audit firm failed to sufficiently consider procedures to ensure audit quality, even though the firm was aware that these significant matters would cause significant difficulty in ensuring the quality of audit engagements.**

(Quality Control Standards Statement No. 1, paragraphs 24, 25, 26, and F26-2; Auditing Standards Statement No. 220, paragraph 11 and F11-2)

«Points to Note»

In addition to the above, there were cases in which, despite it being recognized when assessing contract risks in continuing audit contracts that management had not provided necessary information during the previous year's audit, the integrity of management of the audited company was not considered from the viewpoint of inappropriate limitation in the scope of work, such as a limitation on the scope of the audit, and cases in which the integrity of management of the audited company was not considered based on responses being taken to address the disclosures of significant deficiencies in entity level controls and process level controls, even though such deficiencies were identified.

It should be noted that, not only on accepting but also on continuing audit contracts, decisions should only be made after identifying engagement risks on the basis of information ascertained and considering

response measures to address these risks.

Case 3: Securing audit resources



With regard to the continuance of audit engagements, the audit firm requires engagement partners to obtain approval from EQC reviewer after evaluating the degree of contract risk, taking into account such factors as the integrity of the audited company, audit implementation risks, and the need to secure audit resources.

However, when examining whether or not to continue the audit engagement, the engagement team estimated the planned audit hours for the current period audits as being at the same level as the planned audit hours for the previous period, even though the actual audit hours for the previous period far exceeded the planned audit hours. **The engagement team did not consider a specific method for significantly reducing the actual audit hours for the previous period, or the specific number of hours that could be reduced by such method, while maintaining high-quality audits.**

Furthermore, when approving the continuance of the audit engagement, EQC reviewer did not consider the reasonableness of the scheduled audit hours estimated by the engagement team, and did not adequately consider whether the continuance of the audit engagement was appropriate.

(Quality Control Standards Statement No. 1, paragraphs 25; Auditing Standards Statement No. 210, paragraph 9 and No. 220, paragraph 11 and A7)

Case 4: Risk assessment procedures when accepting amendment audit engagement

Since an amendment audit engagement-covering multiple fiscal years was accepted shortly before the audit report deadline, borrowing audit documentation from the predecessor auditor, evaluating the adequacy of the predecessor auditor's audit procedures, and performing supplemental procedures as needed were difficult. Despite this fact, time and human resources needed for the audit were not sufficiently analyzed when accepting the engagement

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

«Points to Note»

Recent years have seen more than a few instances of listed companies being prompted by the discovery of inappropriate accounting to submit amendment reports of annual securities reports and, as is the case with ordinary financial statement audits, appropriate quality control of amendment audits must be ensured from the decision on whether to accept an engagement until submission of the audit report. When corrections of financial statements covering multiple fiscal years are anticipated, it is necessary to carefully consider the adequacy of the planned number of audit days because the auditor may need more time to obtain sufficient and appropriate audit evidence than in cases of normal audit engagement.

(2) Communication between the predecessor auditor and the prospective auditor

Points of focus

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

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

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

Whether the predecessor auditor responds honestly and clearly to inquiries made by the prospective auditor. In particular, in cases where information on material misstatements that have had or could have had an impact on the audit opinion is identified, whether such information is provided to the prospective auditor without omission;

- ▶ Whether the prospective auditor, in order to appropriately judge whether or not to accept an audit engagement, makes inquiries of the predecessor auditor on all matters required under the audit standards, such as reasons for the replacement of the audit firm and the status of responses to fraud risks;
- ▶ Whether the prospective auditor and the predecessor auditor mutually confirm and respectively create and store detailed records of the processes performed for the handover of the engagement;
- ▶ Whether the audit firm confirms that the handover is properly conducted, by having the engagement team report the status of the handover to an appropriate department or a person who does not belong to the engagement team; and
- ▶ Whether in cases where the conclusion of audit contract has been canceled or an existing contract has been terminated in response to illegal conduct, the predecessor auditor, pursuant to a request from the prospective auditor, provides the prospective auditor with all facts and information concerning confirmed and suspected illegal or suspicious conduct that the predecessor auditor deems that the prospective auditor needs to know prior to determining whether an audit engagement can be accepted.

Outline of inspection results

There were deficiencies in that inquiries to the predecessor auditor were not appropriately conducted, and that the predecessor auditor did not correctly convey to the prospective auditor the management's views on integrity.

Causes of the deficiencies include: the partner who would take charge of the engagement prioritized quick acceptance and quick commencement of the audit engagement rather than performing careful risk assessment, solving any identified problems or performing procedures required by the audit firm in an adequate and timely fashion. There were also cases in which the PICOQC assumed that, if rules were put in place around the termination of audit contracts and the handover of audit engagements, the engagement team would comply with those rules and apply them appropriately.

Expected response

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

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

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

Case: Provision of information to the prospective auditor

When handing over an audit engagement, the audit firm communicated to the prospective auditor its awareness that there were no particular problems with the integrity of the management.

However, although the engagement partner at the audit firm had, in the application to withdraw from the audit engagement prepared as part of the firm's internal procedure for withdrawing, explained that there were significant matters with the integrity of the management, the engagement partner **did not accurately communicate this awareness regarding the integrity of the management during the handover to the prospective auditor**. Furthermore, the quality control department at the audit firm had not established procedures for identifying discrepancies between the minutes of the audit engagement handover meeting and the application to withdraw from the audit engagement.

(Quality Control Standards Statement No. 1, paragraphs 27 and 60; Auditing Standards Statement No. 900, paragraph 13)

《Points to Note》

In addition to the above, there were cases where the prospective engagement partner did not ask questions to the predecessor auditor, and cases where, due to a sharp increase in new audit engagements accompanying business expansion, consideration in accordance with the internal rules developed by the audit firm was not completed by the deadline when taking over audit engagements.

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

5. Recruitment, Education and Training; Evaluation and Assignment

(1) Recruitment, Education and Training

Points of focus

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

- ▶ Whether the audit firm has specific policies and procedures concerning recruitment, and whether they are properly operated.

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

- ▶ Whether the audit firm develops and provides education/training programs that sufficiently take into account the knowledge, experience, competence and capabilities of the professional staff;
- ▶ Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of the professional staff; this may include, for example, accurately identifying areas where professional staff tend to have less understanding and providing training focusing on these areas; and
- ▶ Whether the engagement partner provides 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 professional staff, emphasis was placed on the administration of the audit division rather than the administration of the audit firm as a whole, so recruitment was sometimes unsuited to the audit firm as a whole.

Furthermore, deficiencies in education and training for professional staff were observed, with some firms not providing effective training programs and others failing to provide opportunities for education and training in areas that require special knowledge.

Other deficiencies included a failure to have staff members who have not participated in mandatory training programs do so within the period prescribed by each audit firm despite having identified those persons.

The causes of these deficiencies included a lack of commitment to establishing an appropriate education and training system. For example, in some cases, the PICOQC, etc. depended entirely on engagement partners' direction and supervision in audit field work in encouraging staff members to acquire engagement-related knowledge. In other cases, the PICOQC was not aware of the need to check whether staff members have participated in mandatory training programs.

There were also cases in which audit firms lacked commitment to maintaining and improving audit quality by ensuring that audit team members have a certain level of engagement-related knowledge as a whole, as they left the improvement of skills to the discretion of individual audit practitioner, including part-time staff.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- ▶ The audit firm has set the required number of credits of training about fraud risk at 12 per year, higher than the necessary minimum of 6 credits per year prescribed by the JICPA, under its rules on training, as it believes that learning widely about examples of fraud at other audited companies helps to enhance “the ability to detect fraud” given the limited number of audit engagements performed for listed companies by the audit firm, etc.
- ▶ At training sessions to inform personnel of deficiencies identified in CPAAOB inspections and QC reviews, the audit firm informed personnel of specific areas highlighted and areas where improvements were required by presenting as much of the content of the audit documentation as possible.
- ▶ Staff who have not taken the mandatory training courses designated by the audit firm are obliged to take a test concerning the course content so that the firm is able to check the extent of their knowledge of audit engagements and the like.
- ▶ The audit firm recognizes that part-time professional staff account for a high proportion of professional staff, and is strengthening its recruitment of full-time professional staff and converting part-time professional staff to full-time professional staff as improvement measures. In addition, the firm is giving careful consideration to renewing contracts with part-time professional staff who engaged in for fewer days.

Expected response

Audit firms, when recruiting assistants to engagement partner, should appropriately estimate the necessary number of personnel in light of factors such as the current audit workload, the number of new audit contracts expected to be concluded, and the number of staff members expected to leave the firm in the future.

Furthermore, when providing education and training for audit teams, firms must maintain and improve the skills of engagement team members (including part-time and non-qualified engagement team members) by accurately identifying the areas of audit where they lack sufficient understanding and by preparing and implementing training programs that give due consideration to their respective knowledge, skills and experiences. Moreover, it is necessary to implement effective measures to ensure staff members' participation in mandatory training programs, such as conducting follow-up checks as to whether they have appropriately participated in the mandatory training programs designated by each audit firm. It is also important to enhance the effectiveness of education and training through reviews of

audit documentation, etc. so that knowledge and perspectives acquired through training programs can be fully put to use in audit field work.

Case 1: Recruitment of staff

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

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

Case 2: Effectiveness of training

- ① The audit firm's quality control rules stipulate that opportunities for necessary training and appropriate opportunities for fraud-related education and exercises should be provided to all audit team members. Its anti-insider trading rules obligate all partners and other staff members to participate in the training program concerning anti-insider trading efforts designated by the audit firm.

However, **although an accounting fraud case has occurred at an audited company, the audit firm has not provided opportunities for fraud-related training and exercises by implementing fraud-related training on its own, and so on**. Moreover, the audit firm has not designated a training program concerning anti-insider trading efforts in which partners and other staff members should participate as prescribed by its anti-insider trading rules.

(Quality Control Standards Statement No. 1, paragraphs 28 and F28-2)

- ② The audit firm obliged all partners and professional staff members to earn at least 40 credits per year from continuing professional education (CPE) programs offered by the JICPA, and also held two periodic training sessions per year of its own, along with other ad hoc training courses as needed. However, although the PICOQC was aware that partners and professional staff members lacked an understanding of audit standards and of the level of procedures required under current audit standards, **they failed to prepare and implement training programs that took into account the causes, based on a sufficient analysis of deficiencies identified in QC reviews**.

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

Case 3: Education and training of part-time professional staff

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

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

«Points to Note»

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

- **Audit firms left the maintenance and improvement of knowledge, competence/capabilities to individual effort of each professional staff. They only monitored the achievement status of practitioners' CPE (continuing professional education, Currently Continuing Professional Development (CPD))enrollment obligations, and did not develop an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced;**
- **Audit firms did not continuously conduct education and training to improve the audit quality control capabilities for engagement partners. It resulted in many deficiencies identified in certain individual audit engagements; and**
- **Audit firms did not conduct follow-up checks on the status of training with regard to persons who have not participated in mandatory training programs.**

In many cases, where deficiencies were identified in individual audit engagements, there was insufficient understanding of audit standards resulting from deficiencies in the education/training for professional staff. There are also many cases where the cause of deficiencies in individual audit engagements lay in the education and training of audit teams.

(2) Evaluation, Compensation, and Promotion

Points of focus

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

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

Outline of inspection results

Some audit firms did not evaluate audit team members based on professional skills (quality control-related skills in particular) and compliance with professional ethics.

The reasons given for this deficiency include: evaluation of professional staff and determination of their

remuneration were based on the CEO's subjective assessment; there were no major differences in the quality of audit engagements performed by professional staff; and it was important to ensure that there were no differences in evaluation among professional staff because the audit firm is a small organization.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

As a way of placing emphasis on audit quality, the audit firm adopted as many as 12 evaluation items related to quality control, including the level of understanding of audit procedures and accounting standards, among all 17 evaluation items of partners set by the firm.

Expected response

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

In addition, audit firms should properly evaluate professional staff's efforts to improve and maintain their competence and capabilities as well as their compliance with professional ethics, and appropriately reflect the results of the evaluation in compensation, promotion, and composition of engagement teams, in order to fully reward such efforts.

Case 1: Policies and procedures for evaluating partners

The audit firm stipulated that evaluations and compensation for partners were determined based on factors such as the length of the period since the appointment as a partner office, the quality control of audit engagements performed, and the partner's performance.

However, the audit firm did not establish specific evaluation standards for each evaluation item, nor did it clarify how each evaluation item would be reflected in partners' remuneration. As a result, the audit firm **did not have a system in which the evaluation of audit quality, etc. would be reflected in determining partners' remuneration**.

(Quality Control Standards Statement No. 1, Items 15, 17, 28, A5, A20, and A24)

Case 2: Evaluation of partners



At this audit firm, the CEO carried out evaluations of partners. Based on the performance of each partner, the CEO carried out individual evaluations of each partner on evaluation items such as "audit engagement," "audit quality," and "corporate management," and then carried out an overall evaluation on a three grade scale based on the results of the individual evaluations. In addition, as part of its policy for evaluating compensation based on overall evaluations, the CEO prepared a draft proposal for the following year's partner compensation based on each overall evaluation, and decided on the draft proposal for partner compensation after discussion at the partners' meeting. However, the process for evaluating partners and determining partner compensation at this audit

firm was devised independently by the CEO, and the audit firm did not establish rules relating to this process or disseminate them to partners. In addition, the CEO **did not establish specific evaluation standards for each item in the individual evaluations, and all partners had the same evaluation results for the "audit quality" evaluation item**. Furthermore, the CEO did not clarify how the individual evaluations would be reflected in the overall evaluation, and thus evaluations of partners were not carried out in an effective manner.

(Quality Control Standards Statement No. 1, paragraphs 15, 16, 17, 28, A5, A20, and A24)

Case 3: Evaluation of part-time professional staff

All partners at the audit firm were to carry out evaluations of part-time professional staff and, based on the results of these evaluations by partners, to decide through discussions at the partners' meeting the compensation of part-time professional staff engaged in audits.

However, the CEO and the PICOQC **had not clarified specific assessment items, the assessment methods and the quality control items to be emphasized in making assessments** when deciding on the compensation of part-time professional staff, and had not developed an effective system for evaluating them.

(Quality Control Standards Statement No. 1, paragraphs 28, 29 and 30)

《Points to Note》

In addition to the above cases, the following deficiencies were identified in the evaluation of engagement partners.

- Cases in which the audit firm's monitoring of the audit engagements for which a professional staff member was responsible was inadequate despite the fact that the professional staff member had been identified as having concerns about his / her quality control capabilities, etc.
- Cases in which the compensation of professional staff was determined by the CEO, etc. without being determined by the partners' meeting, although the internal rules on quality control stipulate that the compensation of professional staff members should be determined by the partners' meeting
- Cases in which clear standards were not established for the relationship between the evaluation results of factors to be considered in partner evaluation and the classification of base salary evaluation, as well as for the conditions for the payment of evaluation salary

There were also cases in which, although part-time assistants to engagement partner were subject to the same standard of personnel evaluation as full-time staff, the results of the personnel evaluation of part-time assistants to engagement partner were not sufficiently reflected in promotions/demotions or the composition of engagement teams out of concern that audit engagements could be impeded because part-time staff might quit their jobs if treated strictly.

Evaluation, compensation, promotion, etc., are vivid illustrations of the CEO's management policies, and they also have a major impact on an audit firm's climate. The importance of this must be given due consideration when seeking to formulate appropriate policies and procedures and implement them.

(3) Assignment

Points of focus

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

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

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

Outline of inspection results

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

The audit firm failed to appropriately conduct risk assessment based on the actual status of audited companies, or compose an engagement team based on risk assessment;

Audit firms appoint engagement partners mainly based on which audit department the partners belong to, without due consideration for their quality control skills;

The audit firm gave priority to acquiring new audit engagements without due consideration to the audit practitioners competence/capabilities and experience, or the performance capability of the audit firm as a whole; and

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

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- ▶ Following a merger, the audit firm has appointed partners in charge of individual audit engagements in a way that ensures that, after the expiry of each rotation period, each

engagement partner and the partner in charge of the EQC review is replaced by a person who was affiliated with a different pre-merger audit firm so that the firm is able to promote integrated operation.

- ▶ The audit firm ascertained the operational workload of each partner by means of a comparative analysis of actual engagement performance against the annual engagement plan drawn up by each partner, and revised assignment of responsibility if necessary.

Expected response

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

Case 1: Assignment of engagement partner

- ① When appointing engagement partners, **the audit firm did not identify the engagement partners' workload and level of involvement in each audit engagement , resulting in failure to conduct appropriate monitoring as to whether sufficient time was secured for engagement partners to perform their duties.**

(Quality Control Standards Statement No. 1, paragraphs 29 and A26)

- ② When accepting or continuing audit engagements, the audit firm identified audit engagements assessed as having high audit risk as high-risk audit engagements, and in consideration of the results of the risk assessment, determined the most suitable engagement partner and partner in charge of engagement quality control, and subject them to audit quality monitoring by the quality control division.

However, the audit firm **did not reconsider the assignment of engagement partners of some of the audit engagements selected as high-risk audit engagements from the perspective of identified audit risks, and did not select them as engagements subject to audit quality monitoring by the quality control division.**

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

Case 2: Composition of engagement team

Although the PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office, he/she left audit responses including composition of engagement teams to regional office entirely and did not provide any instruction for improvement as headquarter audit division. **This led to insufficient monitoring by the audit division in head office for the**

composition of engagement teams at the regional office.

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

Case 3: Assignment of IT auditors



With regard to the assignment of IT auditors for each engagement team, the individual responsible for IT had a policy of checking whether or not they were certified as "IT audit experts" as stipulated by the audit firm, and whether they had appropriate capabilities in light of the degree of complexity of IT in the audited company they are in charge of.

However, the procedures for assigning IT auditors at this audit firm were found to have the following deficiencies:

- The individual responsible for IT stated that when assigning IT auditors, the individual evaluated their expert knowledge and capabilities based on audit documentation prepared by the IT audit experts in past years and the engagement team's evaluation, but he **did not record the standards applied in this evaluation, as well as the evaluation process and results.**
- The IT audit division manager only monitored the effort of IT audits estimated by the engagement team with regard to the degree of complexity of IT at the engagement, and **did not perform an adequate evaluation based on the use of IT and the IT environment at the audited company.**

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

《Points to Note》

It is important for audit firms to conduct appropriate risk assessment in line with the actual situation of audited companies, and to compose engagement teams based on the results of such risk assessment. When forming an engagement team, the audit firm shall give due consideration to the quality control capabilities of engagement partners, and shall bear in mind that monitoring by the head office is important for ensuring audit quality.

6. Audit Documentation

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

Points of focus

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

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

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

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

Outline of inspection results

Concerning the preparation of audit documentation and supervision/review by superiors, many deficiencies, such as not documenting audit procedures performed by engagement teams and the basis for auditor's conclusion, were identified. Such deficiencies indicate that engagement teams did not perform appropriate audit procedures. Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were appropriate and such procedures were sufficiently and appropriately documented, deficiencies in audit documentation

were identified.

Causes for the identified deficiencies were as follows:

- As the CEO and the PICOQC place excessive trust in engagement partners, they assume that if the quality control policy and procedures are prescribed by the quality control rules, the partners will appropriately review audit documentation and provide instructions to and supervise their assistants and other staff;
- The professional staff did not fully understand the important role of the audit documentation at the time when the audit firm conducts quality control related tasks or explains their audits to external parties;
- Engagement partners did not consider the need to supervise assistants or review audit documentation and left the audit procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team about audited company's issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation; and
- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and concluded his/her understanding by simply hearing oral explanation or equivalent from the assistants.

(Observed effective efforts)

The following case constitutes an effective effort observed at an audit firm.

- ▶ The audit firm has divided up audit engagement processes granularly into detailed work tasks and documented the content, timing, workload, persons in charge, etc., of each work task, making it possible to carefully manage the progress of audit engagements by engagement partners, and it is conducting suitable and timely reviews of audit documentation as well as providing supervision and instructions to assistants to engagement partners.
- ▶ By providing guidance about how to document the performed audit procedures and obtained audit evidence, the audit firm ensured that audit teams were informed of the level of audit procedures to be performed for individual audit engagements, as well as the required status of audit documentation, including the conclusions reached by practitioners and the basis for reaching their conclusions.

Expected response

Some firms did not prepare audit documentation so that the audit procedures performed for individual audit engagements could be clearly identified. There were also many cases where the processes to reach an important conclusion could not be understood from the audit documentation. Therefore, audit firms should ensure that the professional staff is fully aware of the following items:

All procedures should be recorded clearly in the audit documentation, while confirming their adequacy and completeness; and

Professional staff must check that the audit procedures are consistent with the audit plan that was established, and describe the audit procedures performed, the results of the audit procedures and the audit evidence obtained in the audit documentation. In addition, the audit documentation must also include the conclusions reached by audit practitioners as well as the basis of professional judgments for reaching such conclusions.

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

Case 1: Review of audit documentation

- ① The engagement partner himself prepared audit documentation and reviewed audit documentation prepared by other engagement partners and assistants to engagement partners.

Because preparing the audit documentation for which he was responsible was time-consuming and **sufficient time had not been allotted him for reviewing audit documentation, however, the engagement partner did not adequately confirm if other engagement partners and assistants to engagement partners had carried out suitable audit procedures in dealing with risks and if they had obtained sufficient appropriate audit evidence.**

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

- ② Engagement partners lacked their understanding of procedures required by current audit standards and did not have adequate stance to reflect an understanding of the business of the audited company in audit plans and to verify the sufficiency of audit evidence and audit documentation. Furthermore, engagement partners **were not sufficiently critical because their assistants to engagement partners had audit experience at large-sized audit firms and had been engaged in current audit engagements for a long time, and they were not aware of the need to mutually check the audit documentation prepared by other partners.** Therefore, engagement partners did not sufficiently confirm whether appropriate audit procedures corresponding to risks had been performed and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.

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

Case 2: Instructions to and supervision of assistants to engagement partner

Engagement partners did not sufficiently identify and assess fraud risks in accordance with the audited company's business and its business environment and did not sufficiently plan procedures to respond to audit risks, and did not appropriately instruct or supervise audit procedures performed by assistants to engagement partners. Engagement partners also **did not conduct in-depth reviews of audit documentation from the perspective of whether management's assertions about accounting estimates were critically examined and whether sufficient appropriate audit evidence commensurate with the identified risks of material misstatement had been obtained.** (Quality Control Standards Statement No. 1, paragraphs 31; Auditing Standards Statement No. 220, paragraphs 14, F14-2, 15, F15-2, and 16)

《Points to Note》

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

In particular, there were cases in which those in charge of reviews focused on examining the appropriateness of accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards, and cases in which appropriate reviews based on information obtained from the audited company were not performed. It is important in reviews to critically review whether the level of audit procedures performed by assistants to engagement partners is consistent with current audit standards.

(2) Assembly of final audit files and control and retention of audit documentation

Points of focus

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

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

- ▶ Whether the audit firm has established appropriate policies and procedures for the final assembly of the audit file;
- ▶ Whether the audit firm completed the final assembly of the audit file by the due date, by appropriately applying the policies and procedures mentioned above;
- ▶ Whether the audit firm ensures the traceability of any correction made after the final registration of the audit documentation and the reason and process for the correction, from the perspective of reliability of audit documentation;

- ▶ Whether the audit firm has policies and procedures properly in place for audit documentation so that confidentiality, safe custody, integrity, accessibility, and retrievability are ensured; and
- ▶ Whether the audit firm secures the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation by appropriately applying the policies and procedures mentioned above.

Outline of inspection results

With regard to the management of audit documentation, audit firms have not yet established specific procedures for assembly of final audit file and the management of audit documentation. Some audit firms have already completed the assembly of final audit file before documentation of significant audit procedures had been completed. Some audit firms have not conducted bookkeeping of audit documentation. In addition, audit firms have not established or implemented policies and procedures for the removal of audit documentation and physical inventory. Furthermore, under the circumstances audit firms have introduced electronic audit documentation systems increasingly in recent years, because these systems are not being properly operated, the dates of preparation and review recorded electronic audit documentation are sometimes manipulated.

The main causes of the identified deficiencies included lack of awareness in the control of audit documentation, as well as the lack of understanding among professional staff regarding the importance of audit documentation at the time when the audit firm conducts quality control related tasks or explains their audit to external parties.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- From the viewpoint of ensuring the confidentiality, safe custody, information integrity, accessibility, and retrievability of audit documentation, the audit firm converted audit documentation into an electronic format using audit software available in the market in light of its own resources.
- The time required to complete assembly of final audit file is shorter than that required by audit standards, etc.

NEW

Expected response

Audit firms should set appropriate quality targets for the preservation and retention of audit documentation, taking into account factors such as the safe storage, integrity, accessibility or recoverability of underlying data, and controls over related technologies. Each audit firm should reaffirm the importance of the control and retention of audit documentation, and re-examine the final assembly of the audit file and the control and retention of audit documentation, under the initiative of the PICOQC, etc. It should ensure that the final assembly of the audit file is completed within an appropriate period after the date of the audit report, and take all possible measures to prevent the loss of audit documentation

and the leakage of confidential information.

Case 1: Assembly of final audit file

The audit firm established policies and procedures for the final assembly of the audit file and a deadline for completing the final assembly of the audit file in its quality control rules. In addition, if it became necessary to amend existing audit documentation or add new audit documentation after the deadline for completing the audit file documentation, the audit firm required to document (a) the specific reason for the amendment or addition, (b) the person who made the amendment or addition and the date of making the amendment or addition, and (c) the person who reviewed the amendment or addition and the date of reviewing, and developed a standard audit documentation format for this purpose.

However, the engagement partner **did not retain part of the audit documentation in the audit file, and even though some of the audit documentation had been amended after the deadline for completion of the documentation, the specific reasons for the need for amendments, etc. were not documented as prescribed.**

(Quality Control Standards Statement No. 1, paragraph 44; Auditing Standards Statement No. 230, paragraph 13)

Case 2: The date of preparation and review of the electronic audit documentation;



The audit firm's quality control rules stipulate that the person who prepared the electronic audit documentation and the date of preparation, as well as the person who reviewed the electronic audit documentation and the date of review shall be clearly identified through prescribed electronic signature procedures. However, the PICOQC did not prohibit post-hoc correction of the actual date of preparation and date of review of the audit documentation to a date prior to the date of audit report on the electronic audit documentation system, and did not instruct retention of the edit history of the audit documentation on the electronic audit documentation system.

As a result, although audit documentation was prepared and reviewed after the date of audit report in some audit engagements, a deficiency was identified in that the date of preparation and date of review of audit documentation recorded on the electronic audit documentation system was corrected to a date prior to the date of audit report, and **no measures were taken to prevent post-hoc correction of the actual date of preparation and date of review of audit documentation.**

(Quality Control Standards Statement No. 1, paragraph 31, 45 and A52)

《Points to Note》

In addition to the above, there are cases in which audit firms had not set out specific provisions on such matters as procedures and persons responsible for the final assembly of audit files, cases in which only the audited companies' names, the fiscal years and the total number of audit files were managed, with the contents of audit documentation stored in the audit files left unknown, and cases in which audit

documentation had not been properly carried forward , despite the fact that the adequacy of the audited company's accounting policies had been examined in previous fiscal years in individual audit engagements. In addition, in the process of promoting digitalization of audit documentation, it is necessary to pay attention to whether the electronic audit documentation system is appropriately established and operated in accordance with the quality control rules established by the audit firm.

7. Engagement Quality Control Review

Points of focus

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

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

- ▶ Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer, and whether they maintain objectivity and independence;
- ▶ Whether the EQC reviewer reviews the audit planning, significant audit judgments, and expressions of audit opinion in a timely manner;
- ▶ Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and examines the appropriateness of financial statements and the draft of audit report, etc.;
- ▶ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient and appropriate audit evidence, by reviewing the audit documentation; and
- ▶ Whether it has been appropriately documented that the procedures required by the audit firm's EQCR policies have been implemented, that the EQCR was completed before date of the auditor's report, and that there were no items deemed improper among the significant audit judgements and conclusions made by the engagement team.

Outline of inspection results

There were cases of deficiencies in the qualifications of EQC reviewers, such as failure to appoint persons with abilities corresponding to audit risks, as well as cases where EQC reviewers did not objectively review the sufficiency and appropriateness of audit evidence for significant audit items or the judgment process, and thus failed to identify significant deficiencies in audit procedures. In addition, deficiencies in the operation of EQC reviews were often identified as a result of analyzing the causes of deficiencies in individual audit engagements.

Causes of the identified deficiencies include the following issues:

- Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;

- In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review putting a priority on the audit engagements he/she was in charge of;
- Although the audit firm did not have a sufficient number of partners or other staff members with sufficient knowledge and experience to perform the EQC review, the PICOQC did not examine whether persons with sufficient qualifications to serve as EQC reviewers had been hired or fostered. In addition, due to excessive trust placed in the EQC reviewer, the PICOQC did not aware of the need to develop an adequate review system;

The EQC reviewer only verified the same matters as the deficiencies identified in the CPAAOB inspections and quality control reviews, etc., and did not verify the status of responses to the same matters similar to the deficiencies in the course of the EQC review;

- As the engagement team did not pass on to the EQC reviewer (including in cases outsourced to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the consideration of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters; and
- The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit work papers. In addition, the EQC reviewer lacked awareness to critically examining engagement teams' opinions.

(Observed effective efforts)

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

Besides the normal opinion engagement quality control review, the audit firm carried out preliminary engagement quality control reviews concerning important accounting estimates, such as the recoverability of deferred tax assets, at an early stage during the end-of-term audit, when the work of the engagement team and the EQC reviewer did not become hectic. As a result, engagement quality control reviews were performed with plenty of time and profound perspectives instead of being performed precipitously right before formulating audit opinions.

Expected response

When reviewing the audit planning, the EQC reviewer should review the risk assessment conducted and risk-related audit procedures planned by engagement teams from an objective perspective while taking into account not only audited companies' business activities and business performance trends but also business risks related to their business objectives and strategies.

In addition, the engagement team should not only discuss significant matters for forming the audit opinion with the engagement partner, but also review the audit documentation to determine whether the conclusions of the engagement team are supported by sufficient appropriate audit evidence. In particular,

at some small and medium-sized audit firms, partners who are EQC reviewers are usually extremely busy because they are engaged in business operations with a small number of partners, and because they give priority to their own audit engagements, it is difficult to conduct appropriate EQC reviews. For this reason, it is necessary to take actions to enhance and strengthen EQC reviews while reaffirming the importance of EQC reviews of audit engagements.

Case 1: Eligibility of the EQC reviewer

The audit firm's quality control policies stipulates that a person appointed to the post of EQC reviewer must have more than five years of practical audit experience after becoming qualified as a certified public accountant. However, while the firm was facing a shortage of persons with such practical audit experience, it placed the top priority on complying with the legally mandated rotation rules. As a result, with regard to audit engagements related to all large-sized companies, etc., the firm appointed a partner with less than five years of experience after becoming qualified as a certified public accountant as an EQC reviewer without considering the appointee's eligibility. (Quality Control Standards Statement No. 1, paragraph 38)

Case 2: Ensuring the effectiveness of EQCR

- ① Regarding EQC reviews, the audit firm stipulated in its quality control policy that if any material misstatements due to fraud emerged, the adequacy of the amended audit plan, and the sufficiency and appropriateness of audit evidence obtained should be reviewed at a partners' meeting.

However, **a review at a partners' meeting was not carried out when conducting an audit on amended financial statements arising from a material misstatement due to fraud.**

(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

- ② As only one person was in charge of conducting the EQC reviews for almost all of the audit firm's listed audited companies, he/she was unable to make sufficient time available for each review when several reviews coincided. Accordingly, **the EQC reviewer judged that understanding the engagement teams' explanation of key audit matters would be sufficient, and completed the review by concluding that there were no problems with the key judgments and conclusions of the engagement team, without sufficiently reviewing the relevant audit documentation.**

(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

- ③ **The EQC reviewer assumed that the engagement team had appropriately responded to important matters that had been discussed in ongoing communication with the engagement team.** Therefore, the EQC reviewer concluded that there were no problems with the important judgments and conclusions made by the engagement team without fully examining the related audit documentation with respect to the evaluation of and responses to fraud risk and significant risks and important judgments on significant accounting estimates made by the engagement team.



(Quality Control Standards Statement No. 1, paragraphs 36 and 37)

Case 3: Examination in the Financial Instruments and Exchange Act Audit

The engagement team did not inform the audited company that, at the time the audited company submitted its financial statements to EDINET, the response to consultations from the department in charge and the review of audit engagements had not been completed, and the firm was not in a position to make an official expression of its opinion; this led to the situation where the engagement team submitted the financial statements to EDINET that appeared as if the opinion had already been expressed, despite the fact that the EQC reviews had not been completed and the audited company's audit opinion was not yet expressed.

(Quality Control Standards Statement No. 1, paragraphs 14 and 41; Auditing Standards Statement No. 220, paragraphs 17)

《Points to Note》

The EQC reviewer needs to verify not only whether the accounting processes were suitable but also whether sufficient and appropriate audit evidence was obtained, and to make objective evaluations of engagement teams' explanations based on recorded facts by reviewing audit documentation.

In particular, with regard to audit engagements at regional offices, if the EQC reviewer at the headquarters, who is remotely located, conducts the EQCR via a videoconferencing system, etc., it is necessary to take actions such as sending the necessary audit documentation in advance..

The audit firm must also ensure that, even if it consigns an EQCR to a CPA outside the audit firm, the steps required to be taken are the same as assigning internal personnel to EQCR.

Furthermore, if the date of the audit report based on the Financial Instruments and Exchange Act is the same as the date on which the financial statements, etc. is submitted to EDINET, it is necessary to ensure sufficient communication with the audited company so that the financial statements, etc. is not submitted to EDINET before the examination is completed.

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

Points of focus

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

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

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

- ▶ Whether the audit firm assigns a person with sufficient and appropriate experience as the person responsible for the monitoring of the system of quality control, and vests the assigned person with sufficient authority;
- ▶ Whether the audit firm sets up monitoring system which appropriately understands the status of the establishment and implementation of a quality control system and identifies deficiencies; and
- ▶ Whether the audit firm evaluates the impact of deficiencies identified in the process of ongoing monitoring, and takes appropriate improvement measures in accordance with the results of such evaluation.

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

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

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

The CPAAOB inspects Statements of objection and doubt from the following perspectives:

- ▶ Whether an appropriate system for a statements of objection and doubt has been established;
- ▶ Whether proper investigation is conducted based on the accepted statements; and
- ▶ Whether appropriate corrective action is taken in response to the results of investigations of statements of objection and doubt.

Outline of inspection results

As shown in the case example section below, there were some cases where the persons responsible for implementing ongoing monitoring and periodic inspection (including external persons responsible for those activities) conducted reviews based on checklists, etc. merely as a matter of formality and in which the PICOQC did not give those persons pre-inspection instructions or conduct post-inspection monitoring of them. There were also many deficiencies concerning the operation of the quality control system, such as a failure to appropriately detect deficiencies regarding individual audit engagements in periodic inspections because the person in charge of inspection merely received explanations from engagement teams and failed to spend sufficient time on inspections.

The primary cause of those deficiencies was the audit firm's failure to allocate sufficient time and manpower to inspections due to a lack of sufficient understanding of the importance of monitoring the quality control system.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- From the viewpoint of securing audit quality, the audit firm selects engagements subject to periodic inspection so that each engagement partner's work is inspected at a frequency of around twice every three years.
- In order to detect quality control issues in audit engagements at an early stage and enable audit firms to take systematic action, audit firms select audit engagements to be monitored based on the results of analysis of published financial statements and timely disclosure information, and the content of audit documentation is checked by a monitoring staff separate from the EQC reviewer by the date of the audit report required under the Companies Act.

NEW

Expected response

Audit firms are required to establish and implement an organizational system that adequately performs the primary function of quality control monitoring, which is to enable audit firms themselves to discover and understand problems related to the system of quality control and voluntarily implement remediation measures. Specifically, audit firms should give due consideration to the need to carefully select individual audit engagements and identify the necessary inspection items in light of the economic

environment, the business condition of audited companies, and the results of the previous CPAAOB inspection or the quality control review. They also need to establish a system which ensures that qualified persons inspections conduct periodic inspections, rather than merely conducting superficial inspections based on the checklist, and to develop an environment to check the adequacy of the corrective measures taken against the deficiencies identified through inspections.

It should also be kept in mind that even when a CPA from outside the audit firm has been appointed as the person responsible for implementing periodic inspections, it is necessary to check whether the primary monitoring function is sufficiently exercised, just as it is when a person within the audit firm has been appointed to that post.

Furthermore, it is necessary to establish and implement a system which enables that statements of objection and doubt are recognized in a timely fashion, with appropriate investigations conducted as necessary. For example, one possible way to do that is to establish a system for receiving information from whistleblowers inside and outside the audit firm.

Case 1: Effectiveness of ongoing monitoring

The person responsible for ongoing monitoring of the quality control system only checked on the existence of relevant documents (rules, etc.) based on the ongoing monitoring checklist and the like, and **did not perform in-depth inspections of the content of the relevant documents**. As a consequence, the person failed to point out multiple deficiencies in the quality control system identified by CPAAOB inspections, including those relating to the establishment and implementation of internal rules.

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

Case 2: Effectiveness of periodic inspection

- ① **The persons in charge of periodic inspections merely conducted superficial checks based on the checklist without setting forth specific viewpoints of inspection and did not spend sufficient time on those checks. This resulted in a failure to conduct in-depth inspection from the viewpoint of whether engagement teams obtained sufficient and appropriate audit evidence.** Moreover, despite being aware that the time spent on inspections was short compared with the volume of the checklist and that the number of deficiencies identified was smaller than that of deficiencies identified in the quality control review, etc., the PICOQC did not evaluate the effectiveness of periodic inspections. In addition, the PICOQC did not develop a system to ensure the implementation of effective periodic inspections, for example by increasing the number of persons in charge of periodic inspections.

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

- ② The PICOQC just post a list of deficiencies detected during periodic inspections and the improvement measures required on a noticeboard in the office, so these matters were not

communicated adequately. Furthermore, the descriptions of the required improvement measures only covered the procedures that needed to be followed to address the identified deficiencies. **They were not based on the causes of the deficiencies.**

Furthermore, confirmation of the status of improvements was limited to engagements subject to periodic inspections, and the status of improvements with another engagements was not confirmed. (Quality Control Standards Statement No. 1, paragraphs 49 and 50)

«Points to Note»

In addition to the above, there were cases where persons were selected to carry out periodic inspection without consideration for their abilities with regard to audit quality, where a system was being implemented in a manner leading to collusion, e.g., the majority of partners were selected to carry out periodic inspection and they carried out inspection among themselves, and where audit engagements of specific engagement partners were not targeted for periodic inspection.

Other cases included a failure to develop an effective system for monitoring the quality control. For example, the monitoring of the quality control system was conducted solely by the CEO in some cases, while the frequency of periodic inspection of each audit engagements was too low in other cases.

From the perspective of analyzing deficiencies identified in the quality control review and preventing / discovering the identified deficiencies in advance, it is important to evaluate again whether periodic inspections were not limited to formal confirmation of the existence of audit documentation based on checklists, but were implemented effectively.

Case 3: Statements of objection and doubt

①Even though the representative partners received information about fraud at an audited company via a hotline, they **did not inform the PICOQC of the information they had obtained.**

Furthermore, even though the “Audit Quality Management Rules” stipulated that engagement partners in charge of audited companies should report how they considered whistleblowing from internal and external parties to the division in charge of quality control in writing, they did not make such reports.

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

②However, the audit firm did not set up a contact point for accepting information related to fraud risk received from outside the firm, and **did not establish a specific system for responding to information related to fraud risk received from outside the firm.**

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

«Points to Note»

Audit firms need to establish well-defined whistle-blowing systems so that expert personnel can raise complaints and doubts without being subject to unfair treatment. Audit firms that conduct audit

engagements in compliance with the Standards for Responses to Fraud Risks of Listed Companies, etc. need to receive information relating to fraud risks provided to them by inside and outside audit firms.

It should be noted that it is necessary to take measures to ensure the effectiveness of these systems for internal and external reporting, including not only establishing contact points but also establishing a system that enables appropriate examination by the audit firm, and making professional staff aware of such systems.

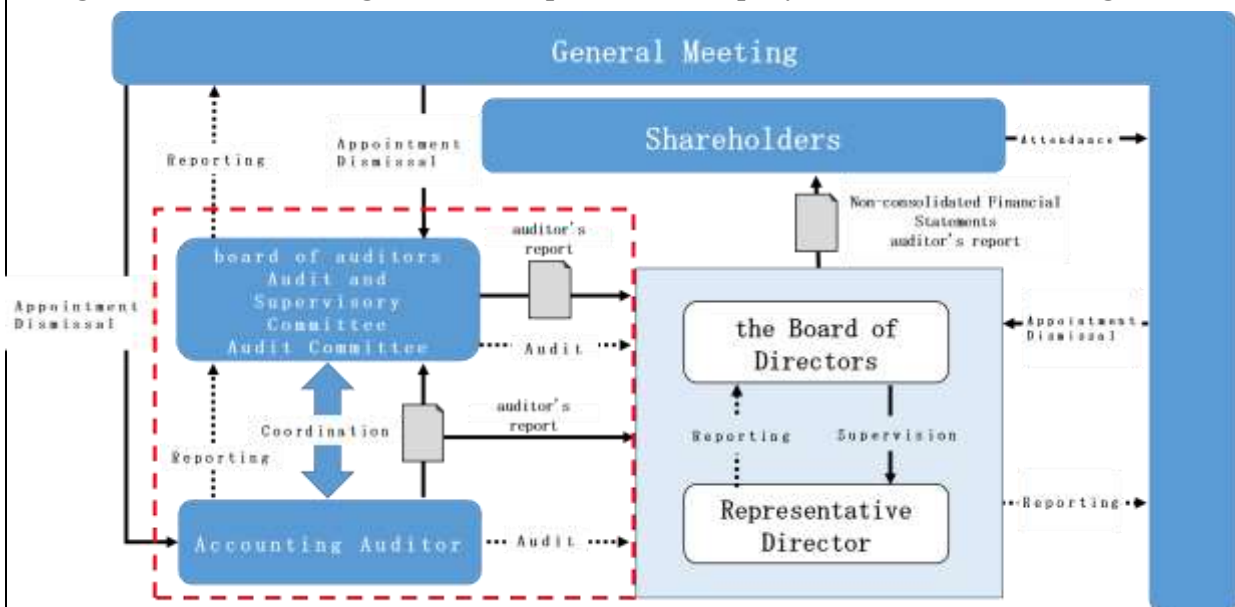
9. Cooperation with Company Auditors

(1) Communication between Accounting Auditors and Company Auditors

Points of focus

Accounting auditors and company auditors are obligated to ensure the appropriateness of financial statements under the Companies Act and applicable laws. To perform this obligation, it is important that they cooperate through actively exchanging information and opinions, for example, they should share information identified during audits in a timely manner, or company auditors should understand the status of QC of audits undertaken by accounting auditors. (Refer to [Figure 5])

[Figure 5] Reference image: Relationship between Company Auditors and Accounting Auditors



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

In light of the importance of collaboration between accounting auditors and company auditors as described above, the CPAAOB inspects whether policies and procedures for communication with company auditors and responses when fraud, etc. is detected are appropriately established and implementation systems are developed and established from the following perspectives:

- ▶ Whether suitable provisions, requiring timely communication with company auditors at each phase of audits (planning, conducting, and reporting) and share of necessary information for enhancing both sides' audit work, have been stipulated;
- ▶ Whether a procedure in which, for example, basic forms and model sentences are prepared, has been put in place so that suitable explanations of the results of CPAAOB inspections and the results of quality control reviews are reported to audited companies in writing; and
- ▶ Whether the audit firm has properly established policies and procedures concerning responses to

non-compliance.

Inspection of communications with company auditors are carried out from the following perspectives:

- ▶ Whether communication with company auditors concerning the accounting auditor's responsibilities, the scope of the planned audit, and an overview of its timing is clearly being carried out ;
- ▶ Whether explanations of the results of CPAAOB inspections and quality control reviews are suitably provided in writing to audited companies ;
- ▶ Whether information on audits is being properly obtained from company auditors ;
- ▶ Whether issues that are discovered during accounting audits and deemed to be important are conveyed in a timely manner to company auditors, etc. responsible for overseeing the financial reporting process; and
- ▶ Whether accounting auditors and company auditors cooperate and engage in effective two-way communication.

Outline of inspection results

As the need for collaboration between accounting auditors and company auditors has been widely accepted among relevant persons, efforts have been made to develop and maintain an environment to facilitate communication between them. As a result, periodic communication has been promoted, although the depth of collaboration may vary case by case.

Audit firms are following the principle of reporting the results of the CPAAOB inspection or the quality control review to company auditors in writing in a timely manner. On the other hand, as shown in the example case section below, due to a lack of understanding of the items requiring communication, there were some cases in which communication was inadequate or in which audit firms, despite having received notification of the results of the quality control review from the JICPA, did not communicate the results to company auditors.

Expected response

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

Auditing Standards Statement No. 260 ("Communication with Company Auditors) revised in February 2019 specifically seeks to enhance communication on particularly important matters when conducting audits, and it concretely manifests provisions on communication with company auditors, e.g., specifically describing the details to be conveyed to company auditors, regarding the results of quality control reviews and CPAAOB inspections and disciplinary actions taken by regulatory authorities and JICPA, as well as the methods by which this information is to be conveyed, as part of explanations of

the establishment and implementation of accounting auditors' quality control systems (Note 1, Note 2). Accounting auditors need to improve the effectiveness of audits through information sharing with company auditors about every stage of the audit – from the audit planning to the implementation of audit procedures and the formation of an auditor's opinion – and significant circumstances identified in the process, exchange views on audit quality control issues highlighted in the results of CPAAOB inspections and quality control reviews, and actively promote collaboration with company auditors. This collaboration will help ensure and improve audit quality as well as enhance/strengthen corporate governance at audited companies.

In addition, the 2018 revision of auditing standards and related revisions to the Auditing Standards Report required the inclusion of Key Audit Matters ("KAM") in audit reports. KAM are to be determined from among those matters discussed between accounting auditors and company auditors and the introduction of KAM has made in-depth communication between accounting auditors and company auditors all the more important.

Audit firms need to establish systems to support engagement teams so that engagement teams can suitably pursue effective two-way communication with company auditors.

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

(Please refer to "III. Handling of Inspection Results" in the "Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board" published on the CPAAOB's website)

(Note 2) In principle, any disclosure, including whether or not the audit firm is being inspected by the CPAAOB, is not permitted during the inspection.

Case: Communication with company auditors

- ① The engagement partner did not sufficiently understand the audit standards pertaining to communication with company auditors and thus **did not convey to company auditors the contents of and the steps taken in response to the “Quality Control Review Report” and the “Follow-up Review Report” received from JICPA** that are very useful for company auditors when selecting accounting auditors.

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



②The engagement team did not communicate sufficiently with the company auditors, as it failed to provide reports on the following matters:

- **Uncorrected misstatements which came to light after the issuance of the audit report on the Companies Act audit;**
- **The draft of the written representations by the auditor in an audit under the Financial Instruments and Exchange Act.**

(Auditing Standards Statement No. 260, paragraph 13 and 14; No. 600, paragraph 48; and No. 610, paragraph 16)

《Points to Note》

Auditor should keep in mind that they must communicate with company auditors on matters required in the Auditing Standards Report in a timely basis. For example, the timing of communication regarding the draft of the written representations and communication regarding independence should be determined based on measures that company auditors are expected to take. In addition, if there are any changes in the audit plan, such as changes in significant risks during the term, or any changes in matters communicated with company auditors, such as uncorrected misstatements discovered after the issuance of the Companies Act Audit Report, it is necessary to communicate with company auditors again in a timely manner. Furthermore, when conducting both Financial Instruments and Exchange Act audits and Companies Act audits of audited companies, the scope of audits and the date of the audit report differ. Therefore, even at the final stage of Financial Instruments and Exchange Act audits, it is necessary to communicate with company auditors on matters required in the Auditing Standards Report, such as draft management agreements and the results of internal control audits. It should be kept in mind that when communicating verbally with company auditors, the auditor must record in the audit documentation when, with whom, and on what topics the communication was conducted.

(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 (a fact such as a violation of laws and regulations) of the audited company, the auditor is obligated to notify company auditors thereof so as to encourage the audited company to implement voluntary corrective action (see Article 193-3 of the Financial Instruments and Exchange Act). In light of the importance of such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

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

Thoroughgoing efforts are being made to familiarize partners, etc., e.g., examples of notifications to be sent to company auditors of audited companies when facts of a non-compliance have been discovered are being presented.

Additionally, as a result of the audit firm having provided notice to the entity in accordance with Financial Instruments and Exchange Act Article 193-3 about matters that could adversely impact the appropriateness of financial documents, the entity revised its Financial statements and sought to reinforce its systems for suitable disclosure.

Expected response

It should be kept in mind that in the event of detecting any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by facilitating audited companies to make corrections, including considering whether to give notice under Article 193-3 of Financial Instruments and Exchange Act.

A support system for engagement teams must also be established so that experts are able to provide appropriate opinions when audit judgments about fraud or non-compliance are made.

Please refer to "Practical Guidelines for Audits of Financial Statements Included in Amendment Reports" (revised in January 2023), Auditing Standards Statement 560, Practical Guidelines No. 2, published by the JICPA, for points to be noted in order for auditors to take appropriate actions in audits of amended financial statements included in amendment reports for financial statements, interim reports, and quarterly reports.

III. Individual Audit Engagements

Audit Engagement Performance

Summary

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

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

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

Furthermore, cases that have continued to appear since being identified in previous program years and identified at multiple audited companies cases are presented with the mark:



Analysis of deficiencies

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

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

- Insufficient consideration for suitability of further audit procedures to audit risk and the sufficiency and appropriateness of audit evidence;
- Lack of an attitude of professional skepticism required of an auditor; and
- Insufficient understanding of the level of procedures required by current audit standards and the Auditing Standards Statement.

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

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

1) Risk assessment at the audit planning stage

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

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

2) Evaluation of obtained audit evidences

Auditor have to conclude whether sufficient and appropriate audit evidences have been obtained. If not, he/she needs to perform additional audit procedures. In principle, whether sufficiency and appropriateness of obtained audit evidence should be checked through means such as a review by superiors, but there were cases in which the obtained audit evidence was not sufficiently evaluated (refer to "1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits"(4) and "3. Audit Evidence")

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

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

Auditors should always strive to improve their professional skills and accumulate knowledge gained through practical experience as professional experts. They are also required to conduct audits with due care as professional experts and professional skepticism throughout the entire audit process. In this regard, there were cases in which, for examples, they failed to perform the procedures for verifying the reasonableness of the management's assertions such as the feasibility of business plans used in accounting estimates due to a lack of professional skepticism (refer to "4. Auditing Accounting Estimates).

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

(3) Insufficient understanding of the level of procedures required by current audit standards and the Auditing Standards Statement.

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

- Cases in which the engagement team did not identify and assess fraud risks according to the types of

revenue and transactions of the audited company (refer to "1. The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements " (2)), or did not perform sufficient audit procedures suited to fraud risks (refer to "1. The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" (3))

- Cases in which substantive procedures were not performed for significant account balances (refer to "2. Risk Assessment and Response to Assessed Risks" (3)).
- Cases in which the reliability of basic data was not evaluated in the substantive analytical procedures (refer to "3. Audit Evidence" (3)), or in which sufficient and appropriate evidence was not obtained when the difference between the booked value and the estimated value was larger than the tolerable level of difference (refer to "3. Audit Evidence" (3)).
- Cases where the suitability and reliability (accuracy and completeness) of information used as audit evidence was not verified (refer to "3. Audit Evidence" (1))
- A case where accounting estimates for the previous fiscal year were not considered in evaluating management's estimates for the current fiscal year (refer to "4. Audit of Accounting Estimates"(4)), or a case where the reasonableness of management's assumptions and the reliability of basic data were not considered (refer to "4. Audit of Accounting Estimates"(4))
- Cases in which the specific procedures to be performed by component auditors in order to address significant risks related to group financial statements were not understood or considered in group audits (refer to "5. Group Audit," Case 4), in which the appropriateness of risk-related audit procedures was not evaluated (refer to "5. Group Audit," Case 8), or in which the matters reported by component auditors were not evaluated (refer to "5. Group Audit," Case 8).
- Cases where the necessity of Auditor's expert has not been considered (refer to "6. Using the Work of Auditor's experts").
- Cases in which, in audits of internal controls over financial reporting, the adequacy of the scope of internal control was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (1)) or in which the impact of the identified material misstatements on the audit of internal controls was not examined (refer to "7. Audit of Internal Control over Financial Reporting" (3)).
- Cases in which procedures not performed are listed as KAM (refer to "8. Key Audit Matters (KAM)").

If the engagement team does not sufficiently understand the level of procedures required by current audit standards and the Auditing Standards Statement, it will not be possible to obtain sufficient appropriate audit evidence from the audit procedures performed, leading to deficiencies in audit procedures.

Expected response

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

according to the requirements of standards of audit in order to reduce audit risk to a reasonably low level. There continue to be many cases where engagement teams argue “deficiency in audit documentation” when identifying deficiencies in individual audit engagements. This argument means that the team actually performed audit procedures but neglected to document them.

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

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

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

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

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

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

(Reference)

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

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
1. The Auditor's Responsibilities Relating to Fraud in Financial Statement Audits	Auditing Standards Statement No. 240, Paragraphs 25, 29, 31	<ul style="list-style-type: none"> ➤ Whether the engagement team easily limits fraud risks. ➤ Whether the engagement team designs and implements adequate audit procedures suited to the identified fraud risks. ➤ Whether the engagement team performs procedures to respond to audit risks, such as verifying evidence, for all journal entries extracted in the journal entry test.
2. Risk Assessment and Response to Assessed Risks	Auditing Standards Statement No. 330, Paragraphs 17, 20	<ul style="list-style-type: none"> ➤ Whether the engagement team plans the nature, timing, and extent of risk-related audit procedures, in accordance with the assessed risks of material misstatement at the assertion level. ➤ Whether the engagement team designs and implements substantive procedures for important transaction types, account balances, and notes, etc., regardless of the degree of the assessed risks of material misstatement.
3. Audit Evidence	Auditing Standards Statement No. 500, Paragraphs 5~8; No. 520, Paragraph 4, 6; No. 530, Paragraphs 7; No. 570, Paragraph 15	<ul style="list-style-type: none"> ➤ Whether the engagement team confirms that it has obtained sufficient appropriate audit evidence for the purpose of each audit procedure for the dual-purpose test. ➤ Whether the engagement team evaluates the competence, capabilities and objectivity of experts employed by the management, and examines the appropriateness of the experts' work. ➤ Whether the engagement team examines the reliability of data prepared by the audited company. ➤ Whether, when performing substantive analytical procedures, the engagement team examines the reliability of the data, the accuracy of the expected values, and reason of any differences that exceed the acceptable level.

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		<ul style="list-style-type: none"> ➤ Whether, when performing audit sampling, the engagement team examines the validity of the sample selection method and sample size. ➤ Whether the engagement team examines, based on specific audit evidence, whether the management's response measures relating to the assessment of the going concern assumption are effective and feasible.
4. Auditing Accounting Estimates	Auditing Standards Statement No. 540, Paragraphs 13, 21~23; No. 500, Paragraph 8	<ul style="list-style-type: none"> ➤ Whether the engagement team examines the appropriateness of policies established by the audited company, such as inventory valuation rules and the grouping for impairment judgement of fixed assets. ➤ Whether the engagement team examines the reliability of data prepared by the audited company when audit of accounting estimates. ➤ Whether the engagement team examines the audited company's material assumptions, such as the feasibility of the business plan, based on concrete evidence. ➤ Whether the engagement team considers and evaluates all relevant audit evidence obtained in the course of the audit, including contradictory information. ➤ Whether the engagement team evaluates the appropriateness of the work of experts used by the management as audit evidence. ➤ Whether the engagement team examines whether expert skills and knowledge are necessary for the engagement team, including whether or not the use of auditor experts is necessary.
5. Group Audit	Auditing Standards Statement No. 600, Paragraphs 29, 30, 39, 40~42	<ul style="list-style-type: none"> ➤ Whether the engagement team is appropriately involved in tasks undertaken by component auditors. ➤ Whether the engagement team comprehensively

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		<p>communicates to component auditors the significant risks and related parties involved in the group financial statements.</p> <ul style="list-style-type: none"> ➤ Whether the engagement team sufficiently evaluates the audit procedures performed by the component auditor in response to audit risks. ➤ Whether the engagement team has taken necessary additional actions as a group engagement team in response to the component auditor's report;
6. Using the Work of Auditor's Experts	Auditing Standards Statement No. 620, Paragraph 6	<ul style="list-style-type: none"> ➤ Whether the engagement team examines the necessity of using the work of experts when specialized knowledge is required;
7. Audit of Internal Control over Financial Reporting	<p>Auditing Standards Statement No. 265, Paragraph 6,7</p> <p>No. 610, Paragraph 13, 14, 19</p> <p>Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, Paragraphs 97, 101, 112, 187</p>	<ul style="list-style-type: none"> ➤ Whether the engagement team examines consistency between the scope of risk assessment in financial statement and that of effectiveness evaluation of internal controls conducted by management. ➤ Whether the engagement team examines the impact on internal control audit of misstatements and internal control deficiencies identified in the course of the financial statement audit. ➤ Whether, in cases where the engagement team uses the work of internal auditors, the engagement team evaluates the objectivity and capabilities of the internal auditors and evaluates the appropriateness of the work to be used, and whether the scope of use of internal auditors is appropriately determined according to the degree of the risk of material misstatement;
8. Key Audit Matters (KAM)	Auditing Standards Statement No. 701, Paragraph 12	<ul style="list-style-type: none"> ➤ Whether the engagement team performed the audit procedures described as an audit response to KAM.

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

Points of focus

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

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

and planned responses to audit risk to include audit procedures that are specifically responsive to the types of possible fraud if it determines that any suspected material misstatement due to fraud exists; and

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

Outline of inspection results

As examples of deficiencies in audit procedures relating to fraud risks in financial statement audits, there were cases in which the engagement team did not sufficiently examine whether unusual or unexpected relationships identified through audit procedures could indicate the risk of material misstatement due to fraud.

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

In addition to the above cases, there were cases in which the engagement team assessed that the impact of the misstatement due to fraud on the financial statements was limited without fully examining the impact of the misstatement on the financial statements because it occurred on an isolated basis.

(Observed effective efforts)

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

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

Because of the commonality in revenue types and transaction formats between the parent company and its sales subsidiaries, the group engagement team conducted a centralized risk assessment and proposed further audit procedures to address fraud risks pertaining to revenue recognition by the audited corporate group inclusive of the parent company and key sales subsidiaries that constitute significant components

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- In order to prevent the omission of fraud risks pertaining to revenue recognition, the audit firm develops a sample work paper within the firm in which all transaction types (business flows) are listed so that the total sales for each transaction type (business flow) matches the amount of sales recorded in the general ledger, and each transaction is examined what fraud risks should be identified.

Expected response

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

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

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

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

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

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

If auditors have identified circumstances that indicate material misstatement due to fraud during the process of audit procedure, they should determine whether the assessment of the risks of material misstatement due to fraud is still appropriate. Furthermore, if auditors have identified circumstances that indicate the possibility of a material misstatement due to fraud, they should make inquiries of and ask for explanations from the management, and they should perform additional audit procedures in order to determine whether the suspected material misstatement due to fraud exists. In cases where there are

suspicious about a possible material misstatement due to fraud, such as when the management's explanations are considered to be not reasonable, it is necessary to keep in mind the need to modify their risk assessment and designed further audit procedures and perform audit procedures that are specifically relevant to the type of fraud that may be assumed.

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

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

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

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

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

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

《Points to Note》

Engagement teams should exercise professional skepticism to identify fraud risk factors, such as motivations or pressures to commit fraud, or events or conditions that provide opportunities to commit fraud, and assess the risks of material misstatement due to fraud, by identifying audited companies' transaction types, industry practices, and past fraud cases. To this end, it is important that engagement teams engage in substantive discussions, with the engagement partners providing leadership. In addition to the above examples of deficiencies, there were cases in which the engagement team's discussion of fraud risks was only a formality, and the engagement team did not substantially discuss the risks considered from fraud cases published to date in relation to the audited company's characteristics, such as industry type and governance. There were also cases in which the engagement team's communication with management and company auditors regarding fraud was only a formality, and the information obtained from the communication was not reflected in the risk assessment.

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

Case: Identifying and assessing fraud risks in revenue recognition

- ① The audited company is engaged in business A and B. In both businesses, transactions for which the price per each transaction is relatively small account for the majority of all transactions.

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However, in business B, transactions for which the price per transaction is high occur several times a year.

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

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

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

FREQUENT

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

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

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

FREQUENT

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

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

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

NEW

FREQUENT

- ④ In examining fraud risks associated with revenue recognition at an audited company that sells nursing care products and welfare equipment, the engagement team identified "motive and pressure" for sales personnel to perform fraud because they have pressure to meet sales targets, and also identified "fraud risk of sales personnel booking fictitious sales" based on examination of other fraud risk factors.

However, despite the engagement team **identifying "motive and pressure" for sales personnel to perform fraud, the engagement team did not understand the content of the sales targets set by the audited company. In addition, the engagement team did not sufficiently examine the risks of material misstatement due to fraud associated with revenue recognition, such as by not examining the existence of "motive and pressure" to perform fraud for persons other than sales personnel.**

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

NEW

- ⑤ Company A, a sub-subsidiary of the audited company, granted the right to use content, etc. (license) to its sub-subsidiary Company B, and received license fees as consideration. The engagement team performed analytical procedures and found that the turnover period for all receivables held by Company A had lengthened to 20 months. However, the engagement team only obtained an overview of the related transactions with respect to Company A's sales to Company B, and **did not adequately examine whether the prolonged turnover period indicated represented a risk of material misstatement due to fraud.**

(Auditing Standards Statement No. 240, paragraph 22) [Large-sized audit firms]

⑥ With regard to sales at drugstores and pharmacies, the engagement team identified the risk of sales being fraudulently booked without going through the enterprise system through the direct entry of fictitious sales data into the accounting system. On the other hand, sales booked through the enterprise system represented sales of products to general customers and were comprised of small-value transactions, and the journal entry of sales was automatically implemented based on sales data recorded by store registers incorporating the point of sales system (POS registers), leaving little room for human intervention. Therefore, the engagement team did not identify fraud risks. It should be noted that when evaluating the status of design of internal control over store sales, the engagement team recognized the possibility that sales data recorded by POS registers might be modified during the process of being booked in the accounting system via the enterprise system.

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

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

《Points to Note》

As shown in the above example deficiencies, many deficiencies were observed in which: the engagement team identified and assessed fraud risks without fully understanding the type of revenue, transaction types, and business processes leading to revenue recognition at the audited company; in which the engagement team identified fraud risks only in areas where higher risks were considered to exist (e.g., fraud committed during a limited period of time, such as the last month of the fiscal year, fraud committed by the use of a miscellaneous account or new account, or fraud committed by specific employees such as sales personnel), while assuming the absence of fraud risks in other areas without conducting sufficient evaluation for committing fraud.

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


- When the audited company engages in multiple businesses within the consolidated group, it is necessary to comprehensively identify and assess fraud risks in accordance with those businesses' respective types of revenue and transactions.
- When considering fraud risk scenarios, it is necessary to fully understand the business processes leading to revenue recognition, based on the understanding of the audited company and the business processes, and examine where and how material misstatement due to fraud may occur in the financial statements.

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

Auditors must always be aware of the possibility of material misstatement due to fraud, and maintain professional skepticism throughout the audit process. For example, if the engagement team identifies unusual or unexpected relationships through the performance of analytical procedures, it is important that the engagement team carefully consider whether these may indicate risks of material misstatement due to fraud.

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



Case 1: Response to fraud risks in revenue recognition

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

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

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

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

-   ② The engagement team identified fraud risks related to revenue recognition for all direct sales transactions on the grounds that there were opportunities for sales personnel to falsify internal vouchers related to direct sales and to record fictitious sales. As a procedure to address this fraud risk, the engagement team performed a detailed test using the population of direct sales for the five business days before and after the year-end closing date. However, the engagement team **did not**

consider the appropriateness of including the five business days before and after the year-end closing date in the test.

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

FREQUENT

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

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

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

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

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

④At an audited company whose main business was to manufacture and sell automated service equipment to game parlors, the engagement team identified fraud risks in sales of game machines and the like and assumed a fraud scenario involving fictitious and early booking of sales by means of the forgery of order forms and other supporting documents by sales staff, along with the falsification of shipments by moving products to a warehouse secured by the audited company. When, amid this situation, the engagement team conducted journal entry tests as a procedure to address the aforementioned fraud risks, the team confirmed that for all 161 journal entries for the

year relating to product sales, the journal entry data showed that the corresponding account was accounts receivable, the summary was sales of system equipment, and the booked date was the last day of the month. As a result, the team concluded that there were no inappropriate or atypical journal entries and no material misstatements due to fraud in respect of sales of game machines and the like. However, when the engagement team checked of the aforementioned journal entry data, the team did not plan and perform further audit procedures responsive to the identified fraud risks, as the team **did not take into account the fact there was a low possibility of being able to identify the forgery of supporting documents or falsification of shipments by inspecting only the journal entry data.**

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

NEW

FREQUENT

- ⑤ The audited company engages in the construction industry, and recognize revenue of short construction periods at the point in time when the performance obligation is satisfied. The engagement team identified the risk of sales being booked ahead of schedule in the month of the account closing (March) as a risk of material misstatement due to fraud, and performed voucher matching on a sample of construction contracts for which sales were booked in the month of the account closing. However, the engagement team only performed reconciliation with a copy of invoice issued by the audited company, which was internal evidence, and **did not perform procedures to obtain stronger or more audit evidence than in cases where no fraud risk had been identified.**

(Auditing Standards Statement No. 240, paragraph 29 and No. 330, paragraph 20) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were many cases in which the design of audit procedures was inadequate. For example, insufficient understanding of the audited company and its environment, such as the characteristics of the business sector and sales channels, was the cause of failure to design sufficient audit procedures. Another case was that the design of audit procedures was inadequate because the engagement team did not specifically examine the types of fraud risks involved in each assertion. There were also cases in which the engagement team assumed fraud risk scenarios but reached conclusions without obtaining sufficient audit evidence, such as concluding that the assumed fraud risks had not materialized by merely asking questions of the audited company and performing analytical procedures such as year-on-year comparisons. In addition, there were cases in which the engagement team merely performed a formal reconciliation between books and vouchers and overlooked abnormal profit ratios and contract details that did not match the reality. There were cases in which the engagement team only performed inquiries of the audited company and performed reconciliation with documents for internal management prepared by the audited company when verifying the estimated total costs on a percentage-of-completion basis. For revenue recognition, Auditing

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

Case 2: Responses to significant transactions with related parties



①During the fiscal year under review, the audited company purchased from Mr. A, Representative Director and President, the shares of Company B for JPY 30 million, which Mr. A had purchased for JPY 30 million four years earlier, and recorded the acquisition as investment securities (the "Acquisition"). The engagement team determined that the Acquisition constituted a material transaction with a related party outside of the ordinary course of business. In addition, the engagement team reviewed the related agreement, the share price valuation report obtained by the audited company from an external expert, and the minutes of the Board of Directors meeting regarding the resolution approving the Acquisition. Based on these, the engagement team determined that there were no indications that the Acquisition was conducted for fraudulent financial reporting or to cover up the misappropriation of assets. However, the engagement team did not examine the reasonableness of the fact that the acquisition price for the share acquisition transaction by Mr. A was the same as the acquisition price for the Acquisition, even though the Acquisition had been executed approximately four years after the share acquisition transaction by Mr. A, and did not sufficiently examine the Acquisition from the viewpoint of the possibility of the Acquisition being conducted to cover up the misappropriation of assets.

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

②The audited company rehired employees that it had transferred to a specific group company in the past as employees of the audited company the current period, and also booked large profits by concluding a new contract to dispatch these employees to the group company. The engagement team identified unusual transactions involving these dispatch contracts that indicated indications of material misstatement due to fraud. As a result of questioning the directors of the audited company, the engagement team was told that similar actions would not be taken in the future in principle, but could be taken as an emergency measure to avoid a crisis at a company in the corporate group. However, the engagement team did not adequately examine the economic rationality of these unusual transactions, etc.

(Auditing Standards Statement No. 240, paragraphs F11-2, 32-2, F35-2) [Mid-tier, and small and

medium-sized audit firms]

《Points to Note》

Auditing Standards Statement No. 550, paragraph 11, provides that internal discussions "should consider the possibility of material misstatements being made in the financial statements due to fraud or error that may arise from the audited company's related party relationships and transactions." In addition, if the engagement team identifies significant related party transactions that are outside the audited company's normal course of business, the engagement team should review the contracts and other documents related to the transactions to assess whether: (i) the business rationality (or lack thereof) of the transactions suggests that the transactions were conducted for fraudulent purposes; (ii) the terms and conditions of the transactions are consistent with the audited company's explanations; and (iii) the transactions are appropriately processed and disclosed in accordance with the applicable financial reporting framework. The engagement team should also take note of the need to obtain audit evidence regarding the authorization and appropriate approval of the transactions. In evaluating the terms and conditions of transactions, if audit evidence obtained from outside experts, such as share valuation reports, is used, it should be noted that it is necessary to assess the appropriateness of significant assumptions, methods, and basic data used in the experts' work, depending on their significance. In particular, in owner-managed enterprises, owner-managers often exert strong influence, making it difficult for internal controls to function effectively in transactions with related parties. When performing audit procedures for transactions with related parties, the engagement team needs to obtain sufficient appropriate audit evidence, taking these characteristics into account.

(4) Addressing the risk of management override

Case 1: Journal Entry Test



① The engagement team identified the risks of management override for journal entries that met the following conditions, and selected them for journal entry testing:

- (a) Unusual journal entries, such as liability / expense or liability / revenue, that would not normally occur;
- (b) Journal entries ended with a run of identical numbers (zero) in the amount;
- (c) Journal entries with specific words ("confidential," "president," "instructions," etc.) in the description column.

The engagement team performed detailed testing on 2 of the 48 journal entries selected under the conditions in (a) above and 5 of the 75 journal entries selected under the conditions in (b) above. The engagement team also did not perform detailed testing on all of the journal entries selected under the conditions in (c) above because the impact on profits and losses was deemed to be minimal. However, the engagement team only performed detailed testing on some of the selected journal entries and **did not perform comprehensive detailed testing on the selected journal entries,**

even though it identified the risks of management override for journal entries that met the conditions in (a) to (c) above.

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

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

However, when excluding automated journal entries from the journal entry testing, the engagement team did not adequately consider the possibility of generating fraudulent automated journal entries due to inputting fraudulent data into the business system or directly correcting data using a privileged ID in the business system.

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

《Points to Note》

There were many cases where the engagement team did not exercise professional skepticism. For example, some engagement team easily concluded that extracted journal entries were not problematic and did not perform procedures to respond to audit risks, such as verifying evidence. Some engagement team also performed journal entry testing by merely setting extraction conditions without fully understanding the business processes for entering and adjusting journal entries.

The engagement team shall keep in mind that it needs to design and implement effective audit procedures after understanding that management is in a position to be able to falsify accounting records and prepare fraudulent financial statements by overriding 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 rationale for significant transactions

- ① The engagement team had determined that the transactions for the five accounts receivables of the audited company (whose fiscal year ended in March) were unusual because the receivables had become delinquent beyond the due date for payment and it was considering changing the collection conditions and collection methods. In addition, the engagement team received an explanation from the audited company regarding the recoverability of the above accounts receivable at the time of the first and second quarterly reviews for the current fiscal year. Subsequently, contrary to the explanation given at the time of the second quarterly review, the audited company explained to the engagement team that "all of the above accounts receivable were deposited in the accounts of

customers in the audited company's name and recovered in November and December of the current fiscal year." Therefore, the engagement team confirmed that the receivables had been deposited in these accounts.

However, although the engagement team **determined that it was unusual for the audited company to repeatedly consider changing the collection conditions and collection method for the above trade receivables after sales were recorded , the engagement team did not consider whether this situation indicated the possibility of fraudulent financial reporting, for example, by not being aware of the reason for considering changing the payment conditions and payment method from those at the time of the transaction.**

(Auditing Standards Statement No. 240, paragraphs 11, F11-2 and 31) [Large-sized audit firms]

- ②The engagement team was aware that six outsourcing costs of the audited company (whose fiscal year ended in March) had not been paid for a long time. In addition, in February of the current fiscal year, the audited company explained to the team that it had "received a complaint from a customer about the delivered goods, and reduced or planned to reduce the outsourcing costs in consultation with the outsourced manufacturer of the delivered goods," and the team recognized that the reduction of each outsourcing cost had been accounted for as of March 31, the end of the current fiscal year.

With regard to the above claims, the engagement team received an explanation from the audited company that "Each claim was not significant in terms of the amount of money for all related sales transactions, and the business of the client was not hindered and the impact was not significant. Each claim could not be handled by the contractor, so it was accepted by the audited company and handled by the sales representative." The team also obtained and reviewed the related request for approval (approved between late January and early February of the current fiscal year) and the detailed report (prepared and confirmed on March 31, the end of the current fiscal year). The team also obtained a delivery slip that stated the amount after the reduction and confirmed whether the amount had been reduced and the amount.

However, the engagement team **did not fully understand the details of the claims made by customers and the reasons why outsources were unable to respond, and it did not obtain sufficient audit evidence to support the audited company's assertions. As such, the engagement team did not evaluate whether these reductions in outsourcing costs indicated the possibility that these reductions had been made for the purpose of producing fraudulent financial reports.**

(Auditing Standards Statement No. 240, paragraph 31; No. 550, paragraph 5) [Large-sized audit firms]

《Points to Note》

Indicators that may suggest that significant transactions that are outside the normal course of business for

the audited company, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include (Auditing Standards Statement No. 240, paragraph A46) :

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

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

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

(5) Evaluation of audit evidence

Case 1: Identifying misstatements and responses to circumstances that indicate the possibility of a material misstatement due to fraud

- ① The audited company reported to the engagement team that it had discovered that two employees in Division A had placed an oral order for construction work without permission. The internal investigation into this matter had not been completed by the date of the audit report, and the full picture of the situation had not been clarified as of the same date. However, the audited company interviewed its business partners concerning the construction work in which two employees were involved, and as a result, it identified the omission of expenses and inventory related to this matter. Under these situation where the internal investigation by the audited company had not completed before forming audit opinion, the engagement team interviewed the Director and CFO about this matter. As a result, the engagement team was able to confirm that the division where the oral order

without prior consent was placed was limited to division A. In addition, given the scale of the construction work that the two employees were in charge of, the engagement team determined that it was unlikely that there would be an impact that exceeded the materiality threshold, and that the qualitative factors contributing to the fraud were not material. In addition, the above expenses and the amount of inventory not recorded were treated as an uncorrected misstatement.

However, **despite the fact that the whole picture of this matter was still unknown, the engagement team only asked questions of the CFO and did not sufficiently examine whether the uncorrected misstatement indicated signs of material misstatement due to fraud.**

(Auditing Standards Statement No. 240, paragraph 34, 35) [Mid-tier, and small and medium-sized audit firms]

- ②The audited company sold the land on which its head office and distribution center were located and the buildings on the sites to a company of which the audited company's shareholder, Shareholder A, was the representative director. The audited company booked the sale as gains on the sale of fixed assets.

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

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

(Auditing Standards Statement No. 240, paragraph F11-2, F35-2; No. 315, paragraph 27) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

Auditors should note that if they identify a misstatement, they should assess whether the misstatement is an indication of fraud, especially if management may be involved, and reassess the impact on their assessment of the risks of material misstatement due to fraud and on the type, timing and extent of the audit procedures performed. In addition to the above, there were cases where the engagement team did not exercise professional skepticism under circumstances that indicated material misstatement due to fraud, such as (I) cases where the team conducted formal inquiries with the audited company, did not critically

examine the answers, and did not examine the contradictory explanations from the audited company, and (ii) cases where the team only obtained answers through inquiries and did not plan or perform additional audit procedures. There were also cases where the engagement team did not appropriately assess the impact of misstatements, such as (I) cases where the team identified misstatements in the audit process but did not sufficiently examine whether they were indications of fraud, and (ii) cases where the team determined that the misstatements identified were indications of fraud but did not pay attention to the relationship with other aspects of the audit.

Case 2: Suspected material misstatement due to fraud

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

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

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

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

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

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

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

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

《Points to Note》

If the engagement team identifies the suspected material misstatement due to fraud, the team needs to revise its planned risk assessment and further audit procedure, and implement audit procedures that directly respond to the situation of possible fraud, including sufficient evaluation of the suspected material misstatement due to fraud, in order to obtain sufficient appropriate audit evidence regarding the suspicion. Furthermore, if the engagement team has identified fraud, or obtained information that indicates the possibility of fraud, the team must, in order to convey to the person responsible for preventing and detecting fraud relating to that responsibility, inform the appropriate level of management of such matters on a timely basis. The team also needs to inform the company auditors of such matters. In addition, if the engagement team suspects that management are involved or are on suspicion of being involved in fraud, the team must report this to the company auditors and hold consultations with the company auditors concerning the nature, timing and extent of the audit procedures required to complete the audit. The team also needs to demand that management take appropriate measures to correct problems. Depending on the nature of the fraud, it may be necessary to report this to the regulatory authorities.

2. Risk Assessment and Response to Assessed Risks

Points of focus

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

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

Outline of inspection results

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

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

Moreover, there were still engagement partners and audit assistants who did not fully understand the concept of a risk-based approach. As a result, there were several cases where the engagement team merely completed templates, such as the “audit tool” and the “documentation sample forms” provided by the audit firm or the JICPA, and did not perform appropriate risk assessment. There were also cases where the nature, timing and extent of the procedures actually taken in response to the assessed risks did not respond to the risks since the engagement team did not evaluate the adequacy of the assessed risks and procedures in the audit plan developed by using audit tools.

In addition, there were cases in which the engagement team did not perform substantive procedures despite having identified the risk of material misstatement, cases in which the absence of notes regarding important transactions with related parties was overlooked at an audited company engaging in a large volume of various types of transactions with relevant parties, cases in which the effects of the identified misstatement on the results of the test of internal control and on the substantive procedures were not considered, cases in which the engagement team lacked sufficient understanding of the overview of the audited company's information systems and of the company's general IT controls, and cases in which the engagement team did not sufficiently examine the appropriateness of the financial statement presentation and notes

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

The audited company is not only actively engaging in corporate acquisitions in order to achieve business growth but is also eagerly starting new businesses. With regard to new businesses, the company expects long-term growth in some cases and earns profits by selling businesses that started to show commercial promise. In addition, the company opts for business closure or selloff immediately once it has judged that it is difficult to continue operating new businesses. This reflects the significant effects that the management's decisions and judgments have had on the company's financial statements.

The engagement team understands the above situation and has requested to have a meeting with the management each month. In the meeting, the engagement team strives to grasp changes in the company's situation and in its business environment in an appropriate and timely manner by checking the management's present assessment of the results of corporate acquisitions and new businesses and by receiving detailed explanations about the matters determined by and reported to the board of directors directly from the management.

Expected response

Professional staff should pay due attention as professional experts and exercise professional skepticism. They should fully understand the audited company and its environment and assess risks through such understanding, and should carefully identify and assess risks by referring to this Case Report and the Audit Recommendations issued by the JICPA, based on a full understanding of the intent of Auditing Standards Report No.315, etc. In addition, when developing responses to audit risk, they should carefully

consider whether the procedures respond to the assessed risks and whether the procedures enable sufficient appropriate audit evidence to be obtained, including not only the types of procedure, but also the timing and the extent of the procedures. In order to do so, they should make sure sufficient hours are spent for not only substantive procedures but also for the audit plans.

Furthermore, some professional staff still do not recognize the importance of audit planning and have no understanding of the need, in audit plans, to link material misstatement risks and details of the procedures responsive to the assessed risks (the nature, timing and extent of the procedures).

Engagement teams must reconfirm the concept of the risk-based approach and the positioning of the audit plan in the current audit, and review the audit plan that they developed, according to the situation. Once again, an audit firm where deficiencies were identified in risk assessment and responses to the assessed risks must consider appropriate responses, such as re-educating professional staff who have failed to catch up with the current audit standards and responding in terms of the assignment of engagement teams.

(Revision of Auditing Standards Statement 315 "Identification and Assessment of the Risks of Material Misstatement")

Auditing Standards Statement No. 315, as amended in June 2021, requires separate assessment of inherent risk and control risk. Inherent risk assessment requires consideration of how and to what extent inherent risk factors (Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls) affect susceptibility of related assertions to misstatement.

(1) Audit planning

Case 1: Materiality

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

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

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

《Points to Note》

In addition to the aforementioned cases, there were also cases in which indicators affecting economic decision-making by users of financial statements were not fully evaluated; for example, with regard to indicators used in deciding materiality, in a situation in which the audited company had booked fictitious profits in past years, the engagement team used sales and net assets—indicators that do not take profits into consideration—rather than types of profit and loss, such as net income before income taxes or operating profit.

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

The audited company, whose main business is to operate nail salons, included franchise sales in the sales account because they were insignificant in the previous term. On the other hand, in light of the increase of sales in the current period, the audited company accounted for them as a separate account, the franchise sales account.

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

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

(Auditing Standards Statement No. 300, paragraph 9; No.315 (Before amendment in June 2021), paragraph 24 and 25) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition, there were cases where the engagement team did not identify significant risks that the Auditing Standards Committee Statement required it to identify, such as risks assessed as material misstatement due to fraud and significant transactions with related parties outside the audited company's normal course of business (Auditing Standards Statement No. 315, paragraph. 11 (10) 2)).

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

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

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

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

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

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

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10) [Mid-tier, and small and medium-sized audit firms]

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

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10 and 12) [Mid-tier, and small and medium-sized audit firms]



- ③ In valuing inventories (examining whether there has been a decline in profitability), the audited company deemed that the net selling value was the amount calculated by deducting the estimated costs necessary to make the sale from the average selling price for a certain period in the past for each product. If the net selling value was below the book value, the audited company determined that the profitability of the inventories had declined and recognized the difference as valuation losses on inventories in cost of sales.

However, the engagement team did not confirm whether the audited company had deducted the estimated costs necessary to make the sale from the average selling price when calculating the net selling value, and did not have a sufficient understanding of the audited company's inventory

valuation method (method for examining whether there was a decline in profitability).
(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 10) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In recent years, there have been multiple cases in which the engagement team did not sufficiently assess the appropriateness of accounting policies adopted by audited companies in relation to the application of the "Accounting Standard for Revenue Recognition" (ASBJ Statement No. 29). The engagement team needs to assess whether the company's accounting policies are appropriate for the business, comply with the applicable financial reporting framework, and are consistent with accounting policies applied in the industry to which the company belongs, by understanding the entity and its environment. In addition, there are cases where fraudulent financial reporting is conducted in businesses other than the principal business. Therefore, when identifying and assessing the risks of material misstatement at the assertion level, the engagement team needs to take into account differences in the business environment and related internal controls of each business.

In other cases, the group engagement team did not comprehensively understand the businesses and distribution channels at the group level. There were also cases in which the group engagement team did not examine the risks of misstatement for each business process, and did not consider the possibility that effective audit procedures or audit evidence that should be obtained may differ due to differences in the types of transactions for the same account.

Case 2: Identifying and assessing the risks of material misstatement

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

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 25) [Large-sized audit firms]

《Points to Note》

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

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

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

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

However, the engagement team **did not perform the procedures to understand what sort of control activities were performed to address the above-mentioned significant risks** although the engagement team understood the overview of transactions relating to the business.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 28) [Mid-tier, and small and medium-sized audit firms]

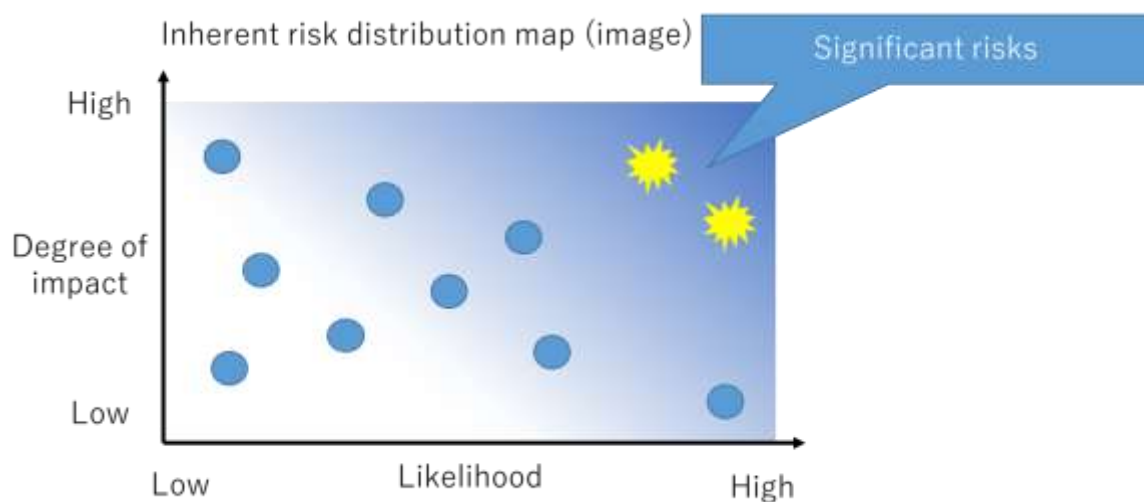
《Points to Note》

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

It should also be noted that the definition of significant risks has been changed to the following in the revised Auditing Standards Statement No. 315 (refer to Figure 6).

- (I) Risks of material misstatement assessed to exist in the areas of highest inherent risk based on the degree to which inherent risk factors affect a combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement (quantitative and qualitative impact)
- (ii) Risks of material misstatement that are determined to be treated as significant risks in accordance with the requirements of other audit standard reports
- Risks assessed as risks of material misstatement due to fraud.
 - Risks related to management override of controls;
 - Significant related party transactions outside the entity's normal course of business;

[Figure 6] Reference image: Distribution of inherent risk



(3) The auditor's responses to assessed risks

Case 1: Audit procedures for risks of material misstatements

FREQUENT

- ① The engagement team identified risks of material misstatement with regard to sales of some businesses among sales reported by the audited company on its non-consolidated financial statements. Based on its understanding that the design and operation of internal controls for the sales of these businesses were effective, the engagement team performed confirmation procedures for confirmed the balance of receivables with the end of the previous month of the fiscal year end as the record date, and roll-forward procedures for the remaining period, as well as performed procedures to respond to fraud risks with respect to sales reported in the fiscal year end. However, although the engagement team identified risks of material misstatement of sales for this business, the engagement team **did not perform substantive procedures for sales recorded before the month before the end of the fiscal year.**

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

NEW

FREQUENT

- ② A consolidated subsidiary of the audited company had incurred early recognition of expenses due to cost transfer in the past. Therefore, as a measure to prevent recurrence, the consolidated subsidiary introduced the same production control system as that of the audited company, and thereafter, the content of cost transfer was required to be registered in the system, and was monitored by the control division of the audited company.

In the audit for the current fiscal year, the engagement team identified a risk that expenses would be recorded early due to cost transfer at the consolidated subsidiary (hereinafter referred to as "risk of early recording of expenses") as a significant risk. As a procedure for dealing with the risk, the engagement team confirms that the implementation of recurrence prevention measures has been ongoing since the previous fiscal year by asking questions to the person in charge of the General Administration Department of the consolidated subsidiary.

However, the engagement team **did not understand the internal controls related to the risk of early recording of expenses, which was a significant risk.** In addition, the engagement team **did not perform substantive procedures to address the risk, even though this risk had been identified as a significant risk.** Furthermore, the engagement team did not examine whether there were reasonable grounds for the audited company to exclude processes related to the risk of early recording of expenses, which was a significant risk, from the assessment of internal controls.

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraph 28; No. 330, paragraph 20, Auditing Standards for Internal Controls over Financial Reporting Statement No. 1 , paragraph 112) [Mid-tier, and small and medium-sized audit firms]

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

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

- Inspection of the agreement concerning the company split;
- Checking compliance with relevant accounting standards;
- Check that the balance of the journal entries related to the company split is consistent between the split company and each succeeding company.
- Inspection of the trial balance prepared by the audited company with respect to the assets and liabilities succeeded to by each succeeding company;

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

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

«Points to Note»

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

It should be noted that substantive procedures must be designed and performed for material classes of transactions, account balances, and disclosures because auditors may not have identified all of the risks of material misstatement and internal controls have inherent limitations, including management override.

Case 2: Adequacy of presentation and disclosure

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


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

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

- ② The engagement team identified the risk of material misstatement in the segment information disclosed by the audited company.

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

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

-  ③ The audited company additionally acquired the remaining equity interest in Company A the current period for cash, even though Company A was consolidated and the audited company held a majority interest in Company A.

However, **the engagement team overlooked the fact that the above-mentioned expenditures for additional acquisition were expenditures for acquisition of interests in subsidiaries that did not result in change in the scope of consolidation and should have been presented in the "Classification of cash flows from financing activities," but the audited company presented them in the "Classification of cash flows from investing activities."**

(Auditing Standards Statement No. 330, paragraph 23) [Large-sized audit firms]

《Points to Note》

There were numerous deficiencies in audit procedures for presentation and disclosure, including a case where the engagement team did not sufficiently verify the presentation and notes of the financial statements and overlooked material misstatement in the presentation of the consolidated statement of changes in net assets, notes on the consolidated statement of comprehensive income, notes on significant subsequent events, etc., a case where the engagement team did not plan and perform audit procedures to assess whether accounting standards, etc. were being followed in the notes on revenue recognition, and a case where the

engagement team did not examine the completeness of data used as the basis for calculating fair value in the notes on investment and leased properties. In addition, there were cases where the engagement team only provided a check mark as a formality and overlooked misstatements in audit procedures using the disclosure checklist.

Engagement teams should design and perform audit procedures to assess whether the overall presentation of the financial statements, including related disclosures, complies with the applicable financial reporting framework.

(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 had introduced a point card system for sales promotion in Business A, and booked the points that were expected to be used in the future as contract liabilities at the end of the fiscal year. The audited company also entrusted the administration of point data used to calculate the amount of contract liabilities to an external administration firm.

When evaluating General IT controls over the systems of the external management company and the audited company that were related to the point data management business, the engagement team conducted interviews with the external management company via the audited company and reviewed the results of the responses.

However, when examining the balance of the contract liabilities and the supporting documents, the engagement team **did not identify the internal controls of the external service provider and the audited company that were related to the point data management business, evaluate the design, or make a judgment on implementation.**

(Auditing Standards Statement No. 402, paragraphs 8, 9; No. 500, paragraphs 8) [Mid-tier, and small and medium-sized audit firms]

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

The audited company used a network built by a company that was entrusted with the operation of IT systems for important business processes (hereinafter referred to as the "Contractor Company"). The audited company obtained the description of the Contractor Company's systems, and an assurance report on controls at the Contractor Company.

However, the engagement team only reviewed the report obtained by the audited company and **did not perform assessment of the services, such as the appropriateness of the assessment procedures performed by the auditor of the** Contractor Company.

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

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not fully understand the operations and internal controls provided by the companies that were entrusted with the shipping and inspection of inventory, despite the fact that such operations were outsourced to warehouse operators.

In cases where an audited company outsources part of its operations, the engagement team must understand how the audited company uses the services of the service provider in its business operations. In understanding the internal controls related to the audit, the engagement team must evaluate designs and implementation of the audited company's internal controls, including the internal controls performed by the service provider. It should be noted that this applies not only to the financial statement audit but also to the audit of internal controls over financial reporting.

In recent years, due to the shift to cloud computing and other developments, depending on the content of services provided by the service organization, it may be difficult to determine whether the audited company (user entity) or the service organization has internal controls over the operations that form the basis of financial reporting. Auditors need to sufficiently understand the content and importance of the services provided by the service organization and their impact on the audited company's internal controls related to audit.

(5) Evaluation of misstatements identified during the audit

Case: Consideration of identified misstatements

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

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

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

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

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

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

《Points to Note》

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

Moreover, auditors need to determine whether identified misstatements would be material, either individually or in aggregate, if they are not corrected. However, there were cases where auditors did not evaluate the impact of uncorrected misstatements of past fiscal years on the financial statements as a whole. Note that it is necessary to state in the list of uncorrected misstatements attached to the written representation (1) uncorrected misstatements included in comparative information or (2) effect of comparative information as a result of correction (or elimination) of the figures for the current term, when auditors discovered uncorrected misstatements for the prior years, and management determined that they were not material and have corrected (or eliminated) them in the current term.

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

Case 1: Formulation of a plan for auditing IT use

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

rely on general controls over the IT systems. Specifically, as substantive procedures, the scope of detailed tests of construction sales by comparing vouchers was expanded.

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

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraphs 20 and 30)
[Large-sized audit firms]



② In the sales process at Company A, a consolidated subsidiary of the audited company, order information was managed using a customer management system. The sales division prepared sales details based on the information in the customer management system, and the control division entered sales journal entries based on the sales details.

The engagement team identified the risk of early booking of sales at Company A as a fraud risk and evaluated the design and operation of internal controls related to Company A's sales process. The team determined that the customer management system was not directly related to the preparation of financial statements and did not include the customer management system in the assessment of general IT controls. However, although the engagement team was aware that sales details had been prepared based on information from the customer management system and sales journal entries had been entered based on these sales details, the engagement team **did not consider whether the customer management system should be included in the assessment of general IT controls, and did not sufficiently examine the appropriateness of the scope of assessment.**

(Auditing Standards Statement No. 315 Before amendment in June 2021, paragraph 17) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluating of deficiencies in General IT control

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

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

However, the engagement team overlooked the fact that the information covered under control activities in which deficiencies had been identified was not listed in the information system development management chart to be prepared for managing progress in program development.

The engagement team also did not confirm the specific operational methods for leaving traces of email approval and otherwise **did not obtain sufficient appropriate audit evidence relating to the effectiveness of general IT controls.**

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

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team lacked sufficient understanding of the content of automated application controls for cost accounting, the scope of related master data, and the use of IT in understanding the cost accounting business process.

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 due to those systems. There were some cases in which the engagement team judged that the potential risks of material misstatements were low without understanding the IT environment. When developing audit plans, the engagement team need to understand the IT environment of the audited company, and identify IT systems that should be included in the assessment for risks of material misstatement.

The group engagement team also need to develop appropriate audit plans by ensuring that they understand the IT environment at the group level, as well as how the entity's control environment, including applicable accounting policies and financial closing systems, is reflected in or related to IT systems.

Furthermore, when using various lists generated by the audited company's information system for the tests of controls or substantive procedures, the engagement team shall evaluate the accuracy and completeness of the information. Depending on the degree of IT use by the audited company, the engagement team may need the support of IT specialists and incur considerable time to complete the audit. Therefore, the engagement team should note that it needs to develop an audit plan for the above procedures at an early phase.

The revised Auditing Standards Report No.315 expands the scope of IT-related statements and includes in the appendix some considerations for understanding IT and for understanding IT general controls.

3. Audit Evidence

Points of focus

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

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

Outline of inspection results

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

- The engagement team did not assess whether the audit evidence obtained through the audit procedures was adequate to identify risks of misstatement;
- The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks;
- The engagement team identified inconsistencies and irregularities with other audit evidence but did not determine the necessity of additional audit procedures;
- In substantive analytical procedures, the engagement team did not evaluate the reliability of the data used in the auditor's estimates of the booked amounts or ratios, and did not evaluate whether such estimates were sufficiently accurate to identify misstatements that could lead to material misstatements;
- In using audit sampling for audit procedures, the engagement team did not examine whether the sample size it had determined was adequate to reduce sampling risk to an acceptably low level;
- Audit evidence was not obtained on all of the specific items selected when sampling was carried out by selecting specific items;
- When testing specific items selected, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining balance; and
- When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes.

For more information in responses to audit risk for revenue recognition, also see items “(2) Identifying and assessing risks of material misstatement due to fraud” and “(3) Response to assessed risks of material misstatement due to fraud” in “1. The Auditor’s Responsibilities Relating to Fraud in Financial Statement Audits.”

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

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

Expected response

The engagement team needs to obtain sufficient appropriate audit evidence corresponding to the identified risks. In particular, the engagement team needs to keep in mind that it must perform substantive procedures to individually respond to significant risks.

Furthermore, many of the examples of deficiencies relating to audit evidence were caused by the engagement team’s failure to appropriately perform risk assessment and design further audit procedures, as well as a lack of in-depth understanding of the audited company’s business for the fiscal year subject to audit.

On the other hand, there were many cases where the engagement team appropriately performed risk assessment and designed further audit procedures, but staffs of the to engagement teams only performed conventional audit procedures because engagement partners, etc. did not provide specific instructions, supervision or review. Therefore, there were discrepancies between audit plans and actual audit procedures. For this reason, when conducting audits, the engagement teams are required to sufficiently discuss risk assessment and audit procedures to be performed throughout the engagement, and confirm the sufficiency and appropriateness of audit evidence actually obtained through reviews.

(1) Matters common to audit evidence

Case 1: Sufficient appropriate audit evidence

① The audit evidence corresponding to the risk of material misstatement

With regard to the fact that the audited company, which is engaged in the land sales business, recorded sales for land sales transactions as of the year-end closing date, the engagement team determined that there was no problem with the attribution of the period for the Transaction because, although the receipt of the sales proceeds and the registration of the transfer of ownership for the Transaction were both made after the year-end closing date, setting the date of transfer of ownership

and the date of delivery on the year-end closing date was based on the buyer's request, and the parties concerned had agreed to it.

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

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

②Dual-purpose test

FREQUENT

The engagement team performed sample inspections of 25 cases as test of controls related to raw material costs included in the audited company's manufacturing costs. The team claimed to have performed these tests as dual-purpose tests that also served as substantive procedures.

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

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

③Observation of physical inventory counting

The engagement team attended the audited company's physical inventory count, but it did not obtain sufficient appropriate audit evidence concerning the completeness and accuracy of the physical inventory records. For example, the team only observed the inventory count procedures and performed test counts, and **it did not perform procedures to confirm the completeness of the physical inventory records or to confirm the accuracy of the closing process for inventory transactions.**

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

《Points to Note》

Generally, inquiries alone do not indicate that sufficient audit evidence has been obtained regarding responses to the risks of material misstatements or regarding the effectiveness of the operation of internal controls. However, there are cases where audit procedures have been completed only by inquiries. In audit procedures for responding to risks, as well as those for responding to significant risks, audit evidence obtained through inquiries needs to be specifically supported by audit procedures other than inquiries.

Depending on the circumstances, auditors may also design substantive analytical procedures, tests of detail, or a combination of these procedures to respond to audit risk. However, depending on the degree of risk

assessed, the extent of audit evidence required will vary.

In one case, the engagement team performed multiple audit procedures but did not examine whether the amount or quality of the audit evidence obtained was sufficient. As a result, the engagement team did not obtain sufficient audit evidence to reduce the overall audit risk to a low level.

Engagement teams should not perform designed audit procedures as a formality, but should comprehensively evaluate events identified in the audit process and the sufficiency and appropriateness of audit evidence obtained through other audit procedures. Engagement teams should also evaluate whether procedures designed to obtain sufficient appropriate audit evidence that satisfies the purpose of each audit procedure have been designed and performed when performing tests of the operation of internal controls concurrently with substantive procedures (dual-purpose tests).

Case 2: Information to be used as audit evidence

① Relevance and reliability of information

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

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

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

② Work of management's experts

FREQUENT

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

Amid this situation, the engagement team evaluated the competence, capabilities and objectivity of the experts used by management to prepare the appraisal report, which is information used as audit evidence, and obtained an understanding of the experts' work before reviewing the appraisal report. However, the engagement team **did not sufficiently evaluate the appropriateness of the appraisal report as audit evidence, as the team did not verify the calculation methods or the source data employed by the experts used by management.**

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

③ Reliability of information produced by companies (i)

NEW

FREQUENT

In examining whether fixed assets were impaired, the audited company grouped its fixed assets by store and calculated operating profits / losses for each store, and determined that there were indications of impairment for the group of fixed assets that contained stores that had posted recurring losses in operating profits / losses by store over the past two fiscal years.

However, the engagement team **did not examine the accuracy of the operating profits / losses by store calculated by the audited company.**

(Auditing Standards Statement No. 500, paragraph 8) [Mid-tier, and small and medium-sized audited companies]

④ Reliability of information produced by companies (ii)

NEW

FREQUENT

In order to examine the appropriateness of the audited company's inventory valuation, the engagement team confirmed the existence of slow-moving products based on the long-term inventory list prepared by the audited company.

However, when using this list, the engagement team **did not verify whether it accurately and exhaustively reflected the status of product retention.**

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

《Points to Note》

When designing and performing audit procedures, auditors should keep in mind that they should take into account the relevance and reliability of information used as audit evidence.

In addition, when using information prepared by experts (e.g., pension actuaries, real estate appraisers, and attorneys) employed by the management as audit evidence, auditors should keep in mind that they should evaluate the competence, capabilities and objectivity of the experts, to understand the experts' work, and to evaluate the adequacy of the experts' work used as audit evidence in light of relevant assertions.

Meanwhile, audited companies often make accounting estimates based on information prepared by themselves, including reference data regarding valuation losses that lists book values and net sales value by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, and data regarding estimated construction profits/losses by construction project and the balance of construction-in-progress expenditures under the percentage-of-completion method, and reference data regarding construction loss provisions. There are still many cases in which information prepared by audited companies as the basis of accounting estimates is used as audit evidence in the audit of accounting estimates without its accuracy and completeness being verified. When performing audit procedures using information prepared by the audited company, the engagement team needs to obtain audit evidence on the accuracy and completeness of the information and fully examine the reliability of the information used.

Case 3: Timing of substantive procedures



① Performing substantive procedures at an interim date

As substantive procedures for accounts payable of the audited company (closed in March), the engagement team designed to perform external confirmation with the end of January as the record date and substantive procedures (roll-forward procedures) for increasing transactions and decreasing transactions during the remaining period (from February to March).

However, **when performing the roll-forward procedures, the engagement team did not perform substantive procedures for decreasing transactions of accounts payable, and did not perform sufficient substantive procedures for the remaining period.**

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

② Physical inventory counting is conducted on a day other than the balance sheet date.

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

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

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

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

《Points to Note》

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

It should also be kept in mind that, when using audit sampling for substantive procedures with regard to income statement items, it is necessary to select items for the sample in such a way that each sampling unit in the population during the period has a chance of selection because the entire data for the whole of that period becomes the sampling population.

(2) External Confirmation

Case 1: Reliability of responses to confirmation request

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

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

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

«Points to Note»

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

Case 2: Alternative audit procedures

With regard to the external confirmation of accounts receivable balances performed with the year-end closing date as the record date, the engagement team performed alternative procedures by verifying the status of payments to the audited company for parties to be confirmed that had not responded.

However, the engagement team only verified that of the amounts for major clients that had not yet responded, several collections had been made in the month following the year-end closing date, and **did not examine the fact that more than 80% of the balances that exceeded the materiality had not yet been answered.**

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

«Points to Note»

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

Case 3: Exception in relation to confirmation



The engagement team reconciled the difference between the accounts payable answered by the confirmed party and the accounts receivable of the audited company.

However, **despite the fact that the response from the confirmed party was dated July, the engagement team did not examine the appropriateness of the management's explanation that the difference arose from transactions delivered in August.**

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

«Points to Note»

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

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

Case 4: Evaluation of reply received

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

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

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

«Points to Note»

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

(3) Substantive analytical procedures

Case 1: Developing expectation

FREQUENT

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

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

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

NEW

FREQUENT

② As substantive analytical procedures for payroll expenses recorded by the audited company, the engagement team calculated the auditor's developed expectation of payroll expenses recorded by the audited company based on the information it obtained from the audited company on payroll expenses per employee and salary increase rate.

However, the engagement team **did not examine the reliability of the salary increase rate, which was information obtained from the audited company.**

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

《Points to Note》

There continue to be cases where the engagement team did not examine the reliability of data and accuracy of developed expectation required to reduce audit risk to an acceptably low level. For example, the engagement team used the results of the previous fiscal year or earnings forecasts as developed expectation without reasonable grounds when designing and performing substantive analytical procedures.

Case 2: Investigation of results of substantive analytical procedures

FREQUENT

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

However, **the engagement team only asked questions of the audited company about the reason for the difference and obtained the response, and did not obtain audit evidence to support the response from the audited company.**

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

《Points to Note》

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

(4) Audit sampling and testing specific items

Case 1: Planning of audit sampling

FREQUENT

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

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

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

NEW

② The engagement team carried out audit sampling using R & D expenses and expenses such as sales commissions and outsourcing expenses ("general expenses") as one population, which included various expenses such as payroll expenses and depreciation for the R & D division.

However, even though the engagement team **recognized that the characteristics of R & D expenses and general expenses were different, it did not examine the appropriateness of including them in one population**.

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

③ In order to verify the audited company's sales, the engagement team cross-checked samples selected through audit sampling against relevant vouchers.

However, the engagement team could not compare some sales transactions in the sample with external evidence such as order forms and acceptance notifications because the audited company did not possess such evidence. Despite this situation, the engagement team **did not examine the appropriateness of audit evidence obtained through alternative procedures**.

(Auditing Standards Statement No. 530, paragraph 10) [Large-sized audit firms]

«Points to Note»

When designing audit sampling, the engagement team needs to consider the purposes to be achieved by the auditor and the optimal combination of audit procedures and evidence to achieve the purpose, taking into account the characteristics of the population from which test items are to be selected.

In deciding the number of samples, it is necessary to note that the way of determination thereof for tests of operating effectiveness of internal control differs from that for tests of details, in general. Therefore, when using the number of samples, which was for the tests of controls, also for the tests of details as in the above example case, it is necessary to examine whether the number of samples is sufficient for tests of details. With audit sampling, samples should be selected in a way that provides opportunities for all items within the population to be selected; therefore, it is necessary to pay attention to the completeness of the population for selection.

Note that if misstatements are discovered in some selected items in a population using sampling, it is necessary to estimate the total amount of misstatement in the population as a whole.

Case 2: Selecting specific items

The engagement team identified risks of material misstatement (including in regard to existence and completeness) in respect of the cost of sales of the audited company (value of goods purchased) and performed cutoff tests using data for transactions near the closing date of the term and also performed balance confirmation procedures regarding accounts payable as of the closing date of the term.

However, the engagement team did not obtain sufficient and appropriate audit evidence regarding the cost of sales (value of goods purchased), as the team only performed tests of details for transactions near the closing date of the term that were subject to the cutoff and the accounts payable balances subject to confirmation procedures, and **did not perform tests of details in respect of the remaining transactions after these had been excluded.**

(Auditing Standards Statement No. 500, paragraphs 9 and A55) [Mid-tier, and small and medium-sized audit firms]

«Points to Note»

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

Testing some selected items in a population, which involves extracting specific items from transaction types or account balances, is an effective method for obtaining audit evidence, as it allows for the examination of atypical transactions, high-risk items, and monetary materiality, as well as the acquisition of information

about the nature of transactions. Unlike audit sampling, however, it needs to be kept in mind that audit evidence is not provided concerning the remaining part of the population, namely the components of the population that are not extracted as samples.

(5) Related parties

Case 1: Verification of reliability of questionnaire responses relating to related party transactions



The engagement team obtained "Questionnaire Responses" from directors and company auditors of the audited company in order to ascertain related party transactions. The engagement team also obtained from the Chairman of the Board a written response stating that there were no transactions that constituted related party transactions. The engagement team inspected the written responses to verify related party transactions. The engagement team also confirmed through inspecting the minutes of the Board of Directors that related party transactions were being conducted with the corporation represented by the Chairman of the Board.

However, the engagement team **did not sufficiently examine the reliability of the written responses even though the aforementioned related party transactions related to the Chairman of the Board were not included in the written responses.**

(Auditing Standards Statement No. 550, paragraphs 8) [Large-sized audit firms]

«Points to Note»

In addition to the above, the following examples of deficiencies were identified.

- The engagement team did not sufficiently examine whether relationships with related parties and transactions with related parties were comprehensively identified;
- The engagement team overlooked the fact that the terms and conditions of related parties transactions were not appropriately disclosed when no interest-free loans or debt guarantee fees were paid.; 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 or not related party relationships and related party transactions are comprehensively identified and appropriately processed and disclosed in accordance with the applicable financial reporting framework.

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

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

With the aim of strengthening its revenue base, the audited company decided to enter a specific new

business and acquired the business from a company with which the audited company had personal connections (the "Acquisition"). Under the business acquisition agreement, the audited company sold its products to only one customer and stored them in an external warehouse designated by that customer.

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

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

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

«Points to Note»

Because related party transactions may carry higher risks of material misstatement than third party transactions, the engagement team should comprehensively understand the audited company's related parties and their relationships with them. The engagement team should also be aware that if it identifies any significant related party transactions outside the audited company's normal course of business, it must treat them as a significant risk.

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

(6) Going concern

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

FREQUENT

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

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

However, the engagement team **did not sufficiently examine the reliability of basic data in the budget prepared by the audited company, nor the evidence for the audited company's assumptions forming the basis for the preparation of the budget. Moreover, with regard to additional borrowing in the statement of cash receipts and disbursement, the engagement team did not conduct a detailed examination of the feasibility of additional borrowing in excess of the maximum credit line.**

(Auditing Standards Statement No. 570, paragraphs 15) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above, there are cases where the engagement team did not examine whether there were additional facts or information concerning the going concern assumption when examining subsequent events.

Since the beginning of a significant event or circumstance that may undermine the continuity of business activities is likely to appear in business activities in advance, the engagement team needs to pay attention to audit evidence related to events or circumstances that may raise significant doubt on the entity's ability to continue as a going concern, and examine whether management's assessment of the existence of such events or circumstances is appropriate. Furthermore, when there are events or conditions that might cast significant doubt on the going concern assumption of the audited company, the engagement team should consider the potential need to revise the evaluation as to the risks of material misstatement and nature, timing and scope of further audit procedures.

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

(7) Subsequent events

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

- ① The audited company executed an agreement to extend the due date of the significant loan that was approximately 20% of the audited company's total assets, and publicly disclosed the information. However, the engagement team **failed to consider whether the due date extension was a subsequent event that would require revisions in the audited company's financial statements or affect the audited company's financial statements in the following year and thereafter.**

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

firms]



② The engagement team had designed to review minutes of the Board of Directors' and Audit & Supervisory Board's meetings held during the period from the day after the year-end closing date to the date of the audit report as one of the procedures to identify subsequent events at the audited company (closing date in March). However, the engagement team did not review the minutes of the Board of Directors' and Audit & Supervisory Board's meeting held in June because it was unable to obtain the minutes.

However, the engagement team **did not ask questions regarding matters discussed at the Board of Directors'** and Audit & Supervisory Board's **meeting, which should be conducted if the minutes could not be reviewed.**

(Auditing Standards Statement No. 560, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

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

If after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall implement the following procedures (Auditing Standards Statement No. 560, paragraph 9):

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

4. Auditing Accounting Estimates

Points of focus

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

- ▶ Whether the engagement team appropriately exercises professional skepticism throughout the audit of accounting estimates;
- ▶ Whether the engagement team appropriately identifies and assesses the risks of material misstatement related to accounting estimates, by evaluating the extent to which estimates are affected by uncertainty and inherent risk factors (complexity, subjectivity or other inherent risk factors), as well as internal controls related to risks; and
- ▶ Whether the engagement team designs audit procedures suited to the assessed risks of material misstatement, and examines the appropriateness of the estimation methods, significant assumptions and data used by management in making accounting estimates, and assesses whether there are any signs of management bias.

Outline of inspection results

In a wide range of auditing accounting estimates, including the valuation of investments and loans to affiliated companies, impairment of fixed assets and goodwill, valuation of inventories, and recoverability of deferred tax assets, the following situations were frequently observed:

- Due to a lack of understanding of the requirements of Auditing Standards Report No. 540, risk assessment procedures such as consideration of the finalized amounts of accounting estimates for the past fiscal years and understanding of management's estimation methods were not appropriately performed.
- Due to a lack of understanding of the requirements under Auditing Standards Report No. 540 and due to a lack of professional skepticism, only qualitative assessments were performed by asking management questions about the business environment, etc. Procedures for examining the appropriateness of estimation methods, significant assumptions, and data used by management in making accounting estimates, such as the feasibility of business plans used in accounting estimates, were insufficient.

(Observed effective efforts)

The following case can be cited as an effective effort observed to improve procedures for auditing accounting estimates.

An audit firm developed and implemented a template corresponding to the requirements of Auditing Standards Statement 540. It provided training on Auditing Standards Statement 540 and used the template to demonstrate the extent of audit procedures to address risks according to the level of risk.

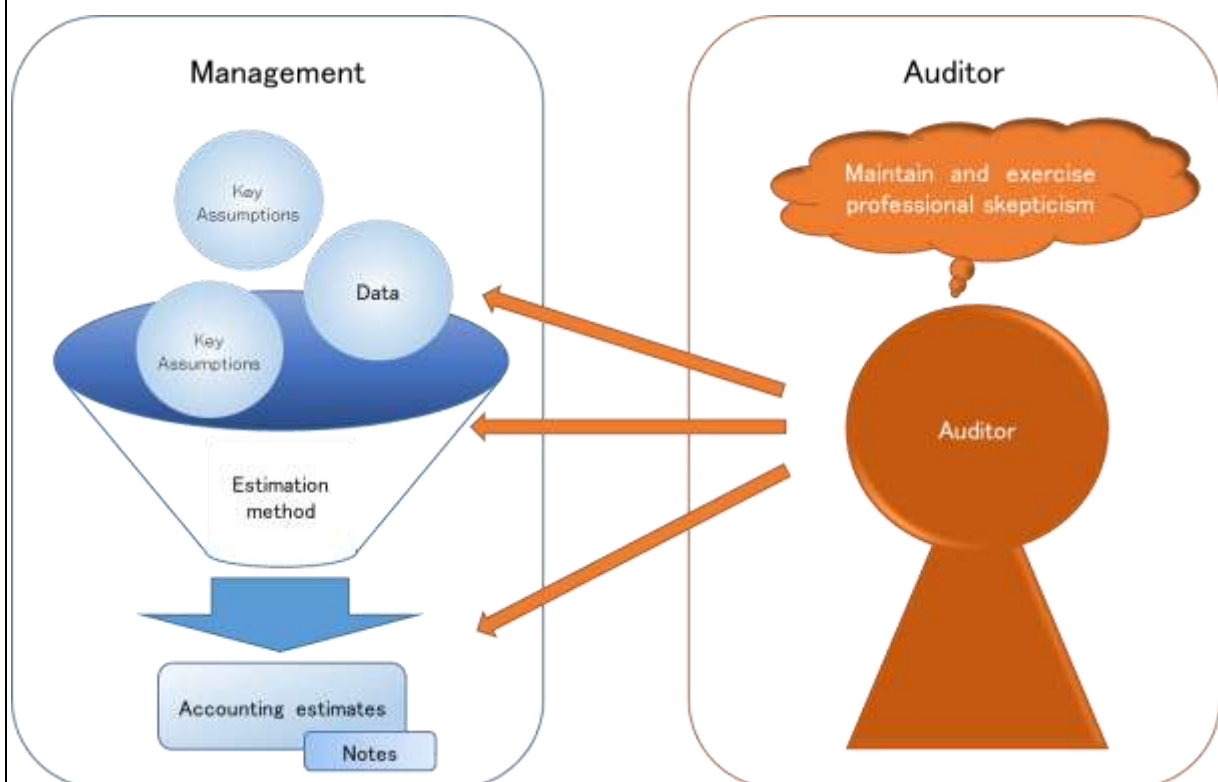
Expected response

It should be noted that the auditing accounting estimates has been significantly enhanced by the revision of Auditing Standards Statement 540 (Auditing Accounting Estimates). When assessing the risks of accounting estimates, auditors need to fully understand the company and its environment, the applicable financial reporting framework, the company's internal control system, etc., and evaluate inherent risk factors (such as the uncertainty, complexity and subjectivity of accounting estimates and other inherent risk factors) based on the review of the finalized amounts of accounting estimates for the past fiscal years.

Auditors should also note that in performing audit procedures for accounting estimates, auditors may examine how management made accounting estimates. Auditors should exercise professional skepticism and perform a critical review, considering all relevant audit evidence obtained, while noting indications of management bias against each of the estimation methods and significant assumptions and data used by management. In addition, they should fully examine the footnotes to the accounting estimates. (Refer to Figure 7)

Auditing Standards Statement 540 (Auditing of Accounting Estimates), which was revised in January 2021, is applicable to the audit of financial statements for the fiscal year ending March 31, 2023. Therefore, the provisions on the basis of deficiencies identified in the CPAAOB's inspection of the audit of financial statements for the fiscal years prior to March 2023 were not amended in January 2021

[Figure 7] How auditors examines accounting estimates made by management



(1) Evaluation of shares in subsidiaries and affiliates

Case 1: Examination of Real Value in Valuation of Shares of Affiliated Companies

The audited company acquired additional shares of Company A, which it had invested in because of its high technical affinity with the audited company, in anticipation of excess profitability, and made it an equity method affiliate.

In valuing Company A's shares that had been recorded as shares of affiliated companies, the audited company examined whether there was any impairment of excess profitability by comparing the business plan at the time of the additional acquisition of Company A's shares with the actual results. Specifically, although Company A's actual profit for the fourth quarter was lower than planned, the cause was a delay in the progress of the business plan. Based on the business plan revised at the end of the fiscal year based on this cause, the Company determined that it was not necessary to write down the value of shares of subsidiaries and affiliates.

Amid this situation, the engagement team confirmed that the cause of actual performance of Company A falling below the plan was the lag, and, after examining the feasibility of the revised business plan, deemed the audited company's assertion that no write-down was required to be valid. However, **despite the fact that the revised business plan for Company A had been revised downward from the business plan at the time of the additional acquisition of Company A's shares, the engagement team did not adequately consider the impact of this situation on the excess profitability that it had initially anticipated.**

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 11 and 12) [[Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases where the engagement team did not consider the need for a write-down of shares held by the subsidiary in an insolvent subsidiary of its own, and thus did not appropriately value the net asset value of shares in the subsidiary.

When the real value of shares of a non-marketable affiliated company declines by 50% or more from their acquisition cost, unless the possibility of recovery is supported by sufficient evidence, the company is required to recognize a considerable impairment loss as a significant decline in the real value.

This treatment is also applied to the valuation of shares of newly established or recently acquired subsidiaries and affiliates.

In particular, in cases where excess profitability is anticipated, it is necessary to identify any deviation between the initial business plan and actual results in a timely manner and carefully examine whether there has been a significant decline in the real value.

Case 2: Consideration of recoverability of shares of subsidiaries and affiliates

NEW

FREQUENT

Although the real value of shares of Company B, a non-consolidated subsidiary, held by Company A, a consolidated subsidiary, fell below 50% of its book value, the audited company did not post a valuation loss on shares of subsidiaries and associates related to Company B's shares because, after examining the possibility of recovery based on Company B's business plan prepared by the audited company, it believed that it could recover with future income.

After examining Company B's business plan, the engagement team deemed that the audited company's judgment that the book value of Company B's shares could recover was reasonable.

However, the engagement team only confirmed that **the sales volume projections in Company B's business plan**, which formed the basis for Company B's future income, matched the sales volume projections for Company B in the audited company group's medium - to long-term plan approved by the board of directors of the audited company, and **did not examine the reasonableness of these sales volume projections**.

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

«Points to Note»

In addition to the above examples of deficiencies, there were cases in which the engagement team did not examine the reasonableness of the audited company's decision not to impair the value of shares of subsidiaries and affiliates despite the fact that the value of shares of subsidiaries and affiliates that were performing poorly had recovered by only about 50% of their book value in the final year of the business plan (five years) for these subsidiaries and affiliates.

There were multiple cases where the engagement team, as a professional expert, did not sufficiently and appropriately examine the appropriateness of the business plan's assumptions made by the management when evaluating the appropriateness of the business plan's assumptions for the valuation of shares of subsidiaries and affiliates, from a critical perspective. For example, the engagement team did not confirm the business plan based on concrete evidence, and only qualitatively evaluated the business plan by asking questions to the management.

With regard to business plans, engagement teams should understand the corporate environment, creation process, and related internal controls, compare them with finalized figures, and carefully examine the feasibility of the estimated figures incorporated into plans for earnings expansion, cost reduction, etc.

(2) Valuation of receivables

Case 1: Examination of calculation method for allowance for doubtful accounts

The audited company booked an allowance for bad debts based on past default rates to prepare for losses due to debt default. Specifically, it categorized claims as either (1) those for which no more than one year had passed since they fell into arrears or (2) those for which more than one year but

no more than three years had passed since they fell into arrears, and then calculated the allowance for bad debts using the three-year-average default rate computed as follows for each of the categories (1) and (2).

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 7 and 14)
[Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not sufficiently examine the appropriateness of the estimation method of taking into account the uncertainties according to the period during which receivables were scheduled to be recovered, or in which, regarding assets scheduled to be seized, the engagement team did not examine the appropriateness of the amount of assets that the audited company asserted could be recovered. When evaluating debt claims in cases where some assets are planned to be seized, it is necessary not only to identify the assets to be seized but also to sufficiently examine the feasibility of seizure and the estimated amount of assets that may be disposed of. In addition, with regard to receivables with default risk, the engagement team should carefully examine whether the audited company adopted an appropriate method for calculating the estimated amount of bad debt (calculation method based on the financial condition evaluation method or the cash flow estimation method) at the time of valuation.

Case 2: Examination of reasonableness of management's assumptions

NEW

FREQUENT

Company A, which was established as a consolidated company, had net losses the current period in the previous two fiscal years and had liabilities in excess of assets. However, the audited company did not make an allowance for doubtful accounts for short-term loans to affiliated companies with regard to the balance of loans to Company A.

The engagement team determined that there was a high risk of material misstatement in the audited company's valuation of short-term loans receivable from affiliated companies.

The achievement status of Company A's business plan was confirmed by comparing the budget and actual performance for the target period in the "Basic Plan for Preparation of Quarterly Consolidated Financial Statements" (hereinafter referred to as the "Basic Plan")

However, the engagement team **did not examine the reasonableness of Company A's business plan, as it did not confirm the management's estimation method for sales, cost of sales, etc. in Company A's business plan.** In addition, the engagement team **did not examine the reasonableness of the fact that the audited company had not reviewed Company A's business plan** despite the fact that Company A's sales for the period under review were lower than those in Company A's business plan and that business progress was delayed.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 11 and 12)[Large-sized audit firms]

《Points to Note》

When evaluating the appropriateness of the management's business plan assumptions for the valuation of the audited company's receivables from affiliated companies, there were several cases where the engagement team did not sufficiently and appropriately examine the business plan from a critical perspective as a professional expert. For example, the engagement team did not confirm the business plan based on specific evidence and only qualitatively evaluated the business plan by asking questions to the management.

With regard to business plans, engagement teams should understand the corporate environment, production process, and related internal controls, compare them with finalized figures, and carefully examine the feasibility of the estimated figures incorporated into plans for earnings expansion, cost reduction, etc.

In addition, there were cases in which the engagement team did not consider the need for the parent company to bear the final burden of the amount of liabilities in excess of assets of a subsidiary of the audited company that had liabilities in excess of assets.

In principle, limited liability to shareholders is limited to the amount invested. However, as a parent company, it is necessary to note the need to provide for the amount of liabilities in excess of assets of the subsidiary in excess of the amount invested.

(3) Inventory valuation

Case1: Review of inventory valuation methods

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

would not have a decline in profitability, as such raw materials would not degrade physically and the audited company would need to hold a wide variety of raw materials.

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 7) [Mid-tier, and small and medium-sized audit firms]

Case2: Examination of reasonableness of management's assumptions;



With regard to the valuation of products and work in process relating to content such as video game software, if the net selling value (selling price at the end of the fiscal year minus the estimated additional manufacturing cost) was below the acquisition cost, the audited company had a policy of recognizing the difference as a valuation loss.

In calculating the selling price at the end of the fiscal year, the audited company assumed that the projected sales volume of each content would be at the same level as the actual sales volume of content deemed similar by the audited company.

In calculating the net selling value, the audited company did not deduct estimated direct sales expenses.

The engagement team identified the above assumption made by the audited company as a significant assumption, and also identified the risk of incorrect valuation of content-related products and work in process as a significant risk. As audit procedures to address this risk, the engagement team performed procedures such as inspecting calculation data prepared by the audited company, understanding the method of estimating selling prices and estimated additional manufacturing costs at the end of the fiscal year, and obtaining basic data.

Furthermore, the Company compares the actual sales volume of content sold the current period with the forecast sales volume for the previous fiscal year and discusses the difference.

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

- The engagement team did not examine the appropriateness of the audited company not deducting estimated direct sales expenses when calculating the net selling value.
- **Despite the existence of content in which actual sales volume in the current period fell short of the sales volume forecast for the previous fiscal year, the reasonableness of assumptions was not sufficiently examined. For example, the engagement team did not examine how management assessed the impact of uncertainties in accounting estimates on assumptions;**

- **In determining the selling price and estimated additional manufacturing cost at the end of the fiscal year, the engagement team did not examine the reasonableness of the estimation method used by management and the accuracy of the underlying data.**

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11, 12, 14; ASBJ Statement No. 9, Paragraph 5) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not sufficiently consider the appropriateness of management's assumption that it would not be necessary to record valuation losses because slow-moving inventories with poor sales records had not deteriorated physically and remained in operation. There were also cases in which the engagement team did not consider the appropriateness of management's assumption that it would not record valuation losses because the audited company did not sell its existing products for sale or inventory held for maintenance at below book value. There were also cases in which the engagement team did not consider the appropriateness of the audited company recording valuation losses at a certain rate of book value according to the delay period. There were also cases where the engagement team did not sufficiently examine the reliability of valuation loss calculation data prepared by the audited company.

Among the inventories held by the audited company are inventories with special characteristics, such as those for which it is difficult to calculate an objective value, such as real estate for sale and development project expenditures.

It should be noted that inventories with such special characteristics cannot normally be excluded from the scope of write-downs based on decreased profitability, and that the necessity of using the work of experts needs to be considered when valuing significant inventories.

(4) Impairment of fixed assets

Case 1: Consideration of grouping of assets

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

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

However, the engagement team **did not examine the appropriateness of the audited company grouping its store assets on the basis of brand units**, even though the audited company published figures for the number of stores opened and closed in its monthly overview of sales and grouped those store assets on the basis of independent store units in those figures.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11)

[Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases where the engagement team overlooked that the grouping of assets deviated from the actual situation, and did not examine the appropriateness of the classification of shared assets.

In addition, there are cases in which the engagement team did not consider whether the asset grouping rules it had considered in previous years would still be in line with the actual state of the company if the company or its surrounding environment changed.

On the other hand, there were cases where the engagement team did not exercise professional skepticism and sufficiently examine whether a change in impairment assessment before and after a change in grouping was an indication of fraud. There were also cases where the engagement team did not sufficiently examine the reasonableness of a change in grouping in light of accounting standards, etc. when impairment was not recognized for a certain asset group as a result of a change in grouping of fixed assets, which had been treated as a single asset group, into multiple asset groups.

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 Finalized Accounting Estimates for Prior Periods

Although consolidated company A of the audited company continued to record operating losses, in examining the recognition of impairment losses on fixed assets the current period, the engagement team determined that it was unnecessary to recognize impairment losses on fixed assets because undiscounted future cash flows based on the business plan exceeded the book value of fixed assets. In addition, based on this business plan, the audited company anticipating expects Company A's fixed costs for the next fiscal year, personnel costs will be reduced through efforts to secure personnel and promote employee retention, and fixed costs other than personnel costs will also be reduced. As a result, overall fixed costs will decrease compared with the current period, and Company A will return to an operating profit.

The engagement team interviewed the management about the management's assumptions regarding Company A's fixed cost reductions in order to understand the management's assumptions.

With regard to personnel expenses, it is understood that the increase in personnel expenses the current period was due to temporary factors, and after comparing the planned figures for the next fiscal year in this business plan with the actual figures for the previous fiscal year, it has been determined that the management's assumptions are not unreasonable.

However, the engagement team did not have a specific understanding of the nature and reason for


the difference between Company A's planned operating loss and actual operating loss in the current period and the fact that Company A had continued to post operating losses, even though Company A's actual operating loss was lower than planned. The engagement team also **did not assess the possibility of management bias in the audited company's management's estimate of fixed costs or the degree of uncertainty included in management's estimate.**


(Auditing Standards Statement No. 540(Before amendment in January 2021), paragraphs 7, 8, 12)
[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In some cases, when reviewing accounting estimates made by management, the engagement team only sought to ascertain the amount of deviation from estimates made in prior years and the actual results for the current year, as well as the reason for it, and did not take the findings into account in assessing the risk of management's estimates for the current year. The engagement team should bear in mind that the purpose of reviewing accounting estimates is to identify the possibility of management bias and to assess the degree of estimation uncertainty. A difference between the finalized accounting estimate and the amount recognized in the prior years' financial statements does not necessarily indicate a misstatement in the prior years' financial statements. However, there are cases where it can be reasonably assumed that an estimate that is close to the finalized amount could have been made if management used information available at the time of the prior year's estimate or information that management reasonably expects to obtain and take into account when preparing and presenting the prior years' financial statements. In such cases, the auditor should consider the possibility that the difference indicates a misstatement in the prior years' financial statements.

Case 3: Review of indications of impairment

 ① With regard to the assessment of indications of impairment of store assets, the audited company did not allocate personnel expenses, advertising expenses, and other expenses related to head office employees "(hereinafter referred to as the "(head office expenses")) to asset groups on the grounds that these expenses were unavoidable in maintaining head office functions and did not fall under indirect expenditures necessary for each asset group to generate future cash flows. The engagement team determined that the management's accounting policy of not allocating head office expenses to asset groups was acceptable from an audit perspective because head office expenses accounted for around 10% of total SG & A expenses.

 However, the engagement team **did not sufficiently examine the appropriateness of management's determination that each item in head office expenses did not fall under expenditures that indirectly incurred by each asset group,** even though the team recognized that personnel expenses and advertising expenses related to head office employees included in head

office expenses had the nature of expenses disbursed with the intention of managing the entire company, including stores, and maintaining and expanding store sales.

(Auditing Standards Statement No. 540, paragraphs 22; ASBJ Guidance No. 6, Paragraph 12)
[Large-sized audit firms]



②When examining the impairment of fixed assets related to the hotel business, the audited company did not identify any indication of impairment in the hotel business asset group because operating income was expected for the next fiscal year based on the budget, although the hotel business had recorded operating losses for the last two consecutive fiscal years. The audited company expects operating revenue for the next fiscal year to recover to approximately 90% of the pre-COVID-19 level under the assumption that the number of guests will increase due to a decrease in the number of COVID-19 cases and a reduction in the scale of restrictions on activities and self-discipline. The engagement team performed the following procedures and determined that management's estimate of operating expenses for the hotel business for the next fiscal year was reasonable:

- Conducted a comparative analysis of the current period's budget and actual expenses to evaluate the accuracy of management's budget estimate.
- Conducted interviews with management to understand management's assumptions included in the estimate of operating expenses in the budget for the next fiscal year.
- Conducted a comparative analysis of operating expenses for previous fiscal years to evaluate the appropriateness of management's assumptions.

However, the engagement team **did not sufficiently examine the appropriateness of management's assumption that the budgeted operating expenses for the hotel business for the next fiscal year would be restrained compared to the increase in operating income, as evidenced by the fact that the engagement team did not check the data and documents that served as the basis for the restraint of operating expenses. This was despite the need for careful consideration of the hotel business's operating profit in the budget for the next fiscal year to assess whether there were any indications of impairment in the hotel business asset group.**

(Auditing Standards Statement No. 540, paragraphs 17, 21 23)Large-sized audit firms]

③As to new stores in business less than two years from the beginning of the fiscal year following their opening, the audited company determined that operating losses incurred or likely to be incurred on a continuous basis would be excluded from the assessment of indications of impairment, except that some significant change in the environment exists, because its new stores tend to suffer operating losses immediately after opening due to the nature of the business.

However, when examining the company's assessment of the indications of impairment for the new stores, the engagement team **did not consider whether the new store's operating losses represented a significant downward deviation from the business plan formulated when the**

store was opened, although there are stores for which impairment losses are recognized just after their first two years in business.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 12 and 14) [Large-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, there were cases in which the engagement team did not examine whether the change in the allocation standard for head office expenses was appropriate in light of changes in the circumstances of the audited company, cases in which the reliability of profit / loss information for each asset or asset group was not evaluated, cases in which the engagement team did not assess indications of impairment using profit / loss from operating activities when both profit / loss from operating activities and cash flow from operating activities were known, and cases in which the engagement team did not assess indications of impairment using actual figures at the end of the fiscal year even though the actual figures at the end of the fiscal year were significantly worse than expected after assessing indications of impairment using expected figures before the end of the fiscal year. The engagement team should keep in mind that, based on all available information, the engagement team should carefully examine indications of impairment. In addition, as a general rule, when an asset or asset group becomes idle, it falls under a change that significantly reduces the recoverable amount of the asset or asset group with respect to the scope or method of using the asset or asset group. Therefore, when examining indications of impairment, the engagement team needs to carefully examine the reasonableness of the period of idle status, such as whether the period of idle status falls under a period that is considered to be necessary to determine future use when the asset has hardly been used.

Case 4: Review of recognition and measurement of impairment

NEW

FREQUENT

① In examining the impairment of fixed assets within the consolidated group, the audited company determined that there were indications of impairment in Company A's asset groups, and as a result of examining the undiscounted future cash flows calculated for each asset group, it did not record an impairment loss.

The engagement team conducted a review based on undiscounted future cash flows for each asset group and found that the audited company's decision not to book impairment losses on Company A's fixed assets was reasonable.

However, the procedures performed by the engagement team had the following deficiencies:

- The engagement team did not examine the reasonableness of the fact that land was the audited company's main asset.
- **The engagement team did not examine the reasonableness of the audited company's assumption that the cash flow calculated based on the business plan for the fifth year**

would continue after the sixth year when estimating Company A's 20-year undiscounted future cash flow.

- **The reasonableness of Company A's capital investment amount was not examined.**
- The engagement team **did not examine the reasonableness of the audited company's estimates of sales volume and unit price to customers, which would have a significant impact on the calculation of some of the audited company's future cash flows,** out of the audited company's significant assumptions about Company A's sales.
- **Among the material assumptions regarding Company A's cost of sales, the reasonableness of the assumption that Company A's personnel expense ratio would decrease due to personnel reduction measures was not examined in light of the feasibility of reducing the specific number of personnel to be reduced and the amount of personnel expense reduction.**

(Auditing Standards Statement No. 540, paragraph 13, 21-23) [Mid-tier, and small and medium-sized audit firms]



② As the audited company continued to post operating losses, it decided to discontinue the asset group for Business A (the "Asset Group"). The Company has determined that there are indications of impairment of fixed assets. In addition, the Company determined that it is not necessary to recognize an impairment loss for the asset group because the total undiscounted future cash flows expected over the remaining economic life of the major assets exceed the book value of the asset group. The audited company disclosed the following information regarding its management policy, etc. for the next fiscal year and beyond.

- (A) Announced management briefing materials indicate that the Company has a policy to consolidate domestic production bases related to Business A at the earliest possible time in the future;
- (B) Announced management briefing materials indicate that the Company expects to incur extraordinary losses associated with the consolidation of domestic production bases as announced in (A) above;
- (C) In the management briefing materials in (B) above and in "Section 2 [Business Overview] 2 [Views and Initiatives on Sustainability]" of the securities report, the management revised upward the target for the rate of reduction in greenhouse gas emissions for a certain period in the future, and as its main measures, the Company will reorganize its production system to improve production efficiency and stop the operation of existing facilities.

The engagement team received an explanation from the management that it would accelerate the reduction of existing facilities, that it expected specific plants to survive, and that it was considering whether to sell facilities at production bases other than these plants, in addition to converting them to other businesses and stopping them.

In addition, the engagement team recognized that the business budget and the estimate of undiscounted future cash flows that were used as the basis for the audited company's calculation of

undiscounted future cash flows reflected the continuous decrease in sales volume of Business A, which was the background to the policy in (A) above.

However, the engagement team **did not obtain specific information on the causes of the extraordinary losses mentioned in (B) above, and did not consider whether or not to recognize such extraordinary losses. In addition, the engagement team did not consider whether and to what extent the shutdown of existing facilities had an impact on the undiscounted future cash flow estimates mentioned in (C) above.**

(Auditing Standards Statement No. 540, paragraphs 21, 22) [Large-sized audit firms]

NEW

FREQUENT

③ Company A, a subsidiary of the audited company, incurred net losses from operating activities in Business B for two consecutive years. As a result, the audited company determined that there were indications of impairment of fixed assets held by Company A relating to Business B and measured impairment losses. In measuring the impairment loss, Company A obtained a "Real Estate Appraisal Report" for land and buildings and a "Report for Calculation of Net Selling Value of Movable Assets" for movable assets of machinery and equipment and certain structures. Company A purchased some structures, tools, furniture and fixtures, etc. (hereinafter referred to as "other structures, etc.") that were excluded from the valuation in the "Report on Calculation of Net Selling Value of Movables". However, since there are no significant fixed assets, the net selling value is the same as the book value. With regard to the valuation of fixed assets at Company A, the engagement team performed the following procedures for measuring impairment loss:

- Evaluation of the competence, capabilities, and objectivity of the experts used by the management, as well as consideration of the appropriateness of the calculation methods adopted by the experts and the basic data used by them
- Confirmation that no significant fixed assets are included in other structures, etc., based on the number of registrations in the fixed asset register and the book value per unit.

However, the procedures performed by the engagement team had the following deficiencies:

- The engagement team did not consider whether it was necessary for the engagement team to use the services of experts in measuring impairment losses on fixed assets related to Business B held by Company A, despite the fact that Company A required expert knowledge of real estate and movables valuation when measuring impairment losses on fixed assets.
- The engagement team **did not examine the reasonableness of the management's assumption that the net selling value of other structures, etc. would be the same as the book value,** despite the fact that the net selling value of the assets subject to valuation in the "real estate appraisal report" and the "report on calculation of net selling value of movables" had fallen below the book value.

(Auditing Standards Statement No. 540(Before amendment in January 2021), paragraph 12, 14; No.660, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above deficiency cases, there are cases in which the engagement team did not examine the reasonableness of the remaining economic life of the asset, which serves as the basis for estimating future cash flows; cases in which capital investment and repair costs to maintain the present value were not included in future cash flows; cases in which a post-tax discount rate was used even though future cash flows were pre-tax figures; cases in which the appropriateness of the discount rate used was not examined; and cases in which impairment loss recognition was determined based on undiscounted future cash flows before allocation of head office expenses.

There were frequent cases where the engagement team did not sufficiently and appropriately examine the reasonableness of the business plan from a critical perspective as a professional expert. For example, the engagement team did not confirm the content of the business plan based on specific evidence and only qualitatively evaluated it by asking questions to the management, although the recognition and measurement of impairment loss largely depended on the estimate of future cash flows based on the business plan prepared by the management.

Therefore, when examining the management's assumptions regarding the necessity of impairment accounting, the engagement team needs to exercise professional skepticism and carefully examine the appropriateness of the estimation method, significant assumptions, and data used by the management, such as the remaining economic life used to calculate the value in use of assets, sales and operating expenses in the business plan that are the assumptions for the estimate, and components of future cash flows such as expenditures related to capital investment.

In examining future cash flows, it is also necessary to pay broad attention to consistency with non-financial information such as sustainability information.

Furthermore, with regard to the use of real estate appraisal reports in calculating the net selling value, there are cases in which the engagement team did not examine the appropriateness of continuing to use real estate appraisal reports obtained in previous fiscal years as audit evidence in the current fiscal year, cases in which real estate appraisal reports were used without evaluating the aptitude, ability, and objectivity of the real estate appraiser used by the management, and cases in which the engagement team did not examine the reasonableness of not deducting the expected disposal cost from the real estate appraisal value in calculating the net selling value.

The engagement team should carefully consider the basis for the net selling value calculation, including the use of real estate appraisal reports in determining the net selling value, as necessary for the work of the auditor's experts.

(5) Valuation of goodwill and identifiable intangible assets

Case 1: Review of amortization period of goodwill

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

Case 2: Impairment of goodwill

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

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Large-sized audit firms]

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

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

However, the engagement team **did not examine the reasonableness of assumptions other than**

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

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 7, 9 and 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

In addition to the above examples of deficiencies, there were cases in which the engagement team did not understand the management's assumptions, such as the breakdown of the amounts for each company in the group and the monetary impact of business measures, when evaluating the goodwill of a corporate group comprised of multiple consolidated subsidiaries. There were also cases in which the engagement team revised the business plan because the business plan at the time of acquisition did not progress as expected and the actual profit / loss fell significantly short of the business plan at the time of acquisition, and booked impairment loss for the difference between the recoverable amount based on the revised business plan and the book value of goodwill, but did not sufficiently examine the feasibility of the revised business plan.

Furthermore, there are cases in which the audited company did not consider additional amortization of goodwill in the corresponding consolidated financial statements even though it booked impairment losses on investments in subsidiaries in non-consolidated financial statements.

The engagement team should comprehensively evaluate whether the events identified in the audit process are comprehensively reflected in the accounting treatment.

Case 3: Consideration of identifiable intangibles (management's expert evaluation)

In identifying and valuing the intangible assets of a company that the audited company acquired during the fiscal year, the audited company obtained an intangible asset valuation report from an external expert that stated: a) only customer-related assets were identified as intangible assets; and b) Such customer-related assets are not recorded in the consolidated financial statements on the

grounds that the amount of such customer-related assets is assessed to be insignificant;

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

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

(Auditing Standards Statement No. 500, paragraph 7; No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

There were cases where the audited company did not sufficiently consider the necessity of accounting treatment to allocate the acquisition cost to identifiable intangible assets when acquiring a company.

The engagement team needs to carefully consider the accounting treatment for allocating acquisition costs to identifiable intangibles, including using such accounting treatment as may be necessary for the experts' work.

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

(6) Recoverability of deferred tax assets

Case 1: Review of company classification

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

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

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

However, **despite the fact that the taxable income for the next term as forecast in the subsidiary’s business plan was smaller than the tax loss, the engagement team did not examine**

whether, for the current year, it met the criteria for stating that a “significant tax loss” had not occurred.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 7 and 11)
[Large-sized audit firms]

《Points to Note》

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

In particular, the engagement team needs to examine more careful consideration for the determination of "taxable income excluding that arising from temporary causes" in Category 2 or Category 3 of the said Guidance.

Case 2: Estimation of taxable income



① The audited company determined that deferred tax assets fell under Category 3 of the Implementation Guidance on Recoverability of Deferred Tax Assets (ASBJ Guidance No. 26).

FREQUENT

Deferred tax assets are recognized for estimated future taxable income for a reasonable and estimable period based on the Company's business plan.

The engagement team determined that all values in the business plan were based on significant assumptions and data.

In addition, the engagement team examined the expected future increase in sales resulting from each measure planned by the audited company against the current period performance, taking into account communication with management.

However, the engagement team did not examine that the above-mentioned expected increase in sales reflected the details of the store opening plan (including the status of securing land, etc.).

With regard to the amount of increase in sales at existing stores, the engagement team did not take into account factors such as an increase in the number of operating days due to a reduction in the number of New Year's holidays and the trend in daily sales at stores. As such, the engagement team **did not adequately consider each value in the business plan that it deemed to be significant assumptions and data.**

(Auditing Standards Statement No. 540, paragraph 13, 21-23) [Mid-tier, and small and medium-sized audit firms]



FREQUENT

② The audited company determined that deferred tax assets fell under Category 3 of ASBJ Guidance No. 26 "Implementation Guidance on Recoverability of Deferred Tax Assets" and that the future reasonably estimable period was one year. As a result of estimating taxable income using figures for the next fiscal year in the medium-term management plan, taxable income may decrease. As a result,

the audited company did not record deferred tax assets related to tax loss carryforwards. On the other hand, the audited company deemed its five year medium-term management plan reasonable and did not take into account any additional decrease in profits when estimating future cash flows for determining impairment of fixed assets.

The engagement team deemed the audited company's judgment that the future reasonably estimable period was one year and the assumption that taxable income may decrease further to be reasonable. However, the engagement team deemed the audited company's five year medium-term management plan reasonable and did not take into account any additional decrease in profits for the plan when estimating future cash flows for determining impairment of fixed assets. On the other hand, the engagement team did not sufficiently examine the reasonableness of setting the future reasonably estimable period at one year and taking into account any additional decrease in profits for the plan when assessing the recoverability of deferred tax assets.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraphs 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In examining the recoverability of deferred tax assets, the engagement team often examines the appropriateness of business plans prepared by management when estimating taxable income. However, there are cases in which the engagement team judges that the estimates are conservative and highly achievable based easily on the fact that management calculates estimates by multiplying business plans by past achievement rates, etc., and does not critically examine business plans themselves.

In addition, business plans that are the basis for estimating taxable income are, in principle, required to be approved by the Board of Directors, etc. It is also necessary to pay attention to the consistency with business plans used in other accounting estimates and the basis of their assumptions. Furthermore, if there is a significant adjustment in tax returns, the engagement team needs to perform sufficient audit procedures to confirm the feasibility of taxable income, such as confirming the reasonableness of adjustments from income in business plans to taxable income for tax purposes.

Case 3: Review of scheduling

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

procedures for posting deferred tax assets relating to the allowance for doubtful accounts to be appropriate.

However, the engagement team **did not examine the reasonableness of the management assumption that the debt waiver would take place based on the facts that the representative directors of the audited company had stated that they could not specify the timing of the debt waiver, and that additional loans had been made to the subsidiaries the current period.**

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above examples of deficiencies, 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. In particular, the engagement team needs to carefully examine the reasonableness of the timing of tax deduction for deductible temporary differences arising from the valuation of investments and loans for affiliated companies, including the need to use experts, since complex situations such as organizational restructuring are often involved.

In addition, in examining the tax effect on retained earnings on a consolidated basis, there were cases in which the engagement team did not sufficiently consider the audited company's policy that subsidiaries do not pay dividends in principle, and cases in which the engagement team did not sufficiently consider whether the dividend policy of a foreign subsidiary had been officially approved by a decision-making body, etc.

(7) Retirement benefit obligations

Case: Reliability of basic data

FREQUENT

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

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

However, the engagement team **did not examine the accuracy of the personnel data (salary, age,**

years of service, etc. of each employee) provided by the audited company to the pension actuary, and did not examine whether the assumptions used by the pension actuary in computing retirement benefit obligations conformed to the applicable financial reporting framework.

(Auditing Standards Statement No. 500, paragraph 8, and No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

«Points to Note»

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

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

(8) Asset retirement obligations

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

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

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

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

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

decided to close.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 8 and 11)
[Mid-tier, and small and medium-sized audit firms]

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 performing restoration obligations. In the case of profitable stores and the company's head office, on the other hand, it has not booked asset retirement obligations on the grounds that it is difficult to reasonably estimate the timing of performing restoration obligations because there are no current plans to close stores or relocate the head office. This is despite the fact that stores have been closed and the head office has been relocated in the past.

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

(Auditing Standards Statement No. 330, paragraph 20; No. 540 (Before amendment in January 2021), paragraphs 11 and 12) [Mid-tier, and small and medium-sized audit firms]

«Points to Note»

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

(9) Others

Case 1: Provisions for loss on order received

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

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

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

- Regarding cases where provisions for loss on order received had not been booked at the end of the previous fiscal year, the engagement team **did not sufficiently examine the completeness of the booking of provisions for loss on order received**, as the team did not examine whether or not there were any cases involving losses during the current fiscal year.
- Amid a situation in which there were cases of loss during the current fiscal year and even though there were other cases in which losses were expected for items with the same name and for the same customer, the engagement team merely vouched figures with the revised cost projection data prepared by the audited company, however, the team **did not examine the reasonableness of specific assumptions used by the audited company, nor did the team examine the realizability of cost reductions**.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 8 and 12)
[Mid-tier, and small and medium-sized audit firms]

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

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

As an audit procedure for revenue on a percentage-of-completion basis for this consolidated subsidiary, which is a significant component, the engagement team confirmed that the estimated total cost of construction used for calculating the progress rate matched the estimated total cost of construction estimated in advance in the document for the estimate prepared by the audited company. However, the engagement team **only examined that the estimated total cost of construction was**

consistent with the amount in the document for the estimate prepared by the audited company and examined the internal approval status, and did not obtain an understanding of the detailed estimation method used by the audited company.

(Auditing Standards Statement No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above cases, there are cases in which a loss was recorded in the current year for a construction contract for which provision for loss on construction was not recorded in the previous year, but the impact of management's estimates on the valuation was not considered. There are also cases in which management's assumptions about the period for which losses are expected to be incurred were not examined.

The engagement team should note that it is necessary to obtain sufficient appropriate audit evidence by taking into account the uncertainty of estimates for construction contracts, appropriately identifying the events for which expenses or losses are expected to be incurred in the future by comparing the accounting estimates for the previous year with the actual values for the current year, and by examining the appropriateness of estimation methods used by management in making accounting estimates, significant assumptions, and data.

5. Group Audit

Points of focus

Recent fraud cases identified at domestic and foreign subsidiaries have increasingly drawn the attention of users of financial statements. 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 qualitative aspects of components such as those with significant risks related to the group consolidated financial statements based on the nature and circumstance of each component, and does not simply make judgments based on whether the individual component is quantitatively material to the group financial statements;
- ▶ 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 an indication of material misstatement due to fraud 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 group 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

There were many cases in which group engagement teams put too much reliance on the audit results of component auditors without sufficiently evaluating them; there were also cases in which group engagement teams did not sufficiently perform risk assessments, such as not considering the possibility that component's financial statements contain significant risks; there were also cases in which communication with component auditors was inadequate, such as not communicating clearly the audit procedures that component auditors should perform; there were also cases in which the group engagement teams did not consider whether audit procedures to address significant risks in group financial statements were adequate; and there were also cases in which the group engagement team did not perform audit procedures for the consolidation process or consolidated journal entries.

(Observed effective efforts)

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

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

Expected response

Group engagement team is required to evaluate the work of the component auditors it uses, always bearing in mind that the responsibility for issuing appropriate auditor's reports lies with the group engagement team.

Group audit requires the group engagement team to sufficiently communicate with the component auditors about the nature, timing and extent 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 opinion about whether the group financial statements have been prepared in accordance with the applicable financial reporting framework. Therefore, the group engagement team needs to develop an appropriate audit plan, perform audit procedures, and evaluate whether sufficient appropriate audit evidence has been obtained to gain a basis for forming an opinion on group financial statements.

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

To properly conduct group audits, auditors are required to possess knowledge and experience required for ordinary audits as well as incidental capabilities suited to the circumstances, such as language skills and knowledge of accounting systems in specific countries.

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

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

Although the concept of "significant components" will be abolished in the revised Auditing Standards Statement No. 600, when determining significant components based on the current Auditing Standards Statement No. 600, it is necessary to appropriately determine not only sales but also assets, liabilities, cash flows, profits, etc. in the group financial statements as financial indicators to be used in determining individual financial significance, depending on the nature and circumstances of the group. It is also necessary to determine the significant components based on the specific nature and circumstances of components, such as take into account the qualitative significance such as the possibility of existing significant risks pertaining to the group financial statements, in addition to individual financial significance.

Case 1: Understanding the Component Auditor

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

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

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

《Points to Note》

The group engagement team should keep in mind that, when instructing a component auditor to perform audit work related to the component's financial information, it should understand if there are any issues pertaining to the component auditor's independence, whether the component auditor has the appropriate competence and capabilities as a professional expert, and whether it can involve itself in the work of the component auditor. In addition, when instructing a foreign component auditor to audit component financial information prepared in accordance with Japanese GAAP, it is necessary to consider whether the

component auditor has sufficient knowledge to perform the audit.

Case 2: Materiality

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

However, although employee fraud had been identified in the previous fiscal year at Subsidiary A, a significant component of the audited company, the group engagement team **did not consider whether it was necessary to set a different materiality depending on the circumstances of each component, including the fraud identified.**

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

《Points to Note》

To reduce the possibility that the total uncorrected and undiscovered misstatements in the group financial statements exceed group materiality to a minimum acceptable level, component materiality shall be set lower than the group materiality. The group engagement team needs to sufficiently understand the business of the audited company's group and its business environment in deciding component materiality. If any changes occur in the business environment, the team needs to appropriately take into account its effects and consider the adequacy of component materiality to perform appropriate audit procedures to address audit risks for each component. In addition to the above case, there were cases in which the group engagement team did not evaluate the appropriateness of the performance materiality, as exemplified by a failure to request component auditors to report on the performance materiality that they had determined.

Case 3: Determining audit procedures to be performed for the financial information of components



- ① In preparing the consolidated financial statements, the audited company used the financial statements of Company A, an overseas subsidiary, based on its provisional closing of accounts as of the consolidated closing date (March 31), because the end of the fiscal year of Company A was December 31.

The group engagement team assessed Company A as a significant component with individual financial significance and identified the risks of material misstatement at the assertion level relating to significant account balances.

The group engagement team sent audit instructions to the component auditor of Company A and requested the auditor to audit the financial information for the period ended December 31 based on component materiality. In light of the response to the audit instructions from the component auditor, the group engagement team also instructed the component auditor to perform the following

additional procedures for the period from January 1 to March 31:

- Detailed test of sales
- Cutoff test of sales
- Inspection of journal entry for cancellation of sales such as returns subsequent to the year-end date (March 31)
- Confirmation of accounts receivable balance (record date: the end of March)
- Valuation of aged accounts receivable
- Valuation of inventories
- Journal entry test
- Investigation of subsequent events

The group engagement team instructed the component auditor of Company A to perform substantive procedures for the risks of material misstatement at the assertion level relating to certain significant accounts above and obtain the results, **however, the group engagement team did not instruct the component auditor to perform substantive procedures for the period from January 1 to March 31** for the risks of material misstatement at the assertion level relating to cash deposits, property, plant and equipment, short-term loans payable, cost of sales, selling, general and administrative expenses, deferred income taxes and other items that were identified as significant account balances by the engagement team.

(Auditing Standards Statement No. 300, paragraphs 21; No. 600, paragraphs 23 and 25) [Mid-tier, and small and medium-sized audit firms]

- ②The group engagement team determined materiality for the entire group financial statements based on the pre-tax net profits in the business plan, which were also used as the basis of the financial indicator to designate a significant component with individual financial significance. The group engagement team did not identify Company A, a component of the audited company's group, as a significant component that was financially significant to the audited company's group because Company A's pre-tax net profits for the current period accounted for less than a certain percentage of its group net profits. On the other hand, the group engagement team identified a fraud risk of overstatement of accounts related to the fraud in response to the detection of fraud at Company A during the fiscal year, designated Company A as a significant component that may include significant risks in the group financial statement, and performed substantive procedures. However, despite the fact that Company A's "revenue," "cost of sales," and "bonds and loans payable" represented a relatively high proportion of each account in the group financial statements, the group engagement team did not perform substantive procedures for these accounts in Company A other than the procedures to respond to such fraud risk above, and **did not obtain sufficient appropriate audit evidence to provide the basis for expressing an opinion on the group financial statements.** (Auditing Standards Statement No. 600, Paragraphs 11 and 17). [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The group engagement team needs to pay attention to whether the work planned by the group engagement team as procedures to be performed for each significant component and non-significant component has been completely communicated to the component auditors, or whether the work to be performed has been appropriately planned and performed by the component auditors.

Case 4: Involvement in audit procedures undertaken by component auditors

FREQUENT

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

However, the group engagement team did not discuss with the component auditor the significant risk of "understatement of working budget" used for the estimate calculation of the percentage-of-completion method of accounting.

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

FREQUENT

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

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

- With regard to the fraud risks in revenue recognition, the group engagement team merely gained an understanding of the relevant assertions and was not sufficiently involved in risk assessment by the component auditors; for example, the team did not obtain the details of the risks in the concrete.
- With regard to the risk of management override, the group engagement team did not fully evaluate the appropriateness of audit procedures to address the risk; for example, the team did not ascertain the extraction criteria for journal entry testing performed by the component auditors as audit procedures to address the risk.

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

《Points to Note》

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

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

Case 5: Consolidation process

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

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

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

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

②The audited company adjusted the financial statements of a consolidated subsidiary due to material discrepancies in accounting records relating to inter-company transactions between the group companies resulting from the difference between the closing date for the consolidated subsidiary and the consolidated closing date.

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

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

③When a consolidated subsidiary, Company A conducted a public offering of shares at the time of listing, Company A received capital injection from the non-controlling shareholders of Company A. As a result, the audited company's equity ratio in Company A decreased. The audited company

accounted for the decrease in the equity ratio as an increase in non-controlling interests for the entire amount of capital injection in the consolidated financial statements.

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

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

《Points to Note》

There were cases in which: when examining consolidated journal entries, the group engagement team merely made comparisons with the previous period's balances and observed documents prepared by the audited company, and did not perform substantive procedures; or, due to a lack of a sufficient understanding of the audited company and its business environment at the group level to provide the basis for risk assessment of group financial statements, the group engagement team did not examine whether unrealized profits were completely eliminated even though complex inter-company transactions had occurred.

There were also cases in which the group engagement team did not examine whether component financial information reported by component auditors was reflected in the group financial statements, and cases in which the group engagement team did not consider the necessity of adjusting the accounting treatment to be based on the same accounting standards as the group financial statements when an overseas component prepared its financial statements based on local accounting standards.

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

Case 6: Subsequent events

The group engagement team instructed the auditors of multiple foreign components of the audited company group to report on subsequent events and seek their responses.

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

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

《Points to Note》

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

Case 7: Communication with component auditors

FREQUENT

① The group engagement team sent audit instructions concerning the financial information of a significant component of the audited company's group to the auditor of the component and received a response from the auditor, but did not sufficiently communicate with the auditor on the following points:

- The audit engagement team did not communicate with the auditor regarding the threshold for accumulating identified misstatements, below which was clearly trivial in respect of the group financial statements.
- Although the group engagement team **had identified significant risks in the group financial statements of the components** (fraud risks related to revenue recognition and risk of management override), the group engagement team did not communicate with the auditors these risks.
- The group engagement team **did not comprehensively communicate the list of related parties with the auditors**, as the team informed them of the audited company's subsidiaries and affiliates as related parties, but did not inform of its major shareholders and executives as related parties.
- The group engagement team did not instruct the auditors to report any indications of management bias at the components material weaknesses in internal controls over financial reporting identified in the components, and any other significant matters that the auditors had reported or planned to report to those charged with governance of the components.

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

NEW

② The group engagement team received a report from the component auditor of Company A, a consolidated subsidiary of the audited company and a significant component, that the team had identified a misstatement relating to an overstatement of sales due to the recognition of revenue at a point of time that should have been recognized over a certain period of time under the new contractual arrangements (hereinafter referred to as the "Misstatement"). The group engagement team carried out additional procedures to ascertain details of the Misstatement and to determine the amount of the Misstatement, including communicating with the component auditor and inspecting related audit documentation. The group engagement team also concluded that the Misstatement was a simple error and did not pose an audit issue after the audited company corrected the Misstatement in its consolidated financial statements. The engagement team did not receive any reports report

from the component auditor on whether or not the Misstatement was an indication of fraud or an internal control deficiency.

However, the group engagement team did not instruct the component auditor to report on the examination of **whether or not the Misstatement was an internal control deficiency of the audited company group or an assessment of whether or not the Misstatement was an indication of fraud**, and did not sufficiently communicate with the component auditor.

(Auditing Standards Statement No. 240, paragraph 34; No. 265, paragraph 6; No. 600, paragraph 40 and 41)[Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

However, as shown above, there were cases in which the group engagement team did not appropriately communicate with component auditors such risks. There were also cases in which: the team did not communicate with the component auditors component materiality; or, even though component auditors reported significant risks to the group engagement team, the team did not sufficiently examine those risks constituted significant risks in respect of the group financial statements; or the timing of obtaining information, including audit plans, from component auditors was too late; or the group engagement team did not present an exhaustive list of related parties that included executives. Group engagement teams need to engage in effective two-way communication with component auditors.

Case 8: Sufficiency and appropriateness of audit evidence obtained



①The group engagement team instructed the auditor of Company A, which the group engagement team deemed to be a significant component of the audited company's group, to perform an audit of the financial information of Company A. The group engagement team received a report from the auditor of this component concerning an uncorrected misstatement in the financial statements of Company A, which exceeded the amount deemed to be clearly trivial in respect of the group financial statements.

However, the group engagement team **did not assess the impact of this uncorrected misstatement reported by the auditor of this component on the audit opinion on the consolidated financial statements**.

(Auditing Standards Statement No. 450, paragraph 4; No. 600, paragraphs 30 and 44) [Mid-tier, and small and medium-sized audit firms]

NEW

FREQUENT

② The group engagement team designated Company A, a consolidated subsidiary of the audited company, as a significant component of the audited company's group, and sent audit instructions concerning Company A's financial information to the component auditor. As a result of performing balance confirmation procedures for related parties, the group engagement team received a report from the component auditor stating that (a) responses to some balance confirmations had not been received, and (b) investigations into some confirmation differences had not been completed.

However, the group engagement team **did not hold discussions with the component auditor regarding the results of performing balance confirmation procedures in (a) and (b) above**. The group engagement team also did not consider whether alternative audit procedures should be performed for the related parties for which balance confirmation had not been answered, and did not consider whether additional procedures should be performed for the related parties for which investigations into confirmation differences had not been completed to determine whether the differences indicated misstatements.

(Auditing Standards Statement No. 505, paragraph 11 and 13; No. 600, paragraph 41 and 42) [Mid-tier, and small and medium-sized audit firms]

③ The group engagement team instructed the auditor of a significant component of the audited company's group to perform an audit and used the results of the audit.

However, despite receiving a report from the auditor of the component that internal control deficiencies had been identified as a result of the assessment of the audit for internal control over financial reporting, the group engagement team did not assess these deficiencies and did not consider the necessity of additional procedures.

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

④ Regarding the financial information for two significant components, the group engagement team sought a quality review for the purpose of expressing an opinion regarding the audited company's group financial statements before completing its review of audit working paper relating to the accounts with risks of material misstatement, including significant risks in respect of the group financial statements. Thus, the group engagement team did not obtain sufficient appropriate audit evidence **before expressing an audit opinion on the audited company's group financial statements.**

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

《Points to Note》

Group engagement teams should evaluate whether audit procedures performed on the consolidation

process and on component financial information by the group engagement team and component auditors provide sufficient appropriate audit evidence to form a basis for expressing an opinion on the group financial statements.

However, as in the above examples of deficiencies, there were cases in which the group engagement team did not receive reports on the results of audit procedures from the component auditors in a timely manner, cases in which the group engagement team only obtained information on the results of audit procedures from the component auditor and did not evaluate the sufficiency and appropriateness of audit evidence obtained for significant risks, and cases in which the group engagement team did not evaluate component misstatements that were uncorrected and in an amount exceeding the amount deemed to be clearly trivial in respect of group financial statements or internal control deficiencies. Notably, even if a 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.

Auditing Standards Statement 600 (Special Considerations – Audits of Group Financial Statements)

As at January 12, 2023, an amendment of the Auditing Standards Statement 600 was released and renamed from "Group Audit" to "Special Considerations – Audits of Group Financial Statements."

The outline of the amendment is as follows:

Effective Date

From an audit of financial statements for the fiscal years starting on or after April 1, 2024 and an interim audit of financial statements for the interim accounting period starting on or after April 1, 2024 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, from an audit of financial statements for the fiscal years starting on or after July 1, 2024 and an interim audit of financial statements for the interim accounting period starting on or after July 1, 2024 by special exception)

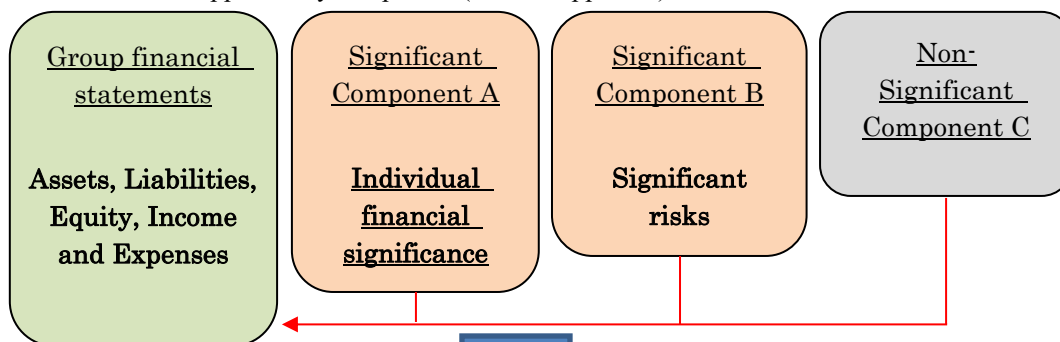
Major amended points

- The name changed from "group audit" to "special considerations –audits of group financial statements"
- Clarified that all other Auditing Standards Statements need to be applied as a matter of course to group audits, in particular by referring to or expanding on Auditing Standards Statements 220, 230, 300, 315 and 330, and emphasized that Auditing Standards Statement 600 provides practical guidance on matters to be considered in group audits; and
- Discontinuation of the concept of significant components;
- Greater emphasis on group auditors' identification and assessment of the risks of material misstatement in the group financial statements, and determination of auditor's responses to the assessed risks of material misstatement in the group financial statements, and more flexibility in component determination (refer to [Figure 8]);
- Materiality
- "Component materiality" was changed to "Component performance materiality" as an appropriate threshold for designing and performing audit procedures for component financial information.
- Materialization of the definition of "group financial statements"
- Even in the case of stand-alone audits, if there are branches, departments, shared service centers, etc., they may be subject to group audits.
- Define the scope of work in the component;
- Provisions of (I) "design and implementation of responses to the assessed risks of material misstatement for overall component financial information", (ii) "design and implementation of

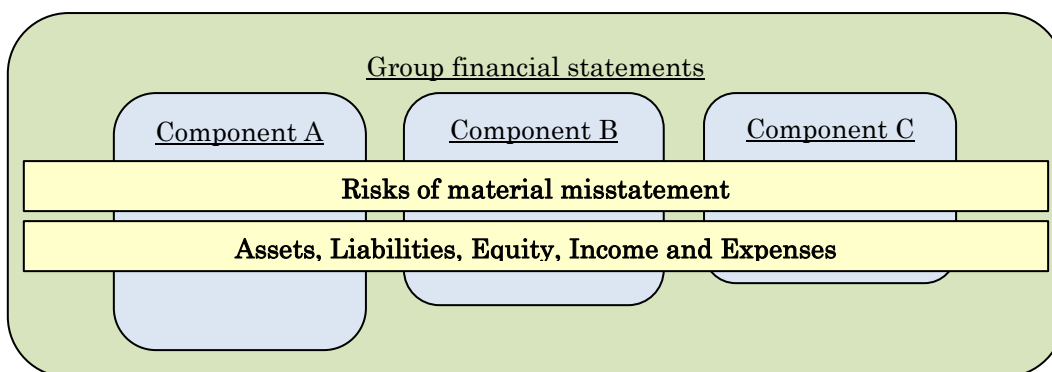
responses to the assessed risks of material misstatements for one or more classes of transactions, account balances and disclosures", and (iii) "implementation of specific responses to the assessed risks of material misstatements";

[Figure 8] Changes in approaches to group audits

(Before amendment) Approach by component (Vertical approach)



(After amendment) Account-level approach for group financial statements(Horizontal approach)



(Materials) Prepared by the CPAAOB based on materials published by the JICPA

6. Using the work of Auditor's expert

Points of focus

The auditor may make use of expert to obtain sufficient appropriate audit evidence if the auditor needs expertise in areas other than accounting or auditing. The CPAAOB inspects whether the engagement team evaluate if the auditor's expert has the necessary competence, capabilities and objectivity for the purposes of the audit of financial statements, and whether the auditor evaluates the appropriateness of the expert's work.

Outline of inspection results

The CPAAOB noted cases that the engagement team did not determine whether to use the work of the auditor's expert even when specialized knowledge was required, and that the engagement team did not sufficiently evaluate the appropriateness of expert's work, due to the engagement team relied excessively on the results of expert's work.

The CPAAOB also noted cases that the engagement team did not have sufficient communication with the auditor's expert about the scope to be used and purpose of the work, and that the engagement team did not sufficiently evaluate the appropriateness of the expert's work.

Expected response

Engagement team should always keep in mind that the engagement team is solely responsible for the audit opinion expressed in the audit of financial statements, and that the use of an expert's work does not relieve its responsibility. Therefore the engagement team should evaluate appropriateness of the auditor's expert's work.

When using expert's work, the engagement team should determine whether to use, evaluate the competency, capabilities and objectivity of the auditor's expert, and evaluate the appropriateness of the expert's work for the audit purpose. Also, the engagement team should sufficiently consult with the expert about the purpose and scope of the work to be used, without relying everything on the expert, in order to obtain sufficient appropriate audit evidence conforming to the audit purpose.

Case 1: Determining the need for auditor's expert



The audited company recorded impairment losses on the fixed assets of Factory A and Overseas Subsidiary B (hereinafter referred to as the "Fixed Assets") based on the net selling value obtained from real estate appraisers who are external experts (hereinafter referred to as the "Appraisers").

The engagement team identified significant risk on impairment of the Fixed Assets and determined it is as Key Audit Matter (KAM). According to such judgment, the engagement team evaluated the competence, capabilities and objectivity of the Appraisers, and also examined the appraisal value by them.

However, the engagement team **did not determine whether to use an auditor's expert**, despite

the fact that the valuation of the fixed assets for the impairment of test needs an expert's knowledge about real estate appraisal.

(Auditing Standards Statement No. 620, paragraphs 6) [Mid-tier, and small and medium-sized audit firms]

Case 2: Competence, capabilities and objectivity of auditor's expert

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

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

Case 3: Agreement with auditor's experts

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

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

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

«Points to Note»

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

In addition to the above cases, the CPAAOB also noted cases in which, although the evaluation method adopted by the auditor's expert was different from the one designated by the engagement team, the team did not examine the appropriateness of the work done by the expert.

It should be noted that, for requirements when the engagement teams undertake consultation on matters that involve difficulties in accounting or auditing judgments, refer to paragraph 35 of "Quality Control in Audit Engagements" in Auditing Standards Statement No. 220 (revised in June 2023). For points to note in the case where audit evidence is based on the work of experts used by the audited company's management, refer to the section "3. Audit Evidence".

7. Audit of Internal Control over Financial Reporting

Points of focus

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

- ▶ Whether the engagement team develops an audit plan in consideration of materiality, with an understanding—based on the audited company’s business environment and business characteristics—of the design and operating effectiveness of internal control and evaluation thereof by the management;
- ▶ Whether the engagement team evaluates the reasonableness of the method used by the management to determine the scope of evaluation of internal controls and the basis for the determination.
In particular, in cases where the management has prepared an internal control report that excludes the scope of matters for which evaluation procedures could not be performed, whether the engagement team examines the reasonableness of the reason why the management has excluded such scope, and the impact of such exclusion on the financial statement audit;
- ▶ Whether the engagement team appropriately evaluate the deficiencies identified by the management; especially in evaluating the degree of control deficiencies, does the engagement team examine the potential impact of the deficiencies and the possibility of the occurrence of a material misstatement by taking into consideration the quantitative and qualitative effect on the overall internal controls over financial reporting of the audited company;
- ▶ Whether, in the course of an audit of internal control over financial reporting, the engagement team reports the deficiencies detected by the engagement team to the appropriate person in a timely manner and examines the possibility of the deficiencies being significant deficiencies to be disclosed;
- ▶ Whether, if the engagement team has discovered a material weakness, the team reports this to the management and requests the management to remediate it, and examines progress made in remediating the deficiencies in a timely manner; and
- ▶ Whether the engagement team evaluates the impact of the misstatements identified during the course of the audit of financial statements on the audit of internal control over financial reporting.

Outline of inspection results

The CPAAOB noted 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 evaluation of internal control, the internal auditors’ capability and objectivity, the appropriateness of samples, and the method for evaluation on internal control and so on.

Furthermore, there were cases in which responses in internal control audits remained perfunctory, despite changes in the environment at audited companies, such as changes in significant business locations due to corporate acquisitions and the commencement of new business. The CPAAOB also

noted cases in which the engagement team did not determine whether to expand the scope of work performed by the auditor itself despite the fact that the process involved significant risks when using the work of internal auditors, etc. The CPAAOB also noted cases in which the engagement team did not determine whether a deficiency identified in the course of the financial statement audit was a significant deficiency that should be disclosed. The CPAAOB also noted cases in which the engagement team did not obtain audit evidence that specifically indicated the status of improvement of the deficiencies.

Expected response

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

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

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

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

In particular, an auditor should carefully evaluate whether sufficient appropriate audit evidence has been obtained for high-risk areas, such as processes newly included in the scope of assessment and processes related to significant risks.

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

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

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

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

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

《Points to Note》

“Significant accounts for business 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 the engagement team should appropriately select significant accounts in consideration of the audited company’s type of industry, business environment and business characteristics. In particular, when changes occur to the audited company's business activities or profit structure, it is necessary to carefully determine the selection of important accounts.

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

NEW

① The audited company included inventories in the scope of internal control evaluation because they are accounts significantly involved with business purposes of a consolidated subsidiary that is a significant business location.

FREQUENT

However, the engagement team **did not examine the reasonableness of the fact that the audited company excluded the processes related to inventories from the scope of internal control evaluation, except for the process of physical inventory count.**

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 97 and 101) [Large-sized audit firms]

NEW

② Although the engagement team identified significant risks in the revenue recognition of a consolidated subsidiary of the audited company, the engagement team **did not examine reasonableness of the fact that the audited company did not to include the sales process in the evaluation of internal controls.**

FREQUENT

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 112) [Large-sized audit firms]

③ The audited company used an ERP system composed of sales management, procurement and inventory management, production management, project management, financial accounting, management accounting, and personnel management modules.

Amid this situation, the engagement team evaluated the design of IT general controls relating to the system, but did not evaluate the operating effectiveness of IT general controls relating to it.

Moreover, in evaluating internal control over business processes, the team evaluated only the operating effectiveness of manual internal controls and did not evaluate the operating effectiveness of IT application controls.

However, although the system was a key system widely related to internal control over business processes and financial reporting, the engagement team **did not evaluate the appropriateness of not testing the operating effectiveness of IT general controls and its IT application controls of the ERP system.**

(Auditing Standards Statement No. 315(Before amendment in June 2021), paragraphs 17 and 20; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 144) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

It is considered that business processes relating to accounts with significant risks should normally be included in management's evaluation of internal controls.

If such business processes are not included in the scope of management's evaluation of internal controls, the engagement team should discuss with the management about the management's method for determining the scope of assessment and the basis for the determination, and carefully examine whether there are reasonable grounds for not including them in the scope of assessment.

In addition, if there is a business process that is included in business processes significantly related to the business objectives of a significant business location, but is excluded from the assessment by the management because it is not related to a significant business or operation and has an insignificant impact on financial reporting, the engagement team should carefully examine the reason for not including it in the assessment.

Furthermore, when evaluating the design of internal controls, the engagement team needs to pay attention to whether or not there are any omissions in the IT application controls that should be subject to evaluation, in order to prevent the IT application controls from not being identified as internal controls.

(2) Method of Evaluation of Internal Control

Case 1: Sampling



① In the procedures for evaluating the operating effectiveness of internal controls related to the audited company's journal entry process, the engagement team did not include journal entries related to sales in the population, and did not set an appropriate population for the purpose of audit procedures. (Auditing Standards Statement No. 530, paragraph 5) [Mid-tier, and small and medium-sized audit firms]



② With regard to internal controls over the operation of checking whether products were appropriately transferred to product installers in the audited company's sales process, when performing an audit

procedures for operating effectiveness of internal control, the engagement team determined the number of samples to be four in consideration of the frequency and risks of internal controls.

As a sample, the engagement team selected four randomly selected months, however, for two of the four selected months, there was no product transfer and the internal controls were not performed. As a result, the engagement team performed tests of the operating effectiveness of the internal controls for two samples selected from the remaining two months.

However, the engagement team did not sufficiently examine the appropriateness of the final sample size (two samples) in the procedures for evaluating the operation of internal controls over the audited company's sales process.

(Auditing Standards Statement No. 530, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

«Points to Note»

When designing audit sampling, it should be noted that consideration must be given to the objectives of the audit and the characteristics of the population from which the sample is to be taken, and that a sufficient sample size must be determined to limit sampling risk to a minimum acceptable level.

When conducting sampling for the procedures for evaluating the operating effectiveness of internal controls, it is necessary to fully understand the purpose of Auditing Standards Report 530 ("Audit Sampling"), and to set an appropriate population and select an appropriate sample.

Case 2: Evaluation of design and operating effectiveness of internal controls

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

However, although the engagement team performed procedures to evaluate the operating effectiveness of internal controls in respect of business processes relating to sales associated with the condominium management business by vouching with the table of approval stamps for selected samples, the team **did not appropriately evaluate the operating effectiveness of internal controls, as the table of approval stamps did not contain any date information and the engagement team only vouched the amounts, without examining the appropriateness of the timing of revenue recognition.**

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

NEW

- ② In performing procedures for evaluating the design of internal controls for the audited company's sales and cost accounting processes, the engagement team **only confirmed changes in key control points, except for the key control points for sales recording, from the previous fiscal year and did not perform procedures for evaluating the design of controls the current period.**

(Auditing Standards Statement No. 315 (Before amendment in June 2021), paragraphs 12) [Mid-tier, and small and medium-sized audit firms]

NEW

- ③ With regard to procedures for evaluating the operating effectiveness of internal controls over the audited company's sales processes, the engagement team **only performed procedures for evaluating IT application controls with regard to internal controls over order approval by the sales division manager, which was a key point in controls. The engagement team did not perform procedures for evaluating the operating effectiveness of internal controls over manual application processes.**

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

《Points to Note》

When evaluating the design and operating effectiveness of internal controls, the engagement team should pay attention to evaluating internal controls that appropriately respond to the identified risks of material misstatement. In addition, when evaluating internal controls for IT, the engagement team should pay attention to designing and implementing appropriate responses to IT-related risks by also referring to Auditing Standards Statement 315 Practical Guidance No. 1.

When evaluating internal controls, the engagement team should also pay attention to changes in the business activities and profit structure of the audited company, without being caught up in past audit experience.

In addition, the closing and financial reporting processes are business processes that are extremely important in terms of the reliability of financial reporting, and there are many internal controls that have a wide range of impact compared to other business processes related to daily transactions. Therefore, the engagement team should note that the engagement team must perform audit procedures with due care when examining the design and operating effectiveness of internal controls.

In addition, the assessment of information processing controls where manual work and IT work together requires a holistic understanding and assessment of both.

In addition to the above examples of deficiencies, the CPAAOB noted cases in which internal control operation evaluation procedures were performed only on the basis of whether approval stamps were affixed, cases in which IT general controls (program changes, responses to system failures, access controls, etc.) were insufficiently evaluated, cases in which the necessity of including automated information processing controls in the scope of internal control audit was not considered, and cases in which, when a system change was made, only the information processing controls of the old system were evaluated and the information

processing controls of the new system were not evaluated.

Case 3: Timing of evaluation procedures

- ① The engagement team did not obtain sufficient and appropriate audit evidence to express an audit opinion regarding the audit based on the Companies Act, as **the engagement team performed audit procedures regarding the audited company's IT application controls** relating to individually evaluated financial closing and reporting processes such as various allowances, taxes and tax effects, and business processes such as automatic journal entries **after the date of the auditor's report under the Companies Act, but before the date of the auditor's report under the Financial Instruments and Exchange Act.**

(Auditing Standards Statement No. 330, paragraph 25) [Mid-tier, and small and medium-sized audit firms]

- ② The engagement team inspected management evaluation result verified based on the samples selected from the transactions in the first quarter, and made inquiries and observed relevant documents as of the interim date. In addition, the engagement team obtained the documents from the audited company confirming whether or not any material changes to internal controls were made, subsequently after the year-end closing date. As the result of the audit procedures above, the engagement team determined that the design and operating effectiveness of process-level controls as effective.

However, the engagement team **did not determine what additional procedures to perform in order to evaluate whether the evaluation results of internal controls as of the interim date, that was verified based on the samples selected from the transactions in the first quarter, remained effective as of the year-end closing date.**

(Auditing Standards Statement No. 330, paragraph 11; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 160) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

With respect to the evaluation of process-level controls of which the engagement team rely on the operating effectiveness in the audit of financial statements, it is necessary to complete procedures for evaluating the operating effectiveness and roll-forward procedures by the date of the Companies Act audit report.

For the determinants of obtaining additional audit evidence in performing roll-forward procedures, please refer to Auditing Standards Statement 330, Paragraph A32.

Furthermore, if the engagement team plans to rely on related internal controls when determining the type, timing and scope of substantive procedures for the financial statement audit, it is recommended that the engagement team complete an audit procedures on an operating effectiveness of process-level controls

before performing significant substantive procedures.

This also applies to the evaluation of the effectiveness of information processing controls, including IT, and general controls over IT that supports the information processing controls.

(3) Assessment of Deficiencies

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

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

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

(Auditing Standards Statement No. 315(Before amendment in June 2021), paragraph 30; IT Committee Practical Guideline No. 6(Abolished in October 2022), paragraph 53) [Mid-tier, and small and medium-sized audit firms]

Case 2: Evaluation of internal controls relevant to misstatements

NEW

The engagement team identified an uncorrected misstatement in the audited company's consolidated financial statements.

FREQUENT

The engagement team also examined whether the misstatement indicated deficiencies in internal controls, and as a result, identified deficiencies in internal controls in the audited company group. However, the engagement team did not ascertain the specific details of the aforementioned internal control deficiencies, and did not examine the likelihood of occurrence of misstatements and the extent of potential impact on financial reporting as a whole due to the deficiencies. The engagement team also did not examine whether these deficiencies, singly or in combination, constituted significant deficiencies to be disclosed by the audited company.

(Auditing Standards Statement No. 265, paragraph 6 and 7; Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 187) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

When finding a deficiency in internal control, the engagement team is required to: confirm which classification it falls under; take into account its quantitative and qualitative materiality and existence of compensating controls; calculate the potential quantitative impact of the deficiency discovered; and examine which accounts will be affected by such deficiency and to what extent, and the likelihood of occurrence of material misstatement. The engagement team needs to pay attention to the fact that it is required to carefully judge if the deficiency discovered falls under significant deficiencies to be disclosed. It should also be noted that if the misstatement identified by the auditor resulted from a failure of the internal control to function, it may indicate the possibility of other misstatements.

(4) Use of the work of internal auditors

Case: Extent of using the work of internal auditors

NEW

① The engagement team identified the risk of inappropriate revenue recognition by the audited company as a significant risk.

FREQUENT

In addition, the engagement team used the work results of the audited company's internal auditors in performing audit procedures for operating effectiveness of internal controls on the sales process. However, although the engagement team **identified a significant risk with the revenue related to the sales process, the engagement team used the work results of the internal auditor to the same extent as if the significant risk had not been identified, and did not sufficiently determine whether to expand the scope of work to be performed by the auditor itself.**

(Auditing Standards Statement No. 610, paragraphs 14) [Large-sized audit firms]

NEW

② The engagement team re-performed part of the sample testing by the internal auditor of the audited company, and tested additional samples selected by the engagement team for operating effectiveness of internal control.

FREQUENT

However, the engagement team **did not confirm the completeness of the population subject to the sample testing** performed by the internal auditor for evaluating operating effectiveness of internal controls.

(Auditing Standards Statement No.530, paragraph 7, No. 610, paragraph 13 and 19) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

From the viewpoint of conducting effective and efficient audits, there are many cases of using the work of internal auditors. However, it should be noted that the auditor is solely responsible to express audit opinion, and the auditor's responsibility cannot be reduced even if the engagement team use the work of internal auditors.

Where the work of internal auditors is used, the auditors must perform audit procedures to assess the objectivity and competence of the internal auditors and to assess the appropriateness of the work used.

In addition, auditors should keep in mind that if the risks of material misstatement, such as significant risks, are high, the scope of use of the work of internal auditors should be reduced compared to otherwise.

(5) Review of internal control report

Case: Review of internal control report



The engagement team did not sufficiently examine the appropriateness of the fact that the audited company had identified four accounts, "sales," "accounts receivable," "inventories," and "sales promotion expenses," as "accounts significantly related to the company's business objectives," but only three accounts, "sales," "accounts receivable," and "inventories," were included in the internal control report.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraphs 257)

[Large-sized audit firms]

《Points to Note》

The engagement team needs to read through the internal control report prepared by the audited company, and examine whether there are any material misstatements (including omissions) with respect to the scope of internal control assessment, assessment procedures, assessment results, and supplementary notes.

Revision of Auditing Standards for Internal Controls over Financial Reporting Statement No. 1

"Audit of Internal Controls over Financial Reporting"

Application period

This shall be applied from the internal control audit for the fiscal year starting from April 1, 2024.

Main points to be noted in connection with the revision

- Fraud risk considerations

- Fraud risks need to be considered in "risk assessment and response", which is a basic element of internal controls.

In evaluating company-wide internal controls, the auditor shall pay attention to whether fraud risks and risks of management ignoring or overriding internal controls are appropriately considered, and whether risks are reassessed in response to changes in risks and responses to risks are reviewed in a timely manner.

It is necessary to pay attention to these risks in business processes as well as in the closing and financial reporting processes.

- Determination of the scope of evaluation

- When selecting business locations and business processes to be evaluated, make a judgment according to the environment in which each company is located and the characteristics of its business, instead of making a mechanical judgment using the listed selection criteria. In addition, it is necessary to consider whether or not it is necessary to include specific business locations and business processes that have been outside the scope of evaluation for a long period of time in the scope of evaluation.

- Impact of the results of the financial statement audit on the internal control audit

- If a deficiency in internal controls is identified during the course of the financial statement audit outside the scope of the management's assessment of internal controls, the impact of the deficiency on the scope and assessment of the internal controls should be fully considered.

- Clear indication of matters that should be included in the internal control report

- The following shall be included in the scope of evaluation of internal controls in the internal control report:
 - (1) Indicators used in the selection of significant business locations and their percentage
 - (2) Accounts that are materially relevant to the business objectives of the company selected in identifying the business processes to be evaluated
 - (3) Business locations and business processes that were individually added to the scope of evaluation

8. Key Audit Matters (KAM)

Points of focus

The CPAAOB inspects audit procedures concerning Key Audit Matters ("KAM") from the following perspectives:

- ▶ Whether the engagement team determines matters that it judges to be particularly important, as a professional expert, as KAM through an appropriate process that includes communication with company auditors, etc.
- ▶ Whether the engagement team appropriately describes the content of KAM and the reason for determining KAM in the audit report.
- ▶ Whether the engagement team appropriately performed the audit procedures described as audit responses in KAM in the audit report.

Outline of inspection results

The CPAAOB noted cases where the reference to the notes in the financial statements included in KAM in the audit report was inaccurate, and some of the audit responses included in KAM were not performed.

(Observed effective efforts)

The following examples can be cited as effective efforts to improve the appropriateness of the content of KAM.

- A dedicated team for KAM was established within the quality control department to provide overall support to engagement teams, including preparation of working paper templates, development and dissemination of example entries and manuals, and implementation of training related to KAM.
- Quality control system for KAM was developed, such as implementing requirement to have KAM draft reviewed by reviewers other than the EQC reviewer and individual reviews by the EQC reviewer.
- Requiring the consultation and senior review on important issues.

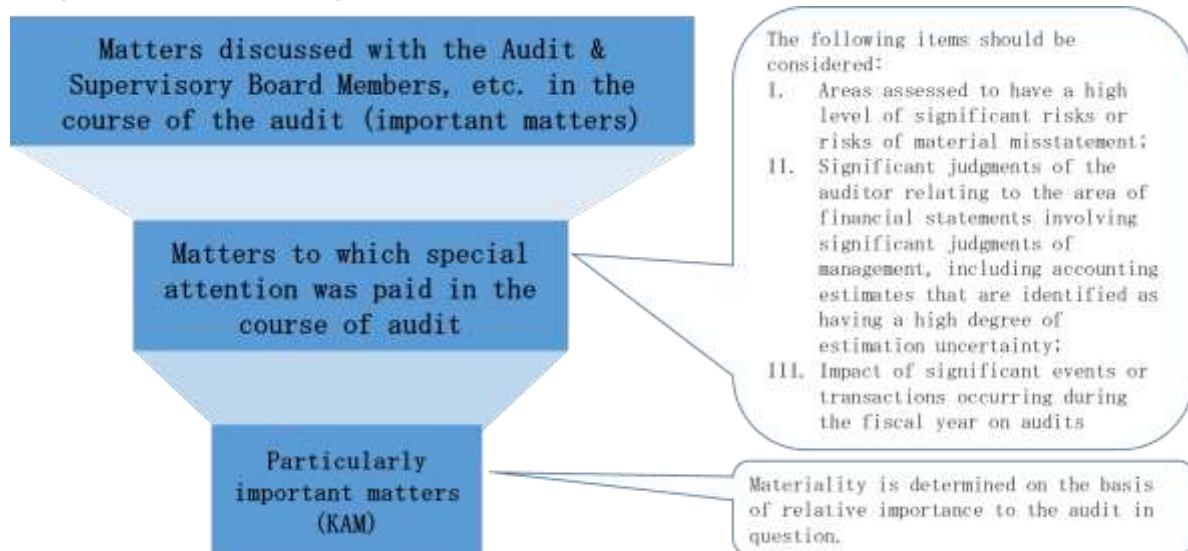
Expected response

The purpose of KAM is to enhance the informational value of audit reports by enhancing transparency regarding audits performed. KAM can also enhance audit transparency by providing users of financial statements with additional information that may help them understand matters that the engagement team, as a professional, determine to be particularly important. Therefore, auditors are required to take appropriate actions based on a full understanding of the purpose of KAM so that they do not turn KAM into a boilerplate or a mere facade. Please refer to [Figure 9] for the process of determining KAM.

For the appropriate description of KAM, please also refer to Auditing Standards Statement 700 Practical Guidance No. 1 "Q & A on Audit Reports (Practical Guidance)" published by the JICPA. When determining KAM, the engagement team is required to have active communication with the management and company auditors of the audited company. It is also necessary to note that the "Description of and Reason for

Determination of KAM" included in the audit report should be directly linked to the audited company's specific circumstances by identifying the scope and amount of the KAM. In addition, the "Audit Response" included in the audit report should be as specific as possible about procedures or audit approaches that conform to the factors listed in the reason for determining KAM.

[Figure 9] Reference image: KAM Determination Process



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

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

In considering the KAM for the audit of the consolidated financial statements, the engagement team determined that the recoverability of deferred tax assets recorded in the company's non-consolidated financial statements is to be as KAM.

However, in the auditor's report on the consolidated financial statements submitted to the audited company, the engagement team specified the amount of deferred tax assets given in the consolidated financial statements after referring to the note in the consolidated financial statements regarding deferred taxes accounting, but without disclosing the scope of deferred tax assets covered by the KAM, thereby resulting in a description which implies that the KAM would cover the examination of the recoverability of entire deferred tax assets recorded in the consolidated financial statement. Thus, the engagement team **did not sufficiently consider the appropriateness of the description of KAM and the reason for deciding on it for the consolidated financial statements.**

(Auditing Standards Statement No. 701, paragraphs 12 and A47) [Mid-tier, and small and medium-sized audit firms]

Case 2: Descriptions relating to audit responses

NEW

FREQUENT

The engagement team stated in the audit report on the audited company's consolidated financial statements that the engagement team determined valuation of goodwill as KAM and performed audit procedures as audit responses, such as comparing past business plans with subsequent results, inspecting materials on recent sales results from major customers, and inspecting materials on expected orders and project wins.

However, the engagement team **did not actually perform the above procedures as an audit response relating to KAM, but stated in its audit report that it did.**

(Auditing Standards Statement No. 701, paragraphs 12 and A46) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

The CPAAOB noted many cases where procedures that were described as having been performed as an audit response were not actually performed. The engagement team should sufficiently confirm the accuracy of KAM, because the KAM is the information how the engagement team respond to matters that the auditor determined to be particularly important in the audit of financial statements for the current fiscal year, from among matters that the engagement team paid particular attention and discussed with company auditors, etc. during the audit process, and because users of financial statements pay close attention to the KAM.

IV. Others

Notification of inspection results

(1) Letter of notification of inspection results

The notification of the results of the CPAAOB inspection is made through the provision of a document (a letter of notification of inspection results) to the CEO of the inspected audit firm.

The main contents of the letter of notification of inspection results are as follows:

1. Matters of particular note
2. Viewpoints of inspection
3. Status of measures to ensure appropriateness of implementation of business processes designed by the audit firm in order to maintain and improve the quality control system (quality control system)
4. Status of implementation of audit engagements (individual audit engagements)

(2) Specifics described in "Matters of particular note"

Of the items of the letter of notification of inspection results, "Matters of particular note" sorts out deficiencies which have been identified in inspection and which are considered to be important. This is comprised of three items, i.e., operations management system, quality control system, and individual audit engagements, with an overall assessment to be given according to the statuses of the three items. An overall assessment of the inspected audit firm's business administration is described at the beginning of "Matters of particular note" in the letter of notification of inspection results, as shown below.

In "(1) Operations management system" of "Matters of particular note," the root causes analyzed by the CPAAOB (refer to "I. Operations Management System, 1. Operations Management System and Root Cause Analysis") with regard to deficiencies identified in inspection are described. In addition, the direction of future improvement considered by the CPAAOB is indicated in the case of some audit firms.

1. Matters of particular note

As a result of the inspection of the audit firm, with regard to the business administration of the firm, it is deemed, within the scope of the inspection, that ..., as described below.

- (1) Operations management system
... (issues related to governance and business administration are described)
- (2) Quality control system
... (deficiencies and other matters related to the quality control system are described)
- (3) Individual audit engagements
... (deficiencies and other matters related to audit engagement are described)

The presentation of overall assessment started with inspections launched in Program Year 2016 in order to accurately convey the CPAAOB's assessment to audit firms and help corporate auditors, etc. of audited companies to which inspection results are disclosed by the audit firms appropriately understand the audit

firms' level of quality control.

(3) Grades of overall assessment

Overall assessment is presented in the following five grades based on the statuses of the inspected audit firm's operations management system, quality control system, and individual audit engagements.

"Good (Overall assessment grade: 1)"

The grade that is given in cases where business administration is considered to be good, such as when few deficiencies have been identified with regard to the statuses of the operations management system, quality control system, and individual audit engagements.

"Generally good despite the presence of some points requiring improvement (Overall assessment grade: 2)"

The grade that is given in cases where business administration is considered to be generally good despite the presence of some points requiring improvement, such as when no serious problem has been identified although some deficiencies have been identified with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good due to the presence of significant points requiring improvement (Overall assessment grade: 3)"

The grade that is given in cases where business administration is not considered to be good, such as when there are significant problems that require improvement with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good and requiring prompt improvement in the status of the operations management system, etc. (Overall assessment grade: 4)"

The grade that is given in cases where business administration is considered to be not good and to require particularly prompt improvement.

"Considerably inadequate (Overall assessment grade: 5)"

The grade that is given in cases where serious deficiencies have been identified with regard to the statuses of the quality control system and individual audit engagements and where voluntary improvement is not expected to be made.

It should be noted that the CPAAOB requires the submission of reports from audit firms to which the assessment grade "Not good and requiring prompt improvement in the status of the operations management system, etc." has been given at the same time as the notification of the inspection results and urges them to make prompt improvement. With regard to audit firms to which the assessment grade "Considerably inadequate" has been given, the CPAAOB recommends that the Commissioner of the Financial Services Agency should take administrative actions or implement other measures.

(4) Communicating "Matters of particular note" to corporate auditors, etc. of audited companies

Audit firms are required to communicate "Matters of particular note" described in the letter of notification of inspection results and the audit firms' handling of those matters to corporate auditors, etc. of all audited companies (Auditing Standards Statement No. 260, paragraphs 16 and A31-2).

In addition, audit firms are required to communicate the specifics of deficiencies identified in the inspection of individual audit engagements and the audit firms' handling of the deficiencies to corporate auditors, etc. of the audited companies whose audit engagements were selected for the inspection.

Company auditors of audited companies are expected to make full use of the information received not only in parts but also in a comprehensive manner, to gain a deeper understanding of the design and implementation status of the quality control system of the audit firm, and to enhance communication with the audit firm.

(5) Regarding treatment of inspection results, etc.

When inspected audit firms disclose the contents of the letter of notification of inspection results to third-party entities, they need to obtain prior consent from the CPAAOB. Recently, there have been many cases in which an audit firm applied with the CPAAOB for prior consent to disclosure of inspection results, etc. based on a request from an audited company's directors, from corporate auditors and directors (including outside directors) of the audited company's parent company, or from a company that may potentially be audited (e.g., a company considering appointing an independent auditor).

However, in consideration of the fact that audit and corporate auditors, etc. of audited companies make use of inspection results and promote communication with audit firms, prior consent is not required in the case of (4) above or when submitting the letter of notification of inspection results to JICPA in accordance with the rules on the treatment of the letter of notification of inspection results set forth in the JICPA Quality Control Committee Operating Rules.

It is desirable that the results of the CPAAOB inspection, etc. be used not only by corporate auditors, etc. of audited companies but also by directors, etc. of audited companies and by companies that may potentially be audited in order to check the statuses of the design and operation of independent auditors' quality control systems.



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