

Provisional Translation

# Case Report from Audit Firm Inspection Results

(Program Year 2025)

July 2025

Certified Public Accountants and Auditing Oversight Board

## Introduction

Since its inception in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) 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 CPAAOB 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 CPAAOB's inspections as well as observed effective efforts and by presenting the audit quality level expected by the CPAAOB. 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. In light of this, since last fiscal year we have prepared a "summary version", and we will further promote its dissemination and understanding among relevant parties by making it easier to understand through measures such as increasing the number of charts.

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 “2025 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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## To All 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 background 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 is not simply the lack of documentation but a situation where it is not possible to objectively prove that the necessary audit evidence has been obtained. 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 ,and if appropriate, 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. In addition, there were cases where professional ethics were lacking. For example, audit firms prioritized the avoidance of issues

pointed out in external inspections, and subsequently falsified audit documentation.

## 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. The execution of duties by management must be supervised by the Board of Directors and audited by corporate auditors. 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.

## 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) For cases newly adopted in this program year and measures that can be appreciated, please refer to the  .
- (8) For cases where deficiencies have been identified since previous fiscal years or cases where deficiencies have been identified at multiple audit firms,  is placed at the beginning of the sentences.
- (9) With regard to Quality Control Standards Statement No. 1 and Auditing Standards Statement 220, at the time of publishing this Case Report, examples of deficiencies based on the revised standards had not been identified. Therefore, Quality Control Standards Statement No. 1 and Auditing Standards Statement 220, which are the provisions that serve as the basis for the deficiencies listed in this Case Report, clearly state "before the 2022 revision," and describe the revised standards that are considered to correspond to the provisions as [Reference]. The revised standards are provided merely as reference information, and do not indicate the CPAAOB's position on the interpretation and scope of the standards.
- (10) With respect to the Code of Ethics and Code of Ethics Practical Guidance No. 1 ("Q & A on Code of Ethics (Practical Guidance)"), among the deficiencies listed in this Case Report, the provisions that serve as the basis for the deficiencies based on the pre-revision Code of Ethics clearly state "before the revision in 2022" and "before the revision in 2023," and the revised Code of Ethics

corresponding to the pre-revision Code of Ethics is listed as reference information based on the old / new correspondence table published by the Japanese Institute of Certified Public Accountants.

(11) Auditing Standards Statement 315 (Identification and Assessment of the Risks of Material Misstatement) and Auditing Standards Statement 540 (Auditing of Accounting Estimates) after the revision have been applied since the audit of the financial statements for the fiscal year ended March 31, 2023. Therefore, the provisions that serve as the basis for deficiencies identified during the CPAAOB's inspection of the audit of the financial statements for the fiscal year ended before March 31, 2023 remain unchanged from before the 2021 revision. In this Case Report, Auditing Standards Statement 315 and Auditing Standards Statement 540 before the revision state "before the 2021 revision," and describe the revised standards that are considered to correspond to the provisions as [Reference]. The revised standards are provided merely as reference information and do not indicate the CPAAOB's position on the interpretation and scope of the standards.

## 2. Main Characteristics of the 2025 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) With regard to "II. Quality Control System" in order to contribute to responses to the revised quality control standards, the new standards are included as reference information in the provisions for the grounds for examples of deficiencies pointed out under the old standards.
- (3) Given that responses to circular transactions and security risks have become urgent issues, we have included a new column entitled "Responses to Circular Transactions and Cybersecurity Risks."
- (4) The charts have been enhanced to assist in understanding the content described in the "Required Actions" and "Points to Note."
- (5) The "Summary version" of "Overview of Inspection Results" and "Required Actions" in this Case Report have been revised by adding charts so that they can be used as understanding the overview of this Case Report and training materials within small and medium-sized audit firms.

## (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	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.  In this case report, they specifically refer to KPMG Azsa LLC, Deloitte Touche Tohmatsu LLC, Ernst & Young ShinNihon LLC, and PricewaterhouseCoopers Japan LLC.
Mid-tier audit firm	An audit firm whose business scale is second only to large-sized audit firms.  In this Case Report, this refers to four audit firms: Gyosei & Co., BDO Sanyu & Co., Grant Thornton Taiyo LLC and Crowe Toyo & Co..
Small and medium-sized audit firm	An Audit firm other than large-sized and Mid-tier audit firms
CPA AOB	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
QCSS	Quality Control Standards Statement
ASS	Auditing Standards Statement

## (List of Standards, etc. for Published Cases)

Audit standards, practical guidelines, etc. related to the cases presented in this Case Report are as follows: Note that the auditing standards and practical guidelines described below are, in principle, the standards effective as of the end of June 2025, and if the standards corresponding to each case were in effect before the revision, such fact is stated.

In addition, Auditing Standards Statement 600 cites provisions prior to the 2023 amendments.

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

Quality Control Standards Statement No. 2 "Engagement Quality Control Review of Audit"

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 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 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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# I. Operations Management System (Root Cause Analysis)

## 1. Operations Management System and Root Cause Analysis

### (1) Necessity of Root Cause Analysis

In inspections conducted by the CPAAOB, it is observed that a considerable number of audit firms implement only formalistic remedial measures for deficiencies identified through QC reviews or through the periodic evaluation of the system of quality management, without conducting a sufficiently thorough investigation into the underlying causes of their occurrence.

As the scope of the QC reviews and the CPAAOB inspections 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, the improvement of the system of quality management of audit firms as a whole becomes ineffective or insufficient, does not lead to fundamental improvements, and consequently fails to enhance the quality of audits performed by audit firms.

On the contrary, for example, when audit firms adopt symptomatic and formalistic remedial measures—such as indiscriminately adding items to checklists in response to identified deficiencies—the amount of ineffective work imposed on the audit team is unnecessarily increased, which in turn becomes an obstacle to the effective and efficient provision of audit services.

Audit firms should recognize the importance of root cause analysis to realize substantial improvements of audit quality.

In recent years, large-seized audit firms have, with respect to deficiencies related to individual audit services identified through external inspections and the periodic evaluation of the system of quality management, not only communicated the nature of such deficiencies, but also undertaken investigations into their root causes as part of the audit firm's system of quality management.

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 measures.

### (2) Root Cause Analysis

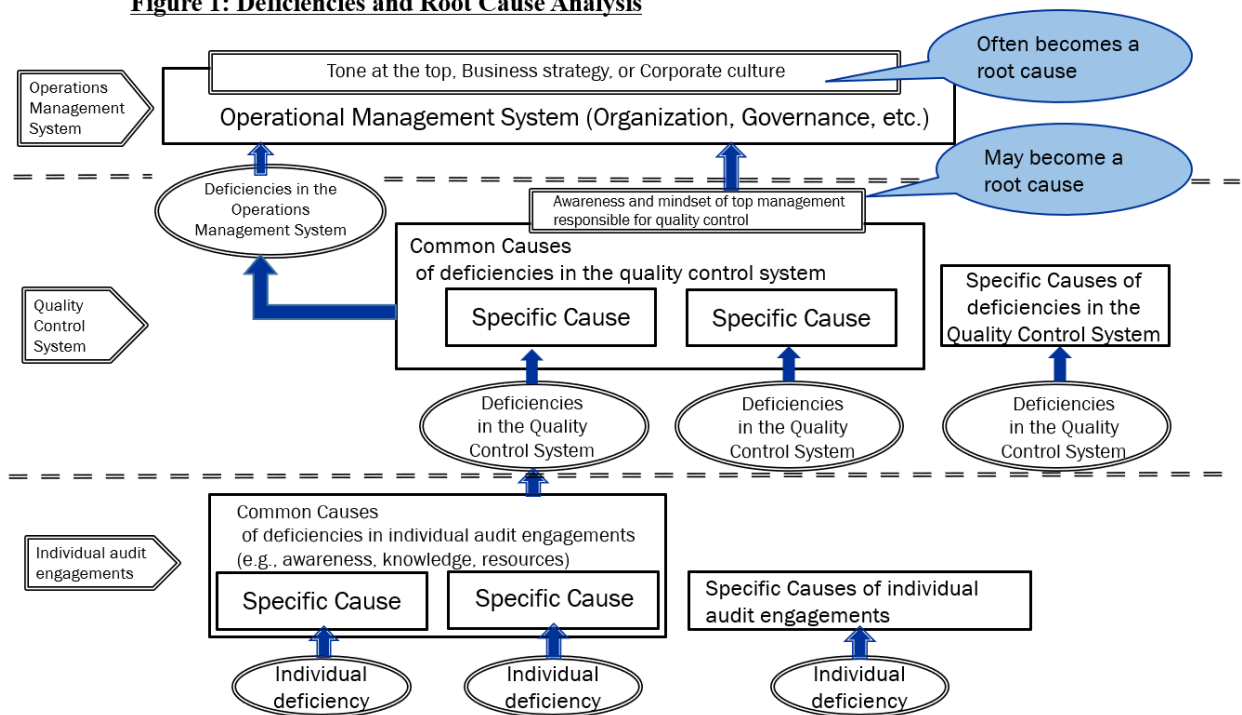
In root cause analysis, it is important to accurately identify the direct causes of deficiencies as a first step. In direct cause analysis, it is necessary not only to consider the knowledge, awareness, and experience of audit teams, but also to consider other aspects of the audit, such as situation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

Direct causes can be divided into "specific causes," which are unique to individual deficiencies, and "common causes" which are 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: Deficiencies and Root Cause Analysis**



Source: Prepared by the CPAAOB

The following is an example of a root cause analysis in which, as a result of analyzing the direct causes of deficiencies identified during inspections by CPAAOB, root causes were found in the operations management system and the quality control system.

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

### **[Case 1]**

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included insufficient professional skepticism on the part of the engagement partners and assistants to engagement when, in performing audits related to the application of the revenue recognition accounting standard and audits of significant accounting estimates, they critically assessed the consistency between the accounting treatments adopted by the audited companies and the information obtained from the audited companies. In addition, common root causes of deficiencies in the quality control system were identified, in that the Quality Management Division had not sufficiently implemented measures to enable audit teams to conduct critical assessments, based on the information obtained from the audited companies, in the performance of audits related to the application of the revenue recognition accounting standard and significant accounting estimates, and that engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management had not sufficiently implemented measures to critically evaluate the audit procedures performed by the audit teams.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. Specifically, the executive management had believed that, by introducing and implementing audit quality improvement measures, all audit teams would proactively address accounting and auditing issues across all audit areas and obtain sufficient and appropriate audit evidence; moreover, they had assumed that, by implementing initiatives such as a system for appointing engagement quality reviewers in accordance with the risks of the audit services and efforts to secure sufficient advance preparation periods for the periodic evaluation of the system of quality management, all engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management would enhance their awareness of the need to perform in-depth evaluations.

### **[Case 2]**

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included the engagement partners and assistants to engagement not sufficiently exercising critical assessment of management's assertions regarding the timeliness of accounting treatments related to accounting estimates, as well as not sufficiently recognizing the need to consider whether audit procedures commensurate with the assessed level of risk had been performed in areas where the risk of material misstatement was assessed as relatively low. In addition, common root causes of deficiencies in the quality control system were identified, in that sufficient coordination was not maintained between the Quality Management

Division and those responsible for implementing the improvement measures. For example, the Quality Management Division, which leads audit quality improvement initiatives, did not clearly specify the scope and level of procedures to be performed by the quality control partners in each audit division who were responsible for implementing the improvement measures when providing organizational support to audit teams facing heightened risks, nor did it sufficiently verify whether such measures were effectively producing improvement effects at the audit engagement level.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management had not sufficiently recognized the need to confirm whether the Quality Management Division and those responsible for implementing improvement measures were closely coordinating with each other to ensure that such measures were operated in line with their original intent and objectives and were effectively producing improvement effects at the audit engagement level.

### **[Case 3]**

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included, in addition to the engagement partners and assistants to engagement lacking sufficient awareness of the need to reassess risks in audit areas assessed as having a relatively low risk of material misstatement in light of changes in the business environment, a lack of sufficient awareness of the need to consider whether audit procedures appropriately responsive to the assessed risks were being performed. In addition, the following common root cause of deficiencies in the quality control system was identified. That is, the Quality Management Division did not sufficiently instruct the audit divisions to confirm whether risks were appropriately assessed through an understanding of the business environment of the audited companies and whether risk response procedures addressing such risks were reliably implemented. In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management, including the Chief Executive Officer, had assumed that, by establishing audit quality improvement measures, audit teams would appropriately perform risk assessments through an understanding of the business environment of the audited companies and properly implement risk response procedures addressing such risks, and had not sufficiently recognized the need to have the audit divisions confirm, through the Quality Management Division and other relevant functions, whether such measures were being appropriately implemented.

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

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

At the audit firm, multiple deficiencies, including significant deficiencies, were identified in a

portion of the individual audit services reviewed as part of the inspections.

The direct causes of these deficiencies included a tendency to carry forward audit approaches applied in prior years and a lack of professional skepticism in critically assessing management's assertions. In addition, a common root cause of deficiencies related to the quality control system was identified, namely that the PICOQC did not recognize that deficiencies had not been adequately detected or remediated because the level of staffing and involvement of the quality management function was insufficient relative to the expansion of audit services.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer lacked sufficient awareness to personally verify the adequacy and effectiveness of the quality control system, as he had not grasped the situation in which the head office functions were unable to adequately assess the sufficiency of staffing amid the expansion of the firm's operations, and had believed that the strengthening of head office functions and improvements to the quality control system would be appropriately implemented if left to the respective responsible officers at the head office.

In addition, the following root cause was also identified. That is, despite insufficient awareness among engagement partners to perform their duties on their own responsibility and an insufficient overall enhancement of the skills of audit practitioners, the Chief Executive Officer and the respective responsible officers at the head office had not established a sufficient framework to verify the degree to which quality control-related measures had been disseminated and were effective at the audit engagement level.

## **[Case 2]**

At the audit firm, pervasive and numerous deficiencies, including significant deficiencies, were identified across all of the individual audit services subject to inspections.

The direct causes of these deficiencies were that the engagement partners and assistants to engagement did not sufficiently understand the level of procedures required by the auditing standards and the current auditing standards, and, in addition, failed to sufficiently understand the significant assumptions used by management in the audit of accounting estimates and to critically assess management's assertions related to those significant assumptions, thereby not adequately exercising professional skepticism. In addition, the Quality Management Division had assumed that, by merely communicating quality control policies and procedures and quality control-related measures through training and other means, audit teams would respond appropriately, and therefore lacked sufficient awareness of the need to ascertain and evaluate the extent to which such policies and procedures had been disseminated and were effective, and to consider, based on the results thereof, whether revisions to such policies and procedures were necessary. Furthermore, when conducting reviews of audit documentation, reviews related to audit services, and the periodic evaluation of the system of quality management, the individual partners lacked a critically evaluative attitude toward the audit procedures performed by their own audit teams as well as by

other audit teams, and consequently did not appropriately fulfill their responsibilities as partners in maintaining and enhancing audit quality across the firm as a whole. As described above, common root causes of deficiencies in the quality control system were identified.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the executive management, led by the Chief Executive Officer, lacked sufficient awareness aimed at fostering a culture that emphasizes audit quality and at establishing an effective and organized operations management system, as evidenced by, among other factors, an insufficient commitment to compliance with professional ethics and internal rules in the firm's operations, including quality management. In addition, despite recognizing the ongoing shortage of audit teams and the need to enhance their overall skill levels, the executive management lacked sufficient awareness to personally practice initiatives aimed at ensuring appropriate audit quality across the firm as a whole, as they focused excessively on the early realization of increasing the number of full-time partners and staffs.

Furthermore, the following root cause was also identified. That is, the individual partners, including the Chief Executive Officer, did not accurately grasp the situation in which the audit teams, including themselves, lacked sufficient understanding of the level of procedures required by the auditing standards and the current auditing standards, nor the situation in which they lacked a sufficiently critical attitude toward assessing management's assertions in the audit of accounting estimates.

### **[Case 3]**

At the audit firm, multiple deficiencies were identified across all of the individual audit services subject to inspections, and among them, numerous deficiencies, including significant deficiencies, were identified in individual audit services of a specific regional office.

These deficiencies in the individual audit services were attributable to common root causes of deficiencies in the individual audit services, namely that the engagement partners and assistants to engagement did not sufficiently understand the level required by the current auditing standards, as evidenced by a lack of professional skepticism in responding to fraud risks and in the audit of accounting estimates, and that they assumed that carrying forward audit procedures from the prior year would be sufficient, thereby lacking sufficient awareness of the need to reassess risk assessments and audit procedures responsive to assessed risks in each audit period. In addition, the deficiencies in the individual audit services of a specific regional office were attributable to common root causes of deficiencies in the individual audit services, in that some engagement partners assumed that audit procedures were being appropriately performed by other engagement partners serving as in-charge, and consequently lacked sufficient awareness of the need to provide appropriate direction and supervision to the audit team and to perform in-depth reviews.

Furthermore, the common root causes of the deficiencies in the individual audit services were

attributable to common deficiencies in the quality control system, in that the PICOQC believed that the dissemination of improvement measures to the audit engagement level should be led by the audit business division, and therefore lacked sufficient awareness to proactively encourage the need for coordination between the quality management function and the audit business division. In addition, the common root causes of the deficiencies in the individual audit services at a specific regional office were attributable to common deficiencies in the quality control system, in that the head of the audit business division assumed that, by appropriately appointing engagement partners, audit teams would be appropriately formed at the regional office, and consequently lacked sufficient awareness of the need for the audit business division to provide organizational support.

In light of these circumstances, as a result of further pursuit of the root causes, the following root causes were identified. That is, the Chief Executive Officer avoided exercising strong leadership in the planning and implementation of audit quality improvement measures and instead placed emphasis on the autonomy of the quality management function and the audit business division, resulting in a lack of awareness of the need to promote improvements in a timely manner. In addition, the executive management likewise respected the autonomy of the quality management function and the audit business division and lacked sufficient recognition of the need for strong coordination between the two functions. In addition, the following root cause was also identified. That is, although the executive management was aware of issues concerning audit quality at certain regional offices, they believed that those regional offices were capable of pursuing improvements on their own, and therefore lacked sufficient awareness of the need to provide proactive support to those regional offices.

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

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

At the audit firm, deficiencies were identified in the quality control system, and moreover, numerous deficiencies, including significant deficiencies, were also identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services were attributable to the following common causes. That is, the engagement partners and assistants to engagement lacked sufficient understanding of the level of procedures required by the current auditing standards with respect to the assessment of and responses to fraud risks and the audit of accounting estimates, and, in addition, because the engagement partners placed excessive reliance on the assistants to engagement, they assumed that the assistants to engagement were appropriately performing their work and, as a result, did not perform in-depth reviews of the audit documentation. In addition, the common root causes of the deficiencies in the individual audit services were attributable to common deficiencies in the quality control system, in that the Chief Executive Officer and the PICOQC had not performed root cause analyses of findings identified through quality control reviews and ongoing monitoring activities

(including the periodic evaluation of the system of quality management) for the purpose of preventing the recurrence of similar deficiencies, and lacked sufficient awareness regarding the implementation of remedial actions, as well as failing to recognize that the assistants to engagement lacked sufficient understanding of the level of procedures required by the current auditing standards. In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer and the PICOQC, based on the assumption that there were no issues with audit quality simply because no significant findings had been identified in past quality control reviews and similar activities, had become less conscious of the need to maintain and enhance audit quality, and, having believed that merely formally establishing a quality control system would naturally lead to improvements in audit quality, failed to exercise leadership toward improving audit quality.

## [Case 2]

At the audit firm, pervasive and numerous deficiencies, including significant deficiencies, were identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services had common causes, including insufficient understanding among the engagement partners and assistants to engagement of accounting standards, auditing standards, and the level of procedures required by the auditing standards, as well as a lack of professional skepticism, as evidenced by their failure to critically assess the assumptions used by management in the audit of accounting estimates. In addition, the common root causes of the deficiencies in the individual audit services were attributable to the following common root causes related to deficiencies in the quality control system. That is, among the partners, including the Chief Executive Officer, awareness was not shared of the importance of ensuring appropriate audit quality through in-depth evaluation of the audit procedures performed by assistants to engagement and audit teams, resulting in a failure to foster an organizational culture aimed at ensuring appropriate audit quality. Furthermore, the Chief Executive Officer and the PICOQC did not sufficiently recognize the need to verify the extent to which improvement measures in response to findings identified in quality control reviews and similar activities had been disseminated and were effective, and therefore had not planned or implemented measures for such verification.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer lacked sufficient awareness to take the initiative in improving audit quality and did not exercise leadership toward establishing an effective and organized operations management system and quality control system to ensure appropriate audit quality. In addition, the Chief Executive Officer and the PICOQC assumed that an appropriate level of audit quality was being ensured because the firm's audit services were performed by partners with extensive practical experience and staffs with experience at large audit firms, and consequently were unable to accurately grasp the overall level of audit quality across the firm.

### [Case 3]

Although the audit firm is small in size, since its establishment it has divided its audit business into two audit divisions, with each division independently managing its audit services, finance, and human resources, thereby fostering an organizational culture that prioritizes the independence of each division. In addition, among the audit team, only the partners are full-time, while all assistants to engagement are certified public accountants engaged as part-time staffs.

Under these circumstances, at the audit firm, multiple deficiencies, including significant deficiencies, were identified in the quality control system, and moreover, numerous deficiencies, including significant deficiencies, were also identified in the individual audit services subject to inspections.

The deficiencies in the individual audit services were attributable to common causes, namely that the engagement partners and assistants to engagement did not sufficiently understand the level required by the auditing standards and lacked professional skepticism, such as critically assessing management's assertions, and that the assistants to engagement, who were part-time staffs, lacked a sense of affiliation with the firm as well as awareness of the need to maintain and enhance audit quality. In addition, the common root causes of the deficiencies in the individual audit services were attributable to the following common root causes related to deficiencies in the quality control system. That is, the Chief Executive Officer and the PICOQC did not sufficiently understand the depth and methods of root cause analysis required to prevent the occurrence of similar deficiencies in response to findings identified through QC reviews and similar activities, and furthermore, they placed excessive reliance on the engagement partners and assistants to engagement based on the assumption that they possessed sufficient capabilities due to their extensive practical experience.

In light of these circumstances, as a result of further pursuit of the root causes, the following root cause was identified. That is, the Chief Executive Officer and the PICOQC did not recognize that all audit teams, including themselves, lacked sufficient understanding of the intent of the current auditing standards as well as the level of quality management and audit procedures required by those standards. In addition, because no significant findings had been identified in past QC reviews and similar activities, they believed that the existing organizational structure, which has remained unchanged since the firm's establishment, was adequate, and therefore did not recognize the need for integrated operations management, such as the consolidation of audit divisions, or the need to establish an organizational audit engagement structure, including enhancing the number of full-time assistants to engagement.

As illustrated by the cases presented above, the root causes of deficiencies often lie in the operations management system and the quality control system, and in order to remediate such deficiencies, it is necessary to address and eliminate these root causes.

Currently, audit firms are undertaking efforts to develop and strengthen their organizational management frameworks in line with the Audit Firm Governance Code; however, due attention should be paid to the

effectiveness of such efforts, and firms should strive to ensure that these initiatives truly contribute to the maintenance and enhancement of audit quality.

### (3) Specific Examples of Root Causes

The cases presented below are specific examples of root causes identified through inspections, including the cases of root cause analysis described above in (2) Root Cause Analysis.

In addressing deficiencies, it is necessary to work toward genuine maintenance and enhancement of audit quality by identifying and remedying fundamental issues—such as problems related to the audit firm’s operations management system—while referring to these specific examples.

#### **[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 these circumstances, in order to enhance the level of quality management throughout the entire organization, it is necessary not only to establish the formal aspects of the quality control system, such as organizational structures and procedures, but also for the executive management, led by the Chief Executive Officer, to exercise strong leadership and to work in close coordination with business divisions and other units close to the audit engagements, so that policies and measures are effectively disseminated and embedded down to each individual audit team.

In recent years, large audit firms have shown a tendency to establish quality control systems not only at the head office level but also by involving business divisions closer to audit engagements in order to make their audit quality improvement initiatives sustainable. As a result, the role of business divisions in improving audit quality and in disseminating such improvements to audit teams has become increasingly important.

However, in initiatives aimed at improving audit quality, there are cases where, on the grounds of prioritizing the autonomy of business divisions, the executive management and the quality management function have left matters largely to those divisions, as well as cases where sufficient communication has not been maintained between the executive management and quality management function and the business divisions. As a result, problems may arise, such as an insufficient understanding of the actual conditions within business divisions and inadequate verification as to whether improvement measures have been appropriately implemented. Therefore, the executive management and the quality management function need to appropriately grasp the status of initiatives undertaken by business divisions and to sufficiently confirm the extent to which improvement measures have been disseminated and are effective.

Specific examples of root causes of deficiencies identified at large audit firms through past inspections by CPAAOB include the following:

- The executive management believed that, by introducing and implementing audit quality improvement measures, all audit teams would proactively address accounting and auditing issues, including through consultations with the Quality Management Division—across all audit areas, including key focus areas, and thereby obtain sufficient and appropriate audit evidence. In addition, they believed that, by implementing initiatives such as a system for appointing engagement quality reviewers in accordance with the risks of the audit services and efforts to secure sufficient advance preparation periods for the periodic evaluation of the system of quality management, all engagement quality reviewers and those responsible for the periodic evaluation of the system of quality management would enhance their awareness of the need to perform in-depth evaluations. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 1] on p. 4)
- The executive management did not sufficiently recognize the need to confirm whether the Quality Management Division, which led improvement measures based on the results of the root cause analysis of findings identified in the previous inspections by CPAAOB, and the quality control partners of the audit business divisions were closely coordinating with each other so as to ensure that such improvement measures were operated in line with their original intent and objectives and effectively produced improvement effects at the audit engagement level. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 2] on p. 5).
- The executive management, including the Chief Executive Officer, assumed that, by establishing audit quality improvement measures, audit teams would appropriately perform risk assessments through an understanding of the business environment of the audited companies and properly implement audit procedures responsive to assessed risks, and did not sufficiently recognize the need to have the audit business divisions confirm, through the Quality Management Division and other relevant functions, the status of such implementation. (With regard to root cause analysis regarding this example, also refer to [Large-sized audit firms] [Case 3] on p. 5).
- The executive management believed that audit responses in important areas other than those involving significant risks would be improved by disseminating guidance regarding the appropriate performance of audit procedures responsive to assessed risks in such other important areas.
- The executive management and the Quality Management Division believed that all engagement partners and assistants to engagement fully understood the significance and importance of the Certified Public Accountant registration system, and that when including information on CPA qualifications, the number of professionals by qualification, and hours worked by qualification in materials submitted outside the firm, appropriate verification and aggregation were being performed.

**[Mid-tier audit firms]**

With regard to mid-tier audit firms, while it can be observed that each firm is making efforts to develop

its quality control system, there are cases where the strengthening of head office functions remains insufficient. In addition, there are cases where the firm leadership's awareness with respect to quality management has not kept pace with the speed of business expansion, where audit services rely heavily on a large number of part-time staffs and assistants to engagement, and where challenges exist in quality management at specific regional offices. On the other hand, as each firm has a different operations management system depending on its history and size, the root causes of the issues differ from firm to firm.

Therefore, each firm needs to pursue the root causes based on a thorough understanding of its history and operations management system, and to engage in effective improvements.

The following are specific examples of root causes of deficiencies identified at mid-tier audit firms through past inspections by CPAAOB:

- While expanding the firm's operations, the Chief Executive Officer had not grasped the situation in which the head office functions were unable to adequately assess the sufficiency of staffing, and believed that the strengthening of head office functions and improvements to the quality control system would be appropriately implemented if left to the respective responsible officers at the head office, thereby lacking sufficient awareness of the need to verify the adequacy and effectiveness of the quality control system. In addition, the Chief Executive Officer and the respective responsible officers at the head office, despite insufficient awareness among engagement partners to perform their duties on their own responsibility and insufficient enhancement of the overall skill levels of audit teams, had not established a sufficient framework to verify the extent to which quality control-related measures had been disseminated and were effective at the audit engagement level. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 1] on p. 6)
- The executive management, led by the Chief Executive Officer, lacked sufficient awareness aimed at fostering a culture that places emphasis on audit quality and at establishing an effective and organized operations management system, as evidenced by, among other factors, an insufficient commitment to compliance with professional ethics and internal rules in the firm's operations, including quality management. In addition, despite recognizing the ongoing shortage of audit teams and the need to enhance their overall skill levels, they lacked sufficient awareness to personally practice initiatives aimed at ensuring appropriate audit quality across the firm as a whole, as they focused excessively on the early realization of increasing the number of full-time partners and staffs. Furthermore, the individual partners, including the Chief Executive Officer, did not accurately grasp the situation in which the audit teams, including themselves, lacked sufficient understanding of the level of procedures required by the auditing standards and the current auditing standards, nor the situation in which they lacked a sufficiently critical attitude

toward assessing management's assertions in the audit of accounting estimates. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 2] on p.6)

- In planning and implementing audit quality improvement measures, the Chief Executive Officer placed emphasis on the need to develop personnel responsible for maintaining and enhancing audit quality; however, since assuming the role of CEO, he also sought to avoid exercising excessively strong leadership and instead emphasized allowing the quality management function and the audit business division to act autonomously. As a result, he lacked sufficient awareness of the need to promote improvements in a timely manner. In addition, the executive management believed that coordination between the quality management function and the audit business division had been achieved through discussions at executive management meetings and similar forums, where issues were organized and shared, and therefore respected the autonomy of each division in advancing audit quality improvements. As a result, they lacked sufficient recognition of the need for strong coordination between the two functions. Furthermore, although the executive management was aware of issues concerning audit quality at certain regional offices, they believed that those regional offices could pursue improvements autonomously and consequently lacked sufficient awareness of the need to provide proactive support to those regional offices, such as arranging the personnel necessary for such improvements. (With regard to root cause analysis regarding this example, also refer to [Mid-tier audit firms] [Case 3] on p.11)
- The executive management assumed that issues related to human and time resources had been resolved through measures such as changes in the allocation of personnel to audit services, the introduction of monitoring of the levels of involvement of engagement partners and others, and an increase in the number of assistants to engagement.
- The executive management, including the Chief Executive Officer, lacked sufficient awareness to take the initiative in earnestly engaging in the maintenance and enhancement of audit quality, and therefore did not exercise leadership toward ensuring an appropriate level of audit quality across the firm as a whole. In addition, because no significant quality control issues were identified as a result of implementing remedial actions in response to deficiencies pointed out through external inspections, the executive management assumed that the personnel's insufficient understanding of the auditing standards had already been resolved and that the firm's audit quality had been improved to an appropriate level, and therefore has yet to accurately grasp the level of audit quality across the firm as a whole.

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

Small and medium-sized audit firms vary in size and background, and accordingly, the level at which their quality control systems are designed, implemented and maintained also differs from firm to firm. However, it is common among such firms that, due to their relatively small organizational size, it is difficult to provide organizational support to audit teams in areas such as quality management.

Consequently, the level of business operations and quality management is often significantly influenced by the capabilities of the individuals belonging to the audit firm, including the Chief Executive Officer, as well as by the relationships between those individuals and the firm. Because there are many cases where a low level of awareness of and involvement in quality management by the Chief Executive Officer affects the firm-wide culture of quality management, it is important for the Chief Executive Officer to exercise leadership in quality management. In addition, attention should be given to the fact that, when significant changes arise in the business environment of an audit firm as a result of a merger, the Chief Executive Officer has the responsibility to fully exercise leadership and to appropriately design the audit firm's quality control system in line with such changes. Specific examples of root causes of deficiencies identified at small and medium-sized audit firms through past inspections by CPAAOB include the following. In recent inspections, there have been cases in which root causes were identified as a lack of leadership by the Chief Executive Officer toward improving audit quality and a failure to accurately grasp the overall level of audit quality across the firm as a whole.

- The Chief Executive Officer and the PICOQC, based on the assumption that there were no issues with audit quality because no significant findings had been identified in past QC reviews, became less conscious of the need to maintain and enhance audit quality. Furthermore, having believed that merely formally establishing a quality control system would naturally lead to improvements in audit quality, they failed to exercise leadership toward improving audit quality. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 1] on p.12)
- The Chief Executive Officer lacked sufficient awareness to take the initiative in improving audit quality and therefore did not exercise leadership toward establishing effective and organized operations management and quality control systems to ensure appropriate audit quality. Furthermore, the Chief Executive Officer and the PICOQC assumed that an appropriate level of audit quality was being ensured because the firm's audit services were performed by partners with extensive practical experience and staffs with experience at large audit firms, and consequently were unable to accurately grasp the overall level of audit quality across the firm as a whole. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 2] on p.12)
- The Chief Executive Officer and the PICOQC lacked an appropriate sense of ethics as professional practitioners, and within the firm, they prioritized avoiding findings in external inspections above all else, thereby fostering and allowing to spread a culture that places little importance on integrity and the preservation of credibility as professional practitioners. As a result, engagement partners instructed the performance of additional audit procedures after the audit report date and the subsequent preparation or falsification of audit documentation, and assistants to engagement carried out such instructions without hesitation. Consequently, among the partners and staffs,



awareness of the need to perform their duties in compliance with laws and regulations, auditing standards, and ethical rules has not been maintained.

- Although the audit firm is small in size, since its establishment it has divided its audit business into two audit divisions, with each division independently managing its audit services, finance, and human resources, thereby fostering an organizational culture that prioritizes the independence of each division. In addition, among the audit team, only the partners are full-time, while all assistants to engagement are certified public accountants engaged as part-time staffs.
- Under these circumstances, the Chief Executive Officer and the PICOQC did not recognize that all audit teams, including themselves, lacked sufficient understanding of the intent of the current auditing standards as well as of the level of quality management and audit procedures required by those standards. In addition, because no significant findings had been identified in past QC reviews, they believed that the current organizational structure, which has remained unchanged since the firm's establishment, was adequate, and therefore did not recognize the need for integrated business operations—such as the consolidation of audit divisions—or the need to establish an organizational audit engagement framework, including enhancing the number of full-time assistants to engagement. (With regard to root cause analysis regarding this example, also refer to [Small and medium-sized audit firms] [Case 3] on p.9)
- The individual partners, including the Chief Executive Officer, lacked a sufficiently critical attitude toward evaluating the quality of individual audit services performed by other partners, indicating an insufficient awareness of the need to improve and enhance audit quality across the firm as a whole. In addition, while extensively engaging in non-audit services through related entities, the individual partners, including the Chief Executive Officer, had become less conscious of placing emphasis on audit quality in performing individual audit services.
- The Chief Executive Officer and the PICOQC have not exercised leadership themselves toward maintaining and enhancing the audit quality of each individual audit service. In addition, the Chief Executive Officer and the PICOQC have not recognized that the audit teams, including themselves, lack sufficient understanding of the current auditing standards and of the level of quality management and audit procedures required by those standards.
- The Chief Executive Officer has not fostered an organizational culture that emphasizes compliance with professional ethics, and the partners and staffs of the audit firm exhibit a markedly insufficient awareness of the importance of professional integrity and the maintenance of credibility. In addition, the Chief Executive Officer and the PICOQC assumed that an understanding of the level of procedures required by the current auditing standards had been sufficiently disseminated within the firm through the hiring of certified public accountants with experience at large audit firms and through training programs required by the audit firm.
- The audit firm has been undertaking business improvements following the issuance of a business improvement order by the Financial Services Agency (improvement of the operations management system) and having received multiple improvement recommendations through the Institute's QC

reviews. Under these circumstances, at the audit firm, a high proportion of the partners are engaged in non-audit services through their own individual practices, resulting in diminished awareness toward maintaining and enhancing the firm's audit quality. Consequently, the above-mentioned improvement recommendations have not been recognized as issues that are fundamental to the firm's business operations. In addition, the Chief Executive Officer and the PICOQC have not exercised leadership toward improving audit quality, indicating a lack of awareness to establish a framework in which the quality control system functions effectively. Furthermore, the individual partners of the audit firm lack awareness of the need to monitor the status of quality improvements in individual audit services in which they are not personally involved, demonstrating an insufficient sense of responsibility as partners with respect to the firm's operations. As a result, the audit firm has not fostered an organizational culture in which partners mutually monitor and restrain one another to maintain and enhance audit quality, and it has not established a framework capable of conducting audits on an organizational basis.

- The audit firm has undergone a merger in recent years; however, although the Chief Executive Officer has stated that it is necessary to operate the firm in an integrated manner with respect to matters such as personnel evaluations, remuneration, and the composition of audit teams, he has not recognized the importance of realizing such integration at an early stage. In addition, the partners of the audit firm, having been engaged for an extended period in the audit services of specific listed audited companies, lack a sufficiently cautious attitude toward carefully assessing audit risks in light of the business environment in which the audited companies operate.
- The Chief Executive Officer believed that, with respect to the firm's operations, it was sufficient for the Chief Executive Officer, the engagement quality reviewer, and the PICOQC to consider important matters, and that there was no need to share information on such matters with the other partners. As a result, he has not endeavored to foster an organizational culture in which partners work collaboratively to maintain and enhance audit quality, nor has he established a framework that enables audits to be conducted on an organizational basis.
- The audit firm is composed of a small number of partners and staffs who have no audit experience at other audit firms, and it has continued to follow the operational structure in place since its establishment. In addition, for many years, a small number of listed companies have served as the firm's principal audited companies, resulting in a high proportion of audit fees from each of those listed audited companies relative to the firm's total operating revenue (i.e., a high level of fee dependence). Under these circumstances, the Chief Executive Officer, who also serves as the PICOQC, has prioritized above all else the maintenance and continuation of relationships with the audited companies that have existed since before the firm's establishment, and, given that there have been few changes in the audited companies over a long period, has assumed that there are no issues with the audits performed or with the firm's operations. In addition, he lacks sufficient awareness of the importance of audit quality and the professional attributes required of certified public accountants, including professional ethics and independence, and has not recognized the

need to establish organizational business operations or a quality control system. Furthermore, the firm's operations have routinely been managed solely by the Chief Executive Officer acting as the PICOQC, and the other partners have not recognized the need to fulfill their responsibilities as partners of the firm.

- In evaluating partners, the Chief Executive Officer places emphasis on quantitative indicators such as the number of audit engagements handled as an engagement partner or engagement quality reviewer and the number of newly contracted audited companies, and does not evaluate the quality of audit services. As a result, he lacks sufficient awareness toward designing, implementing and maintaining a quality control system that places emphasis on audit quality.
- The Chief Executive Officer and the PICOQC have not sufficiently recognized that they themselves, as well as others, lack an adequate understanding of the intent of the current auditing standards and of the level of quality management and audit procedures required by those standards. In addition, the Chief Executive Officer and the PICOQC placed excessive reliance on the firm's partners based on the assumption that they possessed sufficient capabilities due to their extensive practical experience.
- The Chief Executive Officer and the PICOQC, having believed that there were no issues with the firm's current operations, did not recognize the need to establish an organizational quality control system. In addition, the Chief Executive Officer and the PICOQC have not recognized that they themselves lack sufficient understanding of the intent of the current auditing standards and of the level of quality management and audit procedures required by those standards.
- The Chief Executive Officer placed top priority on issuing an unmodified audit opinion within the statutory deadline for the audit report and did not exercise due professional care, nor did he demonstrate sufficient awareness of the role and responsibilities expected by society of an audit firm to ensure the reliability of financial statements. Other engagement partners, including the PICOQC, aligned themselves with the Chief Executive Officer's views and did not exercise oversight or restraint over other engagement partners, including the Chief Executive Officer.
- The audit firm was established by partners who had previously worked together at a large audit firm. The Chief Executive Officer and the PICOQC assumed that, because the audit firm is composed of a small number of partners, they were able to grasp the capabilities of each partner and that each partner was fully demonstrating his or her capabilities. In addition, because no significant findings have been identified in QC reviews conducted to date, they believed that the minimum level of quality control system necessary commensurate with the size of the audit firm had been established. As a result, they have not sufficiently recognized the need to establish an organizational 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 "2025 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 QCSS 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. In addition, QCSCS No. 1 (Quality Control at Audit Firms) and ASS No. 220 (Quality Control in Audit Engagements) were revised and published in June 2022, and QCSCS No. 2 (Quality Control Reviews of Audit Engagements) was also published.

For more information about responses by the size of audit firms, please refer to the "2025 Monitoring Report".

## II. System of Quality Management

## **Implementation of Operation of Quality Management**

### **Outline**

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the System of Quality Management (SQM) are appropriate to the size and characteristics of the firm.

Responses to requirements for SQM 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. System of Quality Management”, 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 SQM 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)**

The revised Quality Control Standards have been 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). As practical guidelines necessary for application of the revised quality control standards in practice, QCSS No. 1 (Quality Control at Audit Firms) and ASS No. 220 (Quality Control in Audit Engagements) were revised and published in June 2022, and QCSS No. 2 (Engagement Quality Control Review) was also published, both of which were simultaneously applied to the revised Quality Control Standards. At the time of publishing this Case Report, examples of deficiencies based on the revised standards had not been identified. Therefore, QCSS No. 1 and ASS No. 220, which are cited as the basis for the deficiencies described in this Case Report, clearly state "before the revision in 2022" and present the revised standards that are considered to correspond to the basis as [Reference]. The revised standards are provided merely as reference information and do not indicate the CPAAOB's position on the interpretation or scope of the standards.

### **(Revision of the Code of Ethics)**

The Code of Ethics was amended in July 2022, and Practical Guidance No. 1 on the Code of Ethics, "Q & A (Practical Guidance) on the Code of Ethics," was published in December 2022. As a result of the amendment of the Code of Ethics and the publication of Practical Guidance No. 1, the "Guidance on Independence," "Guidance on Conflicts of Interest," "Guidance on Responses to Illegal Acts," and "Interpretive Guidance on Professional Ethics" were abolished in March 2023.

Among the deficiencies listed in this Case Report, the provisions that are cited as the basis for deficiencies

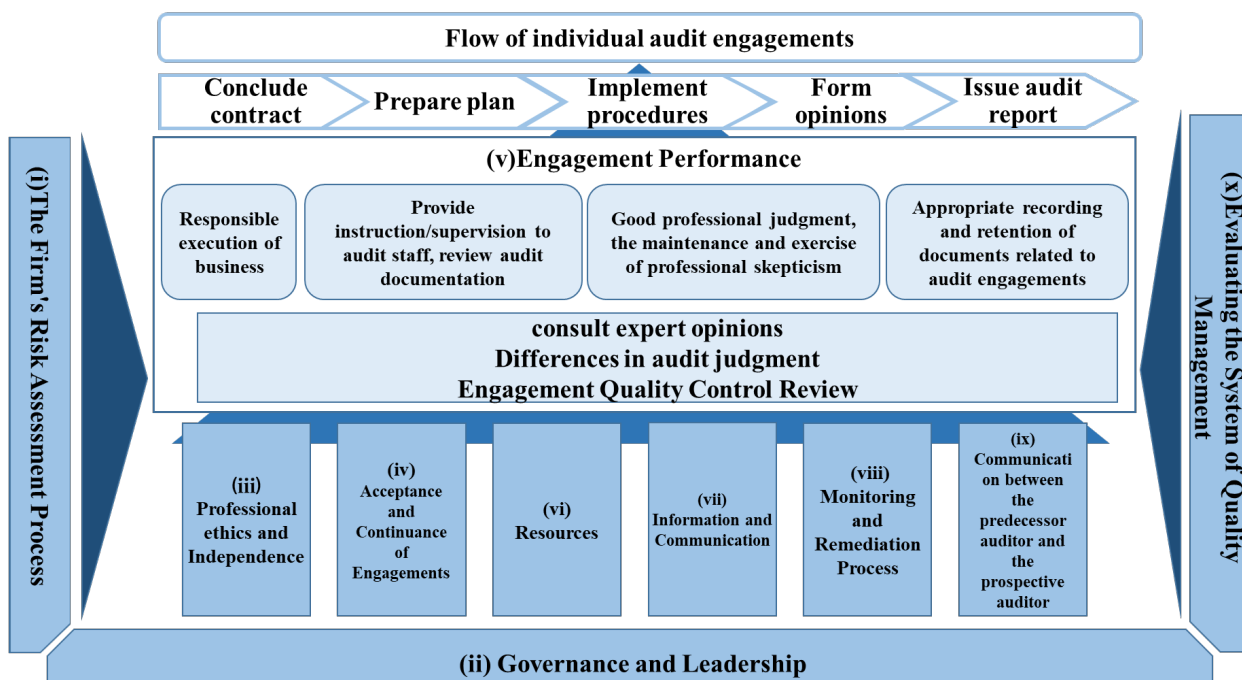
based on the pre-amendment Code of Ethics clearly state as "before the amendment in 2022" or "before the repeal in 2023," and the amended Code of Ethics corresponding to the provisions that served as the basis for deficiencies before the amendment are listed as reference information based on the old / new correspondence table published by the JICPA.

### **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 "QCSR," 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 SQM 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] Image: Relationship between System of Quality Management and Individual Audit Engagements



Source: Prepared by the CPAAOB

**Analysis of deficiencies that occurred**

At large-sized audit firms, although deficiencies related to the design of a SQM 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 SQM. 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 SQM 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 SQM, 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 SQM 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	QCSS No. 1 paragraphs 15, 16, 31 (before the amendment in 2022)	<ul style="list-style-type: none"> <li>➤ For deficiencies identified in inspections, etc., has formulated and implemented specific improvement measures based on the root causes.</li> <li>➤ Whether the proposed improvement measures have been disseminated throughout the organization.</li> <li>➤ Whether the effects of the improvement measures have been verified.</li> </ul>
2. Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards	QCSS No. 1 paragraphs 15, 16, 17, 18 (before the amendment in 2022)	<ul style="list-style-type: none"> <li>➤ Whether the audit firm has developed an organizational culture that ensures compliance with laws, regulations, and professional standards as well as internal rules.</li> <li>➤ Whether the audit firm periodically checks whether there are any discrepancies between the internal rules it developed and their actual implementation.</li> <li>➤ 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.</li> <li>➤ Whether the audit firm has established security rules necessary for the use of Internet server services in the course of</li> </ul>

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		business, and whether it has considered security measures.
3. Professional Ethics and Independence	QCSS No. 1 paragraphs 20, 21, 23, 24 (before the amendment in 2022)	<ul style="list-style-type: none"> <li>➤ Whether the audit firm obtains confirmation letters concerning independence from all target persons at least once a year.</li> <li>➤ Whether the audit firm conducts independence confirmation procedures when accepting or continuing audit engagements.</li> <li>➤ 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.</li> <li>➤ 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.</li> <li>➤ Whether the audit firm has established policies and procedures to comply with the rotation system for engagement partners, etc.</li> <li>➤ Whether substantive measures are implemented in complying with professional ethics, considering the purpose of the requirements set out in the Code of Ethics.</li> </ul>

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
4. Acceptance and Continuance of Engagements	QCSS No. 1 paragraphs 25, 26(before the amendment in 2022) ASS No. 900 Paragraphs 9, 13	<ul style="list-style-type: none"> <li>➤ 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.</li> <li>➤ Whether the identified engagement risks have been appropriately reflected in the audit plans for individual audit engagements.</li> <li>➤ Whether the audit firm examines whether it has sufficient human resources to implement newly accepted engagements.</li> <li>➤ 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.</li> <li>➤ Whether the prospective auditor makes inquiries of the predecessor auditor on matters required under auditing standards in order to determine whether or not to accept the engagement.</li> </ul>
5. Recruitment, Education and Training; Evaluation and Assignment	QCSS No. 1 paragraphs 28, F28-2, 29, 30(before the amendment in 2022)	<ul style="list-style-type: none"> <li>➤ 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.</li> <li>➤ 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</li> </ul>

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		<p>professional ethics with regard to evaluation, remuneration and promotion, and whether these policies and procedures are properly implemented.</p> <ul style="list-style-type: none"> <li>➤ 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;</li> </ul>
6. Audit Documentation	<p>QCSS No. 1 paragraphs 31, 44(before the amendment in 2022)  ASS No. 220  Paragraphs 14, 15, 16(before the amendment in 2022)</p>	<ul style="list-style-type: none"> <li>➤ 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.</li> <li>➤ 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.</li> <li>➤ Whether the audit firm has adequate policies and procedures in place to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.</li> </ul>
7. Engagement Quality Control Review	<p>QCSS No. 1 paragraphs 36, 37, 38(before the amendment in 2022)</p>	<ul style="list-style-type: none"> <li>➤ Whether a person with the necessary experience and skills, etc. and who maintains objectivity and independence has been appointed as the EQC reviewer.</li> <li>➤ Whether the EQC reviewer examines, based on the audit documentation, whether the evaluation of independence,</li> </ul>

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		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	QCSS No. 1 paragraph 47, 48, 49, 50(before the amendment in 2022)	<ul style="list-style-type: none"> <li>➤ Whether the audit firm has assigned responsibility for the operation of the monitoring and remediation process to an individual with appropriate competence and capabilities, and provided that individual with the authority necessary to fulfill that responsibility.</li> <li>➤ 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.</li> <li>➤ 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.</li> <li>➤ Whether at least one completed audit engagement is selected for each engagement partner in each specified period determined by the audit firm as part of periodic inspections.</li> <li>➤ Whether the audit firm evaluates the impact of deficiencies identified through ongoing monitoring and periodic inspections, instructs the relevant</li> </ul>

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		manager (s) to implement corrective measures, and checks the appropriateness of the measures.
9. Cooperation with Company Auditors	ASS No. 260 Paragraphs 13, 14, 15, 16, 22	<ul style="list-style-type: none"> <li>➤ 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.</li> <li>➤ Whether the engagement team provides audited companies with appropriate written explanations about the results of the CPAAOB inspections and quality control reviews.</li> <li>➤ Whether important audit findings are communicated to company auditors in a timely manner.</li> <li>➤ Whether the engagement team clearly communicates with the company auditors, etc. information on fees for audit engagements of public interest entities.</li> </ul>

## [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**

As one of the improvement measures in response to deficiencies identified in the external inspections, the audit firm conducted audit monitoring of important audit areas, mainly accounting estimates.

However, the division in charge of these measures did not adequately confirm whether the procedures for responding to audit risk, which had been prepared at the time of audit planning through audit monitoring, had been implemented, and the effectiveness of audit monitoring was not ensured for some audit engagements.

(QCSS No. 1, paragraphs 15 and 16(before the revision in 2022) ([Reference] QCSS No. 1, paragraph 37))

### **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.**

(QCSS No. 1, paragraphs 15 and 16(before amendment in 2022) ([Reference] QCSS No. 1, paragraph 33))

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

### **Points of focus**

At large-sized audit firms, although deficiencies in the design of a SQM 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 SQM related to individual audit engagements from the perspective of whether the SQM 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.

### **Outline of inspection results**

In terms of the operation of SQM, 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.**

(QCSS No. 1, paragraph 31(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 31)); ASS No. 220, paragraphs 14, 15 and 16 (before the revision in 2022) ([Reference] ASS 220, paragraphs 29, 30, 31, and 32))

- 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 partners excessively. Because of these issues, the engagement partners did not provide appropriate instructions/supervision and did not conduct reviews appropriately.**

(QCSS No. 1, paragraph 31(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 31)); ASS No. 220, paragraphs 14, 15, and 16 (before the revision in 2022) ([Reference] ASS 220, paragraphs 29, 30, 31, and 32))

《Points to Note》

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.

- 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.

(QCSS No. 1, paragraphs 36, 37(before the revision in 2022) ([Reference] QCSS No. 2, Paragraph 25); ASS 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.**

(QCSS No. 1, paragraph 38 (before the revision in 2022) ([Reference] QCSS No. 2, paragraph 18))



- ③ The EQC reviewer did not find any unreasonable points in the explanations from the engagement with regard to significant judgments and conclusions regarding significant accounting estimates, etc. As a result, the EQC reviewer **did not have sufficient awareness of conducting a sufficient**

**review from the viewpoint of whether the engagement team had considered and reached a conclusion in accordance with applicable accounting standards, etc.**

As a result, the EQC reviewer did not sufficiently examine whether the engagement team had considered and reached a conclusion in accordance with applicable accounting standards, etc.

(QCSS No. 1, paragraphs 36 and 37 (before the revision in 2022) ([Reference] QCSCS No. 2, paragraph25), ASS No. 220, paragraphs 19 and 20 (before the revision in 2022))

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

①The 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. (QCSS No. 1, paragraph 47(before the revision in 2022) ([Reference]QCSS No. 1, Paragraphs 37, 38, and 39))

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. (QCSS No. 1, paragraph 47(before the revision in 2022) ([Reference] QSCSS No. 1, paragraphs 37, 38, and 39))

#### **《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 planning statements, and audit results statements containing misstatements that persons engaged in audits of those companies who were not registered as CPAs engaged were represented 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.**

(QCSS No. 1, paragraph 15(before the revision in 2022) ([Reference] QCSS No. 1, paragraph 19); ASS No. 220, paragraph 7 (before the revision in 2022) ([Reference] ASS No.220, paragraph 13); 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.

(QCSS No. 1, Paragraph 1(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 19)5; ASS No. 220, paragraph 7 (before the revision in 2022) ([Reference] ASS 220, No. 13); 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.

(QCSS No. 1, paragraphs 15 and 34(before the revision in 2022) ([Reference] QCSS No. 1, paragraphs 19, 26, and 34); ASS No. 220, paragraph 7(before revision in 2022) ([Reference] Article 220, Paragraph 13)).

#### 《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.

①A 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.

(ASS No. 260, paragraphs 15 and 18)

②After 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.

(ASS No.260, paragraphs 14, 15 and 20)

#### 《Points to Note》

Please refer to the Auditing Standards (ASS No.260, etc.), which specifically describe matters required to be communicated with company auditors, etc.

#### 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.**

(QCSS No. 1, paragraph 45 (before the revision in 2022) ([Reference] QCSS No. 1, paragraph 31), ASS No.220, paragraph 7 (before the revision in 2022) ([Reference] ASS No.220, paragraph 13)

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

### **1. Efforts to Remediation**

#### **Points of Focus**

In principle, CPAAOB inspections are conducted based on reports of QC reviews conducted by JICPA. Such inspections focus on the remediation of deficiencies identified in previous CPAAOB inspections or QC reviews. Specifically, CPAAOB ascertains the status of root cause analysis performed in respect of previously identified deficiencies, as well as the firm's remedial actions and other responses based on the results of such analysis. In addition, CPAAOB assesses the effectiveness of the audit firm's remediation efforts through the inspection of individual audit engagements. Furthermore, where deficiencies are identified in the firm's remediation efforts, CPAAOB endeavors to identify issues relating to the firm's system of quality management that underline such deficiencies.

#### **Outline of Inspection Results**

As illustrated by the cases described below, at some audit firms, initiatives to remediate deficiencies identified through QC reviews were not sufficiently implemented, and in respect of multiple deficiencies, remediation measures were either not implemented or were insufficient.

Possible causes of such situations include the following:

- Although PICOQC or equivalent recognized the need to analyze the underlying causes of matters noted in recommendations for improvement, their analysis was limited to direct and specific causes. As a result, they did not sufficiently understand either the necessity of, or the methodologies for, analyzing root causes within the firm's system of quality management, including governance and leadership;
- The audit firm lacked a firm-wide approach to improving audit engagements as a whole;
- The audit firm had not established a system to effectively monitor the remediation of deficiencies; and
- The divisions responsible for implementing remediation measures had insufficient personnel commensurate with the size of the audit firm.

In addition, many cases were observed in which engagement partners responsible for the review of audit documentation, EQC reviewers, and individuals in charge of periodic inspections completed their work by conducting superficial reviews of audit documentation and formalistic completion of checklists, without sufficiently understanding the purpose of their respective roles. Furthermore, audit firms often left the acquisition of audit-related knowledge and skills to the discretion of individual engagement team members, and did not proactively take responsibility for maintaining and enhancing the competence, capabilities, and suitability of audit personnel. As a result, engagement teams frequently did not sufficiently understand the level of procedures required under applicable auditing standards, such as the Audit Standards Statements. Consequently, in many cases,

the same or similar deficiencies inherent in individual audit engagements were not identified, and appropriate remediation was not implemented.

**(Observed Effective Efforts)**

The following are examples of effective efforts:

- The establishment of a cross-organizational project aimed at improving audit quality, led by the CEO.
- The CEO's direct review and confirmation of the status of remediation of identified deficiencies across all audit engagements;
- Monitoring of audit documentation by partners responsible for quality control prior to the issuance of audit opinion.
- The establishment of a system enabling the early identification of audit issues, including the introduction of a preliminary EQC review process;
- Through discussions within each engagement team, identified deficiencies were analyzed, and remediation measures were communicated and implemented; and
- The establishment of a framework under which expert committees were formed for individual subject matters, in which members (including audit staff) conducted root cause analyses and discussed remediation measures, with the results of such discussions feeding back to the firm's quality control function.

**Expected Response**

Audit firms are required to fully understand the scope and nature of deficiencies that require remediation, taking into account the rationale underlying the deficiencies identified through CPAAOB inspections, QC reviews, and other relevant processes. Based on such understanding, audit firms should develop and implement specific and appropriate remediation measures to address the identified deficiencies. In this regard, it is essential that the CEO exercise strong leadership. At the stage of formulating remediation measures, the audit firm should analyze the root causes of the deficiencies and design effective remediation measures aimed at addressing those causes, rather than merely addressing deficiencies on a formalistic basis. At the implementation stage, the audit firm should ensure that the content of the remediation measures is correctly understood and appropriately applied throughout the organization. In addition, audit firms should verify whether the same or similar deficiencies exist not only in the individual audit engagements in which the deficiencies were identified, but also in other audit engagements. Audit firms should also thoroughly evaluate whether the remediation measures they have formulated are being properly implemented in practice. Through such efforts, audit firms are expected to achieve improvements in audit quality on a firm-wide basis.

**Case 1: Establishment and Implementation of Specific Procedures for Improvement**

- ① The audit firm identified the causes of the deficiencies noted in the QC review as:

- a) insufficient understanding of audit standards;
- b) insufficient understanding of the level of procedures required by auditing standards;
- c) a lack of professional skepticism.

However, the audit firm **did not perform an analysis of the root causes** that led to the occurrence of the matters described in a) to c).

(QCSS No. 1, paragraphs 15 and 16(Before amendment in 2022) ([Reference]QCSS No. 1, paragraph 41))

- ② With regard to the root causes of the deficiencies identified in the CPAAOB inspection, the audit firm identified insufficient involvement of engagement partners in audit work. In response, the firm implemented remediation measures under which engagement partners, taking the lead, discussed and assessed audit risks within engagement teams. In addition, the quality control division confirmed, through periodic inspections and other procedures, the extent to which such remediation measures had been implemented. Furthermore, the CEO continuously communicated the importance of engagement partners' involvement in audit work through opportunities for communication with firm personnel.

However, **the quality control division lacked sufficient personnel** to continue and embed these remediation measures on a firm-wide basis. As a result, **the remediation actions taken in response to the identified deficiencies were insufficient**. In addition, **engagement partners placed excessive reliance on the formats of audit documentation revised in response to QC reviews, and their awareness of the importance of their involvement in audit work did not improve sufficiently**.

(QCSS No. 1, paragraphs 31, A30, and A31(Prior to the revision in 2022) ([Reference] QCSS No. 1, paragraphs 42 and 43), ASS No.220 (prior to the revision in 2022), paragraph 14, 15, and 16 ([Reference] No. 29 and No. 32))

### **Case 2: Dissemination of Specific Policies and Procedures for Remediation**

The PICOQC did not sufficiently ensure the through dissemination of specific policies and procedures for remediation. For example, while the PICOQC reflected deficiencies identified in the QC review and the firm's remediation plans in the checklist used for periodic inspections, the PICOQC **did not explain to firm personnel the underlying causes of the deficiencies or the purpose of the remediation plans. In addition, with respect to part-time staff, the PICOQC merely sent documents describing the deficiencies by postal mail, and did not otherwise ensure that such policies and procedures were adequately communicated and understood**.

(QCSS No. 1, paragraphs 15 and 16) (prior to the 2022 revision) ([Reference] QCSS No. 1, Paragraphs 42 and 43))

### **Case 3: Verification of Remediation Status**

- ① In connection with a merger, the audit firm conducted meetings with those responsible for quality management at the audit firm to be merged with and reviewed the results of inspections conducted by CPAAOB, with the aim of understanding the status of the audit firm's system of quality management.

However, although the PICOQC recognized that the audit firm to be merged with had been subject to numerous findings of deficiencies through CPAAOB inspections and other reviews, **the PICOQC did not sufficiently evaluate whether the quality of that audit firm was acceptable.** In particular, the PICOQC did not specifically identify or analyze the nature or underlying causes of the identified deficiencies.

(QCSS No. 1, paragraphs 15 and 16(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 41))

- ② The audit firm communicated points to be noted in audit performance, which were based on deficiencies identified through external inspections, to staff in the firm through training programs. In addition, the firm also prepared a "Deficiencies Response Table" that listed the identified deficiencies, required engagement partners to perform self-inspections based on that table, and had EQC reviewers confirm the results of such self-inspections. However, the engagement partners and the EQC **reviewer merely confirmed the items listed in the Deficiencies Response Table on a formalistic basis and did not perform in-depth consideration as to whether such deficiencies existed.**

Furthermore, the audit firm limited these self-inspections to audit engagements for specific fiscal year-ends, and **did not perform self-inspections for audit engagements related to the other fiscal year-ends.**

(QCSS No. 1, paragraphs 15 and 16(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 42 and 43))



- ③ When reviewing the status of the implementation of self-inspections performed by the engagement team and the EQC reviewers, the PICOQC merely confirmed, on a formalistic basis, that items on the self-inspection checklists had been marked as completed. The PICOQC did not verify whether engagement partners had conducted self-inspections that were effective in remediating deficiencies in audit engagements, nor whether the EQC reviewers had performed in-depth reviews that appropriately reflected the purpose of remediation.

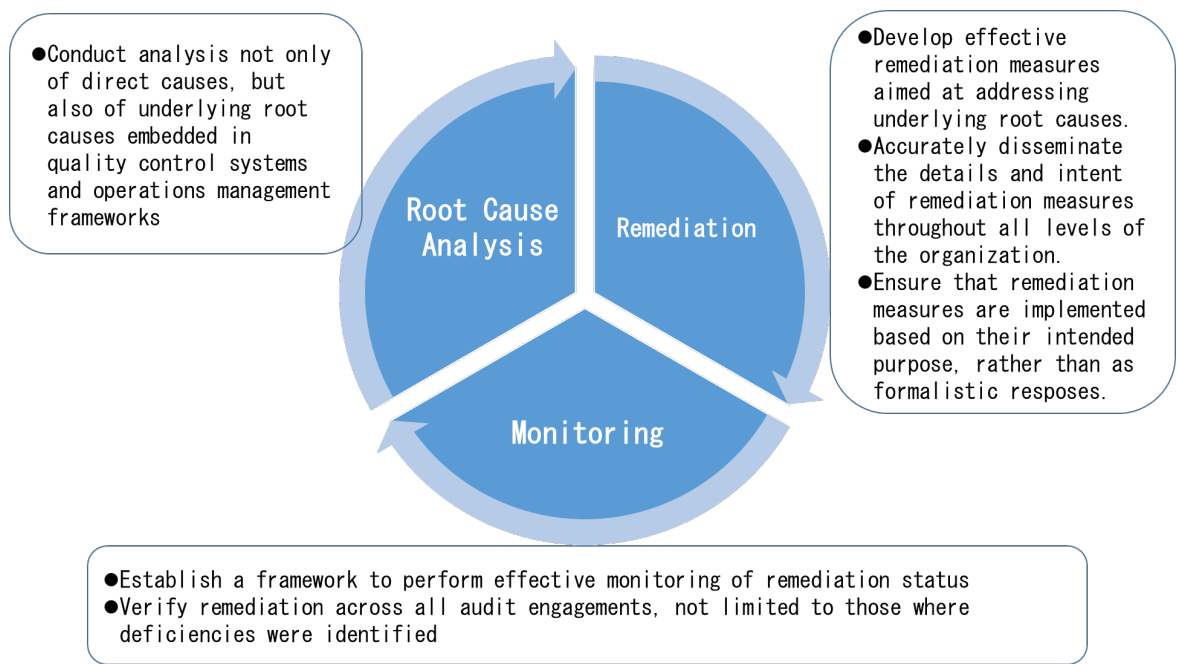
(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 43))

#### 《Points to Note》

The above cases illustrate situations observed at audit firms where deficiencies identical or similar to those identified in past CPAAOB inspections and QC reviews were again identified. Such situations arose from the implementation of formalistic remediation measures, such as merely communicating identified

deficiencies or using remediation checklists, without identifying the underlying root causes of the deficiencies or taking effective actions to address and remediate those causes. Accordingly, the PICOQC should note that it is necessary not only to communicate the details of identified deficiencies to engagement teams, but also to consider and provide specific instructions aimed at remediating deficiencies in audit procedures. In addition, where remediation checklists or similar tools are used, the PICOQC and engagement partners should monitor the status of remediation by taking into account the rationale underlying the identified deficiencies and the scope of audit procedures that require remediation. (Refer to [Figure 3])

[Figure 3] Efforts to Remediation



Source: Prepared by the CPAAOB

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

### **(1) Design, Implementation and Operation of Internal Rules**

#### **Points of Focus**

CPAAOB inspects audit firms with respect to the status of design, implementation, dissemination, and operation of internal rules from the following perspectives:

- ▶ Whether the audit firm has designed and implemented internal rules that reasonably ensure audit quality, taking into sufficient consideration the size and operations of the audit firm;
- ▶ Whether the audit firm endeavors to ensure the adequacy of its internal rules, for example, by sufficiently confirming consistency among rules when designing or revising them, and by revising internal rules as necessary in response to amendments to laws, regulations, and professional standards;
- ▶ Whether the PICOQC or equivalent appropriately communicates internal rules to personnel (including part-time personnel) and ensures their thorough dissemination, for example, by providing oral explanations as necessary; and
- ▶ Whether PICOQC or equivalent verifies the status of compliance with internal rules, for example, by timely understanding and evaluating personnel's compliance with such rules.

#### **Outline of Inspection Results**

With respect to the design, implementation, and operation of internal rules, as illustrated by the cases described below, there were audit firms in which deficiencies were observed not only in the operation of internal rules but also in their design and implementation.

As possible causes of such deficiencies, there were cases in which audit firms had an insufficient understanding of the laws, regulations, and professional standards applicable to audit firms; cases in which audit firms adopted, without modification to reflect their actual circumstances, the template of "Audit Quality Management Rules" provided by the JICPA; and cases in which audit firms considered that revisions to rules were unnecessary because no issues had arisen in the past.

#### **(Observed Effective Efforts)**

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

The audit firm promoted understanding of the relationship between the audit manual and the ASS by annotating each provision of the audit manual with the relevant requirements of the applicable ASS. Using such an audit manual, the audit firm provided education to personnel on the level of audit responses required by the ASS.

### **Expected Response**

Audit firms should re-examine whether their internal rules are appropriately designed and implemented in compliance with applicable laws, regulations, and professional standards, and whether such rules are suitable in light of the size and actual circumstances of the audit firm, and should revise such internal rules as necessary. In addition, audit firms are required to establish an operations management framework that supports the appropriate design, implementation, dissemination, and operation of internal rules, for example by developing workflows that appropriately reflect actual business practices, and by ensuring the personnel understand and comply with such internal rules on an ongoing basis.

### **Case 1: Design of Internal Rules (Articles of Incorporation and Organizational Rules)**

The CEO considered that there had been no issues in the firm’s operations since the audit firm underwent a merger in the past, and therefore **did not examine whether it was necessary to redesign internal rules or review whether the existing provisions appropriately reflected the size and actual circumstances** of the audit firm. As a result, with respect to matters subject to deliberation and resolution at the general meeting of partners, the articles of incorporation merely stipulated “important matters pertaining to the operations of the audit firm,” without providing specific examples or guidelines as to what constitutes such “important matters” in internal rules or other documents.

Furthermore, the audit firm had not established any organizational rules, and therefore had not specified the relationships among quality management-related functions, including the quality control function and the engagement quality review function, nor had it defined the purposes, roles, positioning, or other key aspects of important committees or meetings.

(QCSS No. 1, paragraphs 17 and 18 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

### **Case 2: Design of Internal Rules (Partners' Meeting)**

The audit firm has established a partners' meeting, consisting of all partners, as a body for making decisions on important matters relating to management and operations.

However, the audit firm had not established appropriate internal rules or arrangements for the proper operation of the partners' meeting. For example, **the audit firm did not formally stipulate in writing the matters to be resolved by the partners' meeting or the methods of resolution. In addition, the audit firm did not retain records of the deliberation process or the content of resolutions, even with respect to matters purported to have been resolved by the partners' meeting.**

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

### Case 3: Dissemination of Internal Rules

The audit firm stipulated in its quality control regulations that the PICOQC is required to document policies and procedures relating to quality management in such regulations, distribute the regulations to personnel, and explain, at the time of new employment and upon the adoption or revision of such regulations, their content, the objectives to be achieved, and the fact that each individual bears responsibility for audit quality.

However, the audit firm **merely kept various internal rules, including quality control regulations, in a cabinet within its office**, and the PICOQC **did not distribute the quality control regulations to personnel**. In addition, the PICOQC did not **sufficiently communicate to personnel the content of the quality control regulations or the objectives to be achieved, either at the time of new employment or when such regulations were newly established or revised**. (QCSS No. 1, paragraphs 15 and 16 (prior to the in 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

### Case 4: Operation of Internal Rules (Retirement Age Rules)

An audit firm stipulated in its retirement age regulation that the retirement age for partners is 65.

However, **with respect to partners who had reached or exceeded the retirement age, the audit firm permitted them to attend partners' meeting and maintained their registration as partners without adopting any resolution to extend the retirement age. As a result, the audit firm did not treat such partners in accordance with the retirement age regulation.**

(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

### Case 5: Operation of Internal Rules (Seeking Expert Opinions)

The audit firm stipulated in its "Audit and Quality Control Manual" that, when seeking expert opinions, engagement teams are required to document the issues to be consulted, relevant matters at issue, and relevant facts in a prescribed form.

However, the audit firm did not establish specific procedures for obtaining expert opinions. For example, the audit firm **did not specify reporting procedures to be followed when an engagement team identified matters on which an expert opinion should be sought, nor did it identify individuals inside or outside the firm from whom such expert opinion should be obtained.**

(QCSS No.1, paragraph 33, F33-2 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 31, F31 and 4JP))

### Case 6: Operation of Internal Rules (Quality Control Regulations)



The audit firm stipulated in its "Audit Quality Control Regulations" that, when all engagement partners responsible for the audit of the same entity are replaced, important matters identified in the course of the audit, including fraud risks, must be appropriately communicated."

However, at the time of such replacement the audit firm did not communicate to the succeeding engagement partners important matters identified in the course of the audit, including fraud risks. (QCSS No. 1, paragraph F32-2 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph F31-2JP), ASS No.220 (prior to the June 2022 Revision), F14-3 ([Reference] ASS No.220, paragraph F34-3JP))

### **Case 7: Operation of Internal Rules (Partners' Meeting Regulations)**



The audit firm stipulated in its "Partners' Meeting Regulations" that the approval of financial statements and business reports constitutes matters to be resolved by the partners' meeting.

However, the audit firm did not hold a partners' meeting to approve the financial statements and business reports in accordance with the regulations.

(QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

#### **《Points to Note》**

**In addition to the cases described above, the following deficiencies were identified:**

- **The audit firm had not established an appropriate channel to receive information related to fraud risks from external parties, nor had it defined specific mechanisms for responding to such information.**
- **The audit firm had not established a system for aggregating and managing personnel working hours, which serve as a basis for audit planning and other audit-related processes.**
- **With respect to audit strategies that obtain audit evidence solely through substantive procedures without performing tests of controls, the audit manual did not set out guidelines regarding the conditions for applying such strategies, or the nature, timing, and extent of the substantive procedures to be performed.**
- **When entering into contracts for non-audit services, the audit firm did not perform the procedures prescribed in its internal rules, such as notification to all partners and deliberation thereon.**

**As the templates provided by JICPA and other relevant bodies have become more comprehensive, deficiencies in the design of internal rules, such as the absence of such rules, have been decreasing. However, there continue to be cases in which audit firms adopt such templates without modification, resulting in internal rules that do not reflect the actual circumstances of the audit firm and do not function effectively in practice. Accordingly, audit firms should note the importance of periodically assessing whether there are any discrepancies between their internal rules and their actual operational practices.**

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

### **Points of Focus**

Under the Act and other applicable laws, regulations, and professional standards, various restrictions and obligations are imposed on CPAs and audit firms from the perspective of ensuring the

appropriateness of their operations. Accordingly, CPAAOB inspects the status of compliance with relevant laws, regulations, and professional standards, as well as the status of the design, implementation, and operation of operations management frameworks intended to ensure such compliance.

### **Outline of Inspection Results**

From the perspective of compliance with laws, regulations, and professional standards, deficiencies were observed in areas such as internal rules designed to ensure compliance with restrictions on competition among partners, the rotation of key personnel in charge of audit engagements, inappropriate responses to inspections, and false statements concerning CPA qualifications.

Possible causes of these deficiencies include instances in which the PICOQC or equivalent did not have a sufficient understanding of the applicable laws, regulations, and professional standards, as well as cases in which audit firms did not clearly and specifically define the responsible personnel or workflows for the tasks that require verification of compliance with laws, regulations, and professional standards.

### **Expected Response**

Audit firms should remain mindful at all times of the mission and responsibilities of CPAs and foster an organizational culture that promotes compliance with laws, regulations, and professional standards. In addition, audit firms should identify operations for which verification of compliance with laws, regulations, and professional standards is required, designate personnel responsible for carrying out such verification, and establish appropriate operations management frameworks to ensure compliance with such requirements.

### **Case 1: Prohibition on Competitive Activities by Partners**

A certain partner affiliated with the audit firm had continuously provided services falling within the scope of the audit firm's engagements, including audit services, at their own audit office since before becoming a partner of the audit firm, thereby violating the Act, which prohibits partners from engaging in competitive activities. In addition, the audit firm overlooked the fact that this partner was in violation of the Act.

(Article 34-14, paragraph 2 of the Act; QCSS No. 1, paragraph 19 (prior to the 2022 revision)  
([Reference] QCSS No. 1, paragraph 29)

### **Case 2: Rotation of Key Engagement Team Members**

With respect to long-term involvement in audit engagements, the audit firm's quality control regulations require that key engagement team members (namely, engagement partners, EQC reviewers, and other individuals who make important decisions or judgments regarding significant matters of audit engagement) be rotated after 7 years for audit engagements for "large companies, etc." as defined under the Act, and after 10 years for audit engagements of entities other than "large

companies, etc."

However, the CEO, who concurrently serves as the PICOQC, lacked a sufficient understanding of laws and regulations relating to independence. **As a result, in circumstances where a partner engaged in audit engagements for “large companies, etc.” as an assistant to the engagement partner had been involved for an equivalent or longer period than the engagement partner, the CEO/PICOQC did not consider whether such partner fell within the category of other individuals who make important decisions or judgments regarding significant matters of audit engagements.** In addition, some engagement partners deviated from the firm's policy on long-term involvement in audit engagements for entities other than “large companies, etc.” by continuing their involvement for more than 10 years.

(Article 24-3 of the Act; Article 9, paragraph 3 of the Ordinance for Enforcement of the Act; Guideline for Independence, Part 1, paragraph 139 (prior to abolition in 2023) ([Reference] Ethics Rule R524.6), QualityQualityQualityQualityQualityQualityQualityQCSSQuality No. 1, paragraph 24 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

### **Case 3: Inappropriate Responses to Inspections**

The audit firm submitted the inspection-related documentation to inspectors as inspection materials without disclosing the fact that certain partners and personnel had prepared quality management-related documents after the inspection cut-off date, or had retroactively prepared audit documentation and inserted such documentation into audit files that had already been finalized and assembled.

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

### **Case 4: Responses to QC reviews**

The PICOQC of the audit firm made statements to partners and personnel **that could reasonably be interpreted as encouraging or permitting the addition, modification and updating** of audit documentation relating to audit engagements subject to JICPA QC reviews during the period after the audit report date and before the completion of the assembly of the final engagement files.

(QCSS No. 1, paragraphs 17, and A4(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 28)).

### **Case 5: Input of Working Hours by Personnel**

Personnel at the audit firm were required to input working hours into the attendance management system.

However, numerous cases were identified in which the working hours of personnel, including those on statutory holidays, were not input into the attendance management system. In addition, there were multiple cases where the hours recorded in audit summary documents were understated, as well as cases where working hours on statutory holidays were recorded as working hours on regular

business days. Despite these issues, the audit firm did not implement **corrective measures to ensure the accuracy of recorded working hours across personnel as a whole, and appropriate management of personnel working hours was not achieved.**

(QCSS No. 1, paragraph 15; (Prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), ASS No.220, paragraph 7 (prior to the 2022 revision) ([Reference] ASS No.220, paragraph 13); Article 5, paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

### Case 6: Conflict-of-Interest Transactions



The representative partner of the audit firm concurrently served as the representative partner of a tax accounting firm, and the audit firm entrusted accounting and other services to that tax accounting firm.

However, the audit firm sought to entrust accounting services and other services to the tax accounting firm, the representative partner did not obtain the approval of a majority of partners other than the representative partner, as required under the main clause of Article 595, paragraph 1, item 1 of the Companies Act, which is applied mutatis mutandis pursuant to Article 34-22, paragraph 1 of the Act, despite the fact that such entrustment constituted a conflict-of-interest transaction.

(Article 34-13 and 34-22, paragraph 1 of the Act; Article 595, paragraph 1 of the Companies Act)

#### 《Points to Note》

**In addition to the cases described above, the following deficiencies have also been identified:**

- **The requirement that a majority of partners have been engaged in audit and attestation services for 3 years or more after being registered as a CPA was not met.**
- **The audit firm had not established internal rules setting forth procedures for identifying whether services that compete with the audit firm were being conducted, nor had it specified concrete approval procedures relating to such competitive activities.**
- **There is a discrepancy between the purpose of the audit firm as stated in the Articles of Incorporation and the actual scope of the audit firm's business activities.**
- **Notification of amendments to the Articles of Incorporation was not submitted within the statutory filing deadline.**
- **The audit firm did not obtain the required approval for transactions involving conflicts of interest.**
- **The audit firm did not aggregate or manage the actual working hours of partners and other personnel, and did not establish an appropriate framework for preparing audit summary documents.**
- **Approval procedures were not conducted for contracts relating to services outsourced by affiliated companies of the audit firm.**
- **The audit firm submitted audit planning documents to certain audited entities containing false statements indicateing that individuals engaged in the audits, who were not registered as CPAs, were**

qualified as CPAs.

- **The audit firm issued business cards indicating that an individual was a CPA to persons whose registration as certified public accountants had not been completed.**

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

#### **Points of Focus**

Firm personnel routinely obtain confidential information of audited entities and carry personal computers on which such information is stored. They also use e-mail for business communications with persons in charge at audited entities and store electronic audit documentation, as well as electronic data prior to documentation, at audit firms and on external servers. Accordingly, audit firms are required to establish and operate information security systems that appropriately address risks associated with the IT environment.

In consideration of the above, CPAAOB inspects audit firms with respect to the status of the establishment and operation of information security systems from the following perspectives:

- ▶ Whether the audit firm properly assesses information leakage risks, for example, by analyzing the types of information held by the audit firm;
- ▶ Whether the audit firm has established and operates security policies and other internal information security rules appropriate to such risks; and
- ▶ Whether the individuals responsible for information security ensure compliance with internal information security rules, for example, by continually monitoring whether personnel (including part-time personnel) comply with such rules.

#### **Outline of Inspection Results**

As illustrated by the case example below, deficiencies were identified, including failures to appropriately implement measures to prevent information leakage; failures to establish rules governing the use of internet-based server services for business operations; failures to appropriately apply security rules to part-time staff; and failures to appropriately anonymize personal information contained in audit documentation.

Causes of the identified deficiencies include the following:

The individual responsible for information security or equivalent established internal information security rules only on a formal basis and left their operation entirely to staff (including part-time staff) who use personal computers and other information devices;

The individual responsible for information security or equivalent, being overly confident that staff comply with internal rules, did not implement measures to monitor the actual status of operation of such rules at the audit firm;

- The individual responsible for information security did not adequately understand their

responsibilities and failed to establish rules suited to the actual use of information devices at the audit firm;

- Personal information was not anonymized as required;

Those responsible for information security did not sufficiently understand or recognize the importance of information security and therefore failed to recognize the necessity of appropriately establishing an information security management system.

### **(Observed Effective Efforts)**

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

To mitigate the risk of information leakage resulting from the loss of personal computers, an audit firm introduced a virtual desktop infrastructure (VDI) using thin-client terminals and utilized an external cloud storage service for exchanging data with audited entities by creating individual dedicated sites accessible only by engagement team members and the audited entities. When introducing the external cloud storage service, the audit firm identified risks associated with its adoption and implemented additional management measures, as necessary, to address risks not covered by the service provider.

### **Expected Response**

Although opportunities to obtain large volumes of electronic data have increased due to the digitization of confidential information of audited entities, many deficiencies in information security continue to be identified. Audit firms should fully recognize that information leakage may have serious adverse effects on the operation of the firm and should establish and operate appropriate information security systems in line with the actual usage of information devices at each audit firm.

In addition, data leakage resulting from unauthorized external access or cyberattacks aimed at causing system failures constitutes a significant management risk for audit firms. Accordingly, audit firms should ensure that cybersecurity measures are strengthened in accordance with advances in information technology.

## **Case 1: Appointment of Security Officers and Personnel**



The audit firm stipulated in its Basic **Policy** Information**Policy on** Security Policy that it should appoint an information security officer responsible for information management on a firm-wide basis, as well as information security personnel responsible for the audit firm's information systems and for each audit engagement.

However, **contrary to the provisions of the Basic Information Security Policy, the audit firm had not appointed any information security officer or information security personnel.**

(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), ASB Practical Guideline No. 5, paragraph 11)

## **Case 2: Design and Operation of Internal Information Security Rules**

The information security officer of the audit firm did not sufficiently understand the required level or scope of information security measures and therefore established security policies and other internal information security rules, and conducted reviews of the implementation of such measures, only on a formal basis. As a result, the following deficiencies were observed:

- Although security policies were established to prevent information leakage, no policies or procedures were established regarding actions to be taken in the event of information leakage;
- Data held by the audit firm were not classified according to their level of importance, backup or encryption of stored data was not implemented, and user IDs and passwords were not assigned to personnel when accessing important electronic data;
- Although the audit firm required all partners and other personnel to submit a “Security Policy Compliance Status Report,” some partners and other personnel failed to submit such reports; and
- The audit firm did not sufficiently disseminate internal rules, including the Basic Information Security Policy, to partners and other personnel, nor did it conduct periodic education or training on information security.

(Article 27 of the Act; QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision); QCSS No. 1 Practical Guidelines No. 1 sections III-1, IV-2, and IV-5 (prior to the 2023 revision))

## **Case 3: Operation of Internal Information Security Rules for Part-Time Personnel**

The PICOQC stipulated in the “Information Security Regulations” that, when part-time personnel use their personal computers for audit engagements, it must be confirmed that no audit engagement data remains on such personal computers.

However, the PICOQC **merely reviewed the “Information Security Checklist” on a formal basis** and did not actually confirm whether audit engagement data remained on the personal computers.

(Article 27 of the Act; QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), QCSS No. 1 Practical Guidelines No. 1, sections IV-2, IV-5, and V-2 (prior to the July 2023) revision)))

### **«Points to Note»**

**In addition to the cases described above, there were also cases in which audit firms used internet-based server services provided by major internet service providers as file servers, without establishing rules that clearly set out the security measures required when such services are used for business operations.**

**when whenWhenwhen part-time personnel use their own personal computers for audit engagements and perform the same tasks as full-time personnel, and when they handle the same types of information, it should be noted that audit firms are required to implement security measures at the same level as those applied to full-time personnel.**

**In addition, when periodically evaluating service providers, audit firms should note the importance of assessing the status and adequacy of the service providers' security measures.**

#### **(4) Prevention of Insider Trading**

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

If a CPA, who holds the important social mission of ensuring the reliability of capital markets, engages in insider trading using insider information of an enterprise obtained in the course of their work, trust in audits performed by CPAs may be seriously undermined.

In addition, not only will the CPA involved in insider trading be held liable, but such involvement may also significantly undermine the credibility of the audit firm to which the CPA belongs. Accordingly, audit firms are required to constantly implement effective measures to prevent insider trading by their members.

In consideration of the above, CPAAOB inspects audit firms with respect to the status of the establishment and operation of insider trading prevention systems from the following perspectives:

- ▶ Whether the audit firm has established internal rules that set out effective procedures to prevent insider trading by its members and ensures that such rules are properly communicated;
- ▶ Whether the audit firm appropriately implements insider trading prevention measures stipulated in its internal rules and, where necessary, conducts monitoring measures, including verification of transactions in specified securities by its members.

##### **Outline of Inspection Results**

As illustrated in the case examples below, there were cases in which audit firms established internal rules based on the “Rules for Preventing Insider Trading” template provided by the JICPA; however, such rules were not properly implemented.

Causes of the identified deficiencies include the following:

The individual responsible for insider trading prevention or equivalent did not comprehensively understand the insider trading prevention measures required under the internal rules; and

The individual responsible for insider trading prevention or equivalent did not verify whether members were actually complying with the internal rules, due to overreliance on the assumption that members were appropriately complying with the relevant rules.

##### **Expected Response**

Audit firms should recognize that public awareness of the adverse effects of insider trading on capital markets has increased and, accordingly, should implement more effective measures to prevent such trading.

Specifically, audit firms should take appropriate actions by taking into full consideration the “Q&A Concerning Insider Trading” issued by the JICPA (September 2, 2008) and other relevant materials, re-

examining the status of the design and operation of insider trading prevention rules, and considering whether further strengthening of insider trading prevention systems is necessary.

### **Case: Submission of Written Pledges for Insider Trading Prevention**

The PICOQC requires all members to submit a written pledge to comply with the “Rules for Preventing Insider Trading,” which prohibit members from trading in specified securities of audited entities to which the audit firm provides services. However, such written pledges **were required only at the time of hiring**, and no insider trading prevention measures, such as monitoring members’ transactions in specified securities, were implemented thereafter.

(Article 26 of the Act; QCSS No. 1, paragraph 19 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

#### **《Points to Note》**

**In addition to the cases described above, the following deficiencies have also been identified:**

- **The audit firm has not comprehensively established internal rules, as it only prohibited transactions in specified securities of entities to which services are provided under the “Rules for Preventing Insider Trading” and prohibited excessive entertainment and gifts under the “Code of Conduct and Ethics”;**
- **Although the “Rules for Preventing Insider Trading” stipulate that a list of entities to which services are provided shall be distributed to members in order to raise awareness of insider trading, the individual responsible for insider trading prevention did not distribute such a list; and**
- **Although members were instructed to submit written pledges not to trade in specified securities of entities to which services are provided in accordance with the “Rules for Preventing Insider Trading,” written pledges from certain members were not obtained, as the submission status was not monitored.**

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

#### **Points of Focus**

For audits performed by CPAs to be viewed as trustworthy by stakeholders, it is essential that auditors maintain a fair and impartial attitude, not be influenced by any specific interests, and make fair judgments on the appropriateness of financial statements. Accordingly, audit firms are required to establish policies and procedures regarding professional ethics and independence in order to objectively demonstrate that auditors maintain such impartiality. In addition, engagement partners are required not only to comply with such policies and procedures themselves but also to ensure that audit personnel comply with them.

In consideration of the above, CPAAOB inspects audit firms with respect to professional ethics and independence from the following perspectives:

- ▶ Whether the audit firm obtains, at least annually, confirmations regarding compliance with policies and procedures for maintaining independence from all persons subject to independence requirements, and whether appropriate confirmation procedures are performed based on the categories of such persons;
- ▶ Whether the audit firm performs independence confirmation procedures prescribed in its internal rules when accepting and continuing audit engagements, and, at the time of issuing the auditor's report, appropriately confirms that no changes in independence have occurred;
- ▶ Whether the audit firm has established and operates a framework to ensure that lists of entities subject to independence requirements, which are necessary for assessing whether persons subject to the requirements comply with independence rules, are updated in a timely and accurate manner;
- ▶ Whether the audit firm establishes and communicates policies and specific procedures relating to compliance with professional ethics, including fee dependency, employment restrictions, confidentiality, and gifts and hospitality, and whether audit personnel comply with such policies and procedures prescribed in the audit firm's internal rules;
- ▶ Whether the audit firm establishes and appropriately operates policies and procedures regarding long-term involvement in order to comply with statutory rotation requirements; and
- ▶ Whether substantive measures are taken to ensure compliance with professional ethics in light of the objectives of the mattersmattersmattersmattersmattersmattersmattersmattersrequirements set out inmatters required the ethicaethicaethicaethicaethicaethicaethicalCode of Ethicsethical.

#### **Outline of Inspection Results**

As illustrated in the case examples below, deficiencies were identified, including cases where independence confirmation procedures prescribed in internal rules were performed only as a formal review and conclusions that there were no independence issues were readily reached, as well as cases where such procedures were not comprehensively performed. In addition, deficiencies were identified where internal rules were not updated in response to amendments to laws and regulations relating to

independence.

Possible causes of these deficiencies include instances in which the PICOQC or equivalent did not clearly and specifically define procedures for independence confirmation (including procedures for updating lists of entities subject to independence requirements), the timing of such procedures, and the personnel responsible for implementation.

### **Expected Response**

Given that deficiencies relating to professional ethics and independence continue to be observed, audit firms should, in order to enhance the reliability of audits, comply with the fundamental principles set out in the “Code of Ethics” issued by the JICPA and establish appropriate operations management frameworks by applying the conceptual framework approach. In addition, when identifying, evaluating, and addressing threats to independence, audit firms should conduct careful assessments based on actual circumstances. (Refer to [Figure 4])

**[Figure 4] Conceptual Framework Approach**



Source: Prepared by the CPAAOB

### **Case 1: Confirmation of Independence in Collegial Review**

As part of the independence confirmation procedures for collegial review, the audit firm verbally confirmed the independence of prospective review committee members, and, where no independence issues were identified, recorded in the "Independence Confirmation" section of the "Review Request Form" that the independence confirmation procedures had been completed.

However, the audit firm **did not perform independence confirmation procedures for some prospective review committee members.**

(QCSS No. 1, paragraphs 20 and 38 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29, QCSS No. 2, paragraph 18))

### **Case 2: Confirmation of Independence When Accepting New Audit Engagements**

The audit firm performs independence confirmation procedures for members who conduct preliminary investigations for new audit engagements prior to commencing such investigations, and for other engagement team members before the start of audit engagements.

However, **the audit firm did not establish internal rules that set out specific procedures for independence confirmation, such as the persons subject to the procedures and timing of implementation.** As a result, for some audit engagements, **independence confirmation**

**procedures prior to preliminary investigation or prior to commencement of audit engagements were not performed.**

(QCSS No. 1, paragraph 20 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

**Case 3: Inadequate Preparation of a List of Entities Subject to Independence Requirements**

In performing independence confirmation procedures, the audit firm prepared a list of entities subject to independence requirements and attached this list to the independence checklist for confirmation. However, the audit firm did not verify the completeness of the list and omitted **multiple entities subject to independence requirements.** In addition, in performing independence confirmation procedures, although there were omissions in the responses obtained from partners and personnel, the audit firm did not ascertain the reasons therefor and therefore did not sufficiently verify compliance with independence requirements.

(QCSS No. 1, paragraphs 20 and 21 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

**Case 4: Assessment of Network Relationships**



The audit firm entered into a membership agreement with a certain network for the purpose of “cooperating among members in providing services to existing clients and acquiring new clients, as well as forming and maintaining a network of international accounting firms with high quality and reputation.” Based on the right to use the brand name granted under the membership agreement, the audit firm publicly indicated that it is a member of the network, including by using the brand name on its website.

However, the audit firm resolved at a partners’ meeting that no network exists to which the audit firm belongs, on the grounds that there is no ownership or control relationship within the network. As a result, the audit firm did not assess the application of network-related provisions in the Code of Ethics in accordance with the intent of Ethics Rule R400.53, which requires that “a network must be determined to exist when entities are structured for the purpose of cooperation and share a common brand name.”

(Ethics Rule R400.53)

**Case 5: Framework for Obtaining Information on Non-Audit Services Provided by Related Entities**

The audit firm performed non-audit services, such as financial due diligence, based on engagements outsourced from related entities.

However, **the audit firm did not establish policies and procedures for maintaining independence in relation to the acceptance of non-audit engagements by related entities.** In addition, with respect to non-audit services performed by the audit firm, the audit firm did not establish specific procedures regarding: a) assessment of whether such services fall within prohibited non-audit services, including consideration of capital relationships between the client of

the non-audit services and the audited entity and the nature of such services; (b) consideration of safeguards to be applied when providing non-audit services; and (c) approval by the engagement partner and the PICOQC.

(QCSS No. 1, paragraph 1, 20 and 21 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraph 29)

#### Case 6: Long-term Involvement of Engagement Personnel



With respect to the long-term involvement of key engagement personnel, including engagement partners and EQC reviewers, the audit firm stipulated in its internal rules on rotation that it must assess the significance of threats to independence and, where necessary, apply safeguards to eliminate such threats or reduce them to an acceptable level.

However, when appointing as an engagement partner an individual who had been involved for a long period as audit personnel, the audit firm did not assess whether threats to independence existed, taking into account the role performed and the duration of involvement by that individual.

(QCSS No. 1, paragraph 24 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29), Ethical Code R540.10)

#### Case 7: Calculation of Fee Dependency

Fees received from a specific audited entity accounted for more than 15% of the audit firm's total fees for 2 consecutive periods. As a safeguard, the audit firm requested an external CPA, who was not affiliated with the audit firm, to perform a review after issuance of the audit opinion. In calculating fee dependency, the firm included in the numerator both the audit fees from the audited entity and the total audit fees from its consolidated subsidiaries.

However, **the audit firm did not establish criteria for determining “cases in which fees account for a significant proportion” or “significantly exceed 15%,” as referred to in the Interpretive Guidance for Professional Ethics, and did not assess whether such criteria were met. In addition, the audit firm did not identify related entities in accordance with such guidance and did not assess whether there were related entities that should be considered in calculating fee dependency.**

(Guideline for Independence, Part 1, paragraphs 27, 220 and 222 (prior to abolition in 2023) [Reference] Ethical Code, R400.20, paragraphs 410.10 A1-A3, 410.14 A1, and 410.14 A3-A4, Interpretive Guidance for Professional Ethics Q1 and Q13 (prior to abolition in 2023) [Reference] Practical Guidance on the Code of Ethics, No. 1, Q410-5-1 to Q410-5-6, QG-4-1)

#### Case 8: Involvement Period of Engagement Partner

After ceasing involvement as an engagement partner due to rotation requirements, the CEO attended meetings to report audit results to representative directors of certain audited entities during the cooling-off period.

However, although the individual responsible for independence was aware of this fact, no assessment was performed from the perspective of independence, including whether the CEO's participation had a direct impact on the outcome of audit engagements.

(QCSS No. 1, paragraph 20 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

#### **Case 9: Employment with an Audit Client**

A former partner who had been involved in audit engagements for an audited entity was scheduled to assume a position as an officer of that entity. In assessing threats to independence and their significance, the audit firm only confirmed whether audited financial statements had been issued during the period between the partner's resignation as engagement partner and the assumption of the position.

However, the audit firm did not assess other relevant factors, including whether economic benefits had been provided by the audit firm to the former partner, whether the audit firm had any outstanding obligations to the former partner, or the extent of the former partner's continuing involvement in the firm's professional services.

(Guideline for Independence, Part 1, paragraphs 135 and 139 (prior to abolition in 2023) ([Reference] Ethical Rule R524.4 and R524.6))

#### **Case 10: Payment of commission for referral to assurance services**

The audit firm paid its personnel a certain percentage of the contract value of assurance engagements as compensation for referrals that resulted in the conclusion of such engagements. In addition, the firm engaged external business partners to identify and introduce new clients and paid them referral fees for assurance engagements.

However, such payments violated the Code of Ethics, which prohibits the payment of referral fees in relation to assurance engagements.

(Code of Ethics, Article 23 (prior to the 2022 revision) [Reference] Ethics Rules paragraphs 330.5 A1, R330.5 (JP))

#### **«Points to Note»**

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

- **The firm included, in the denominator used to calculate the fee dependency ratio, fees received by partners engaged in outside activities from companies at which those partners serve as part-time directors; however, the audit firm did not consider whether it is appropriate to include such fees as income of the audit firm in the denominator.**
- **The audit firm had neither established policies and procedures regarding the long-term involvement of audit personnel, nor had it established criteria for identifying persons subject to rotation or determining when safeguards are required to eliminate or reduce threats to independence.**

### Safeguards Regarding Fee Dependency

If fees received from a client for a specific audit engagement account for a large proportion of the total income of the audit firm expressing an audit opinion (hereinafter referred to as "fee dependency"), concerns about losing fees from such client for audit and other non-audit services may influence the level of self-interest of the auditor. This creates a self-interest threat to independence by giving rise to undue pressure. Accordingly, it is necessary to consider and implement safeguards to eliminate the threat or reduce it to an acceptable level.

#### <Calculation of Fee Dependency >

The calculation of fee dependency is described in Q410-5-4 of Practical Guidance No. 1, "Q & A on the Code of Ethics (Practical Guidance)." For details, please refer to the guidance.

**The total fees received from the client and its related entities;**

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**Total income of the audit firm**

#### < Safeguards for Audit Engagements for Public Interest Entities (PIE) >

When providing audit services to a client that is a Public Interest Entity (PIE) (\*), the audit firm is required to apply the following safeguards regarding fee dependency (where such safeguards are determined to be appropriate):

- When fee dependency from the client represents, or is likely to represent, more than 15% for two consecutive years: A review equivalent to an engagement quality control review performed by a professional accountant who is not a member of the audit firm, prior to the issuance of the audit opinion for the second year.
- When such circumstances continue for five consecutive years: The audit firm shall, in principle, cease to act as auditor after the audit opinion for the fifth year has been issued.

It should also be noted that, under the revised Code of Ethics, the provisions on safeguards relating to fee dependency have been amended, and post-issuance reviews (including periodic inspections or reviews by JICPA) are no longer recognized as safeguards for audit engagements for PIE.

(\*)Public Interest Entity (PIE) refers to "Large company etc." under the Act and other entities that are additionally treated as PIEs by the audit firm.

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

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

#### **Points of Focus**

In order for audit firms to reasonably ensure audit quality, it is necessary to carefully assess engagement risks prior to the acceptance or continuance of audit engagements. This requires collecting a wide range of information, including information relating to the integrity of the audited entity. If an audit firm performs an insufficient risk assessment regarding the circumstances of the audited entity, or makes a judgment on whether to accept or continue an engagement based on an incorrect understanding of its audit engagement structure, it may result in a failure to adequately fulfill its responsibilities as an auditor. Accordingly, it is evident that careful judgment based on sufficient and appropriate information is required when accepting or continuing audit engagements.

For this purpose, audit firms are required to consider, for example, the following matters when accepting or continuing audit engagements:

- ▶ Whether engagement risks exist, including risks relating to the integrity of management (note that interviews with management are useful in assessing such integrity);
- ▶ Whether the audit firm is able to assign sufficient and appropriate personnel and time, and perform audit procedures in accordance with the identified engagement risks;
- ▶ Whether the audit firm has audit personnel with the knowledge, experience, and capabilities necessary to appropriately address the identified engagement risks; and
- ▶ Whether compliance with relevant requirements relating to professional ethics and independence can be ensured.

In particular, when assessing the integrity of management, audit firms should obtain information considered necessary based on the specific circumstances. Where issues are identified, audit firms should carefully consider whether to accept or continue the engagement and appropriately document the basis for their conclusion.

Furthermore, audit firms are required to establish policies and procedures for the acceptance and continuance of audit engagements that include assessing engagement risks, including fraud risks, and requiring that such assessments be reviewed by an appropriate function or individual outside the engagement team, at the time of acceptance and, for continuance, depending on the level of risk.

In consideration of the above, the CPAAOB inspects audit firms from the following perspectives:

- ▶ Whether specific procedures for assessing engagement risks have been established and whether such risks are appropriately assessed;
- ▶ Whether identified engagement risks are appropriately reflected in the audit plans for individual engagements;
- ▶ Whether, in forming the audit engagement team, sufficient consideration is given to whether the audit firm has the competence, capabilities, and resources necessary to perform the engagement;

and

- ▶ Whether engagement risks are evaluated and approvals within the audit firm are made in a timely and appropriate manner.

### **Outline of Inspection Results**

Acceptance and continuance of audit engagements are core management decisions for audit firms. However, as illustrated in the case examples below, deficiencies were identified, including cases in which risk information —such as information relating to the integrity of management obtained by the prospective engagement partner through preliminary investigations, handovers from predecessor auditors, and prior-year audits—was not appropriately shared among those responsible for approving the acceptance or continuance of engagements (e.g., the partners' meetings), resulting in inadequate risk assessment. In addition, deficiencies were identified where audit firms did not appropriately sufficiently consider the audit resources required for the engagement, as well as appropriately assess risks cases in which, despite identified identified identified identified identified identified identified identifying identified inappropriate revenue transactions or significant deficiencies in internal control that should be disclosed, appropriate risk assessments were not performed.

Causes for the identified deficiencies include the following:

Prospective engagement partners prioritized expediting the conclusion of audit engagements and early commencement of work over conducting careful risk assessments and appropriately resolving identified issues;

Prospective engagement partners lacked sufficient experience to make appropriate judgments regarding management fraud, internal control audits, and accounting estimates, and therefore did not appropriately assess engagement risks based on facts identified through preliminary investigations and handovers;

When discussing whether to accept new audit engagements, partners did not sufficiently understand the importance of conducting firm-wide risk assessments based on information obtained from predecessor auditors, and partners other than the prospective engagement partner failed to critically evaluate engagements obtained by other partners.

### **(Observed Effective Efforts)**

The following are examples of effective efforts observed at audit firms.

When considering acceptance of an engagement for a high-risk entity in which revenue fraud had been identified in the previous period, the audit firm carefully evaluated the status of internal controls designed to prevent fraud. The prospective engagement partner obtained not only information from management and internal personnel, but also objective and detailed information to corroborate management's assertions, including by interviewing external experts directly involved in the entity's fraud prevention measures;

To establish an environment in which companies preparing for listing can receive appropriate audits, the audit firm has established a dedicated department within its organizational structure. This department provides consultation services to such companies, supports engagement teams to ensure audit quality, and plans and implements training to develop personnel capable of conducting audits of IPO-ready entities.

### **Expected Response**

In determining whether to accept or continue audit engagements, audit firms should identify engagement risks and consider appropriate responses based on information obtained through preliminary investigations, handovers from predecessor auditors, and prior-year audits, as well as the integrity of the audited entity, taking into account their own capabilities and resources. Audit firms should not allow their financial or operational priorities to unduly influence such decisions and should exercise due care to avoid inappropriate conclusions.

In recent years, there have been many cases of audited entities changing auditors from large audit firms to mid-tier or small and medium-sized audit firms. In particular, where the circumstances surrounding such changes indicate elevated engagement risk, audit firms should exercise enhanced caution.

In addition, the number of new engagements for audits equivalent to those required under Article 193-2, Paragraph 1 of the Financial Instruments and Exchange Act for entities preparing for listing has increased significantly. As many such entities face challenges in internal control and governance frameworks, audit firms should carefully assess whether they can perform audits of appropriate quality, paying particular attention to the following:

Carefully evaluate the integrity of management.

Assess whether it is possible to perform audits commensurate with engagement risks by securing sufficient and appropriate audit resources, including personnel and time; and

Ensure the availability of audit personnel with the necessary knowledge, experience, and capabilities, including expertise relevant to IPO-related engagements.

Furthermore, from the perspective of establishing a framework for continuously providing audit services to IPO-ready entities, audit firms need to develop personnel capable of handling such engagements and to accumulate and centralize relevant knowledge and expertise.

### **Case 1: Implementation of Risk Assessment Procedures when Accepting New Audit Engagements**

- ① The prospective engagement partner had assessed engagement risk as high after identifying, from prior-year audits, that submission of audit reports had been delayed due to deficiencies in the audited entity's accounting and management systems. The prospective engagement partner made inquiries to the predecessor auditor and, based on the responses received, concluded that there were no issues regarding the integrity of management, and submitted the matter to the partners' meeting for approval of the acceptance of the audit engagement.

However, although the prospective engagement partner had not conducted any direct meetings

with management, the partners' meeting approved the acceptance of the audit engagement based solely on the results of inquiries made to the predecessor auditor, and did not sufficiently assess the integrity of management.

(QCSS No. 1, paragraphs 25 and 26 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraph 30)



② In connection with the acceptance of a new audit engagement, the prospective engagement partner, through inquiries made to the predecessor auditor, became aware of circumstances such as inappropriate revenue recognition and material weaknesses in entity-level internal controls that should be disclosed.



However, the audit firm did not perform appropriate evaluations based on these circumstances with respect to items specified in its engagement acceptance checklist, including whether there was fraud or suspected fraud and whether there were significant deficiencies in internal control. (QCSS No. 1, paragraphs 25, 26, and F26-2 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraphs 30 and F30 -2JP, ASS No. 220, paragraphs 11 and F11-2 (prior to the 2022 revision) [Reference] No. 220, paragraphs 22, F22 and 2JP)

#### 《Points to Note》

**In addition to the cases described above, the following deficiencies have also been identified:**

- **Cases where audit engagements are approved before completing procedures required by the audit firm, such as obtaining responses to inquiries made to the predecessor auditor or obtaining approval at the partners' meeting;**
- **Cases where auditors accept appointments based on the assumption that, even if issues are identified as a result of necessary engagement risk assessment procedures after acceptance, such appointments can be readily withdrawn; and**
- **Cases where, in the context of mergers with other audit firms, sufficient consideration is not given to audit engagements undertaken by the merged firm.**

**It should be noted that, even in the case of a merger of audit firms, necessary procedures, including engagement acceptance procedures, must be completed and appropriate engagement risk assessment procedures must be performed.**

**In addition, when obtaining information regarding the integrity of audited entities, audit firms should consider, with reference to paragraph A69 of QCSS No. 1 (as revised), the following examples:**

- **For existing engagements, where applicable, information obtained from current or past engagements, or inquiries made to other personnel who have performed services for the client;**
- **For new clients, inquiries, in accordance with applicable ethical requirements, to persons currently or previously providing accounting or auditing services to the client;**
- **Discussions with third parties such as financial institutions, legal professionals, and other entities in the same industry; and**

- **Background checks using relevant databases, including, where appropriate, the use of external service providers.**

### **Case 2: Implementation of Risk Assessment Procedures upon Continuance of Audit Engagements**

The engagement team identified significant matters in the audit of the audited entity, including material weaknesses in internal control that should be disclosed, disclosures relating to the going concern assumption, and transactions with a major shareholder whose business rationale was questionable. The engagement team also assessed such transactions as circumstances indicating a risk of material misstatement due to fraud.

However, upon the continuance of the audit engagement with the audited entity, **the audit firm did not sufficiently consider the procedures necessary to ensure audit quality, despite being aware that these matters presented significant challenges in maintaining audit quality.**

(QCSS No. 1, paragraphs 25, 26, and F26-2 (prior to the 2022 revision) ([Reference] QCSS No.1, paragraphs 30 and F30-2JP), ASS No. 220, paragraphs 11 and F11-2 (prior to the 2022 revision) ([Reference] ASS No. 220, paragraphs 22 and F22-2JP))

#### **«Points to Note»**

**In addition to the cases described above, the following deficiencies have also been identified:**

- **Cases where, in evaluating engagement risks upon the continuance of audit engagements, the engagement team identified that necessary audit information had not been provided by management in the previous audit, but did not assess the integrity of management from the perspective of possible scope limitations;**
- **Cases where, despite identifying material weaknesses in entity-level and process-level internal controls that should be disclosed, the engagement team did not assess the integrity of management in light of the entity's response to such deficiencies.**

**Audit firms should note that, not only at the time of acceptance but also at the time of continuance of audit engagements, they are required to determine whether to continue the engagement only after identifying engagement risks and considering appropriate responses based on the information obtained.**

### **Case 3: Securing Audit Resources**

With respect to the continuance of audit engagements, the audit firm requires engagement partners to obtain approval from the EQC reviewer after evaluating the degree of engagement risk, taking into account factors such as the integrity of the audited entity, audit risks, and the availability of audit resources.

However, in considering whether to continue the audit engagement, the engagement team estimated the planned audit hours for the current period at the same level as those planned for the previous period, despite the fact that the actual audit hours for the previous period had significantly exceeded the planned hours. The engagement team did not consider specific methods

for reducing the audit hours while maintaining audit quality, nor did it consider the extent of reductions that could be achieved through such methods.

Furthermore, in approving the continuance of the audit engagement, the EQC reviewer did not assess the reasonableness of the planned audit hours estimated by the engagement team and did not sufficiently consider whether continued acceptance of the audit engagement was appropriate.

(QCSS No. 1, paragraph 25 (prior to the 2022 revision) [Reference] QCSS No. 1, Paragraph 30) QCSS No. 210, Paragraph 9, QCSS No. 220, Paragraphs 11 and A7 (prior to the 2022 revision) [Reference] QCSS No. 220, Paragraphs 22 and A50)

#### «Points to Note»

**In recent years, there have been a number of cases in which listed companies have submitted amended securities reports due to the discovery of inappropriate accounting treatments. In such cases, as with ordinary financial statement audits, audit firms are required to ensure appropriate quality control throughout the entire process, from determining whether to accept the engagement to the issuance of the audit report. Where corrections of financial statements covering multiple periods are anticipated, auditors may require additional time to obtain sufficient and appropriate audit evidence compared with ordinary audit engagements. Accordingly, audit firms should carefully assess whether the planned number of audit days is sufficient.**

## (2) Communication with the Predecessor Auditor

### **Points of Focus**

In cases where auditors change, information obtained by the predecessor auditor in prior audit engagements is highly important. Accordingly, both the predecessor auditor and the prospective auditor are required to ensure appropriate communication between audit firms so that the prospective auditor can obtain useful information for determining whether to accept the engagement and for performing the audit.

In consideration of the above, CPAAOB inspects audit firms in terms of their communication with predecessor auditors from the following perspectives:

- ▶ Whether the predecessor auditor communicates in a timely and sufficient manner to provide useful information to the prospective auditor for determining whether to accept the engagement and for performing the audit, and responds honestly and clearly to inquiries made by the prospective auditor; in particular, where information relating to material misstatements that have affected or may affect the audit opinion has been identified, whether such information is fully communicated;
- ▶ Whether the prospective auditor, in order to appropriately determine whether to accept an audit engagement, makes inquiries of the predecessor auditor regarding all matters required under auditing standards, including the reasons for the change of auditors and the status of responses to fraud risks;

- ▶ Whether the prospective auditor and the predecessor auditor mutually confirm the content of the communication performed and each prepares and retains appropriate documentation;
- ▶ Whether the audit firm ensures that communication with the predecessor auditor has been appropriately conducted by requiring the engagement team to report the results to an appropriate function or individual outside the engagement team; and
- ▶ Whether, where acceptance of an audit engagement has been declined or an existing engagement has been terminated due to identified or suspected non-compliance with laws and regulations, the predecessor auditor, upon request from the prospective auditor, provides all relevant facts and information necessary for the prospective auditor to determine whether to accept the engagement.

### **Outline of Inspection Results**

Deficiencies were identified where inquiries to the predecessor auditor were not appropriately conducted, as well as cases where the predecessor auditor did not properly convey its assessment of management's integrity to the prospective auditor.

Causes of these deficiencies include cases where the prospective engagement partner prioritized expediting the acceptance and commencement of engagements over conducting careful risk assessments and appropriately resolving identified issues. In addition, deficiencies were observed where the PICOQC assumed that, once policies and procedures regarding termination of engagements and communication with predecessor auditors had been established, engagement teams would comply with and appropriately implement them.

### **Expected Response**

The predecessor auditor should recognize the importance of providing clear and sufficient information to the prospective auditor regarding audit risks and other relevant matters identified during prior audit engagements.

In addition, the prospective auditor should establish a framework to ensure that information obtained through communication with the predecessor auditor is properly documented and effectively utilized in performing the audit.

Similarly, in cases where engagement teams change within the same audit firm, information relating to audit risks should be appropriately communicated. In particular, important audit matters, including fraud risks, should be clearly and sufficiently conveyed from the predecessor engagement team to the successor engagement team.

### **Case: Provision of Information to the Prospective Auditor**

In connection with the handover of an audit engagement, the audit firm communicated to the prospective auditor its assessment that no significant issues were identified regarding management integrity.

However, the engagement partner of the audit firm had, in an application for withdrawal from the audit engagement prepared as part of the firm's internal procedures, explained that there were significant

concerns regarding management integrity. Despite this, **the engagement partner did not accurately communicate this assessment to the prospective auditor during the handover**. In addition, the audit firm's quality control function had not established procedures to identify discrepancies between the minutes of the audit engagement handover and the application for withdrawal from the audit engagement. (QCSS No. 1, paragraphs 27 and 60 (prior to the 2022 revision) [Reference] QCSS No.1, paragraphs 34 and 62 jp, QCSS No. 900, paragraph13)

**《Points to Note》**

**In addition to the cases described above, the following deficiencies have also been identified:**

- **Cases where the prospective engagement partner did not make inquiries to the predecessor auditor;**
- **Cases where, due to a rapid increase in new audit engagements resulting from business expansion, required procedures for the handover were not performed in accordance with the audit firm's established policies within the prescribed timeframe;**
- **Cases where, because the predecessor auditor was a large audit firm, the engagement team accepted the audit engagement without sufficiently evaluating the appropriateness of the audited entity's accounting policies, and it was subsequently identified that such policies had been inappropriately applied.**

**In performing the handover, audit firms should note that excessive reliance should not be placed on the predecessor auditor and that a cautious approach is required.**

## **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.

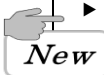
The causes of these deficiencies included a lack of commitment to establishing an appropriate education and training system. For example, in some cases, the PICOQC, etc. depended entirely on engagement partners' direction and supervision in audit field work in encouraging staff members to acquire engagement-related 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.
- ▶ Not only is it obligatory for part-time personnel to attend training sessions held once a month at least five times a year, but part-time personnel are also appointed as trainers to encourage them to actively participate in training.
- ▶ 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.

(QCSS No. 1, paragraphs 17, 28, and A20 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 28, 32, and A90))

### 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.

(QCSS No. 1, paragraphs 28 and F28-2 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32, F32-2JP))

- 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 (currently known as Continuing Professional Development (CPD)) 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.**

(QCSS No. 1, paragraphs 28 and A22(before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32 and A88)))

### **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.

(QCSS No. 1, paragraphs 28, A21, and A22 (before amendment in 2022) ([Reference] QCSS No. 1, paragraphs 32 and A88))

#### **«Points to Note»**

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

- **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' 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**
- **The cause of the deficiencies in individual audit engagements was insufficient education and training for professional staff.**

**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 the evaluation of assistants to the engagement partner**



When evaluating assistants to the engagement partner and calculating their remuneration, the audit firm stipulated that decisions should be made with due consideration to the execution of audit engagements, improvement of capabilities, and capability development through practical experience.

However, the partners' meeting only received reports on the evaluation results (evaluation points) for each engagement partner collected by the CEO and PICOQC, and the partners' meeting did not perform the audit firm's evaluation procedures, such as discussion and approval of the evaluation results. Furthermore, the audit firm only performed evaluations of engagement partner as a formality and **did not provide them with specific explanations of the evaluation results of each**

**engagement partner and the basis for their evaluation.** As such, the audit firm **did not establish a framework for fairly evaluating and rewarding engagement partner for enhancing and maintaining their capabilities.**

(QCSS No. 1, Nos. 15, 28, A20, and A24 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32, A90, A91, A92, and A93))

### **Case 2: Evaluation and compensation of partners**

- ① 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. (QCSS No. 1, paragraphs 15, 16, 17, 28, A5, A20, and A24(prior to the revision in 2022) [Reference] QCSS No. 1, paragraphs 28, 32, A90, A91, A92, and A93))



- ② The audit firm stipulated that evaluations and compensation for partners were determined based on factors such as the term of office of the partner, the quality control of audit engagements performed, and the performance of the partner.

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 establish a system to reflect the evaluation of audit quality, etc. in determining partners' remuneration.

(QCSS No.1, paragraphs. 15, 17, 28, A5, A20, and A24 (before amendment in 2022) [Reference] QCSS No. 1, Nos. 28, 32, A90, A91, A92, and A93))

### **Case 3: Evaluation of Part-time Employees**



When evaluating full-time personnel, the audit firm first performed a primary evaluation and then a secondary evaluation, with (I) work objectives, (ii) target figures, (iii) objectives other than direct work, (iv) management ability, (v) technical knowledge, (vi) work performance ability, and (vii) job

performance attitude rating as evaluation items, and then determined the evaluation and compensation on a five grade scale through discussions among partners.

However, **policies and procedures for evaluation of part-time personnel have not been established, annual evaluations have not been conducted, and a mechanism for determining the remuneration of part-time personnel by taking into account the quality and capability of audit engagements of each part-time personnel has not been established.**

(QCSS No. 1, paragraphs 15, 17, 28, A5, A20, and A24 (before the amendment in 2022) [Reference] QCSS No. 1 paragraphs 28, 32, A91, A92, and A93))

#### 《Points to Note》

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

- **Despite identification of persons with concerns about their quality control capability, etc. the firm's monitoring of audit engagements handled by such persons was inadequate.**
- **There are no clear standards regarding the relationship between the evaluation results of factors to be considered in employee evaluation and the classification of base salary evaluation, or regarding the conditions for the payment of evaluation salary.**

**In addition, the following deficiencies were identified in the evaluation of part-time personnel engaged in audits.**

- **Although personnel evaluations were conducted in the same way as for full-time personnel, the results of personnel evaluations were not sufficiently reflected in promotions / demotions or the composition of engagement teams out of concern that harsh treatment of part-time personnel would lead to their resignation and impede audit engagements.**

**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.

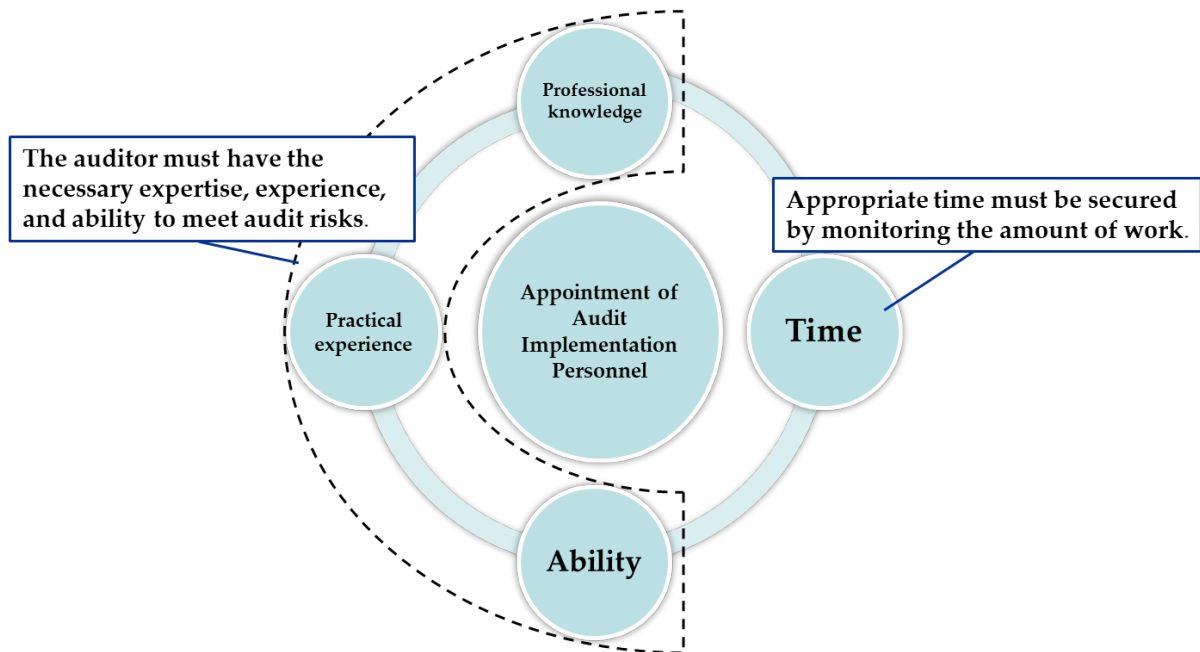
### **Expected response**

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. When forming engagement teams, audit firms need to give due consideration to the quality

control capabilities of engagement partner, and strive to establish a framework for the performance of audit engagements by quality control division, etc. that ensures that engagement partner, including engagement partner, have sufficient time to perform audit engagements by, for example, taking measures such as monitoring workload. (See Figure 5)

Note that if a merger etc. has occurred, an integrated response is required for the audit firm as a whole.

**Figure 5: Considerations for Selection of Audit Practitioners**



Source: Prepared by the CPAAOB

**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.**

(QCSS No. 1, paragraphs 29 and A26(before amendment in 2022) ([Reference] QCSS No. 1, paragraph 32))

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.**

(QCSS No. 1, paragraphs 15 and 16(before amendment in 2022) [Reference] QCSS No. 1, Paragraphs 32 and 37))

#### **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.**

(QCSS No. 1, paragraphs 15, 29, and 30(before amendment in 2022) ([Reference] QCSS No. 1, paraguraph 32))

#### **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.**

(QCSS No. 1, paragraphs 30, and A27) (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32 and A98))

#### **Case 4: Designation of a contact for conslutation**



The audit firm's quality control rules stipulate the scope of specific cases on which inquiries for expert opinions should be made and the persons to whom inquiries for expert opinions should be made. In particular, the audit firm designated some of its representative partners (two persons) as persons to whom inquiries should be made regarding "matters relating to the audit of accounting estimates" and "analysis of complex or unusual challenges for compliance with tax laws."

However, the engagement team did not consider whether it would be appropriate, from the perspective of ensuring objectivity, to designate the representative partner as the contact for inquiries mentioned above, given that both of the two representative partners were engagement partner for audit engagements.

(QCSS No. 1, Paragraph 33 (prior to revision in 2022) ([Reference] QCSS No. 1, Paragraph 31), ASS No. 220, Paragraph 17 (prior to revision in 2022) ([Reference] QCSS No. 220, Paragraph 35))

## **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**

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. 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 should exercise direction and supervision from the perspective of whether assistants could understand partner's instructions and whether assistants are performing tasks in accordance with the audit plan, etc. Engagement partners should also fully confirm, through the review of audit documentation, whether the conclusions reached by the engagement team are supported by the audit evidence obtained.

### Case 1: Review of audit documentation

-  ① Because engagement partner did not have sufficient time to perform the audit engagements for which they were responsible, they did not provide appropriate instructions and **supervision to assistants to the engagement partner in terms of whether they appropriately identified and assessed the risks of material misstatement based on an understanding of the corporate environment and whether they obtained sufficient appropriate audit evidence for the identified risks of material misstatement, and they did not conduct in-depth reviews of audit documentation.**

(ASS No.220, paragraphs 14, 15, and 16 (before amendment in 2022) ([Reference] ASS No.220, paragraphs 29, 30, 31, and 32))

-  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.

(QCSS No. 1, paragraphs 31, A30, and A31 (before amendment in 2022) [Reference] QCSS No. 1, paras. 31, A75, and A76), QCSS No. 220, paragraphs 15 and 16 (before amendment in 2022) [Reference] QCSS No. 220, paragraphs 31 and 32))

### 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.**

(QCSS No. 1, paragraphs 31 (prior to revision in 2022) [Reference] QCSS No. 1, paragraph 31), QCSS No.220, paragraphs 14, F14-2, 15, F15-2, and 16 (prior to revision in 2022) [Reference] QCSS No.220, paragraphs 29, 30, 31, 32, and F34-2JP))

«Points to Note»

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

- **Engagement partners focused on examining the appropriateness of the accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards in review;**
- **Appropriate reviews were not performed in light of information obtained from the audited company;**

**In the review, it is important to critically review whether the level of audit procedures performed by assistants to the engagement partner 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**

As shown in the cases below, there were cases in which audit documentation was newly prepared or revised based on the results of audit procedures performed after the date of the auditor's report, cases in which audit documentation was systematically falsified to avoid detection of deficiencies in external inspections, cases in which part of the audit documentation was not stored in the audit file, and cases in which, even though part of the audit documentation was revised after the deadline for completion of audit documentation, the specific reasons for the need for revision were not documented.

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 sense of guilt about preparing or amending audit documentation after the date of the audit report and a lack of awareness of the need to manage audit documentation.

### **(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.

### **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, controls over related technologies, and the use of IT applications. 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 inappropriate additions to or modifications of audit documentation.

It should be noted that the final assembly of the audit file is nothing more than an administrative task, and performing new or additional audit procedures or drawing new conclusions is a violation of audit standards.

In addition, in moving forward with the 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.

### Case 1: Assembly of final audit file

- ① 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.**

ASS No. 220, paragraphs 14, 15, and 16 (before amendment in 2022) ([Reference] ASS No.220, paragraphs. 29, 30, 31, and 32))

- ② Engagement partners did not sufficiently reflect an understanding of procedures required by current audit standards and an understanding of the business of the audited company in audit plans, and did not sufficiently verify the sufficiency of audit evidence and audit documentation.



Furthermore, engagement partners were not sufficiently critical because their assistants to the engagement partner had audit experience at large-sized audit firms and had been engaged in 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 partner did not perform appropriate audit procedures corresponding to risks and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.

(QCSS No. 1, paragraphs. 31, A30, and A31 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 31, A75, and A76), QCSS No. 220, paragraphs. 15 and 16 (before amendment in 2022) [Reference] QCSS No. 220, paragraphs. 31 and 32))

### 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.**

(QCSS No. 1, paragraph 31 (prior to revision in 2022) [Reference] QCSS No. 1, paragraphs 31), QCSS No.220, paragraphs 14, F14-2, 15, F15-2, and 16 (prior to revision in 2022) [Reference] QCSS No.220, paragraphs 29, 30, 31, 32, and F34-2JP))

**《Points to Note》**

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

- **The person in charge of review focused on examining the appropriateness of the accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards;**
- **Appropriate reviews were not performed in light of information obtained from the audited company;**

**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.

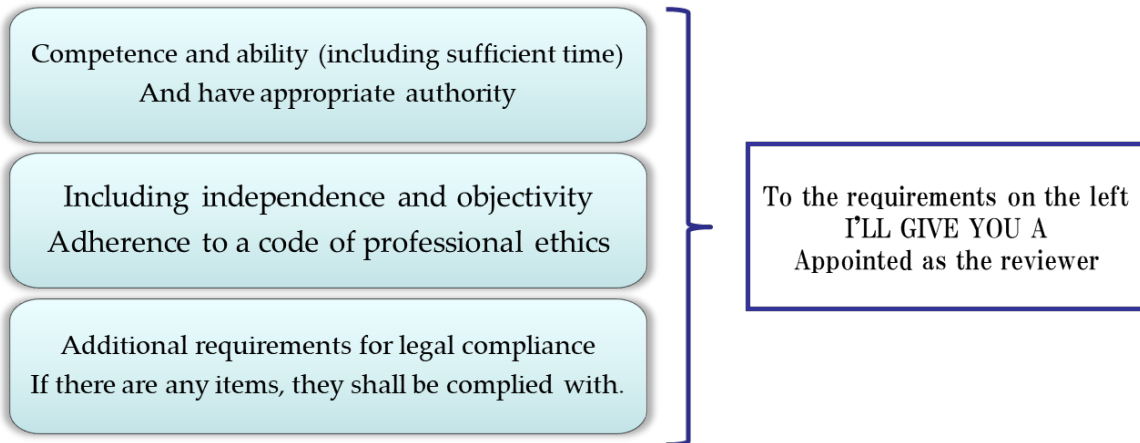
**Expected response**

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 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

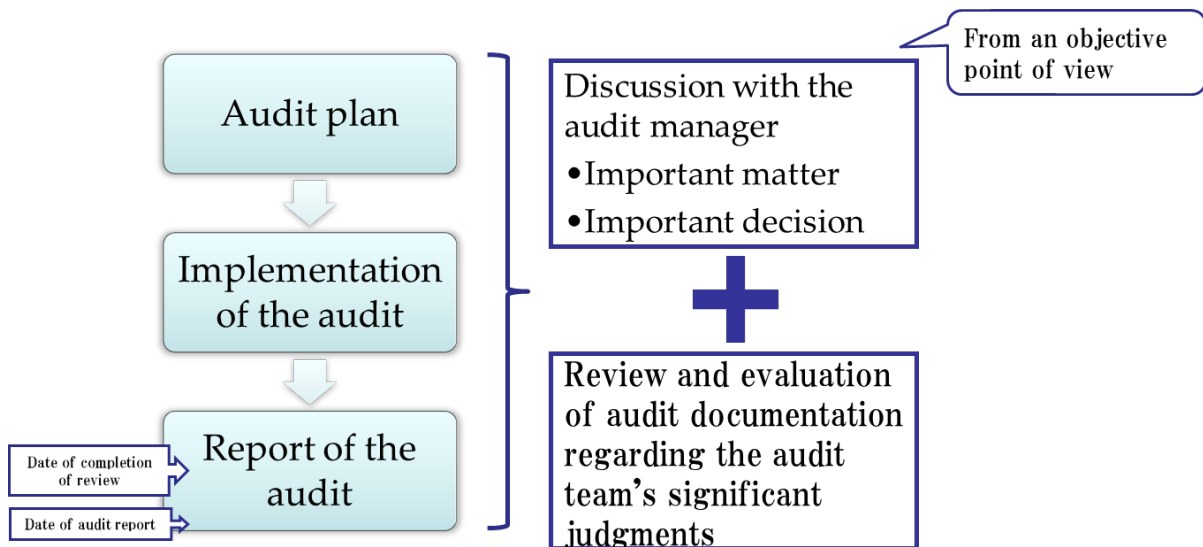
small and medium-sized audit firms, partners who are EQC reviewers are usually extremely busy because they are engaged in business operations with a small number of partners, and because they give priority to their own audit engagements, it is difficult to conduct appropriate EQC reviews. For this reason, it is necessary to take actions to enhance and strengthen EQC reviews while reaffirming the importance of EQC reviews of audit engagements. (see [Figures 6 and 7]).

**Figure 6: Competency of Auditors**



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

**Figure 7: Procedures Performed by Auditors**



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

### Case 1: Eligibility of the EQC reviewer



In quality control reviews conducted by the JICPA, the audit firm continued to receive multiple deficiencies, some of which were significant, in audit engagements of audited companies under review.

However, the audit firm did not evaluate whether the EQCRer had the knowledge, experience, ability, etc. required to perform the role of an EQCRer, and did not examine the appropriateness of the EQCRer.

(QCSS No. 1, paragraphs 36, 37, and 38 (before amendment in 2022) ([Reference] QCSS No. 2, paragraphs 18 and 25), QCSS No. 220. paragraphs 19 and 20 (before amendment in 2022))

### Case 2: Ensuring the effectiveness of EQCR



- ① In its Quality Control Rules, the audit firm stipulated that it should request an immediate review by the partners' meeting when it suspected a material misstatement due to fraud, when a material detection was not corrected, when a material matter was not finalized, when a material audit was not completed, when a material problem arose in the expression of an audit opinion, or when a material deficiency in internal controls that should be disclosed occurred.

However, although the EQCRer was aware that there was a material deficiency in the internal controls that should be disclosed, he / she did not request an EQCR by the partners' meeting.

(QCSS No. 1, paragraphs 36, 37, and 38 (before amendment in 2022) ([Reference] QCSS No. 2, paragraphs 18 and 25), QCSS No. 220, paragraphs 19 and 20 (before amendment in 2022))



- ② The EQCRer did not have sufficient understanding of the audit standards and the level of procedures required by the current audit standards, placed priority on the audit engagements for which he / she was the engagement partner, and did not allow sufficient time for the review. Therefore, the EQCRer concluded that there were no problems with the significant judgments and conclusions made by the engagement team and completed the review without sufficiently discussing with engagement partner and reviewing the related audit documentation regarding the fraud risk response, accounting estimates, and audit procedures for group audits, etc. that the engagement team had performed.

(QCSS No. 1, paragraphs 36 and 37 (revised in 2022) ([Reference] QCSCS No. 2, paragraph 25))

- 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.

(QCSS No. 1, paragraphs 36 and 37 (prior to the revision in 2022) [Reference] QCSS No.2, paragraph 25)

### **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.

QCSCS No. 1, paragraphs 14 and 41 (before amendment in 2022) ([Reference] QCSS No. 2, paragraph 27), ASS No. 220, paragraph 17 (before amendment in 2022) ([Reference] QCSS No. 220, paragraphs 35 and 36))

#### **《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 SQM plays an important role in ensuring and improving audit quality as a process to voluntarily identify and understand issues relating to the SQM and to remediate such issues. For this reason, audit firms are required to perform ongoing monitoring of the SQM to ensure the appropriate establishment and implementation of policies and procedures relating to the SQM; 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 SQM 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 SQM 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 SQM.

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

- ▶ Whether the audit firm assigns a person with sufficient and appropriate experience as the person responsible for the monitoring and improvement process 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 its daily monitoring activities, 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 at least one completed audit engagement is selected for each engagement partner in each specified period determined by the audit firm as part of periodic inspections;
- ▶ Whether the audit firm analyzes the impact of deficiencies identified as a result of periodic 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 periodic 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 deficiencies in the following areas: audit engagements of specific engagement partner were not subject to 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 and there was a framework in which monitoring of the quality control system was performed by the CEO alone.. 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.

### **Expected response**

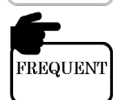
Audit firms are required to establish and implement an organizational system that adequately performs the primary function of quality control monitoring, which is to enable audit firms themselves to discover and understand problems related to the system of quality control and voluntarily implement remediation

measures. Specifically, audit firms required to identify individual audit engagements and items to be inspected, taking into account the size and industry of the audited company, the tenure and experience of the engagement partner, and 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 should be noted that, in the same way as when persons from within the audit firm are appointed, it is necessary to confirm whether the primary monitoring function is being fully exercised.

In addition, 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. It should also be noted that audit firms that conduct audit engagements that comply with the standards for responding to fraud risks at listed companies, etc., need to receive information relating to fraud risks that is provided to audit firms by sources inside and outside the firm.

### Case 1: Effectiveness of ongoing monitoring



The audit firm did not consider the appropriateness of having the CEO, who was responsible for establishing the quality control system, assume the responsibility for day-to-day monitoring activities for the quality control system. Furthermore, the person responsible for the day-to-day monitoring activities for the quality control system did not report the results of the implementation of the day-to-day monitoring activities to the partners' meeting. Furthermore, the person responsible for the day-to-day monitoring activities for the quality control system merely confirmed the status of the establishment of rules, etc. as a formality, for example, determining that there were no problems with the existence of rules, etc. based on a checklist.

(QCSS No. 1, paragraphs. 47 and 52 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 36, 37, 39, 46, and 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.

(QCSS No. 1, paragraphs. 47 and 48 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 37, 38, 39, 40, and 41))

② The PICOQC did not sufficiently confirm the implementation records of periodic inspections in the past. Therefore, the PICOQC did not perform periodic inspections of audit engagements in which specific engagement partner were involved without specific reason.



(QCSS No. 1, paragraph 47 (before amendment in 2022) ([Reference] QCSS No. 1, paragraph 38))

#### 《Points to Note》

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

- 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
- 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

① Even 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.

(QCSS No. 1, paragraph F54-2 (before amendment in 2022) [Reference] QCSS No. 1, paragraph F34-4JP))

- ② However, 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.**  
(QCSS No. 1, paragraphs 54, and F54-2 (before amendment in 2022) [Reference]QCSS No. 1, paragraphs 34, F34-4JP))

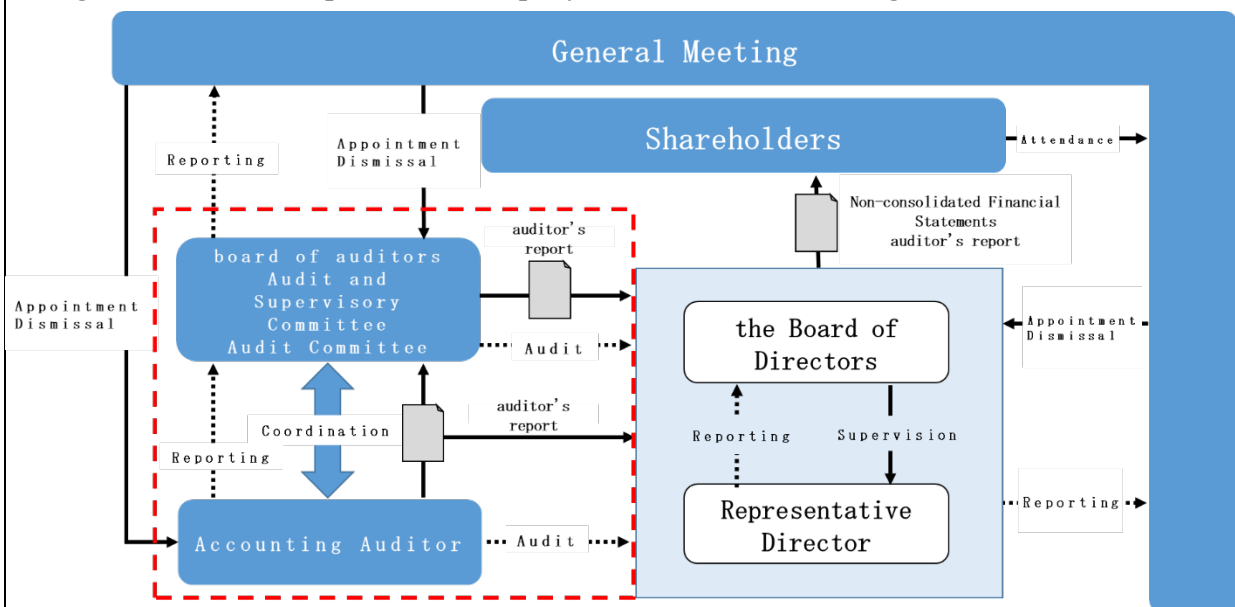
## 9. Cooperation with Company Auditors

### (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 8])

[Figure 8] 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.
- ▶ Is there clear communication with company auditors about information related to compensation for audit engagements, which are business entities with a high degree of social impact?

#### **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."

ASS 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.

Furthermore, it should be noted that, pursuant to the revision of the Code of Ethics in July 2022, communication with company auditors is required regarding information related to compensation for audit engagements, which are entities with a high degree of social impact. Communication regarding information related to compensation includes matters related to audit fees and fees for non-audit engagements, as well as, in cases where the degree of dependence on fees exceeds 15%, details of the fact, the possibility that the situation will continue, and applicable safeguards.

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.

(ASS No. 260, paragraphs 16 and A31)



- ② The 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.**

(ASS 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 ASS 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 ASS 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 September 2024), ASS 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 CPAAQB'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 ASS. 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 been continuously identified in the past 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 ASS ("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 ASS.

#### **(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 4) 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"(45 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 ASS.**

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 ASS.

- 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) Case 1), 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) Case 2).
- the suitability and reliability (accuracy and completeness) of information used as audit evidence was not verified (refer to "3. Audit Evidence" (1) Case 2)
- 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 ASS, 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 SQM 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 SQM, 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 engagement partners and appropriate assignment.

According to the ASS 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	ASS No. 240, Paragraphs 25, 29, 31	➤ Whether the engagement team easily limits fraud risks.

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
Relating to Fraud in Financial Statement Audits		<ul style="list-style-type: none"> <li>➤ Whether the engagement team designs and implements adequate audit procedures suited to the identified fraud risks.</li> <li>➤ 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.</li> </ul>
2.Risk Assessment and Response to Assessed Risks	<p>ASS No.315, Paragraph 25  ASS No.330, Paragraphs. 17, 20, and 23.</p> <p>No.450 Paragraph 10</p>	<ul style="list-style-type: none"> <li>➤ Are internal controls understood, including control activities relating to significant risks?</li> <li>➤ 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.</li> <li>➤ 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.</li> <li>➤ Whether the FCO has designed and implemented audit procedures to evaluate whether the overall presentation of financial statements, including notes thereto, complies with the applicable financial reporting framework.</li> <li>➤ Whether the FCO evaluates the impact of uncorrected misstatements in prior periods on its financial statements, etc. as a whole.</li> </ul>
3.Audit Evidence	<p>ASS No. 500, Paragraphs 5~8;  No. 520, Paragraph 4, 6;  No. 530, Paragraphs 7;  No. 570, Paragraph 15</p>	<ul style="list-style-type: none"> <li>➤ 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.</li> <li>➤ Whether the engagement team evaluates the competence, capabilities and objectivity of experts employed by the management, and examines the appropriateness of the experts' work.</li> </ul>

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		<ul style="list-style-type: none"> <li>➤ Whether the engagement team examines the reliability of data prepared by the audited company.</li> <li>➤ 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.</li> <li>➤ Whether, when performing audit sampling, the engagement team examines the validity of the sample selection method and sample size.</li> <li>➤ 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.</li> </ul>
4.Auditing Accounting Estimates	ASS No. 540, Paragraphs 12,13, 21,22 23; No. 500, Paragraph 8	<ul style="list-style-type: none"> <li>➤ Whether the engagement team understands the estimation methods used by the audited company, such as inventory valuation rules and the grouping for impairment judgement of fixed assets, and future business plans, and examines their appropriateness.</li> <li>➤ Whether the engagement team reviews the finalized amounts of accounting estimates made by the audited company in previous fiscal years;</li> <li>➤ Whether significant assumptions and data included in the audited company's business plan have been examined on the basis of specific evidence.</li> <li>➤ Whether the engagement team examines the reliability of data prepared by the audited company when audit of accounting estimates.</li> <li>➤ Whether the engagement team considers and evaluates all relevant audit evidence obtained in the course of the audit, including contradictory</li> </ul>

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		<p>information.</p> <ul style="list-style-type: none"> <li>➤ Whether, when examining accounting estimates, 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.</li> </ul>
5. Group Audit	<p>ASS No.600 (before amendment in June 2022), Paragraphs 29, 30, 39, 41,42</p> <p><b>【reference】</b> ASS No. 600 (as amended in June 2022), Paragraphs 31, 33, 42, 45~48</p>	<ul style="list-style-type: none"> <li>➤ Whether the engagement team is appropriately involved in tasks undertaken by component auditors.</li> <li>➤ Whether the engagement team comprehensively communicates to component auditors the significant risks and related parties involved in the group financial statements.</li> <li>➤ Whether the engagement team sufficiently evaluates the audit procedures performed by the component auditor in response to audit risks.</li> <li>➤ Whether the engagement team has taken necessary additional actions as a group engagement team in response to the component auditor's report;</li> </ul>
6. Using the Work of Auditor's Experts	ASS No. 620, Paragraph 6	<ul style="list-style-type: none"> <li>➤ Whether the engagement team examines the necessity of using the work of experts when specialized knowledge is required;</li> </ul>
7. Audit of Internal Control over Financial Reporting	<p>ASS 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"> <li>➤ 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.</li> <li>➤ 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.</li> <li>➤ Whether, in cases where the engagement team uses the work of internal auditors, the</li> </ul>

Deficiency	Provisions Often Serving as Criteria for Identification	Relevant Points to Note
		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)	ASS No. 701, Paragraph 12	➤ 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

- 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**

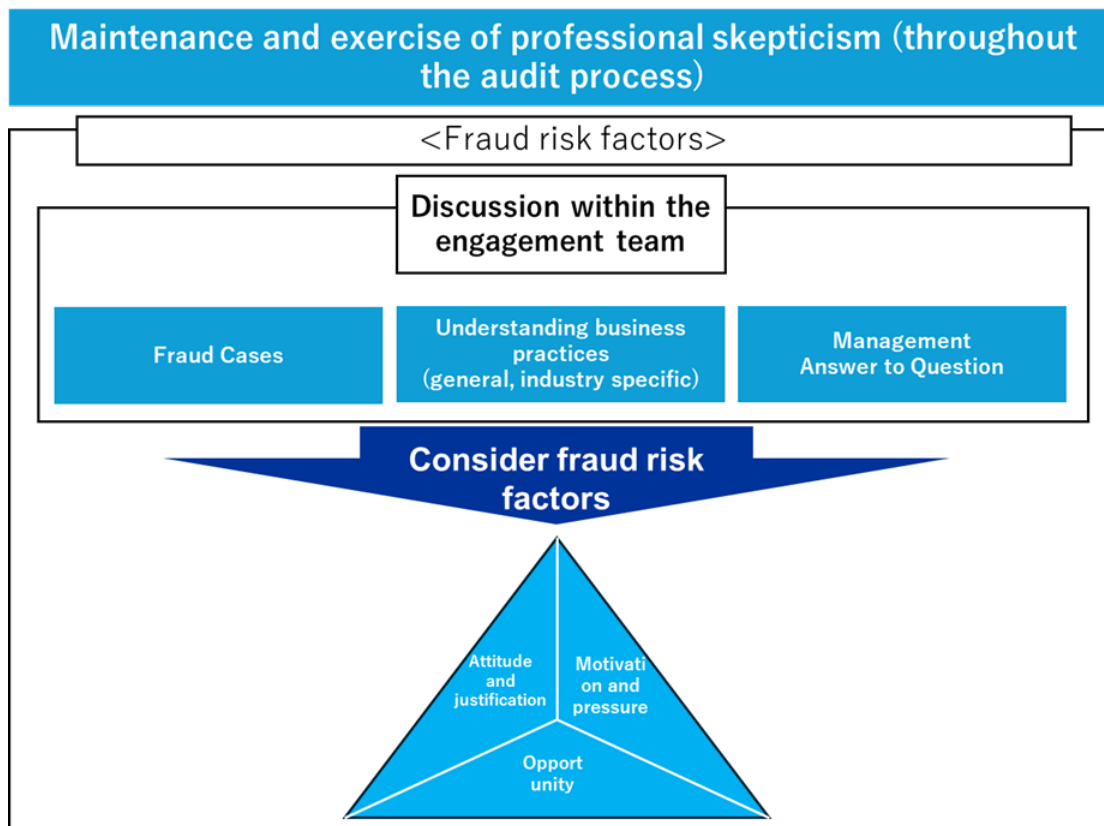
Conventionally, auditors have been required to maintain professional skepticism. Since the Fraud Risk Response Standard emphasizes the maintenance and exercise of professional skepticism, auditors should pay attention to the fact that they are expected to maintain professional skepticism in all processes 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, auditors are required to recognize once again that the reliability of accounting audits has been called into question again following the recent accounting fraud cases.

To this end, when developing an audit plan, the engagement team is required to: understand the audited company's business transactions, major fraud cases that have been publicly disclosed, and general and industry-specific business practices that may be abused; obtain information by making inquiries to management and other corporate members; and carefully consider, through discussion within the engagement team under the leadership of the engagement partner, whether or not this information indicates the existence of fraud risk factors, such as motivations or pressures to commit fraud, or events or conditions that provide opportunities to commit fraud. (see Figure. 9)

**Figure 9 : Maintenance and exercise of professional skepticism and Consider fraud risk factors**



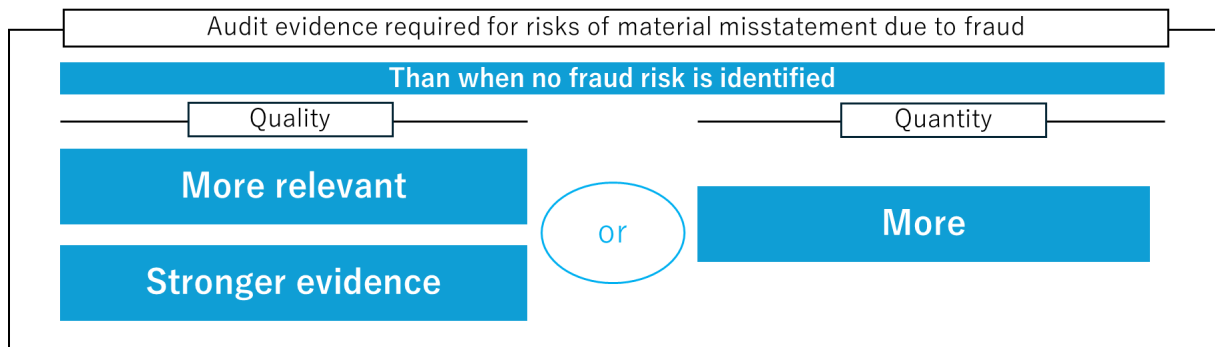
Source: Prepared by the CPAAOB

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. (see Figure 10).

**Figure 10: Audit evidence required for risks of material misstatement due to fraud**

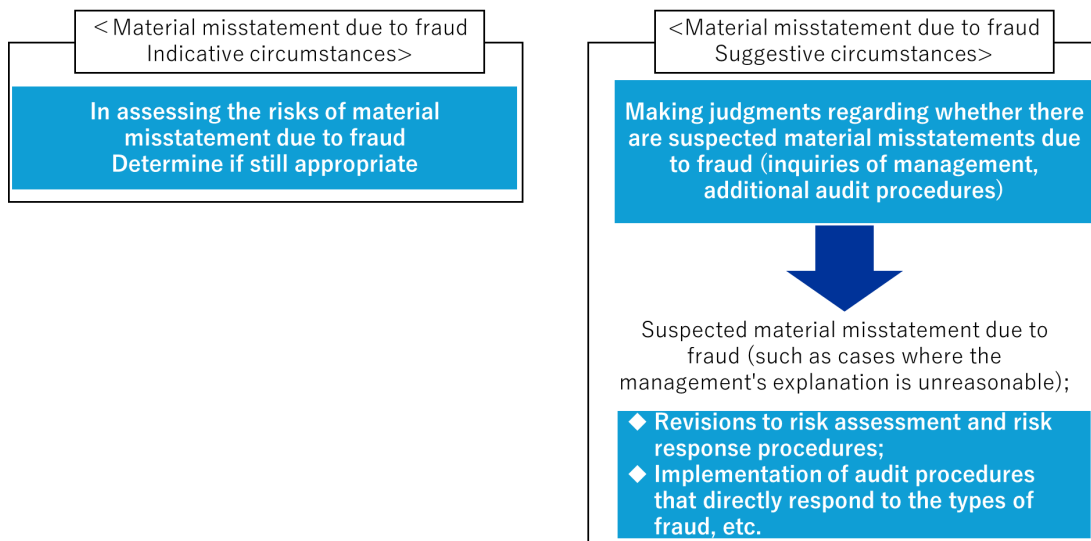


Source: Prepared by the CPAAOB

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 (see Figure 11).

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 suspicions about a possible material misstatement due to fraud, such as when the management's explanations are considered to be not reasonable, it is necessary to keep in mind the need to modify their risk assessment and designed further audit procedures and perform audit procedures that are specifically relevant to the type of fraud that may be assumed (see Figure 11)..

**[Figure 11] Responses to situations that present indications of material misstatement due to fraud and situations that present indications of material misstatement due to fraud**



Source: Prepared by the CPAAOB

## **(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.**

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

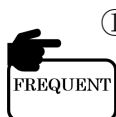
### **《Points to Note》**

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

- **The engagement team's discussion of fraud risks was only perfunctory, and the team did not substantively discuss possible risks from fraud cases published to date in relation to the characteristics of the audited company, such as industry type and governance.**
- **Communication with management and company auditors regarding fraud remained perfunctory, and information obtained from this communication was not reflected in the risk assessment.**
- **The engagement team did not discuss the possibility of material misstatement on the audited company's financial statements due to fraud or error that could result from the audited company's relationship with related parties and transactions with related parties;**

## **(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. 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.**

(ASS No. 240, paragraphs 25) [Large-sized audit firms]



- ② The audited company sold marine products, livestock products, general processed foods, and other products (hereinafter referred to as the "Products") and was entrusted with distribution services (hereinafter referred to as "distribution services"). Sales transactions subject to input into the core system were automatically linked from the core system to the accounting system, while sales slips were manually created in the accounting system for sales transactions not subject to input into the core system.

With regard to sales from the sale of the Products, the engagement team ascertained the amount of sales booked through manual entry, understood that it was not booked in a large amount, and recognized that it accounted for less than 0.1% of sales from product sales. In addition, with regard to sales from the sale of the Products, the engagement team identified a risk of management intentionally inflating sales by disabling internal controls and manually entering fraudulent sales into the accounting system without going through the core system.

The engagement team ascertained the manually entered sales recording amount out of the sales pertaining to logistics services, understood that it was recorded in a large amount, and recognized that it accounted for 65% of logistics services sales. In addition, with regard to logistics services sales, the engagement team ascertained the main customers and the content of transactions, analyzed quarterly sales and cost ratios by department for the past seven years, and determined that there were no irregularities. On the other hand, the engagement team identified a risk of misstating the recorded amount due to exceeding the materiality threshold as a risk of material misstatement.

However, the engagement team identified fraud risk associated with the nullification of internal controls for the sales of the Products, but did not sufficiently assess fraud risk for sales of logistics services by, for example, examining the necessity of identifying fraud risk associated with the nullification of internal controls based on an understanding of the internal controls related to the sales recording process.

(ASS No. 240, paragraph 25) [Large-sized audit firms]



- ③ With 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.**

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



- 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.**

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

- ⑤ Company A, a sub-subsubsidiary of the audited company, granted the right to use content, etc. (license) to its sub-subsubsidiary 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.**

(ASS 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.**

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

#### 《Points to Note》

**When identifying and assessing the risks of material misstatement due to fraud, the engagement team shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, sales transactions or assertions give rise to such risks. 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.**

(ASS 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.**

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



- ③ The audited company sells systems purchased from outside.

With regard to system sales, the engagement team identified the risk of material misstatement due to fraud, regarding circular transactions as a fraud risk scenario. As a procedure for responding to this fraud risk scenario, the engagement team compared the unit purchase price and unit sales price for the previous fiscal year to determine whether they had increased, and assessed that the unit purchase price had increased in line with price increases.

However, the engagement team only qualitatively assessed that the cause of the increase in purchase unit prices was due to the impact of price increases, and did not perform quantitative assessments of factors other than price increases. Furthermore, the engagement team did not

examine whether there was an increase in purchase unit prices that was suspected of falling under circular transactions, despite circular transactions being assumed as a fraud risk scenario.  
(ASS No.240, paragraph 29) [Mid-tier, and small and medium-sized audit firms]



- ④ The audited company engages in event production services. The engagement team identified fraud risks related to fictitious and accelerated sales recording throughout the accounting period because management, supervisors of sales divisions, and sales persons in charge were under pressure to achieve performance. As a procedure for responding to the fraud risks, the engagement team extracted sales transactions for which the contract amount exceeded a certain amount, compared them with external evidence such as contracts, and confirmed the handwriting identity between the signature on the estimate and the signature on the completion confirmation form.

However, the engagement team did not reconcile some of the sales transactions selected based on the aforementioned extraction conditions with external evidence, and for some of the sales transactions, the engagement team did not obtain completion confirmation documents and did not confirm the identity of the planned handwriting.

(ASS No.240, paragraph29; ASS No.500, paragraph 5; ASS No.530, paragraph 7) [Mid-tier, and small and medium-sized audit firms]



- 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.**

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

#### 《Points to Note》

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

- The engagement team did not sufficiently understand the company and its environment, such as the characteristics of the industry and sales format, which led to the failure to develop adequate procedures to respond to audit risks.
- The failure to specifically examine the types of fraud risks involved in each assertion led to the failure to develop adequate procedures to respond to audit risks.

- Although a fraud risk scenario was assumed, the engagement team reached a conclusion without obtaining sufficient audit evidence. For example, the team only performed analytical procedures such as asking questions of audited companies and making year-on-year comparisons and concluded that the assumed fraud risks had not materialized.
- Cases in which audit procedures designed as fraud risk response procedures were not completed; overlooking abnormal profit margins and contract details that did not match the actual situation by merely matching books and records with vouchers as a formality.
- In examining the estimated total cost based on the percentage-of-completion method, the engagement team only conducted inquiries with the audited company and cross-checked against internal control data prepared by the audited company.

For revenue recognition, ASS 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

- ① During 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 whether the Transaction suggested the possibility that it was executed for the purpose of concealing the misappropriation of assets.

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

- ② The 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.**

(ASS No. 240, paragraphs F11-2, 32-2, F35-2) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

ASS 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.

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



- ② As procedures for responding to the risk of management override, when performing journal entry tests, the engagement team understood the outline of the data linkage between the receivables management system, etc. and the accounting system, and that the person in charge of accounting would make journal entries and the head of the Accounting and Finance Department would approve such journal entries. Furthermore, the engagement team assumed that possible forms of fraud (fraud risk scenarios) included the execution of opaque overseas investments by the president or other authorized persons without internal approval.

However, **when examining fraud risk scenarios based on the risk of management override, the engagement team did not take into account the details of the journal entry preparation and approval processes (the status of setting access rights to the accounting system, processes for granting and restricting access rights, processes for adjusting journal entries, etc.).**

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

#### 《Points to Note》

The engagement team should plan and perform effective audit procedures by exercising professional skepticism and 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.

**Furthermore, when excluding automatic journal entries from journal entry tests, the engagement team should pay attention to the possibility that fraudulent automatic journal entries may be generated as a result of inputting fraudulent data into the business system or directly correcting data using a privileged ID in the business system.**

#### 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.**

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

- ② The 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.**

(ASS 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 (ASS 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.**

(ASS No. 240, paragraphs 34and 35) [Mid-tier, and small and medium-sized audit firms]

- ② The 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.**

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

#### 《Points to Note》

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

- The engagement team did not exercise professional skepticism in situations that indicated material misstatements due to fraud, such as by making formal inquiries of the audited company, not critically examining the answers, and not examining the contradictory explanations provided by the audited company.
- No additional audit procedures were planned or performed; only questions were answered.
- The engagement team identified a misstatement in the audit process but did not adequately consider whether it constituted an indication of fraud; the impact of the misstatement was not appropriately assessed; for example, the engagement team identified the misstatement as an indication of fraud but did not pay attention to the relationship between the misstatement and other audit aspects.

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

## 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.**

(ASS No. 240, paragraph F35-2) [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 consider the necessity of using the services of fraud investigation experts when designing procedures to respond to fraud risks in situations where there was a suspicion of collusion or spoofing by the management, multiple employees, and business partners.

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.

**Responses to circular transactions and cybersecurity risks**

With regard to circular transactions and responses to cybersecurity risks, which have been increasing in importance in recent years, the Japan Audit & Supervisory Board Members Association, the Internal Auditing Association of Japan, and the Japanese Institute of Certified Public Accountants have jointly published the "Joint Research Report on Internal Controls for Circular Transactions" (hereinafter referred to as the "Study Report"), and the Japanese Institute of Certified Public Accountants has published Technology Committee Research Paper No. 10, "Auditors' Responses to Cybersecurity Risks (Study Paper)" (hereinafter referred to as the "Study Paper"). The outline of the Study Report is as follows:

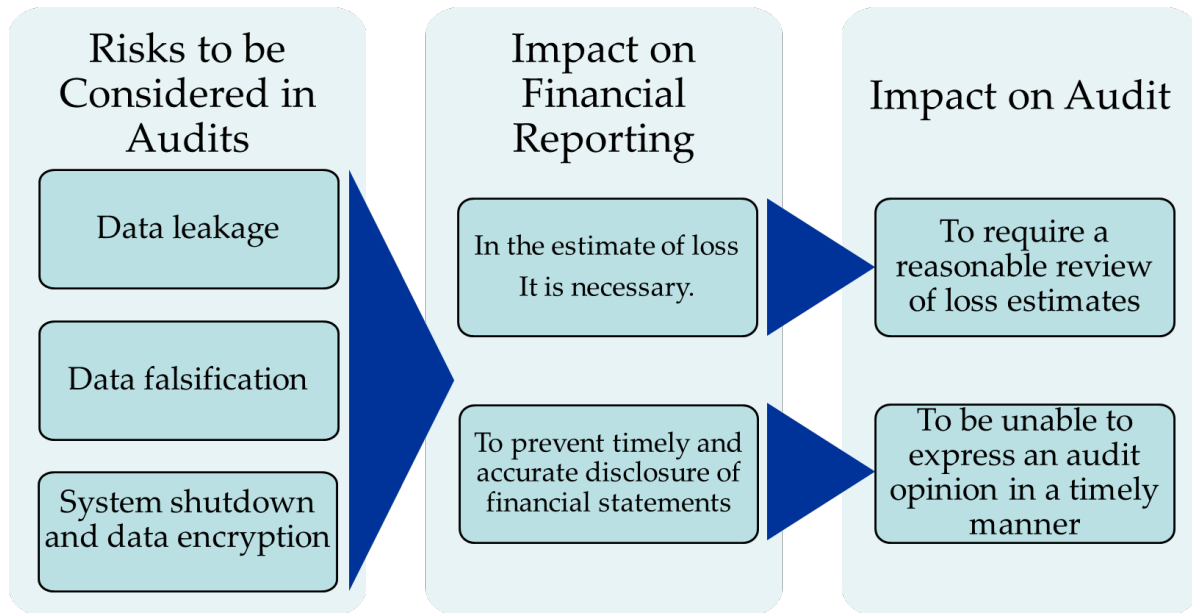
## &lt;Circular transactions&gt;

- Circular transactions sometimes start with small transactions but end with large transactions. Therefore, it is important to establish internal controls to prevent them and detect them at an early stage.
- Specific examples of situations and signs that indicate circular transactions include transactions where the business rationale is unclear, direct transactions, and cases where authority is concentrated in a specific person.
- In establishing internal controls to prevent and detect circular transactions, it is important that company-wide internal controls (for example, whistle-blowing systems, education and training, and internal audits, on the premise of establishing a corporate organization and culture that does not tolerate fraud) are established and appropriately operated.
- Preventive internal control is more useful than detective internal control, and examining the business rationality of transactions for which orders are scheduled to be received is effective internal control in preventing and detecting circular transactions.
- It is also useful to refer to Auditing Standards Report 240, Study No. 1, Using Technology to Respond to Circular Transactions, which describes the potential use of technology in addressing the detection of signs and triggers of circular transactions.

## Cybersecurity Risk

- Among the risks caused by cybersecurity incidents, risks and impacts that should be noted in audits are shown in [Figure 12].

[Figure 12] Risks and impacts to be noted in the audit of cybersecurity risks



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

- As a normal response, it is necessary to understand the corporate environment and internal control systems related to cybersecurity risks. Examples of specific internal control systems are provided.
- In the event of an emergency, the SESC will sort out and identify "areas related to financial reporting" from "areas affected by cyberattacks," and then assess whether there is any material impact on financial reporting (disclosure, etc.).

Source: "Joint Research Report on Internal Controls for Circular Transactions" (The Japan Audit & Supervisory Board Members Association, The Internal Auditing Association of Japan, and The Japanese Institute of Certified Public Accountants), Technology Committee Research Paper No. 10 "Auditors' Response to Cybersecurity Risks (Research Paper)" (The Japanese Institute of Certified Public Accountants)

## **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 at the financial statement and assertion levels when it develops an audit plan, considering the entity and its environment, business risks and controls, 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 ASS to be taken into account; and whether the team understands controls relating to significant risks;
- ▶ Whether the engagement team develops an overall response required by the ASS in accordance with the assessed risks of material misstatement at the financial statement, and plans the nature, timing, and extent of further audit 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 FCO has designed and implemented audit procedures to evaluate whether the overall presentation of financial statements, including notes thereto, complies with the applicable financial reporting framework.
- ▶ 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 entity 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 understand and 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 proces.

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.

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 ASS 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 ASS 315 "Identification and Assessment of the Risks of Material Misstatement")**

ASS 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.

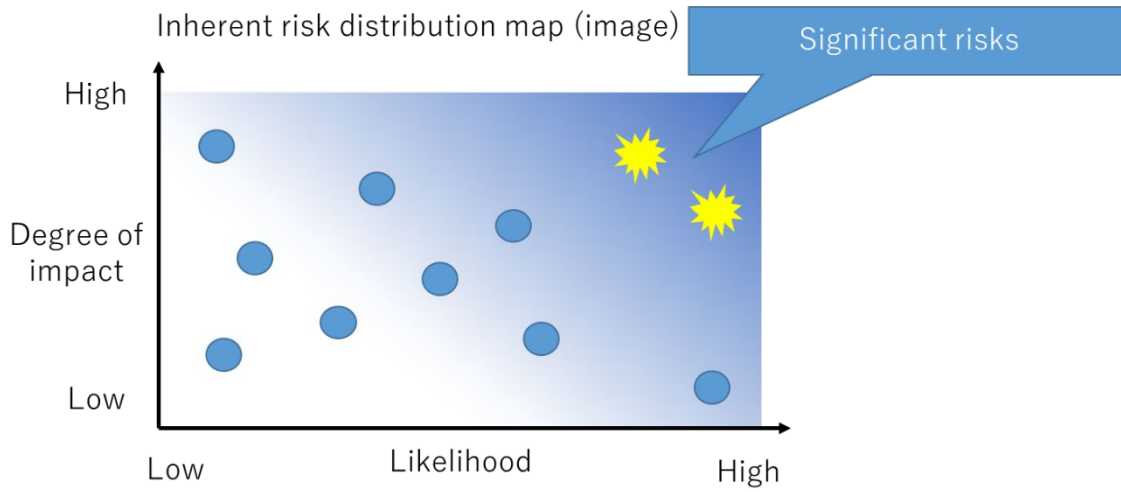
It should also be noted that the definition of significant risks has been changed to the following (see Figure 13):

(I) For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or

(ii) That is to be treated as a significant risk in accordance with the requirements of other ASS.

- Risks assessed as risks of material misstatement due to fraud.
- The risk of management override of controls;
- Significant transactions with related parties outside the ordinary course of business of the entity;

**Figure 13: Inherent risk distribution**



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

The June 2021 revision of ASS 315, "Identifying and Assessing the Risks of Material Misstatement," will be applied beginning with audits of financial statements for the fiscal year ending March 31, 2023. Therefore, the provisions that serve as the basis for deficiencies identified in the CPAAOB's inspections of audits of financial statements for the fiscal years prior to March 2023 are those that existed prior to the June 2021 revision. In this Case Report, ASS 315 before the revision states "before the 2021 revision," and describes the revised standards that are considered to correspond to the provisions that serve as the basis as [Reference]. The revised standards are provided merely as reference information, and do not indicate the CPAAOB's position on the interpretation or scope of the standards.

## **(1) Audit planning**

### **Case 1: Materiality**

In determining the benchmark to be used for establishing materiality, the engagement team had selected profit before tax in the prior fiscal year; however, in the current year, as a net loss before tax was expected due to the impact of COVID-19, the engagement team selected the average of profit before tax for the past three fiscal years as the benchmark. As a result, the materiality for the current fiscal year was set at a higher level than that for the prior fiscal year.

However, **although audit risk was elevated in the current fiscal year due to the impact of COVID-19**, including with respect to the valuation of fixed assets, investments in and loans to subsidiaries and associates, deferred tax assets, and the assessment of the going concern assumption, the engagement team **did not perform sufficient consideration in determining materiality, including a comparison with the prior fiscal year's materiality.**

(ASS No. 320, paragraphs 9 and A2) [Mid-tier, and small and medium-sized audit firms]

#### **«Points to Note»**

**In addition to the above cases, there were instances where, in selecting the benchmark to be used for determining materiality, the engagement team did not sufficiently consider indicators that influence the economic decisions of users of the financial statements. For example, despite the audited company having a history of fictitious revenue recognition in prior periods, the engagement team did not adopt non-profit-based benchmarks such as revenue or net assets, and instead used profit-based measures such as profit before tax or operating profit.**

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

The audited company, whose primary business includes the operation of nail salons, had previously recorded franchise revenues as part of the overall revenue account in the prior year due to their immateriality; however, in the current year, in light of the increase in such revenues, it recorded them as a separate account titled “franchise revenue.”

When developing the audit plan at the beginning of the period, the engagement team identified risks of material misstatement at the assertion level based on an analysis using the prior year-end account balances. Subsequently, at the year-end, the engagement team concluded that there had been no significant changes in the entity and its environment and determined that no revision of the audit plan established at the beginning of the period was necessary.

However, the engagement team **did not consider the need to revise the audit 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 franchise revenue recognized in the current period exceeded the materiality.

(ASS No. 300, paragraph 9; No.315 paragraph 24 and 25 (before amendment in 2021) ([Reference] ASS No.315, paragraphs 27 and No. 28)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

In addition to the above cases, there were instances where the engagement team did not identify significant risks required to be identified under ASS, such as risks of material misstatement due to fraud and significant transactions with related parties outside the audited company's normal course of business.

**(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 engagement team identified sales and accounts receivable as a significant class of transactions, account balance or disclosure for Company A, which was a significant component of the audited company, and identified the sales management system as an IT application related to sales and accounts receivable.

However, with regard to sales and accounts receivable, the engagement team did not understand the information processing activities related to a series of processes by which sales and accounts receivable data were generated based on product sales data collected by the sales management system and recorded in the general ledger.

(ASS No. 315, paragraph 24) [Mid-tier, and small and medium-sized audit firms]

- ② In valuing inventories (i.e., assessing whether there has been a decline in profitability), the audited company determined the net realizable value by deducting the estimated costs necessary to make the sale from the average selling price for a certain period for each product. If the net realizable value was lower than the carrying amount, 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 verify whether the audited company had deducted the estimated costs necessary to make the sale from the average selling price in calculating the net realizable value, nor did it obtain a sufficient understanding of the audited company's inventory valuation method (i.e., method for assessing whether there has been a decline in profitability).

(ASS No. 315, paragraph 10 (Before amendment in 2021) ([Reference] ASS No. 315, paragraphs 18 and 19)) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

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

- The group engagement team did not have a comprehensive understanding of the group's business and transaction flows at the group level.
- The engagement team did not assess the risks of material misstatement on a process-by-process basis

and did not consider the possibility that differences in the nature of transactions within the same account could result in differences in the audit procedures to be performed and the audit evidence to be obtained.

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 those applied in the industry to which the company belongs, by obtaining an understanding of the entity and its environment. In addition, there are cases where fraudulent financial reporting may occur in businesses other than the primary 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.

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

The audited company, which operates in the information and communications industry, was listed during the interim period and revised its earnings forecasts downward 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, **although the engagement team identified fraud risks regarding sales and software, it did not consider the need to identify the risk of material misstatement related to completeness and cutoff assertions for costs, despite having assumed that the audited company might fraudulently overstate its profits.**

(ASS No. 315, paragraph 25(Before amendment in 2021) ([Reference] ASS 315, No. 27)) [Large-sized audit firms]

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



One of the audited company's primary businesses is generating revenue by granting customers 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, although the engagement team understood the general nature of transactions related to the business, **it did not perform procedures to obtain an understanding of the control activities relevant to the above-mentioned significant risks**

(ASS No. 315, paragraph 28 (Before amendment in 2021) ([Reference] ASS 315, No. 27)) [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.

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

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



① The engagement team identified risks of material misstatement in relation to a portion of revenue recognized in the individual financial statements of the audited company, specifically for certain business segments. In addition, based on its understanding that the internal controls over revenue for this businesses were properly designed and operating effectively, the engagement team performed confirmations of accounts receivable as of the end of the month preceding the fiscal year-end, rollforward procedures for the remaining period, and procedures to address fraud risks for revenue recognized in the final month of the fiscal year.

However, although the engagement team identified risks of material misstatement related to revenue for this business, it **did not perform substantive procedures on revenue recognized prior to the month preceding the fiscal year-end.**

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



② A consolidated subsidiary of the audited company had previously recognized expenses prematurely through cost reallocations. In response, as a measure to prevent recurrence, the subsidiary introduced the same production management system as that used by the audited company and has since required that all cost reallocations be recorded in the system and be subject to monitoring by the audited company's administrative department.

In the audit for the current fiscal year, the engagement team identified the risk that expenses may be recognized prematurely through cost reallocations at the subsidiary (hereinafter referred to as "risk of premature expense recognition") as a significant risk. As a procedure to address this risk, the engagement team made inquiries of personnel in the subsidiary's general affairs department and confirmed that the preventive measures have continued to be implemented since the prior year. However, the engagement team **did not obtain an understanding of the internal controls relevant to the risk of premature expense recognition, despite treating it as a significant risk.** In addition, although the engagement team identified this risk as a significant risk, it **did not perform substantive procedures to address the risk.** Furthermore, the engagement team **did not evaluate whether there was a reasonable basis for the audited company's exclusion, from the scope of internal control evaluation, of the process related to this significant risk.**

(ASS No. 315, paragraph 28 (Before amendment in 2021) ([Reference] ASS 315, No. 25), 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]

- ③ Through the company split, the audited company transferred the businesses it had operated to each successor entity. In addition, the audited company determined that the company split constituted a transaction under common control and transferred the assets and liabilities attributable to the splitting entity (the audited company) to each successor entity at their book values as of the date of the company split.

In light of these circumstances, the engagement team identified significant risks related to the company split, taking into account the non-routine nature of the transaction and the materiality of the amounts involved, and performed the following procedures to address those risks.

- Inspection of the contracts related to the company split;
- Verification of compliance with the relevant accounting standards;
- Confirmation that the debits and credits of the journal entries related to the company split recorded by the splitting entity and each successor entity are in agreement;
- Inspection of the trial balance prepared by the audited company in relation to the assets and liabilities transferred to each successor entity.

However, **despite identifying the company split as a significant risk, the engagement team did not evaluate the consistency between the assets and liabilities transferred to each successor entity and the business operations of each successor entity.**

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

#### «Points to Note»

**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 identify all risks of material misstatement and internal controls have inherent limitations, including management override.**

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

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

Under these circumstances, the engagement team understood that management judgement affects the estimation of the total construction costs under the percentage-of-completion method, and that estimates of such matters as work content, labor hours, and raw material prices involve uncertainty. However, **in assessing the need for disclosure of significant accounting estimates, the engagement team did not evaluate whether these estimates could have a material impact on the financial statements of the audited company in the following fiscal year, nor did it evaluate the size of the quantitative impact on the following fiscal year's financial statements or the likelihood of such an impact occurring.**

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



- ② The audited company identified seven business segments, including the consulting business, as reportable segments and disclosed segment information for each of these segments in the "Segment information" section of the notes under "Segment information, etc." in its securities report. In addition, it disclosed segment information for other businesses by classifying them as "Other."

However, the engagement team did not consider whether businesses other than these seven segments (classified as "Other") should be separately presented as reportable segments.

(ASS 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 disclosed the amount of contract liabilities recorded by its subsidiary, Company A, in the notes to the consolidated financial statements in its securities report, including the "Notes to the Consolidated Balance Sheet" (contract liabilities) and the "Notes on Revenue Recognition" (balance of contract liabilities and transaction price allocated to remaining performance obligations).



However, the engagement team overlooked the fact that deposits received by subsidiaries Company B and Company C, which constituted contract liabilities that should have been disclosed by the audited company, were not included in the notes.

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

#### 《Points to Note》

**In addition to the above cases, the following deficiencies were identified.**

- **The engagement team did not sufficiently examine the presentation and disclosures in the financial statements and overlooked significant errors in the presentation of the consolidated statement of cash flows, the disclosures related to the consolidated statement of comprehensive income, and the notes on tax effect accounting.**
- **The engagement team did not design or perform audit procedures to assess compliance with accounting standards in relation to the disclosures in the notes on revenue recognition.**
- **The engagement team did not examine the completeness of the data used as the basis for determining fair value in the notes on investment and rental property.**
- **In performing audit procedures using disclosure checklists, the engagement team overlooked misstatements by merely placing check marks as a formality**

**It should be noted that the engagement team is required to design and perform audit procedures to assess whether the overall presentation of the financial statements, including related disclosures, is in compliance 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 introduced a point card system for sales promotion in Business A and recognized points expected to be redeemed in the future as contract liabilities at the fiscal year-end. The audited company also outsourced the administration of point data used to calculate the amount of contract liabilities to an external service provider.

In evaluating general IT controls over the systems of both the external service provider and the audited company related to the management of point data, the engagement team conducted inquiries of the external service provider via the audited company and reviewed the responses obtained.

However, in examining the balance of contract liabilities and the related supporting documentation, the engagement team **did not identify the internal controls of the external service provider and the audited company related to the management of point data, nor did it evaluate their design or determine whether such controls had been implemented.**

(ASS 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 systems operated by a company to which IT operations for important business processes had been outsourced (hereinafter referred to as the "Contractor Company"). The audited company obtained system documentation of the Contractor Company and an assurance report on controls at the Contractor Company.

However, the engagement team merely reviewed the report obtained by the audited company and **did not assess the services provided by the Contractor Company, including the appropriateness of the procedures performed by the service auditor of the Contractor Company.**

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

### **«Points to Note»**

**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 statements for the prior period, which were included in comparative information, was recognized in the current period and that the uncorrected misstatement from the prior fiscal year had been corrected in the current period.

However, the engagement team **did not evaluate the effect of the prior fiscal year misstatement on the audit of internal control over financial reporting. In addition, it did not include, in the management representation letter, matters such as "uncorrected misstatements included in comparative information" and "the effect on comparative information of corrections made in the current period."** Furthermore, the engagement team did not communicate to the board of auditors the effect of uncorrected misstatements related to prior fiscal years on the relevant classes of transactions, account balances, or disclosures, and on the non-consolidated and consolidated financial statements as a whole.

(ASS 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]

② The audited company disclosed the "amount of inventories recognized as expense" in the notes on inventories in the consolidated financial statements for both the prior and current periods.

In this regard, the engagement team noted in the audit documentation that the amount disclosed for the prior period was incorrect.

However, the engagement team did not sufficiently understand that comparative information is presented as an integral part of the current year's financial statements. As a result, it did not determine the difference between the misstated amount and the amount that should have been disclosed, **nor did it evaluate whether the misstatement was material as an uncorrected misstatement.**

(ASS 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 by taking into account the results of the assessment of**

internal controls and the impact on substantive procedures..

Moreover, auditors must determine, either individually or in aggregate, whether the identified misstatements are material as uncorrected, and must assess the impact of prior years' uncorrected misstatements 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, but, 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.**

(ASS No. 315, paragraphs 20 and 30(before amendment in 2021) [Reference] ASS No.315, paragraphs 25 and 36)) [Large-sized audit firms]

②In 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 recorded sales journal entries based on the sales details.

The engagement team identified the risk of premature revenue recognition at Company A as a fraud risk and evaluated the design and operating effectiveness 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 it in the scope of general IT controls testing.

However, although the engagement team recognized that sales details were prepared based on information from the customer management system and that sales journal entries were recorded based

on these details, it **did not consider whether the customer management system should be included in the scope of general IT controls, nor did it sufficiently assess the appropriateness of that scope.** (ASS No. 315 paragraphs 17 (Before amendment in 2021) , ([Reference] ASS No.315, paragraphs 24 and 25)) [Mid-tier, and small and medium-sized audit firms]

## **Case 2: Evaluation 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 evidencing 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 aboves cases, there were cases 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 process.**

**Entities use information systems to conduct their business operations. Understanding the status, characteristics and operation of such systems forms the basis for appropriately identifying and assessing the risks of material misstatements arising from those systems. There are cases where the engagement team concludes that the risks of material misstatement are low without obtaining an understanding of the IT environment. In planning the audit, the engagement team is required to obtain an understanding of the IT environment, and to identify the IT systems to be included in the assessment of risks of material misstatement.**

**In addition, the group engagement team is required to ensure that it obtains an understanding of the IT environment at the group level. It should also take into account how the entity's control environment, including applicable accounting policies and financial reporting systems, is reflected in or related to IT**

systems when developing appropriate audit plans.

Furthermore, when using information produced by the audited company's information systems for tests of controls or substantive procedures, the engagement team should evaluate the accuracy and completeness of such information. Depending on the extent of IT usage by the audited company, the engagement team may require the involvement of IT specialists and significant time to complete the audit. Therefore, the engagement team should ensure that audit plans for these procedures are developed at an early stage.

Revised ASS No.315 expands IT-related considerations and, in its application material, includes considerations for understanding IT and general IT 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 fiscal fisicalyear:

- The engagement team identified significant risks but did not perform substantive procedures that responded individually to the risks;
- When using information prepared by the audited company, the engagement team did not evaluate whether the information had sufficient reliability for audit purposes;
- 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, and did not evaluate whether such estimates were sufficiently accurate to identify misstatements;
- In using audit sampling, the engagement team did not examine whether the sample size it had determined was adequate to reduce sampling risk to an acceptably low level;
- When performing tests of specific items, the engagement team did not examine whether it was necessary to obtain additional audit evidence for the remaining balance; and

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 effective efforts observed at 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.

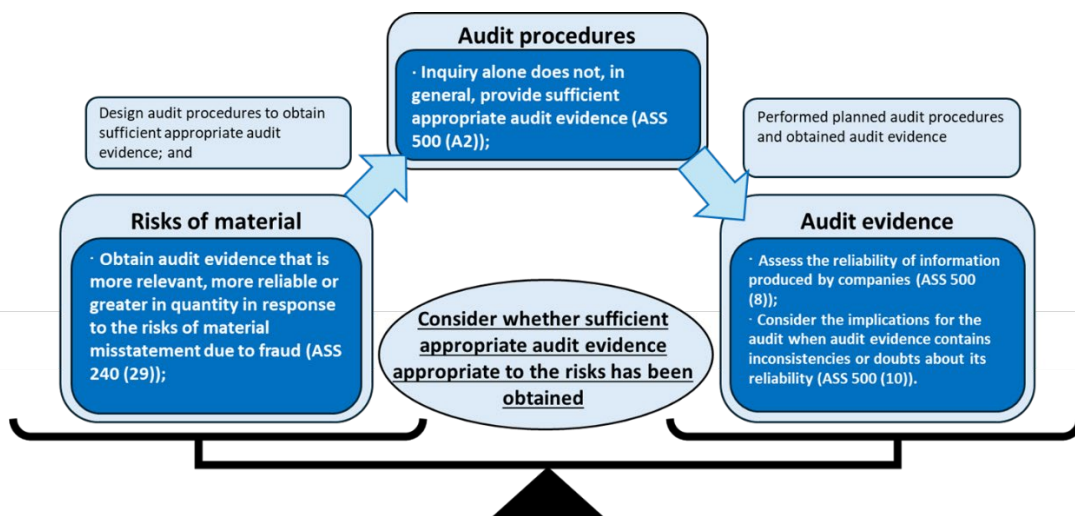
**Expected response**

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, in many cases where the engagement team appropriately performed risk assessments and designed further audit procedures, but engagement team members only performed conventional audit procedures because engagement partners or more experienced team members did not provide specific instructions, supervision, or review. Therefore, there were discrepancies between audit plans and actual audit procedures. For this reason, the engagement teams are expected to discuss risk assessments and audit procedures in sufficient detail throughout the engagement, and to confirm the sufficiency and appropriateness of audit evidence actually obtained through reviews. (See figure 14)

**【Figure 14】 Expected response in audit evidence**



Source: Prepared by the CPAAOB

## (1) Matters common to audit evidence

### Case 1: Sufficient appropriate audit evidence

- ① The audit evidence corresponding to the risk of material misstatement

Regarding 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 issue with the timing of revenue recognition 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 had agreed to it.

However, the engagement team **only inspected 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.**

(ASS No. 330, paragraph 5) [Large-sized audit firms]

- ② Dual-purpose test



The engagement team tested a sample of 25 items as test of controls related to raw material costs included in the audited company's manufacturing costs. The team stated it had 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 adequately evaluate whether the sample size of 25 items was sufficient, nor did it design and perform substantive procedures for the period between January and March, which was not covered by the test of controls.**

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

- ③ Observation of physical inventory



The engagement team did not sufficiently evaluate the appropriateness of internal controls over this physical inventory, such as by not evaluating the audited company's methods for collecting and managing inventory count sheets and controls over inventory movement and storage, nor did it evaluate management's instructions and procedures for recording and managing inventory results.

(ASS No. 501, paragraph 3) [Mid-tier, and small and medium-sized audit firms]

### 《Points to Note》

In addition to the above cases, the following deficiencies were identified.

- Only inquiries are performed as risk response procedures (substantive procedures or test of controls).
- In one case, the engagement team performed multiple audit procedures but did not evaluate 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 audit risk to a low level.

In dual-purpose tests, engagement teams should evaluate whether procedures are appropriately designed and performed to obtain sufficient appropriate audit evidence to meet the objective of each audit procedure. Furthermore, inquiries alone usually do not constitute sufficient audit evidence as risk response procedures. Therefore, audit evidence obtained through inquiries withwithwithshould be corroborated through otherwith audit procedures.

Moreover, engagement teams should not perform planned audit procedures merely as a formality. Rather, they should comprehensively evaluate the sufficiency and appropriateness of matters identified in the audit process and audit evidence obtained through other audit procedures.

## Case 2: Information to be used as audit evidence

### ① Relevance and reliability of information

The audited company provides 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 recognizes revenue on a monthly basis based on the customer list.

Although the engagement team selected samples from the customer list as a substantive procedure to test the occurrence of revenue, **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.

(ASS No. 500, paragraph 6) [Large-sized audit firms]

### ② Use of management's expert



In relation to sales transactions for specific real estate, the audited company had entered into an agreement with the buyer under which it was required to maintain ongoing involvement with the property after delivery and to have an obligation to discuss potential repurchase depending on the circumstances.

The audited company obtained a legal opinion from a management's expert (a lawyer) stating that it did not have an obligation to repurchase the property under the agreement and recognized revenue from the transaction.

When evaluating whether such an obligation existed, the engagement team used the work of the management's expert as audit evidence and checked the expert's registration details and firm affiliation in order to assess the expert's competence.

However, the engagement team did not evaluate the competence of the management's expert in the

relevant area or assess the suitability of the expert for the engagement. As a result, the team did not sufficiently evaluate the competence, capabilities and objectivity of the expert.

(ASS No. 500, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

③ Reliability of information produced by the audited company



*New*

When evaluating the recoverability of receivables, the engagement team relied on a list of receivables (a schedule showing amounts by customer and by month of origin) prepared by the audited company.



FREQUENT

However, when using the list to examine the collectability of receivables, the engagement team did not perform procedures to verify the accuracy of the information (the amounts of receivables by month of origin) included in the list.

(ASS No. 500, paragraph 8) [Mid-tier, and small and medium-sized audited companies]

《Points to Note》

**When designing and performing audit procedures, auditors are required to consider the relevance and reliability of information used as audit evidence.**

**In addition, when using the work of management's experts (e.g., pension actuaries, real estate appraisers, and attorneys) as audit evidence, auditors are required to evaluate the competence, capabilities and objectivity of such experts, obtain an understanding of their work, and evaluate the appropriateness of the work as audit evidence in light of the relevant assertions.**

**Meanwhile, audited companies often make accounting estimates based on information prepared by the audited company (including reference data regarding valuation losses that lists book values and net selling value by inventory and reference data regarding indications of impairment that lists book values of fixed assets and operating profits/losses by asset group, etc.). When performing audit procedures using information prepared by the audited company, the engagement team is required to obtain audit evidence regarding the accuracy and completeness of such information and to sufficiently evaluate its reliability.**

**Case 3: Timing of substantive procedures**



*New*

The audited company conducted physical inventory counts at each store as of a date prior to the year-end.



FREQUENT

The engagement team observed the physical inventory count performed by the audited company. However, **the engagement team did not perform substantive procedures for the remaining period between the record date of the attendance and the year-end date for some of the stores it had witnessed.**

(ASS No. 330, paragraphs 21、 No.501, paragraph 4) [Mid-tier, and small and medium-sized audit firms]

《Points to Note》

**When substantive procedures for balance sheet items are performed at a date prior to the period-end, the**

engagement team is required to perform additional substantive procedures for the remaining period in order to obtain sufficient and appropriate audit evidence for extending the results of those procedures to the period-end.

## **(2) External Confirmation**

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

The engagement team identified fraud risks relating to accounts receivable, noting 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. The engagement team performed confirmation procedures by sending confirmation requests via email to counterparties with long-outstanding receivables, obtaining responses, and performing procedures including comparing the domains of the respondents' email addresses with those of the counterparties' websites.

However, despite a partial mismatch between the domain of the respondents' email addresses and that of the counterparties' websites, the engagement team **did not consider the need for additional procedures.**

(ASS No. 505, paragraphs 6) [Large-sized audit firms]

#### **«Points to Note»**

**External confirmation procedures generally provide auditors with strong audit evidence. However, if auditors have concerns about the reliability of the responses, such as receiving replies via facsimile or email, obtaining replies through the audited company, it is necessary to perform audit procedures to verify the reliability of the responses in order to mitigate the risks of fraud such as falsification.**

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

In relation to the external confirmation of accounts receivable balances as of the year-end date, the engagement team performed alternative procedures for non-responding counterparties by verifying subsequent cash receipts from those counterparties to the audited company.

However, the engagement team only verified that several collections had been made in the month following the year-end closing date in respect of amounts due from major clients that had not responded, and **did not examine the fact that more than 80% of the outstanding balances exceeding the materiality threshold remained unconfirmed.**

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

#### **«Points to Note»**

**Where the engagement team is unable to obtain responses to its confirmation requests, it needs to perform alternative audit procedures. In such circumstances, the team should carefully evaluate whether the audit evidence obtained through alternative procedures is sufficient and appropriate in response to the risks of**

material misstatement.

### Case 3: Differences identified through confirmation



The engagement team reconciled differences between the accounts payable confirmed by the counterparties and the accounts receivable of the audited company.

However, **although the confirmation response from the counterparty was dated in July, the engagement team did not examine the appropriateness of the management's explanation that the difference arose from transactions relating to deliveries made in August.**

(ASS No. 505, paragraphs 13) [Mid-tier, and small and medium-sized audit firms]

#### «Points to Note»

Exceptions might indicate misstatements or potential misstatements in financial statements. In such circumstances, the engagement team should investigate the exceptions, and obtain corroborating audit evidence, including supporting documents.

If the engagement team identifies a misstatement from the exceptions the team should evaluate the effectiveness of internal control and its impact on the financial statements.

### Case 4: Evaluation of responses received

The engagement team identified the risk of material misstatement related to the existence of inventory, and for inventories held by third parties, requested confirmations from all entities entrusted with storing those inventories to confirm inventory balances.

However, the engagement team **reconciled only some of the inventory balance data provided by the third parties with the system data and did not reconcile all of the inventory balance data included in the confirmation responses from the third parties.** As a result, the engagement team did not obtain sufficient appropriate audit evidence regarding the existence of inventory.

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

#### «Points to Note»

In assessing the results of the confirmation procedures, it is necessary to determine whether sufficient and appropriate audit evidence has been obtained in respect of all amounts subject to confirmation.

## (3) Substantive analytical procedures

### Case 1: Developing an expectation

As substantive analytical procedures for payroll expenses, the engagement team developed an expectation of payroll expenses based on information obtained from the audited company, including payroll expenses per employee and the rate of salary increases.

However, the engagement team **did not assess the reliability of the rate of salary increases obtained from the audited company.**

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

《Points to Note》

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

**The prior year results or earnings forecasts are used as expectations without reasonable grounds.**

**The same expectation is applied to financial data with different characteristics, such as variable costs and fixed costs.**

**The procedures were limited to year-on-year or monthly comparisons and, as a result, did not meet the requirements for substantive analytical procedures.**

**When performing substantive analytical procedures, sufficient consideration should be given to the reliability of data and precision of expectations in order to keep audit risk at an acceptably low level.**

**Case 2: Investigation of differences**

In substantive analytical procedures for cost of sales, the engagement team identified that the differences between the components of cost of sales and the auditor's expected amounts exceeded the threshold.

However, **the engagement team only made inquiries of the audited company regarding the reasons for the differences, and did not obtain audit evidence to support the response.**

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

《Points to Note》

**In performing substantive analytical procedures, the engagement team should investigate the reason for differences from the expectations or inconsistencies with other relevant information, given that differences requiring further investigation may represent material misstatements.**

**(4) Audit sampling and testing specific items**

**Case 1: Planning of audit sampling**



① The engagement team planned to apply audit sampling as tests of details over purchases of the audited company. The team performed dual-purpose tests, comprising tests of controls and tests of details, by inspecting supporting documents for a sample of 25 items relating to purchases between April and September. In addition, the team inspected supporting documents for a sample of 24 items relating to purchases between March 16 and March 30.

However, the engagement team **restricted the period of the population subject to substantive procedures and, as a result, did not select samples in such a way that each sampling unit in the population had a chance of selection.**

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



② The engagement team applied audit sampling to a population consisting of R&D expenses and expenses such as sales commissions and outsourcing costs ("general expenses"). R&D expenses included various types of costs, such as personnel expenses and depreciation related to the R&D function.

However, although the engagement team **recognized that R&D expenses and general expenses were of a different nature and had different characteristics, it did not consider the appropriateness of treating them as a single population.**

(ASS No. 530, paragraphs 5) [Mid-tier, and small and medium-sized audit firms]

③ The engagement team applied audit sampling to test sales of the audited company and inspected supporting documents for the selected items.

However, for some sales transactions included in the sample, the engagement team was unable to obtain relevant external supporting documentation, such as order forms and goods receipt documents, because the audited company did not retain such documentation. Despite this, the engagement team **did not consider the appropriateness of the audit evidence obtained through alternative procedures.**

(ASS No. 530, paragraph 10) [Large-sized audit firms]

《Points to Note》

**When designing audit sampling, the engagement team should consider the audit objectives and the optimal combination of audit procedures and audit evidence to achieve those objectives, taking into account the characteristics of the population from which test items are to be selected.**

**In determining the sample size, for both the tests of details and the tests of controls, the engagement team should consider factors that affect the sample size (such as the degree of reliance on the evaluation of the risks of material misstatement and the effectiveness of the operation of internal controls) in order to reduce sampling risk to an acceptable low level.**

**In applying audit sampling, samples should be selected in a way that each sampling unit has a chance of selection, and due consideration should be given to pay attention to the completeness of the population. Note that when misstatements are identified in the sample, it is necessary to project the misstatements to the population as a whole.**

**Case 2: Selection of specific items**



The engagement team identified occurrence, completeness, and accuracy of payroll expenses included in the audited company's cost of sales and SG&A expenses as risks of material misstatement and performed substantive procedures on payroll expenses incurred in April 2022.



However, the engagement team did not consider whether substantive procedures were necessary for the untested portion, even though that portion significantly exceeded the materiality threshold.

(ASS No. 500, paragraphs 9) [Mid-tier, and small and medium-sized audit firms]

## 《Points to Note》

**It should be noted that selecting specific items from a population, unlike audit sampling, does not provide audit evidence regarding the remaining items in the population that are not selected.**

### (5) Related parties

#### Case 1: Review of written responses to questions regarding related party transactions from directors officers



The audited company sent questionnaires to 15 directors to identify related parties and related party transactions for disclosure in the notes to the financial statements and received written responses from 14 of them.

In assessing the completeness and accuracy of the related party disclosures, the engagement team performed audit procedures, including review of the reviewed the minutes of the shareholders' meetings meeting and BoardBoardBoardmeetingsBoard of DirectorsDirectorsDirectorsthe board of directorsDirectors, review the respondersresponseof the responsewritten responsesresponse obtained by the audited company from 14 directors, and comparison of the summary of related party transactions prepared by the audited company with the related disclosures.

However, the engagement team did not consider whether additional audit procedures were necessary despite the fact that a written response had not been obtained from one director.

Furthermore, though thethoughthoughthoughthough the written responses from two directors referred to entities in which the directors themselves or their close family members held a majority of voting rights, the engagement team did not identify the namenamenamenamesname of such entities, nor did it perform procedures to determine corporation or whether any transactions existed between those entities corporation and the audited company.

(ASS No.330, paragraphs 25、 No. 550, paragraphs 10 and 13) [Mid-tier, and small and medium-sized audit firms]

## 《Points to Note》

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

- **The engagement team did not sufficiently evaluate whether relationships with related parties and transactions with related parties were comprehensively identified;**
- **The engagement team did not identify that the terms and conditions of related party transactions were not appropriately disclosed when no interest-free loans or debt guarantee fees were paid;**
- **The engagement team did not sufficiently evaluate the terms and conditions of transactions that were disclosed as being conducted on an arm's length basis; and**
- **The engagement team did not examineexamineexaminesufficiently evaluateexamine the reliability of the responses to the questionnairequestionnairequestionnairequestionnairequestionnaire regarding related party transactions with directors of the audited company.**

The engagement team should carefully evaluate whether related party relationships and related party transactions are comprehensively identified and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

For cases related to the identification and assessment of the risks of material misstatement and audit procedures responsive to those risks regarding related party transactions, including the consideration of fraud risk required in the ASS No. 240, see also “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 close relationships (the "Acquisition"). Under the business acquisition agreement, sales of the products were limited to a single customer, and the products were stored in an external warehouse designated by that customer.

The engagement team determined that the Acquisition, which was undertaken to enter a new business, was a significant transaction outside the audited company's normal course of business, and through inquiries of management, the engagement team obtained an understanding of the transaction flow of the business and the economic rationale of the business model.

However, the engagement team **did not identify 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 nature of the business.** In addition, **regarding the rationale for the Acquisition, the engagement team did not critically examine and assess whether the transaction may have been carried out for fraudulent financial reporting or to conceal the misappropriation of assets.**

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

#### **«Points to Note»**

Because related party transactions may involve higher risks of material misstatement than transactions with third parties, the engagement team should obtain a comprehensive understanding the audited company's related parties and its relationships with those parties. 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 significant risks requiring special audit consideration.

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 such transactions have been disclosed, but also whether their commercial rationale, or lack thereof, indicates the possibility that the transactions may have been conducted for fraudulent financial reporting, and whether the transaction terms are consistent with the explanations provided by management.

## (6) Going concern

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



The audited company concluded that no material uncertainty exists as at the end of the reporting period, although events or conditions exist that may cast significant doubt on its ability to continue as a going concern, such as a significant decline in sales and the recognition of significant operating losses. This conclusion was based on measures implemented by the audited company to address these conditions, including securing financing through negotiations with its main banks, reducing rent for directly operated stores, and reviewing variable costs."

The engagement team performed the following audit procedures to evaluate whether the cash flow forecast prepared by the audited company for the subsequent period was based on reasonable assumptions and supported by sufficient evidence:

- Backtesting of cash plansplansplansflow forecastsplans prepared in prior periods;
- Evaluation of the feasibility of management's plans;
- Assessment of the reasonableness of the assumptions underlying the cash flow forecast;
- Inquiries of the lending officers at the audited company's main banks regarding the possibility of extending loan repayment terms.

However, thoughthoughthoughthoughthe extension of the loan repayment terms constituted a key factor in assessing material the uncertainty..., the engagement team only obtained oral representations based solely on the personal views of the lending officers. The team did not obtain sufficient appropriate audit evidence to support its conclusion regarding the likelihood of such extensionextensionextensionextensionextension.

In addition, the engagement team did not evaluate the reasonableness of the projected cost reductions. (ASS No. 570, paragraphs15) [Mid-tier, and small and medium-sized audit firms]

### «Points to Note»

**In addition to the above cases, instances have been observed where the engagement team did not evaluate whether additional facts or information relevant to the entity's ability to continue as a going concern had arisen when examining subsequent events.**

**Indicators of events or conditions that may affect an entity's ability to continue as a going concern are often identifiable in advance through its business activities. Accordingly, the engagement team should remain alert to audit evidence relating to such events or conditions and evaluate whether management's assessment of the existence of such events or conditions is appropriate.**

**When events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern, the engagement team should evaluate examine, based on sufficient appropriate audit evidence, whether the risks of material misstatement should be reassessed and whether management's plans are effective and feasible.**

## (7) Subsequent events

### Case: Evaluation of management's judgment on the disclosure of subsequent events



At a meeting of the board of directors held after the balance sheet date, the audited company resolved to sell all shares of a consolidated subsidiary, but did not disclose this matter in the notes to the annual securities report as a subsequent event.

The engagement team performed procedures to identify subsequent events, including inquiries of the audited company's accounting personnel and inspection of minutes of board of directors' meetings. In addition, through communication with those charged with governance, the engagement team indicated that the share transfer may constitute a disclosable subsequent event.

However, the engagement team did not evaluate the appropriateness of the audited company's decision not to disclose this matter as a material subsequent event, taking into account the potential impact on the consolidated financial statements in subsequent periods arising from the deconsolidation of the subsidiary.

(ASS No.330, paragraph 23, No.560, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

**The engagement team shall 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 the following:**

- **Understanding the procedures performed by the management to identify subsequent events;**
- **Inquiries of management;**
- **Inspection of the minutes of meeting of the board of directors; or, if such minutes are not available, inquiries of matters discussed at those meetings meeting;**
- **Reading the latest interim 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 at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall perform the following procedures;**

- **Discussing the matter with management**
- **Determining whether the financial statements require amendment or disclosures**
- **If amendment or disclosure is required, inquiring of management how the matter will be addressed 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**

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, valuation of inventories, and valuation of investments and loans to affiliated companies, 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 evaluating inherent risk factors by reviewing 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.

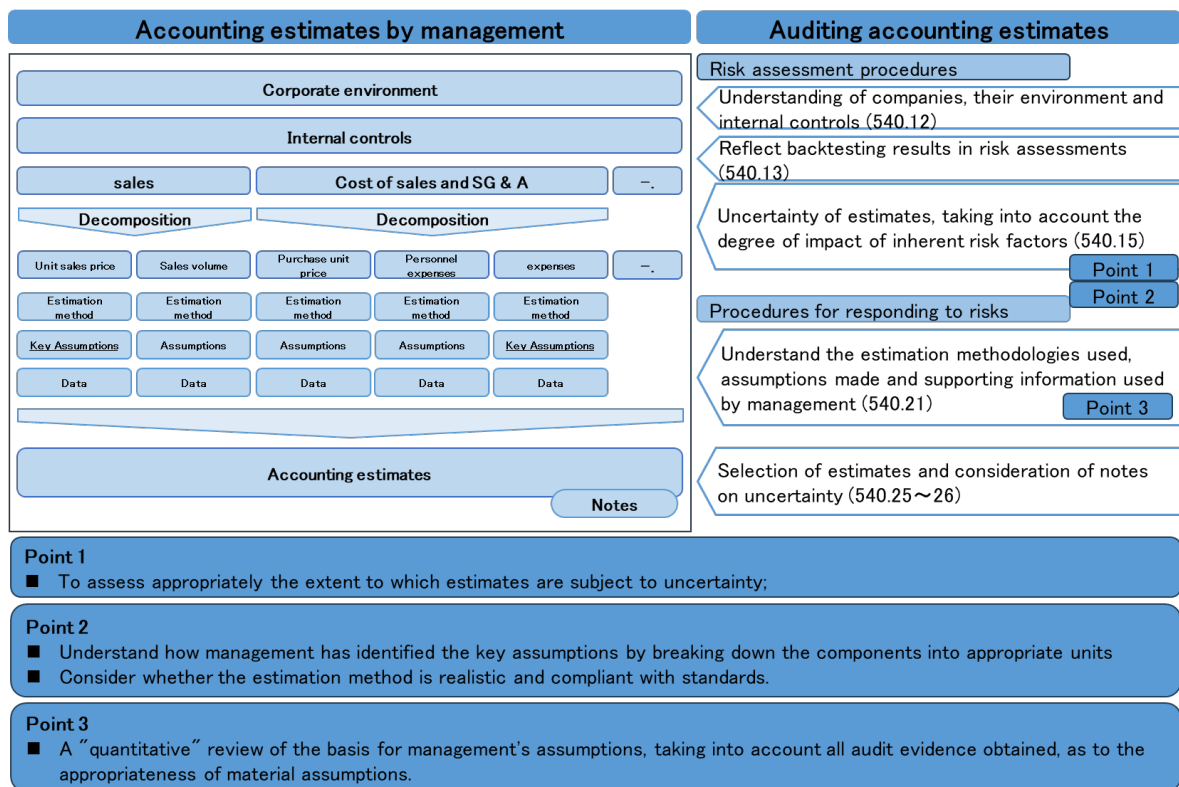
An audit firm developed and implemented a template corresponding to the requirements of ASS No.540. It provided training on ASS No.540 and used the template to demonstrate the extent of audit procedures to address risks according to the level of risk.

**Expected response**

It should be noted that audit procedures have been clarified as a result of the revision (January 2021) of ASS No. 540. The auditing accounting estimates has been significantly enhanced by the revision of ASS 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 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 15)

**[Figure 15] Key points in auditing accounting estimates (e.g., business plan review)**



Source: Prepared by the CPAAOB

ASS 540 (Auditing 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. In this Case Report, ASS 540 before the

revision states "before the revision in 2021," and describes the revised standards that are considered to correspond to the provisions that served as the basis for the deficiencies as [Reference]. The revised standards are provided merely as reference information and do not indicate the CPAAOB's position on the interpretation or scope of the standards. In this Case Report, ASS No.540 before the revision states "before the revision in 2021," and describes the revised standards that are considered to correspond to the provisions that served as the basis for the deficiencies as [Reference]. The revised standards are provided merely as reference information and do not indicate the CPAAOB's position on the interpretation or scope of the standards.

## (1) Impairment of fixed assets

### Case 1: Consideration of grouping of assets



The audited posted non-current assets as of the end of March 2023, and grouping of fixed assets based on management accounting classifications.



The engagement team confirmed that the audited company had grouped its fixed assets based on management accounting classifications.

However, the engagement team **did not have sufficient understanding of the following information, which was necessary for appropriately identifying and assessing the presence of risks of material misstatement related to accounting estimates for indications of impairment:**

Specific grouping units and handling of corporates assets determined by the audited company based on the classification for management accounting

Description and amount of fixed assets classified by the audited company into each asset group and corporates assets

The method by which the audited company identifies indications of impairment for each asset group and for larger units, including corporates assets;

(ASS No. 540, paragraphs 12 and 15) [Mid-tier, and small and medium-sized audit firms]

### 《Points to Note》

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

- The engagement team did not sufficiently examine the fact that the grouping of assets deviated from the actual situation, such as grouping multiple stores by brand name.
- The engagement team did not consider whether the groupings suited the actual situation of the company when changes were made to the company and its surrounding environment.
- In cases where impairment assessment differed before and after a change in grouping, the engagement team did not exercise professional skepticism and adequately examine the reasonableness of the change in grouping as to whether the change in grouping was an indication of fraud.

In principle, assets should be grouped by the smallest unit that generates cash flows that are largely independent of the cash flows of other assets or asset groups. It is necessary to examine whether grouping is appropriate based on the classifications used for management accounting and the units used for

investment decision-making. In addition, it is necessary to continue to apply the units of grouping and fully examine the reasonableness of the changes (changes in management accounting classifications, investment decision-making, and relationship with segment information) when making changes.

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



At the end of the fiscal year, the audited company determined that there were indications of impairment of fixed assets in the asset group of Business A because profits / losses from operating activities had continued to be negative.

In measuring impairment loss for this asset group, the audited company calculated the value in use based on the audited company's three year business plan, which made certain assumptions regarding the status of products handled by each customer, sales discount rebates, and selling, general and administrative expenses (consisting of charter fees, logistics center usage fees, etc.) in relation to future projections such as sales forecasts and expense forecasts.

The audited company booked an impairment loss for the amount by which the book value of the asset group exceeded the value in use.

With regard to accounting for impairment of fixed assets, the engagement team identified the risk of an incorrect amount of impairment loss as a risk of material misstatement.

The engagement team also understood that the audited company had made the following assumptions: (I) for some customers, the number and type of products sold would increase; and (ii) the expected ratio of distribution center usage fees to sales for a specific future period was the average of the actual ratios over the past five years.

However, the engagement team did not examine which of the audited company's assumptions in the business plan were material assumptions.

In addition, the engagement team did not understand how the audited company assessed the degree of uncertainty of the assumptions in (I) and (ii) above.

Furthermore, the engagement team did not understand under what assumptions the audited company calculated the estimates of sales discount rebates and charter fees for the business plan. (ASS No. 540, paragraphs 12, A42) [Large-sized audit firms]

#### 《Points to Note》

**In addition to the above cases, there are cases in which the engagement team only ascertained the amount of deviation between management's accounting estimates for past fiscal years and the finalized amounts for the current fiscal year and the reason therefor, and did not take into account the risks of material misstatement in accounting estimates for the current fiscal year in their identification and assessment.**

**Engagement teams should understand the business environment including internal controls by using external data and peer comparisons, and examine the finalized amounts of accounting estimates for previous periods. They should then identify and assess material misstatements in**

**accounting estimates by taking into account the extent to which accounting estimates are affected by estimation uncertainty, and the extent to which the estimation methods, assumptions, and data used in accounting estimates are affected by complexity, subjectivity, and other factors.**

### 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.

(ASS No. 540, paragraphs 22; ASBJ Guidance No. 6, Paragraph 12) [Large-sized audit firms]



② When 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 level prior to the deterioration in business performance will increase. 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 regarding the estimate of operating expenses in the budget for the next fiscal year. , interviews with management were conducted and a comparative analysis was conducted with the results of previous fiscal years.

However, the engagement team **did not sufficiently examine the reasonableness of the budget for the next fiscal year, 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.**

(ASS No. 540, paragraphs 17 and 21) Large-sized audit firms]

- ③ As 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.

(ASS No. 540, paragraphs 12 and 14) (prior to the revision in 2021)([Reference] ASSNo.540, paragraph 22)) [Large-sized audit firms]

#### 《Points to Note》

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

- Overlooking the fact that some head office expenses have not been allocated.
- 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.
- The reliability of profit / loss information for each asset or asset group used to determine indications of impairment was not evaluated,
- 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

Despite falling into a current period operating loss, the company did not check its earnings forecast for the next fiscal year and said there were no indications of impairment.

- 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 whether the accounting policies adopted by the audited company comply with accounting standards and whether the management's estimation methods are in line with the actual situation.

#### Case 4: Review of recognition and measurement of impairment



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 of consolidated subsidiary A, and as a result of examining the calculated 20-year undiscounted future cash flows calculated for each asset group, it did not record an impairment loss.

The engagement team conducted a review based on the undiscounted future cash flows for this asset group and concluded that the company's decision not to recognize an impairment loss the Company's asset group 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 in this asset group.
- **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 the undiscounted future cash flow.
- **The auditor did not evaluate the reasonableness of the amount of capital investment in the undiscounted future cash flows for this asset group.**
- The engagement team **did not examine the reasonableness of estimates of sales volume and unit price to customers, which would have a significant impact on the calculation of some of 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.**

(ASS No. 540, paragraph 13, 21,22 and 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 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 this asset group because the total undiscounted future cash flows expected over the remaining economic life of the major assets exceed the book value of this 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.**

(ASS No. 540, paragraphs 21, and 22) [Large-sized audit firms]



- 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.

(ASS No.540, paragraph 12 and 14(Before amendment in 2021) ([Reference]ASS No.540, paragraph 23; No. 620, paragraph 6) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

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

- **The engagement team did not examine the reasonableness of the remaining economic life of the asset, which serves as the basis for estimating undiscounted future cash flows.**
- **Cases where capital investment and repair costs to maintain the present value were not included in undiscounted future cash flows. Even though undiscounted future cash flows were pre-tax figures, a post-tax discount rate was used.**
- **The appropriateness of the discount rate used was not examined**
- **The 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.

When calculating the net selling value of important real estate, the engagement team needs to consider the necessity of requesting the audited company to obtain real estate appraisal reports if the audited company has not obtained them. In addition, the engagement team needs to evaluate the competence, ability, and objectivity of the experts used by the audited company when considering the net selling value, and at the same time, carefully consider the necessity of using the experts' work by the auditor.

## **(2) 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 and set the amortization period for goodwill at five years.

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.

However, the engagement 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.

(ASS No. 540, paragraphs 11 and 12 (Before amendment in 2021) ([Reference] ASS No. 540, paragraph 17 and 22)) [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.**

(ASS No. 540, paragraphs 11 and 12 (Before amendment in 2021) ([Reference] No. 540, paragraph17 ,22)) [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 compared the sales growth rate with market forecasts in related industry published by external organizations and sales growth rates of other companies in the same industry for sales growth rate.

However, the engagement team **did not understand the extent to which the business plan used for the audited company's impairment test was subject to uncertainty,**, 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 **did not examine the reasonableness of sales growth factors specific to the acquired company (including the management's estimation method and basic data used).**

(ASS No. 540, paragraph 7, 9 and 12 (Before amendment in 2021) ([Reference] ASS No. 540, paragraph12,15 and 23)) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

**In addition to the above cases, the following deficiencies have been identified. It should be noted that if these deficiencies were due to insufficient examination by the audited company, the engagement team should request the audited company for necessary information for the audit and should also examine whether the insufficient examination by the audited company itself constituted a deficiency in internal control.**

**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.

- 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.
- 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 pay sufficient attention to the possibility that, if the amount allocated to goodwill or intangible assets other than goodwill is relatively large, it may be determined that there are indications of impairment even in the year of business combination.

### **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.**

(ASS No. 500, paragraph 7; No. 540, paragraph 12 (Before amendment in 2021 ([Reference]ASS No.540, paragraph22)) [Mid-tier, and small and medium-sized audit firms])

#### **《Points to Note》**

The engagement team needs to carefully consider whether the audited company needs to use external experts, and the auditor also needs to consider the use of such experts, and then carefully consider the accounting treatment for allocating acquisition costs to identifiable intangibles. It should be noted that the valuation of identifiable intangibles is particularly important when goodwill is not amortized, as is the case under International Financial Reporting Standards and US GAAP.

### **(3) 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.

(ASS No. 540, paragraphs 7 and 11 (Before amendment in 2021) ([Reference]ASS No.540, paragraph12 and 21)) [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).

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.**

(ASS No. 540, paragraph 13, 21,22 and 23) [Mid-tier, and small and medium-sized audit firms]



- 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 years 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 years 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.

(ASS 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 ,in examining the recoverability of deferred tax assets, 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. In addition, additionif 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 adopted Japanese group tax consolidation system. In determining the recoverability of deferred tax assets for the entire group, the audited company classified its deferred tax assets as Category 2 based on the Implementation Guidance on Recoverability of Deferred Tax Assets (ASBJ Guidance No. 26). In addition, the audited company recognized deferred tax assets for unschedulable deductible temporary differences related to the allowance for doubtful accounts for external loans of consolidated subsidiary Company A, at an amount deemed recoverable at some point in the future based on Paragraph 21 of the Implementation Guidance.

However, the engagement team **did not examine the reasonableness of the audited company's judgment that deferred tax assets were likely to be recoverable in light of the information on borrowers.**

(ASS No. 540, paragraph 21 and 23) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

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

- 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 examining the tax effect on retained earnings on a consolidated basis, the engagement team did not sufficiently consider the audited company's policy that subsidiaries do not pay dividends in principle.
- The engagement team did not adequately consider whether the dividend policy of a foreign subsidiary had been formally approved by a decision-making body, etc.

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.

## (4) 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 not subject to condition 2 would not suffer a decline in profitability, because such raw materials do not physically deteriorate and the audited company needneedneedsneed 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 valuation method for products and raw materials of the audited company was appropriate to determine declines in the profitability of products and raw materials.**

(ASS No. 540, paragraph 7 (Before amendment in 2021) ([Reference]ASS No.540, paragraph 12))  
[Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

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

- **The engagement team did not examine whether the accounting policies of the audited company, which excluded some inventories from valuation and recognized write-down losses at a certain rate according to retention period, were in line with the actual situation and complied with accounting standards, etc.**
- **The engagement team did not perform a comparative analysis between management's estimates for past fiscal years and actual results for the current fiscal year. The team only ascertained the amount of deviation and the reason for such deviation and did not incorporate the results in the assessment of the risk of material misstatement in accounting estimates.**

#### **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 identified the risk of incorrect valuation of content-related products and work in process as a significant risk. To address this risk, the engagement team performed procedures such as inspecting calculation data prepared by the audited company, reviewing 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 actual sales volume in the current period fell short of the sales volume forecast for the previous fiscal year for certain content, 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.**  
(ASS No. 540, paragraph 11,12 and 14 (Before amendment in 2021) ([Reference] ASS No.540, paragraph. 21 to 24, ASBJ Statement No. 9, Paragraph 5))) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

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

- **Regarding slow-moving inventories, for which there were few sales records, the engagement team did not sufficiently examine the appropriateness of management's assumption that it would not be necessary to record valuation losses because the inventories had not physically deteriorated and were still being operated on.**
- **The engagement team did not examine the appropriateness of management's assumption that a write-down would not occur because the audited company would not sell its current sales or inventory held for maintenance below book value.**
- **The engagement team did not examine the appropriateness of the audited company posting a valuation loss at a certain rate of the book value according to the retention period.**
- **The reliability of the valuation loss calculation data prepared by the audited company was not sufficiently examined.**

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.

#### (5) 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 because of defaults.**

(ASS No. 540, paragraph 7 and 14 (Before amendment in 2021) ([Reference]ASS No.540, paragraph 12, 22 and 23) [Large-sized audit firms])

#### 《Points to Note》

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

- **The engagement team did not sufficiently examine the appropriateness of the estimation method that considered uncertainty according to the expected collection period of receivables.**
- **With regard to assets scheduled for seizure, the engagement team did not examine the appropriateness of the amount that the audited company claimed 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.**

**Regarding doubtful receivables, it is necessary to sufficiently examine whether the audited company has adopted an appropriate method for calculating the estimated amount of bad debts (a method based on the financial condition evaluation method or the cash flow estimation method) at the time of evaluation.**

#### **Case 2: Examination of reasonableness of management's assumptions**



Company B was established by Company A, a wholly owned subsidiary of the audited company. At the time of establishment, Company B formulated a business plan that stated that it expected to become profitable at a certain point in the future, and Company B had liabilities in excess of assets as of the end of the current period.

The audited company had receivables from Company B as of the end of the current period. However, Company B's operations were expected to become profitable, and if it became difficult to collect

receivables from Company B, Company A was expected to take over the receivables. Therefore, the audited company determined that it was not necessary to record an allowance for doubtful accounts on the non-consolidated financial statement for receivables from Company B.

The engagement team considered that the audited company's decision not to require an allowance for doubtful accounts for receivables from Company B was appropriate because there was no change in the expectation that Company B's operations would return to profitability, even though it recognized that there was a gap between the actual figures and the budgets in the previous fiscal year and the current period in the business plan, and that Company A's cash flow was tight at the time of the current period.

However, with regard to the expectation that Company B's business would become profitable, the engagement team did not consider the specific expected sales volume and unit sales price and did not consider the situation where the budget in the business plan diverged from the actual results.

Furthermore, the engagement team did not consider the prospect of Company A assuming the receivables from Company B considering Company A's financial position.

(ASS No. 330, paragraph 17, No.540, paragraph. 12 and 32)) [Mid-tier, and small and medium-sized audit firms]

#### «Points to Note»

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

When evaluating the appropriateness of management's business plan assumptions in the valuation of the audited company's receivables from affiliated companies, 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 management. Even though a subsidiary of the audited company had liabilities in excess of assets, the engagement team did not consider the need for the amount of liabilities in excess of assets at the subsidiary to be ultimately borne by the parent company.

**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.**

Furthermore, while taking into account the principle of limited liability of shareholders, the engagement team needs to pay attention to the need for the parent company to book an allowance for the amount equivalent to liabilities in excess of assets of the subsidiary in excess of the amount of investment.

#### **(6) EvaluationValuationEvaluation 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.**

(ASS No. 540, paragraphs 11 and 12 (Before amendment in 2021) ([Reference] No. 540, paragraph 17 and 23)) [[Large-sized audit firms]

#### 《Points to Note》

**In addition to the above, 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



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**.

(ASS No. 540, paragraph 7) [Mid-tier, and small and medium-sized audit firms]

#### «Points to Note»

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

- **The engagement team did not examine the reasonableness of the audited company's decision not to impair shares of subsidiaries and associates, despite the fact that the valuation of shares of subsidiaries and associates that were performing poorly had recovered only about 50% of their book value in the final year of the business plan (five years) for these subsidiaries and associates.**
- **When evaluating the appropriateness of business plan assumptions made by management in valuing shares in affiliated companies, the engagement team did not confirm the business plan based on specific evidence, and only qualitatively evaluated it by asking questions to management. As a professional expert, the engagement team did not sufficiently and appropriately examine the business plan from a critical perspective.**

**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.**

#### **(7) Asset retirement obligations**

##### **Case 1: Consideration of finalized or re-estimated accounting estimates for prior periods**

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**.

(ASS No. 540, paragraphs 8 and 11 (Before amendment in 2021) ([Reference] No. 540, paragraph 13 and 22)) [Mid-tier, and small and medium-sized audit firms]

### Case 2: Appropriateness when reasonable estimates cannot be obtained



The audited company has adopted the following policies for accounting for and disclosure of asset retirement obligations related to stores.



For stores that have been resolved to close, asset retirement obligations shall be recorded by estimating the timing of fulfillment of asset retirement obligations in two years in principle. For stores other than stores that have been resolved to close, asset retirement obligations shall not be recorded because the timing of closing is unclear and it is difficult to estimate the timing of fulfillment of asset retirement obligations.

With regard to asset retirement obligations that have already been recorded in the financial statements, the outline of the asset retirement obligations, the method for calculating the amount, and changes in the total amount shall be stated in the notes. With regard to asset retirement obligations that have not yet been recorded, the fact that the amount of asset retirement obligations has not been recorded in the balance sheet, and the reason and outline thereof shall not be stated.

However, the engagement team did not examine the appropriateness of the audited company's statement that it was difficult to estimate the performance timing of asset retirement obligations, and did not examine the appropriateness of the audited company's statement that it did not make notes on unrecorded asset retirement obligations.

(ASS No. 330, paragraph 23; No. 540, paragraphs 21) [Mid-tier, and small and medium-sized audit firms]

### 《Points to Note》

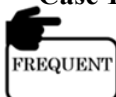
**If differences have arisen as a result of examining the finalized estimates of asset retirement obligations for past years, it is necessary to understand the details of the differences and identify and assess the risks of material misstatement related to the estimates of asset retirement obligations for the current year by taking into account the nature of the estimates.**

**Cases where asset retirement obligations cannot be reasonably estimated are limited to cases where the amount cannot be reasonably calculated even after all evidence available as of the balance sheet date is taken into consideration and the best estimate is made.**

Therefore, when an audited company claims that asset retirement obligations cannot be reasonably estimated because the timing of performance of asset retirement obligations and the method of asset retirement are not clear, the engagement team needs to keep in mind that it is required to carefully examine the scope and probability of performance obligations, taking into account the availability of information for reasonably estimating asset retirement obligations.

## (8) 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.

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 for 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 have a sufficient understanding of the extent to which such projects would be affected by uncertainties in management's estimates**, 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 managements , nor did the team examine the realizability of cost reductions**.

(ASS No. 540, paragraphs 8 and 12(Before amendment in 2021) ([Reference]ASS No. 540, paragraphs 13 and 23)) [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.**

(ASS No. 540 (Before amendment in January 2021), paragraph 12) [Mid-tier, and small and medium-sized audit firms]

#### «Points to Note»

**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 understand 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.**

#### Case 3: Reliability of Basic Data on Retirement Benefit Obligations

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.**

(ASS No.500, paragraph 8 and No. 50 paragraph 12 (Before amendment in 2021) ([Reference] No.540, paragraph 24) [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 when using the work of the management's experts.**

**The engagement team shall bear in mind that the appropriateness of the basic rates used by the audited company needs to be carefully examined since the calculation results of retirement benefit obligations are sometimes significantly affected by basic rates such as discount rates.**

## **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 ASS No. 600, when determining significant components based on the current ASS 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.

(ASS 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.**

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

### 《Points to Note》

**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.**

**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.**

## 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.

(ASS No. 300, paragraphs 21; No. 600, paragraphs 23 and 25) [Mid-tier, and small and medium-sized audit firms]

- ② The 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.**

(ASS 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



① The engagement team identified Company A, a consolidated subsidiary of the audited company, as a significant component, and sent audit instructions concerning the audit of Company A's financial information (hereinafter referred to as the "Instructions") to the auditor of the component.

The engagement team identified the risks of the existence and attribution of revenue and the risk of management override of internal controls as significant risks associated with group financial statements, based on communication with the component auditor of the component regarding risk assessment and interviews with the management of Company A. The engagement team also recognized that the component auditor had identified the following risks (a) through (d) as significant risks based on the component auditor's response to the Instructions (the "Response").

- (a) Risks related to the existence and attribution of revenue
- (b) Risks related to overstatement of sales, assets and profits
- (c) Risks related to the accuracy of inventories and rights and obligations
- (d) Risks related to the completeness of tax liabilities

However, the engagement team did not discuss with the component auditor the ways in which related fraud could be committed with respect to the risks in (a) and (b) above (which fall under fraud risks), and did not discuss with the component auditor whether the risks in (c) and (d) above should be identified as significant risks in the group financial statements.

(ASS No. 240, paragraphs 25, No. 315, paragraphs 31, No. 600, paragraphs 29) [Mid-tier, and small and medium-sized audit firms]



② The group engagement team identified Company B, a consolidated subsidiary of the audited company, as a significant component, and sent audit instructions concerning the audit of Company B's financial information to the auditor of this component.

The engagement team was aware that the component auditor performed journal entry tests on journal entries above a certain amount as part of the procedures to address the risk of management override of internal controls at Company B ("override risk procedures"). The engagement team also received a report from the component auditor that no significant unusual transactions had been identified as a result of the override risk procedures.

However, the engagement team did not understand the procedures performed by the component auditor to address the "management bias in accounting estimates" as a reversal risk procedure, and did not examine the appropriateness of the amount basis in the aforementioned journal entry test performed by the component auditor.

By inspecting the audit documentation prepared by the component auditor, the engagement team

discovered that the component auditor, as a procedure to address the risk of non-existent revenue, selected transactions above a certain amount using sales transactions as the population, and conducted a detailed test of these transactions.

Furthermore, the engagement team was aware that the component auditor was performing audit sampling on the rest of the population.

However, with Company B's sales increasing significantly, the engagement team did not examine whether the above procedures performed by the component auditor were sufficient to detect new business partners, business partners with significantly increasing sales, abnormal unit prices, etc. (ASS No. 240, paragraph 29 and 31, No. 600, paragraph 30,41 and 43) [Mid-tier, and small and medium-sized audit firms]

#### 《Points to Note》

**In order to address significant risks in group financial statements, the group engagement team needs to assess the sufficiency and appropriateness of the audit procedures planned by the component auditor in response to risks through appropriate communication with the component auditor.**

#### Case 5: Consolidation process

- ① With 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.

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

- ② The 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.**

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

- ③ When 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.**

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

#### 《Points to Note》

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

- **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.**
- **The group engagement team did not examine whether component financial information reported by component auditors was reflected in the group financial statements.**
- **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 evaluate the appropriateness and completeness of adjustments and reclassifications for consolidation.**

#### Case 6: Subsequent events



The group engagement team identified Company A as a significant component among the audited company's consolidated subsidiaries, and sent audit instructions concerning the audit of Company

A's financial information (hereinafter referred to as the "Instructions") to the component auditor. In response to the Instructions, the engagement team also received a report from the component auditor stating that the management of Company A was planning to transfer all shares of Company A's subsidiary to an affiliated company of the audited company.

However, the group engagement team **did not examine whether there were subsequent events at Company A (events that occurred from the date of receipt of the Response to the date of the Financial Instruments and Exchange Act Audit Report), such as not being aware of the details of the aforementioned share transfer.**

(ASS 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



- ① The group engagement team identified Company A as a significant component with individual financial importance among the audited company's consolidated subsidiaries and sent audit instructions concerning Company A's financial information to the component auditor. The team also provided the component auditor with the names of the audited company's subsidiaries, and the representative director and president and representative director and vice president of the audited company and its subsidiaries as related parties.

However, the group engagement team did not communicate to the component auditor, as related parties, the names of the principal shareholders of the audited company or other officers of the audited company, and therefore did not comprehensively communicate information regarding related parties within the audited company group.

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

- 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.

(ASS 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》

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

- **The group engagement team did not appropriately communicate risks to the component auditor;**
- **Component materiality thresholds have not been communicated.**
- **Despite the fact that the group engagement team received a significant risk report from the component auditor, the group engagement team did not adequately consider whether the risk was a significant risk in the group financial statements;**
- **The timing for the group engagement team to obtain information such as the audit plan from the component auditor was late;**

**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.**

#### **Case 8: Sufficiency and appropriateness of audit evidence obtained**

- ① The 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.**

(ASS No. 450, paragraph 4; No. 600, paragraphs 30 and 44) [Mid-tier, and small and medium-sized audit firms]



- 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.

(ASS No. 505, paragraph 11 and 13; No. 600, paragraph 41 and 42) [Mid-tier, and small and medium-sized audit firms]

- ③ ASS 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.**

(ASS 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 , even if the component auditor is part of the same network as the group engagement team.**

### ASS 600 (Special Considerations – Audits of Group Financial Statements)

As at January 12, 2023, an amendment of the ASS 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)

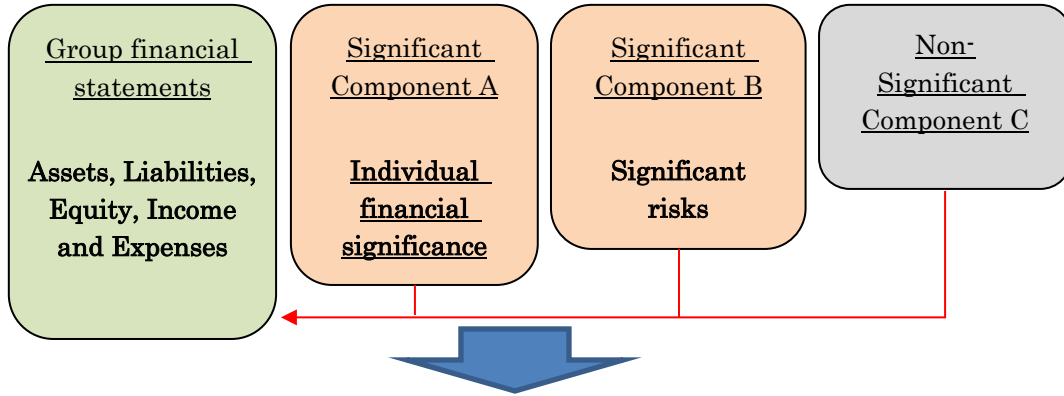
#### Major amended points

- The name changed from "group audit" to "special considerations –audits of group financial statements"
  - Clarified that all other ASSs need to be applied as a matter of course to group audits, in particular by referring to or expanding on ASSs 220, 230, 300, 315 and 330, and emphasized that ASS 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,

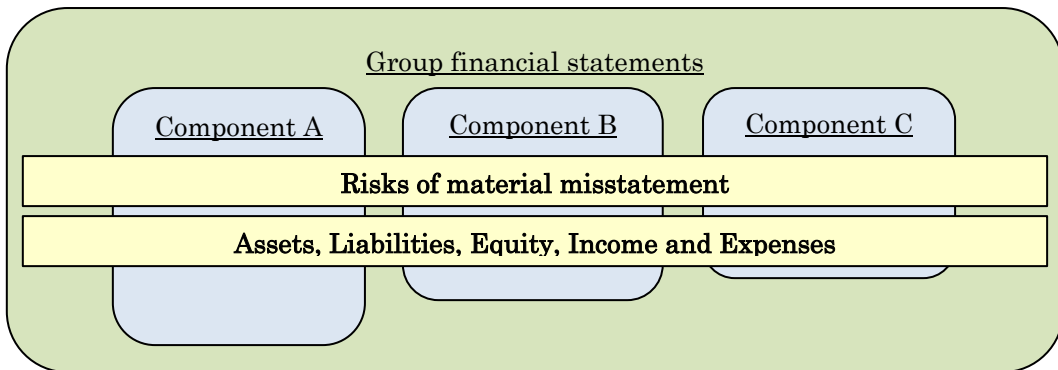
account balances and disclosures", and (iii) "implementation of specific responses to the assessed risks of material misstatements";

**[Figure 16] Changes in approaches to group audits**

(Before amendment) Approach by component (Vertical approach)



(After amendment ) Account-level approach for group financial statements(Horizontal approach)



(Source) 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.

See ASSASS No. 220 (Quality Control in Audit Engagements), paragraph 35 for requirements for engagement teams to obtain expert opinions on matters that may cause difficulties for accounting or audit judgments. See "3. Audit Evidence" for points to be noted when the information used as audit evidence is based on the work of experts used by the management.

### **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.

(ASS 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**.

(ASS 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**.

(ASSs No. 620, paragraph 10) [Large-sized audit firms]

## **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



- 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.

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]



- ② In evaluating internal controls over financial reporting, the audited company did not include business processes relating to sales of part of the audited company's business and sales of part of subsidiary Company A's business (hereinafter referred to as the "sales") in the scope of management's evaluation of internal controls.

The engagement team identified significant risks in the revenue recognition of the audited company and its subsidiary Company A, 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.**

However, the engagement team did not examine the reasonableness of the fact that the management of the audited company did not include the business processes related to these sales, which had been identified as significant risks, in the assessment of internal controls.

(Auditing Standards for Internal Controls over Financial Reporting Statement No. 1, paragraph 112)

[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.  
(ASS No. 530, paragraph 5) [Mid-tier, and small and medium-sized audit firms]

- ② With regard to the audited company's sales, the engagement team identified fraud risks associated with fictitious or accelerated sales recording accounting, and evaluated the audited company's business processes for sales.



Furthermore, the engagement team identified an internal control system at the audited company under which a purchase order was to be obtained and a contract was to be created when concluding or renewing a contract for new or continuing contracts exceeded a certain amount, and performed procedures to evaluate operation of the internal control system.

However, despite the fact that some of the sales transactions selected as samples for the above operational evaluation procedures had not yet been contracted and were inappropriate for the procedures, the engagement team did not perform procedures on a replacement item for the sales transactions.

(ASS No. 530, paragraph 9) [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 ASS 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 cut-off of revenue recognition related 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 in 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.**

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



- ③ 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.**

(ASS No. 315, paragraphs 12 (Before amendment in 2021)) ([Reference] No. 315, paragraphs 25z [Mid-tier, and small and medium-sized audit firms])



- ③ Company A, a significant component of the audited company, used a sales management system (the "System") developed and operated by an external company (the "System Company") to process information related to sales, accounts receivable, inventories, cost of sales, etc., and entrusted the System Company with the repair and maintenance of the System.

In relation to this system, the engagement team performed operational assessment procedures for the IT general controls developed by the audited company.

However, the engagement team did not understand the services provided by the System Company to Company A, and did not consider whether it was necessary to perform operational evaluation procedures for the IT general controls developed by the System Company in relation to the System.

(ASS No. 402, paragraphs 8 and 9) [Mid-tier, and small and medium-sized audit firms]

## 《Points to Note》

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

- In the procedures for evaluating the operation of internal controls, the engagement team only assessed whether seals were affixed or not.
- There is insufficient assessment of IT general controls (e.g., program changes, response to system failures, access controls).
- The engagement team did not consider the necessity of including automated information processing controls in the scope of internal control audit.
- 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.

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 ASS 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.

### Case 3: Timing of evaluating the assessment of the design and the operating effectiveness

- 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.**

(ASS No. 330, paragraph25) [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.**

(ASS 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 ASS 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, the engagement team may 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.**

(ASS No. 315, paragraph 30 (Before amendment in 2021) ([Reference] No. 315, paragraph 36; IT Committee Practical Guideline No. 6, paragraph 53 (Abolished in 2022)) [Mid-tier, and small and medium-sized audit firms]

## Case 2: Evaluation of internal controls relevant to misstatements



- ① The engagement team identified an uncorrected misstatement in the audited company's consolidated financial statements.

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. (ASS 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]



- ② The engagement team discovered multiple misstatements during the audit for the audited company and Company A, a subsidiary that had been individually identified as a significant component with financial significance.

However, the engagement team **did not identify relevant internal controls** in response to the misstatement it had discovered, and did not examine whether it constituted a deficiency in the internal controls of the audited company and Company A. (ASS No. 265, paragraph 6 and 7) [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

- ① The engagement team identified the risk of inappropriate revenue recognition by the audited company as a significant risk.

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.**

(ASS No. 610, paragraphs 14) [Large-sized audit firms]

- ② In the procedures for evaluating the operation of internal controls, 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. However, when using the work of the internal auditor, the engagement team **did not examine the appropriateness of the population from which the internal auditor had extracted samples, nor did it examine the appropriateness of the sampling method used by the internal auditor.**

(ASS No. 610, paragraph 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 the internal control report

##### Case: Review of the 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.

Furthermore, even within business processes and the closing and financial reporting processes, it is necessary to give due consideration to these risks.

- 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 there is a need to include within the scope of the evaluation certain business locations or business processes that have been excluded from the evaluation scope over a long period of time.

- Impact of the results of the financial statement audit on the internal control audit

- If, in the course of the financial statement audit, a deficiency in internal controls is identified 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 of most significance, as a professional expert, as KAM through an appropriate process that includes communication with those charged with governance.
- ▶ 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 description 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**

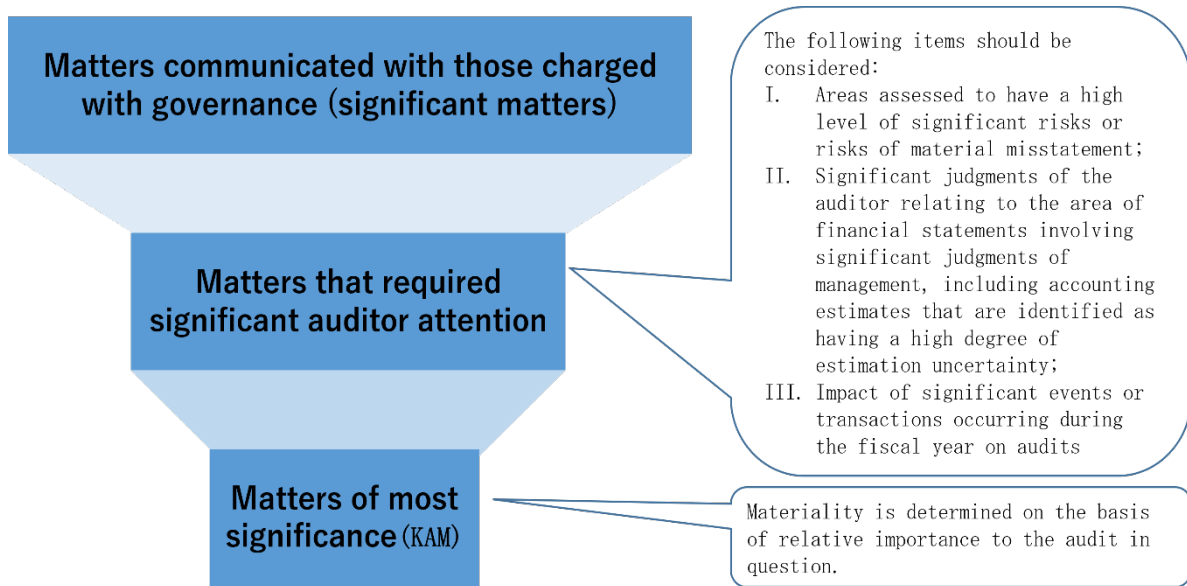
The purpose of KAM is to enhance the informational value of audit reports by enhancing transparency regarding audits performed. KAM can also enhance audit transparency by providing users of financial statements with additional information that may help them understand matters that the engagement team, as a professional, determine to be of most significance. Therefore, auditors are required to take appropriate actions based on a full understanding of the purpose of KAM and paying attention to the accuracy of the content, so that they prevent KAM from becoming boilerplate or mere formality .

Please refer to [Figure 17] for the process of determining KAM. For the appropriate description of KAM, please also refer to ASS 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 those charged with governance 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 17] 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.**

(ASS No. 701, paragraphs 12 and A47) [Mid-tier, and small and medium-sized audit firms]

## Case 2: Descriptions of audit responses to KAM



In the audit report on the audited company's consolidated financial statements, the engagement team determined in Cutoff of sales as KAM and described that it had analyzed sales and the gross profit margin for each month as an audit response.



However, even though the above audit procedures had not been performed, the engagement team described in its audit report that it had performed these procedures.

(ASS No. 701, paragraphs 12 and A46) [Mid-tier, and small and medium-sized audit firms]

## 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 (ASS No. 260, paragraphs 18 -2JP and A32-4JP).

The actions taken by the audit firm include the analysis of root causes and implementation of measures to prevent recurrence as an audit firm, as well as the explanation that deficiencies in audit quality were reflected in the evaluation.

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. The action taken by the audit firm refers to a situation in which the audit firm fulfills its accountability to the audit and supervisory board members, etc. who determine that the results of the audit are appropriate by ex post facto examining individual deficiencies identified in the inspection and communicating the conclusion to the audit and supervisory board members, etc. of the audited company as to whether or not the audit report and financial statements should be corrected.

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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<https://www.fsa.go.jp/cpaob/english/index.html>