

### 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**

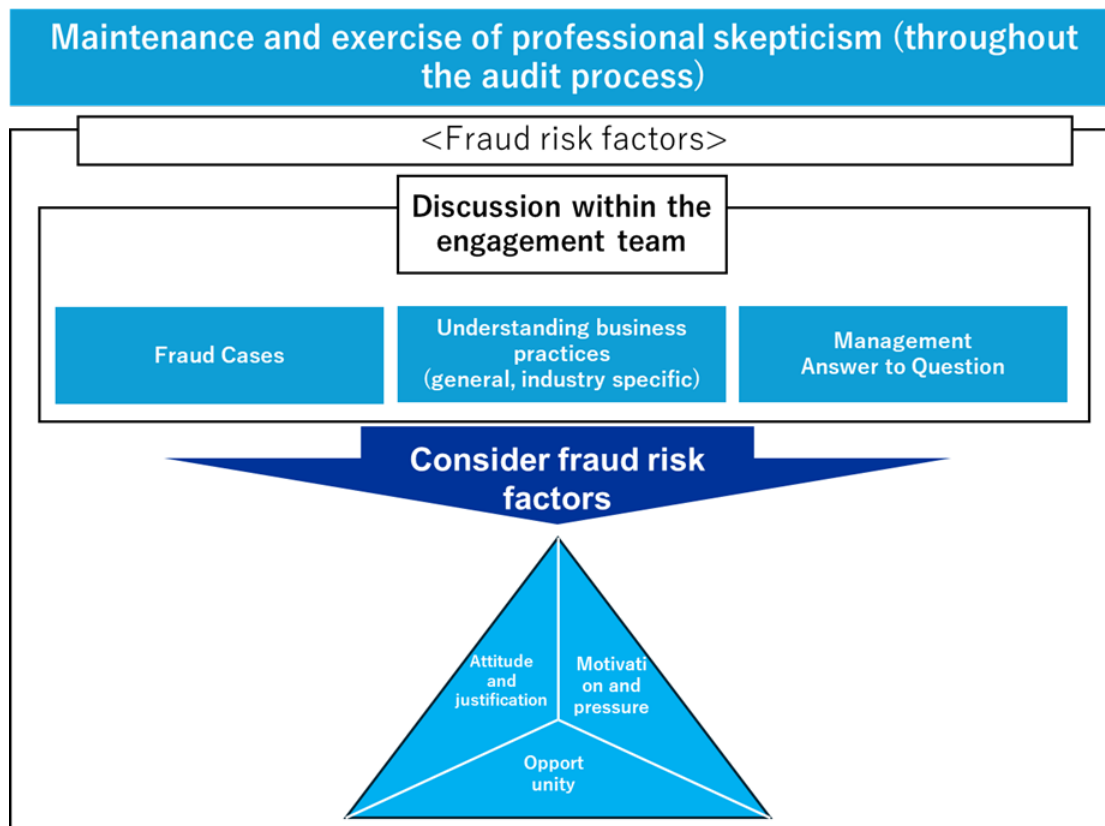
Conventionally, auditors have been required to maintain professional skepticism. Since the Fraud Risk Response Standard emphasizes the maintenance and exercise of professional skepticism, auditors should pay attention to the fact that they are expected to maintain professional skepticism in all processes 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**



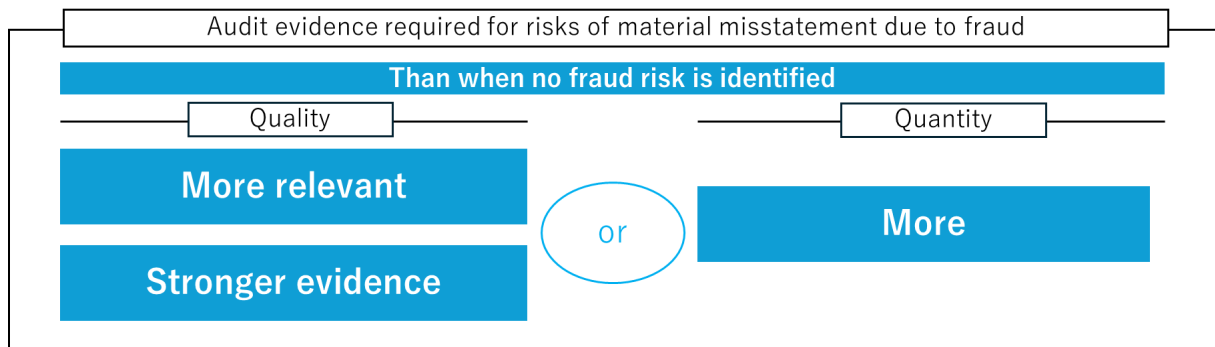
Source: Prepared by the CPAAOB

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**

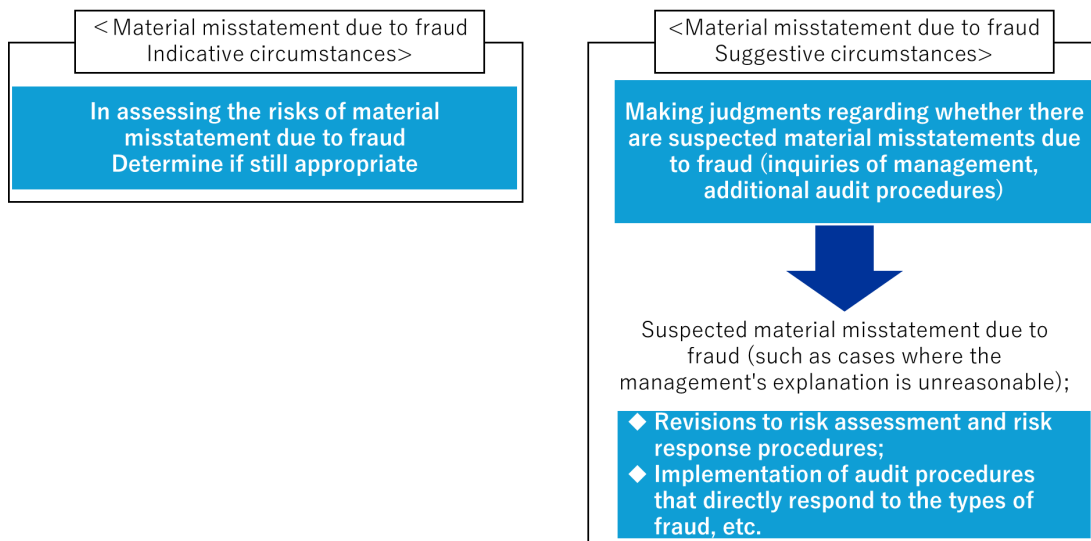


Source: Prepared by the CPAAOB

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]

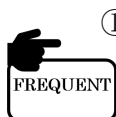
### **《Points to Note》**

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:

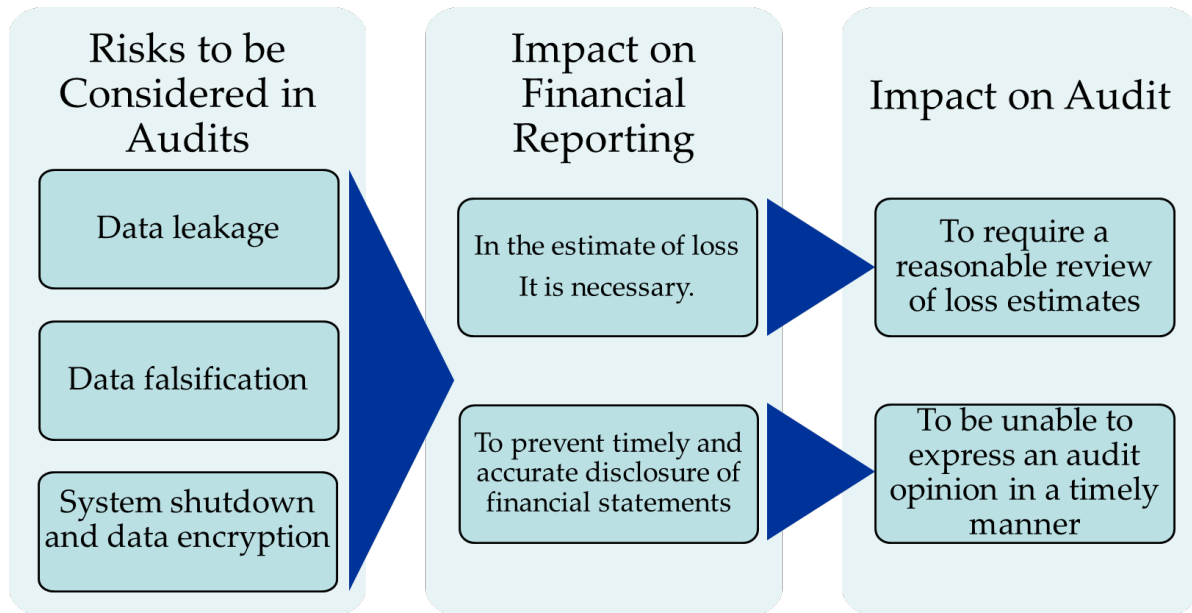
## &lt;Circular transactions&gt;

- 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.

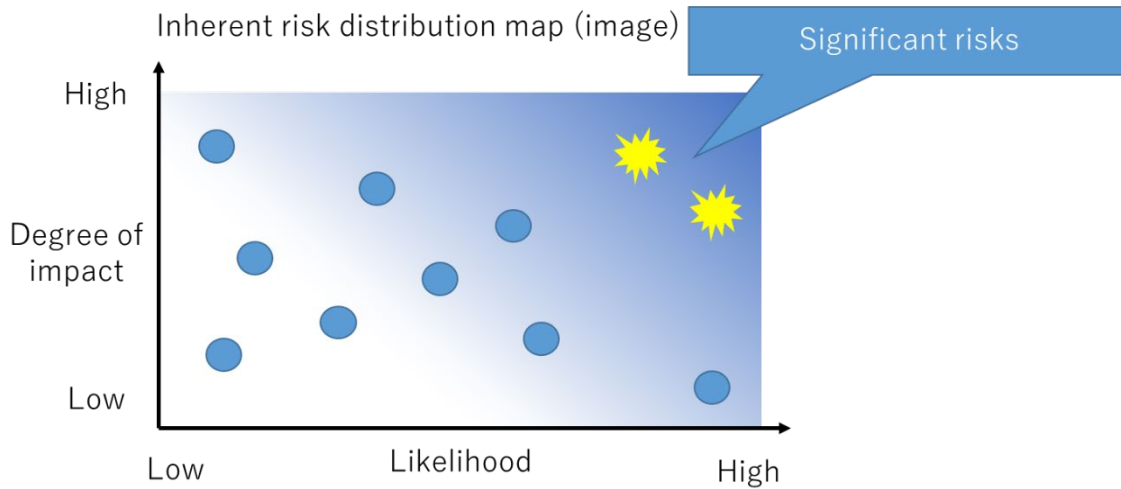
It should also be noted that the definition of significant risks has been changed to the following (see Figure 13):

(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 abovecases, 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.

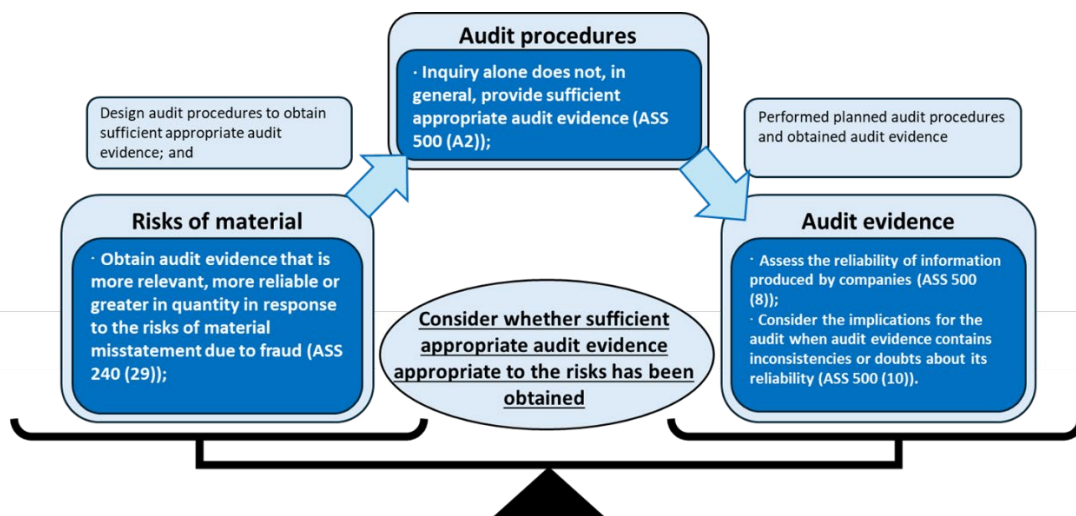
**Expected response**

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 hehehethethe 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 flow forecasts 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, though the 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 extension.

In addition, the engagement team did not evaluate the reasonableness of the projected cost reductions. (ASS No. 570, paragraphs 15) [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, 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.

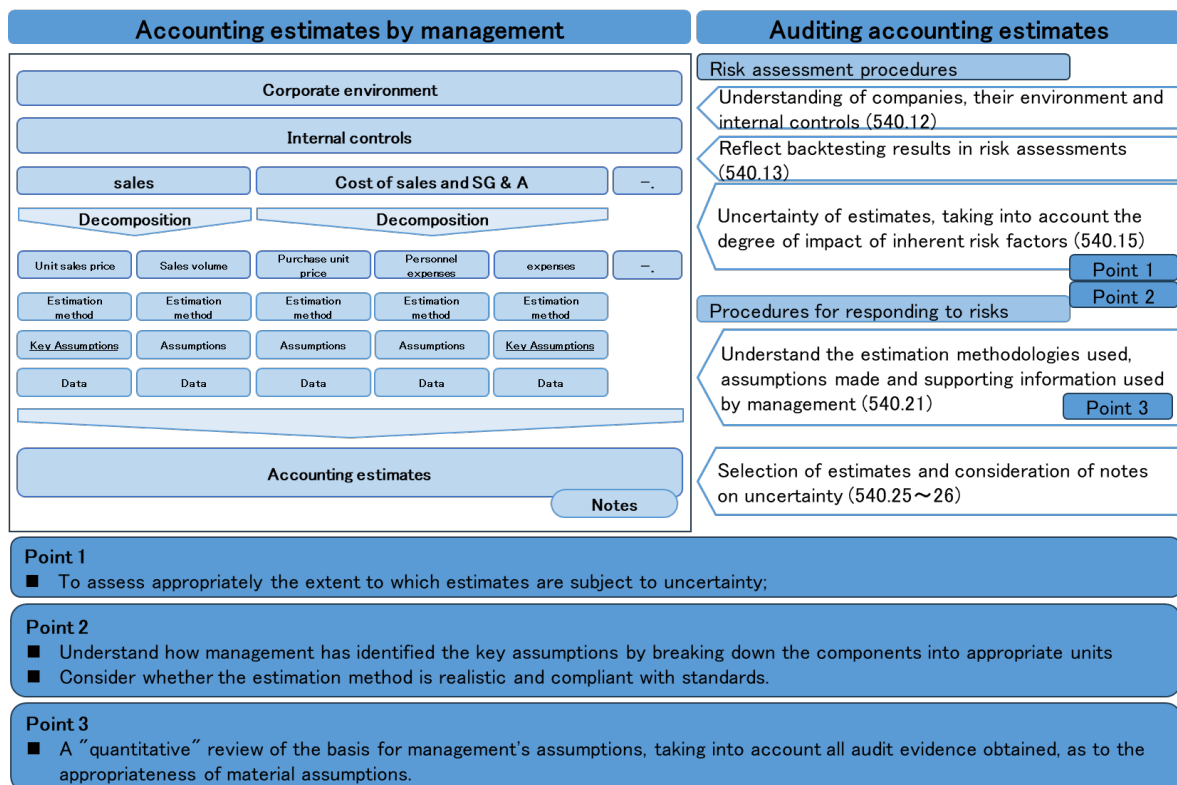
An audit firm developed and implemented a template corresponding to the requirements of ASS No.540. It provided training on ASS No.540 and used the template to demonstrate the extent of audit procedures to address risks according to the level of risk.

**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.

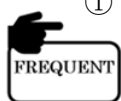
(ASS No. 540, paragraphs 7 and 11 (Before amendment in 2021) ([Reference]ASS No.540, paragraph12 and 21)) [Large-sized audit firms]

#### 《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》

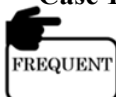
**If differences have arisen as a result of examining the finalized estimates of asset retirement obligations for past years, it is necessary to understand the details of the differences and identify and assess the risks of material misstatement related to the estimates of asset retirement obligations 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]

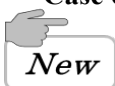
#### 《Points to Note》

**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)

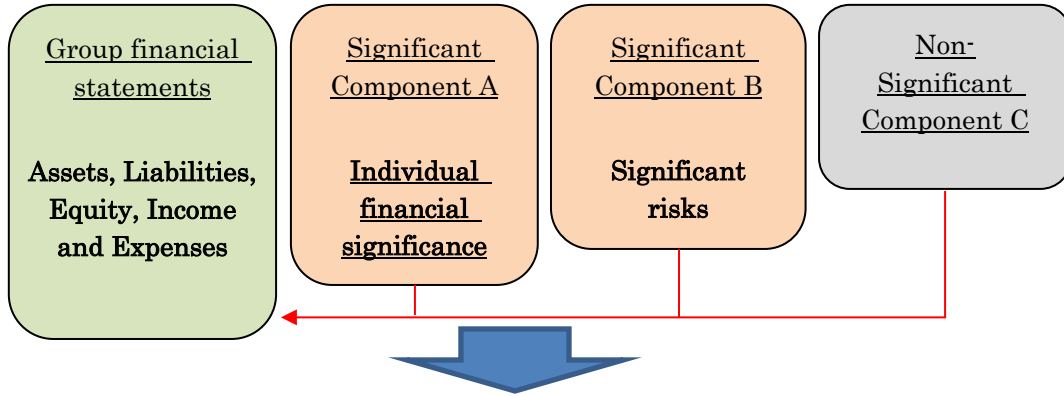
#### Major amended points

- 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,

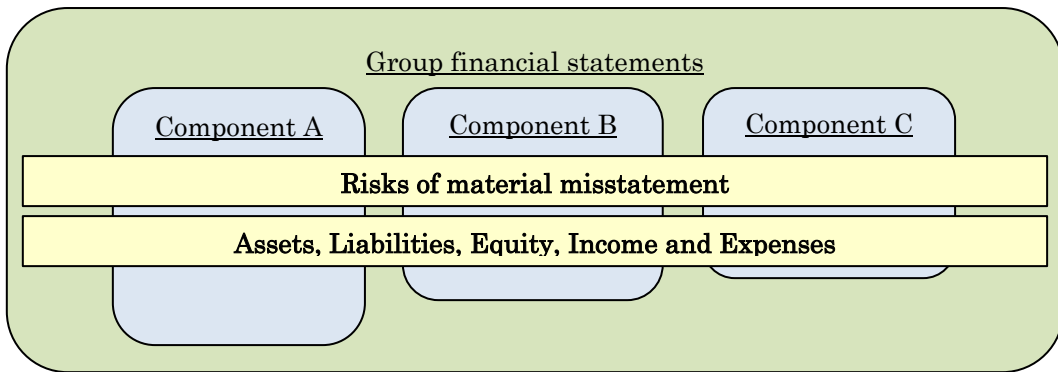
account balances and disclosures", and (iii) "implementation of specific responses to the assessed risks of material misstatements";

**[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**

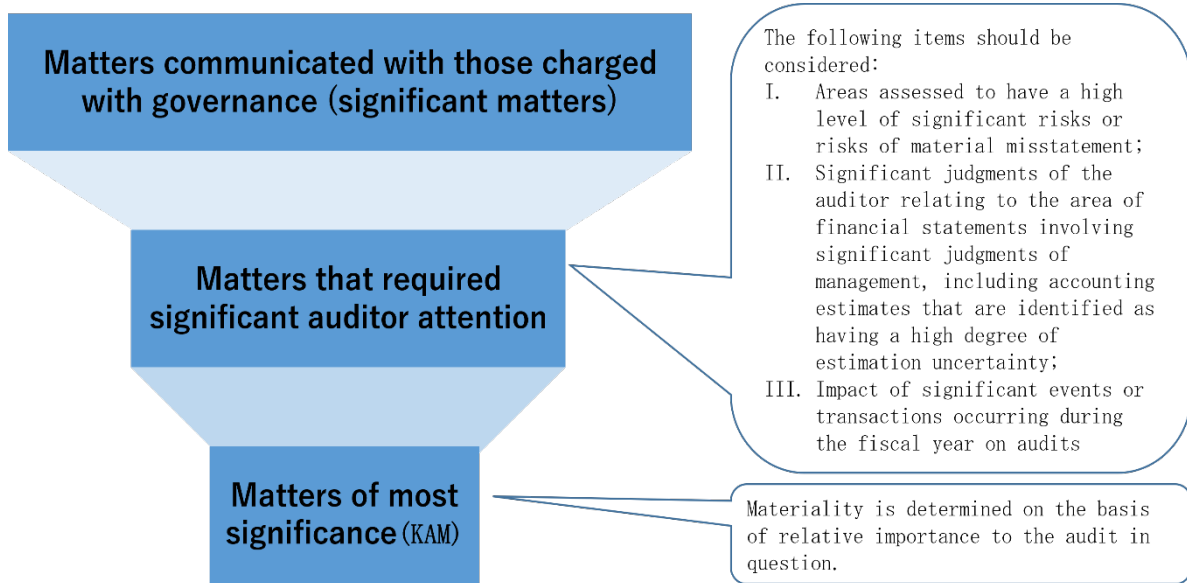
The purpose of KAM is to enhance the informational value of audit reports by enhancing transparency regarding audits performed. KAM can also enhance audit transparency by providing users of financial statements with additional information that may help them understand matters that the engagement team, 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]