

IV. Others

Notification of inspection results

(1) Letter of notification of inspection results

The notification of the results of the CPAAOB inspection is made through the provision of a document (a letter of notification of inspection results) to the CEO of the inspected audit firm.

The main contents of the letter of notification of inspection results are as follows:

1. Matters of particular note
2. Viewpoints of inspection
3. Status of measures to ensure appropriateness of implementation of business processes designed by the audit firm in order to maintain and improve the quality control system (quality control system)
4. Status of implementation of audit engagements (individual audit engagements)

(2) Specifics described in "Matters of particular note"

Of the items of the letter of notification of inspection results, "Matters of particular note" sorts out deficiencies which have been identified in inspection and which are considered to be important. This is comprised of three items, i.e., operations management system, quality control system, and individual audit engagements, with an overall assessment to be given according to the statuses of the three items. An overall assessment of the inspected audit firm's business administration is described at the beginning of "Matters of particular note" in the letter of notification of inspection results, as shown below.

In "(1) Operations management system" of "Matters of particular note," the root causes analyzed by the CPAAOB (refer to "I. Operations Management System, 1. Operations Management System and Root Cause Analysis") with regard to deficiencies identified in inspection are described. In addition, the direction of future improvement considered by the CPAAOB is indicated in the case of some audit firms.

1. Matters of particular note

As a result of the inspection of the audit firm, with regard to the business administration of the firm, it is deemed, within the scope of the inspection, that ..., as described below.

- (1) Operations management system
... (issues related to governance and business administration are described)
- (2) Quality control system
... (deficiencies and other matters related to the quality control system are described)
- (3) Individual audit engagements
... (deficiencies and other matters related to audit engagement are described)

The presentation of overall assessment started with inspections launched in Program Year 2016 in order to accurately convey the CPAAOB's assessment to audit firms and help corporate auditors, etc. of audited companies to which inspection results are disclosed by the audit firms appropriately understand the audit

firms' level of quality control.

(3) Grades of overall assessment

Overall assessment is presented in the following five grades based on the statuses of the inspected audit firm's operations management system, quality control system, and individual audit engagements.

"Good (Overall assessment grade: 1)"

The grade that is given in cases where business administration is considered to be good, such as when few deficiencies have been identified with regard to the statuses of the operations management system, quality control system, and individual audit engagements.

"Generally good despite the presence of some points requiring improvement (Overall assessment grade: 2)"

The grade that is given in cases where business administration is considered to be generally good despite the presence of some points requiring improvement, such as when no serious problem has been identified although some deficiencies have been identified with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good due to the presence of significant points requiring improvement (Overall assessment grade: 3)"

The grade that is given in cases where business administration is not considered to be good, such as when there are significant problems that require improvement with regard to the statuses of the operations management system, quality control system, or individual audit engagements.

"Not good and requiring prompt improvement in the status of the operations management system, etc. (Overall assessment grade: 4)"

The grade that is given in cases where business administration is considered to be not good and to require particularly prompt improvement.

"Considerably inadequate (Overall assessment grade: 5)"

The grade that is given in cases where serious deficiencies have been identified with regard to the statuses of the quality control system and individual audit engagements and where voluntary improvement is not expected to be made.

It should be noted that the CPAAOB requires the submission of reports from audit firms to which the assessment grade "Not good and requiring prompt improvement in the status of the operations management system, etc." has been given at the same time as the notification of the inspection results and urges them to make prompt improvement. With regard to audit firms to which the assessment grade "Considerably inadequate" has been given, the CPAAOB recommends that the Commissioner of the Financial Services Agency should take administrative actions or implement other measures.

(4) Communicating "Matters of particular note" to corporate auditors, etc. of audited companies

Audit firms are required to communicate "Matters of particular note" described in the letter of notification of inspection results and the audit firms' handling of those matters to corporate auditors, etc. of all audited companies (ASS No. 260, paragraphs 18 -2JP and A32-4JP).

The actions taken by the audit firm include the analysis of root causes and implementation of measures to prevent recurrence as an audit firm, as well as the explanation that deficiencies in audit quality were reflected in the evaluation.

In addition, audit firms are required to communicate the specifics of deficiencies identified in the inspection of individual audit engagements and the audit firms' handling of the deficiencies to corporate auditors, etc. of the audited companies whose audit engagements were selected for the inspection. The action taken by the audit firm refers to a situation in which the audit firm fulfills its accountability to the audit and supervisory board members, etc. who determine that the results of the audit are appropriate by ex post facto examining individual deficiencies identified in the inspection and communicating the conclusion to the audit and supervisory board members, etc. of the audited company as to whether or not the audit report and financial statements should be corrected.

Company auditors of audited companies are expected to make full use of the information received not only in parts but also in a comprehensive manner, to gain a deeper understanding of the design and implementation status of the quality control system of the audit firm, and to enhance communication with the audit firm.

(5) Regarding treatment of inspection results, etc.

When inspected audit firms disclose the contents of the letter of notification of inspection results to third-party entities, they need to obtain prior consent from the CPAAOB. Recently, there have been many cases in which an audit firm applied with the CPAAOB for prior consent to disclosure of inspection results, etc. based on a request from an audited company's directors, from corporate auditors and directors (including outside directors) of the audited company's parent company, or from a company that may potentially be audited (e.g., a company considering appointing an independent auditor).

However, in consideration of the fact that audit and corporate auditors, etc. of audited companies make use of inspection results and promote communication with audit firms, prior consent is not required in the case of (4) above or when submitting the letter of notification of inspection results to JICPA in accordance with the rules on the treatment of the letter of notification of inspection results set forth in the JICPA Quality Control Committee Operating Rules.

It is desirable that the results of the CPAAOB inspection, etc. be used not only by corporate auditors, etc. of audited companies but also by directors, etc. of audited companies and by companies that may potentially be audited in order to check the statuses of the design and operation of independent auditors' quality control systems.