

Public Report

May 2013

Certified Public Accountants and Auditing Oversight Board



About this Public Report

Pursuant to Article 16 of the Certified Public Accountants and Auditing Oversight Board (CPAAOB) Rules of Operation as below, which is stipulated on the basis of Article 2 of the CPAAOB Cabinet Order, this Public Report publishes the activities of the CPAAOB for FY2012 (from April 1, 2012, to March 31, 2013).

To better meet the needs of readers, the Report also includes information on activities taken before and after FY2012.

- CPAAOB Rules of Operation

- Article 16 The CPAAOB shall, after the end of each fiscal year, publish its activities for that year, such as measures taken and the number of inspections conducted.

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1 Organization

1.1 Certified Public Accountants and Auditing Oversight Board

The Certified Public Accountants and Auditing Oversight Board (CPAAOB) is a council system government institution established by the Financial Services Agency (FSA), based on Article 35, Paragraph 1 of the Certified Public Accountants Act (CPA Act) and on Article 6 of the Act for Establishment of the FSA (established April 2004).

The CPAAOB is comprised of a Chairperson and up to 9 Commissioners with understanding and knowledge of matters concerning CPAs who are appointed by the Prime Minister and approved by both Diet houses. Most of the Commissioners serve part-time, but one of them can serve full-time. They are appointed for a term of three years (Articles 36, 37-2 and 37-3 of the CPA Act).

The Chairperson and Commissioners exercise authority independently, and excluding situations where there are legal reasons, that independence shall not be violated by their dismissal during their appointed terms (Articles 35-2 and 37-4 of the CPA Act).

The third CPAAOB, comprising ten Members (Chairperson Yoshimasa Tomosugi, full-time Commissioner Toshiro Hiromoto, and eight part-time Commissioners), expired at the end of March 2013. As of April 1, 2013, the board starts as the fourth CPAAOB with Kunio Chiyoda as the newly appointed Chairperson and Toshiro Hiromoto as full-time Commissioner (See Annex 1.).

The main work of the CPAAOB is as follows:

- Inspect CPAs, audit firms, foreign audit firms, etc.¹ and the Japanese Institute of Certified Public Accountants (JICPA)
- Implement the CPA examinations
- Deliberate matters concerning disciplinary actions against CPAs, audit firms, etc.

1.2 Executive Bureau

The CPAAOB has an Executive Bureau to handle its administrative duties (Article 41, Paragraph 1 of the CPA Act).

¹ Signifying parties located in a foreign country, which do the work of audit attestation on the financial documents of foreign companies etc. which submit securities reports, etc. in Japan.

The Executive Bureau is comprised of the Office of Coordination and Examination and the Office of Monitoring and Inspection, under the Secretary-General of the Executive Bureau. The Office of Coordination and Examination is in charge of implementing the CPA examinations, deliberating disciplinary actions against CPAs, etc., and general coordination of the Executive Bureau. The Office of Monitoring and Inspection is in charge of monitoring the operation of audit services provided by audit firms, etc., monitoring the appropriateness of the operation of JICPA, and inspecting audit firms, etc., foreign audit firms and JICPA.

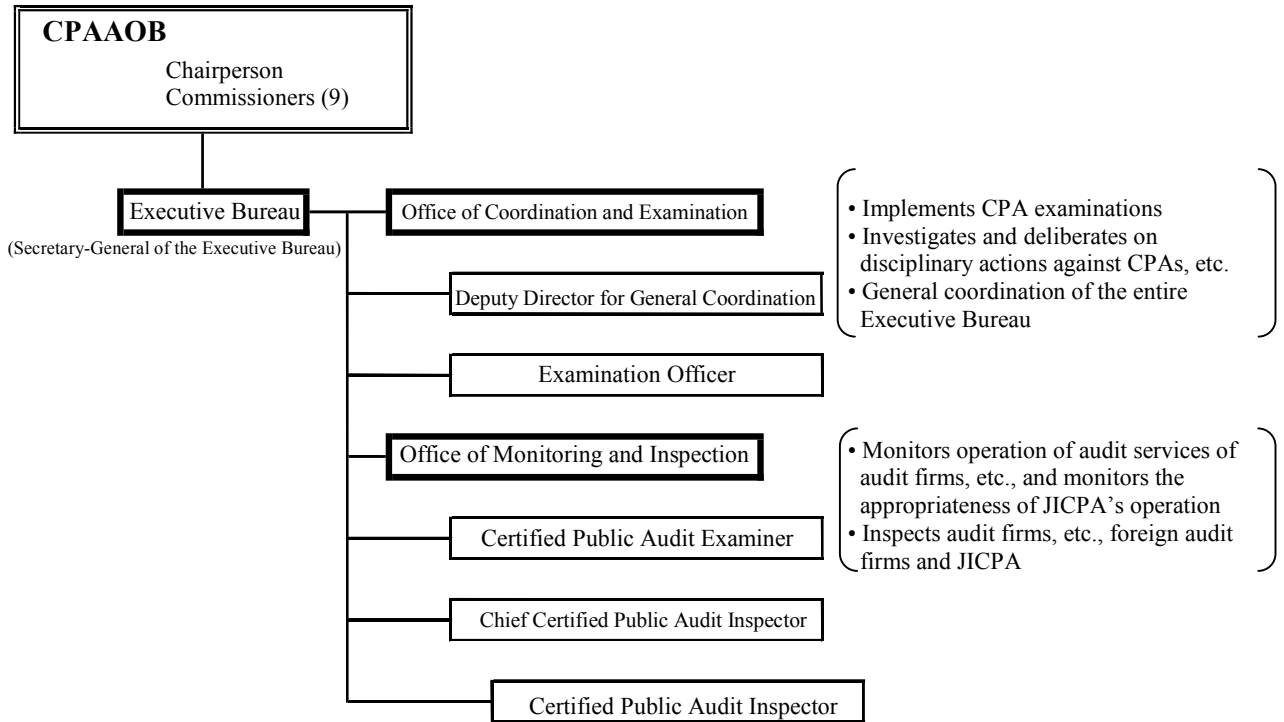
The Executive Bureau had 40 staff members when it was launched in April 2004. Its staff was steadily increased thereafter, to 14 in the Office of Coordination and Examination, and 42 in the Office of Monitoring and Inspection: for a total of 56 staff members on March 31, 2013.

Changes in staffing of the Executive Bureau

(Fiscal year-end basis)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Office of Coordination and Examination	11	12	12	12	12	14	14	14	14
Office of Monitoring and Inspection	29	29	31	35	39	41	44	43	42
Chief Inspectors	4	4	4	4	5	5	7	7	7
Inspectors	18	18	20	24	26	28	28	27	26

Organization Chart of the CPAAOB



2 Examinations and Inspections

2.1 Outline

System

Previously, JICPA's quality control reviews (see Note) of audit firms, etc. had been self-regulated. However, from the perspective of ensuring the fairness and transparency of capital markets and establishing a market capable of gaining the trust of investors, and as a measure for enhancing and strengthening the monitoring and oversight functions over audit firms, etc., the June 2003 revision of the law resulted in quality control reviews becoming statutory, and being monitored by the CPAAOB.

Furthermore, for the purpose of ensuring the soundness of Japan's financial and capital markets, as a result of the June 2007 revision of the law, foreign audit firms, etc. that audit foreign companies etc. subject to the disclosure regulations under the Financial Instruments and Exchange Act became subject to the inspections and supervision of Japan's authorities, and the CPAAOB was given the mandate to collect reports and conduct on-site inspections.

Specifically, the authority related to the following matters has been delegated from the Commissioner of the FSA to the CPAAOB (Article 49-4, Paragraphs 2 and 3 of the CPA Act):

- Business pertaining to the receipt of reports on the results of reviews by JICPA on the operation of members' services (audit and attestation services) set forth in Article 2, Paragraph 1 of the CPA Act (Article 46-9-2, Paragraph 2 of the CPA Act)
- Collection of reports and inspections, etc. on JICPA, CPAs and audit firms, which are conducted in relation to the abovementioned reports (Article 46-12, Paragraph 1 and Article 49-3, Paragraphs 1 and 2 of the CPA Act)
- Collection of reports and inspections on foreign audit firms, etc. (Article 49-3-2, Paragraphs 1 and 2 of the CPA Act)

As a result, the CPAAOB is required to examine quality control review reports, and, if the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, to collect reports and conduct inspections.

Furthermore, based on the results of examination or inspection, if the CPAAOB

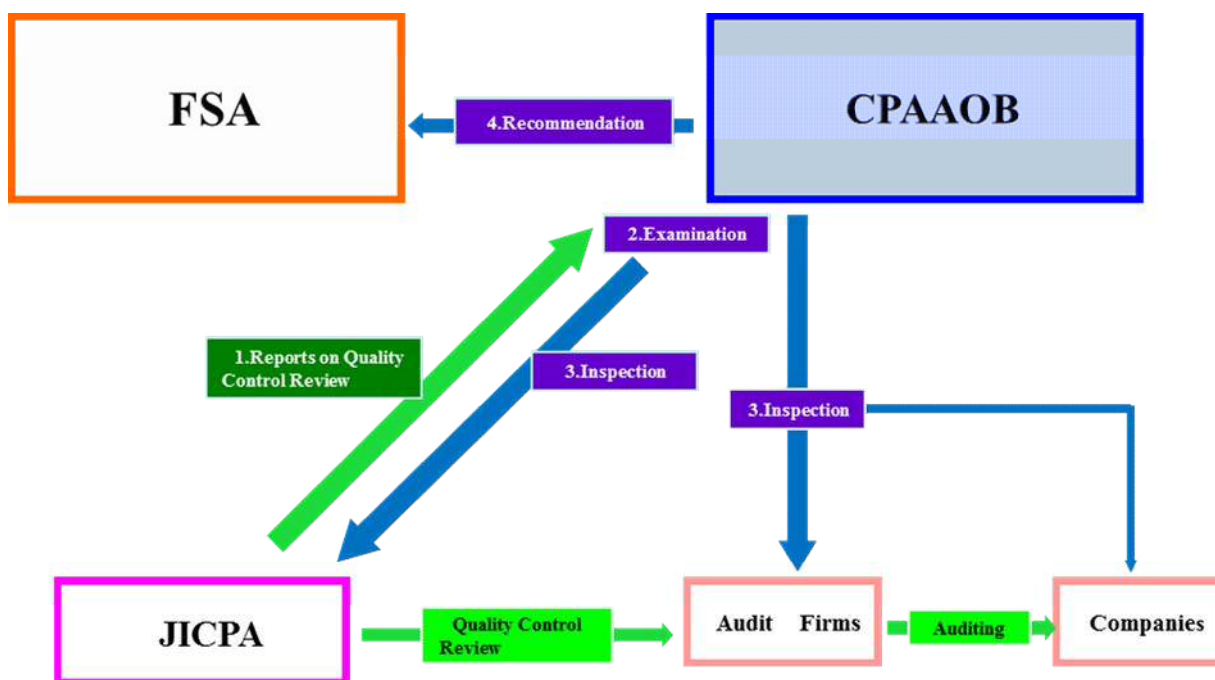
considers it necessary, it shall make a recommendation to the Commissioner of the FSA for administrative actions or other measures (Article 41-2 of the CPA Act).

(Note) Quality control reviews

A quality control review is a review performed by JICPA to assess the status of audit quality control. It is performed for the purpose of “review by JICPA of the status of the operation of services set forth in Article 2(1) of the Act” as specified in Article 46-9-2 of the CPA Act.

Specifically, with the aim of maintaining and improving an appropriate quality level of audit service as well as maintaining and enhancing social confidence in auditing, JICPA reviews the status of the quality control of audits performed by audit firms and CPA offices (audit firms), makes recommendations for improvement as necessary, and receives reports on the status of improvement with regard to those recommendations.

Outline of Examinations and Inspections



1. Reports on quality control review

Once every three years in principle (or once every two years, if JICPA finds it necessary), JICPA reviews and assesses an audit firms’ compliance with laws, regulations, audit standards, JICPA’s rules, and other related regulations. The CPAAOB receives reports on the results of those reviews.

2. Examination

The CPAAOB examines JICPA’s reports and ascertains: (i) whether the quality control

review system is being appropriately operated by JICPA, and (ii) whether audit services are being appropriately provided by audit firms.

The CPAAOB may request the submission of reports or other materials from JICPA or audit firms, if in the course of its examination, the CPAAOB finds it necessary to do so.

3. Inspection

Based on the results of its examination, the CPAAOB conducts inspections of JICPA, audit firms and any other related sites (such as those of audited companies), if the CPAAOB considers it necessary and appropriate in light of public interest or investor protection, or if the CPAAOB considers it necessary to do so from the viewpoint of securing the appropriate operation of JICPA.

4. Recommendation

Based on the results of examination or inspection, the CPAAOB may make a recommendation to the Commissioner of the FSA for administrative actions or any other measures for securing fair operation of audit services by audit firms or that of administrative operations of JICPA, when the CPAAOB considers it necessary.

Note: Regarding the collection of reports from and inspections on foreign audit firms, etc., refer to section 2.3.6 “Guidelines for Collection of Reports from and Inspections on Foreign Audit Firms, etc.”.

2.2 Basic Policies and Basic Plan for Examinations and Inspections

2.2.1 Basic Policies for Examinations and Inspections

In the third term (April 2010 to March 2013), the CPAAOB established and published “Basic Policy for Examinations and Inspections – To Ensure Reliability of Audits –” (in June 2010 and partly revised it in March 2011 and in April 2012) based on the results of examinations and inspections during the first term (April 2004 to March 2007) and the second term (April 2007 to March 2010).

(i) Background and basic concepts underlying formulation of the basic policies

With regard to the compliance of audit firms with the Standards on Quality Control for Audits, etc., the examinations and inspections conducted during the second term revealed occasional cases of individual audit firms whose establishment of quality control systems remained inadequate. Given this, the basic policy for the third term is to carry out examinations and inspections based on the following perspectives and goals.

(ii) Details of the basic policies (revised in April 2012)

- Perspectives

In carrying out examinations and inspections, the CPAAOB shall take a public-interest standpoint, always from the people's perspective, and shall maximize the use of its authority, so as to actively work to ensure and enhance audit quality. Also, the CPAAOB shall strive to disseminate information in Japan and overseas. It shall provide useful information from examinations and inspections in exchange of views with JICPA and other relevant organizations while communicating, through the IFIAR, etc., with foreign audit oversight authorities concerned and proactively responding to international trends.

- Goals

Examinations and inspections implemented by the CPAAOB do not focus directly on whether individual audit opinions themselves are suitable. Instead, the basic goal shall be to promote further improvement of the functions of quality control reviews by JICPA, from a public-interest standpoint, and to ensure proper operation of audit firms and foreign audit firms, etc.

- Basic policy for examinations

The CPAAOB receives reports on quality control reviews conducted by JICPA. It requests relevant information and materials from JICPA and utilizes various other pieces of information to examine the content of these reports.

Examination is conducted based on the following policy.

• Positive entrenchment of audit quality control

Given that there are occasional cases of audit firms whose establishment of quality control systems remains inadequate, the CPAAOB shall conduct examinations with a focus on whether audit firms are implementing quality control properly. In doing so, the CPAAOB shall encourage such audit firms to establish appropriate quality control, such as through opportunities for focused reviews (collection of reports).

• Improvement of the functions of JICPA's quality control reviews

Given that JICPA's quality control reviews are a mechanism fundamental to ensuring appropriate business operations at audit firms, the CPAAOB shall review the appropriateness of systems and operations in light of the

results of examinations and inspections, and shall conduct two-way discussion with JICPA establishing opportunities for the exchange of views. In doing so, the CPAAOB shall encourage further improvement of the functions of quality control reviews.

- Effective examination

Not only quality control review reports from JICPA, but also various information from relevant organizations, shall be taken into comprehensive consideration, and the revision of laws, regulations, audit standards, etc. and the cross-sectional topics surrounding the audit profession are matters to be particularly kept in mind when conducting examinations. As such, the CPAAOB shall be mindful of conducting effective examinations, such as specifying the groups of audit firms that have these kinds of common issues, and the areas and matters to be reviewed.

Furthermore, aside from cases of inspection in which it is recommended that supervisory authorities take administrative actions or other measures, with respect to any problems notified as part of inspection results, from the perspective of confirming the subsequent state of quality control, the CPAAOB shall, as necessary, require reports to be submitted after a certain period of time has elapsed since the notice of inspection results.

- Basic policy for inspections

Based on the results of the examinations of reports on the quality control reviews conducted by JICPA, the CPAAOB conducts inspections as it deems necessary.

Under the basic policy for inspections, the CPAAOB shall categorize the audit firms to be subjected to on-site inspections pursuant to the CPA Act. In addition, it shall specifically state the circumstances under which inspections will be required for each category, and shall conduct them in accordance with the separately established “Basic Policy for Inspections Conducted by the CPAAOB.”

Furthermore, with regard to the collection of reports and inspections of foreign audit firms, etc., the CPAAOB shall conduct these in accordance with “A Framework for Inspection/Supervision of Foreign Audit Firms, etc.” which was published in September 2009, and with the “Basic Guidelines on Collection of Reports from and Inspection on Foreign Audit Firms etc. by the CPAAOB,” which was published in January 2010.

(Reference) Basic Policies for Examinations and Inspections (for the first and second terms)

During the first term, the CPAAOB established and published in June 2004 “To Ensure Reliability of Audits – Basic Policy for Examinations, etc. –,” which contained the basic viewpoints and goals of its activities as well as the basic guideline for examination and the framework for inspection. Under this policy, the CPAAOB conducted examinations and inspections during the term, adopting the basic concepts of “proactively responding to expectations for ensuring the quality and more effectiveness of audits” and “continuing oversight of audit services and further enhancing JICPA’s quality control review function.”

During the second term, based on the results of examinations and inspections during the first term, the CPAAOB established and published in June 2007 “For Further Improvement of Audit Quality – Basic Policy for Examinations, etc. –” Based on this policy, the CPAAOB conducted examinations and inspections during the term, adopting the basic concepts of “firmly establishing improvements for previously identified issues” and “responding to new challenges.”

2.2.2 Basic Plan for Examinations and Inspections

The CPAAOB establishes a Basic Plan for Examinations and Inspections every fiscal year as a guide for examinations and inspections for that year.

In FY2012, based on the Basic Policies for Examinations and Inspections mentioned above, the CPAAOB established and published on April 9, 2012, the FY2012 Basic Plan for Examinations and Inspection, which provided for conducting well-balanced verifications focused on the essential problems in business operations by accurately analyzing where the risks of individual audit services lie, and narrowing down the review items.

Summary of the Basic Plan for Examinations and Inspections

Based on the results of inspections conducted by the CPAAOB and quality control reviews conducted by JICPA, there have been cases confirmed of some audit firms whose establishment of quality control systems and whose voluntary improvements remain inadequate.

The Basic Plan for Examinations states that the CPAAOB shall conduct examinations to accurately identify the risks of audit firms and individual audit services through reports

on JICPA quality control reviews and exchange of views with JICPA and other relevant organizations.

Also, the Plan states that the CPAAOB shall focus on reviewing the establishment and management of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control, or those for which voluntary improvements need to be encouraged.

Furthermore, the Plan mentions that the CPAAOB shall comprehensively review the appropriateness of JICPA's quality control review system because it is important to ensure the establishment of appropriate audit quality control at audit firms by enhancing the function of JICPA quality control reviews to thereby improve audit quality.

The quality control reviews conducted by JICPA are carried out for large audit firms once every two years. The Basic Plan for Inspections states that, with respect to large audit firms (audit firms which audit at least 100 listed companies or which employ at least 1,000 full-time auditors), the CPAAOB, in principle, conducts its inspections based on the results of examinations of the quality control review reports from JICPA, considering such factors as their roles in capital markets, and domestic and foreign trends concerning audit supervision. The CPAAOB also inspects, as required, audit firms that have a relatively large number of listed companies as their audit clients.

In conducting such inspections, the CPAAOB works toward conducting well-balanced verifications focused on essential problems in business operations by obtaining important information on the quality control and individual audit services of audit firms, and in light of past inspection results and the monitoring activities of overseas alliance partners, etc., focusing on the risks of individual audit services, accurately analyzing where those risks are, and narrowing down the review items.

In relation to small- or medium-sized audit firms, the results of recent examinations, inspections and quality control reviews, have revealed occasional cases of problems with the risk assessment associated with the replacement of accounting auditors, with the establishment of operation control systems at new audit firms, and with the approach to improvements for matters identified in quality control reviews. For this reason, the Basic Plan for Inspections states that the CPAAOB shall effectively and flexibly conduct inspection of such audit firms as required, based on the results of examination regarding the reports from JICPA, so as to confirm their status of audit

contract execution, establishment of operation control systems, and efforts for the improvement of quality control reviews.

As follow-up measures after examinations and inspections, the CPAAOB shall collect reports from audit firms when a certain period of time has passed since giving notice of inspection results, so as to, if necessary, check and verify their status of quality control. The CPAAOB shall also extract industry-wide issues from the analysis of inspection results and exchange views with JICPA and relevant organizations.

2.3 Examinations and Inspections

2.3.1 Quality Control Reviews by the Japanese Institute of Certified Public Accountants (JICPA)

In FY2012, JICPA performed 95 quality control reviews of audit firms (56 audit firms, including 6 joint CPA offices, and 39 CPAs). By March 31, 2013, 73 reports on those quality control reviews had been submitted to the CPAAOB (see Note). The status of quality control reviews is as follows.

(Note) The quality control review report (monthly report) consists of basically the following items:

- Quality control review report
- Recommendation for improvement report
- Response to recommendation for improvement report
- Quality control review documents

(i) Status of Implementation of Quality Control Reviews

The status of implementation of quality control reviews is as follows.

Status of Implementation of Quality Control Reviews

Date of quality control review	2012						2013			Total
	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	
Number of audit firms reviewed for quality control	14	17	1	14	23	13	10	3	0	95

(ii) Results of Quality Control Reviews

All of the 73 cases reported to the CPAAOB included recommendations for

improvement. The conclusions of those reports were as follows.

- Unqualified conclusion: 62 cases (35 audit firms, 27 CPAs)
- Qualified conclusion: 11 cases (3 audit firms, 8 CPA)
- Negative conclusion: None

Also, in FY2012, JICPA performed follow-up reviews (see Note) of 71 audit firms (63 audit firms and 8 CPAs). The results of 61 reviews, which were reported to the CPAAOB by March 31, 2013, were as follows.

- Improvement measures sufficiently completed: 60 case (53 audit firms, 7 CPAs)
- Improvement measures insufficiently conducted: 1 cases (1 audit firms)

(Note) Follow-up review

A “follow-up review” is a review conducted by JICPA as part of its quality control review to assess the status of improvement measures implemented by an audit firm. Specifically, JICPA assesses the status of improvement measures by confirming the status of (i) changes to the quality control systems, (ii) communication to the auditors (including their education and training), and (iii) corrective actions implemented through monitoring the quality control systems, etc., all of which are expected to be performed by the audit firm in accordance with the improvement measures contained in the improvement plan submitted during the earlier quality control review.

2.3.2 Status of *Examination of Quality Control Reviews*

(i) Scope and perspectives for examination

During FY2012, the quality control reviews conducted by JICPA in FY2011 and FY2012 were examined. The results of the examination of the FY2011 quality control reviews are as follows. As for the FY2012 quality control reviews, the CPAAOB has progressively commenced examination of 73 cases for which reports had been received by March 31, 2013.

Quality Control Review Reports (FY2011)

(Number of audit firms)

Category	Unqualified conclusion		Qualified conclusion		Negative conclusion		Total
	(a)	a/c	(b)	b/c		-	
Audit firm	65	91.5%	6	8.5%	-	-	71
CPA	12	80.0%	3	20.0%	-	-	15
Total	77	89.5%	9	10.5%	-	-	86

(Note) All of the above 86 cases included recommendations for improvement.

During the examination, the CPAAOB uses the following perspectives to analyze the quality control review reports and to review the results of interviews and the collection of reports:

- Appropriateness of JICPA's quality control reviews
- Status of the development and operation of quality control systems established for ensuring the quality of audit services in audit firms in a reasonable manner
- Compliance of the quality control systems established in audit firms for individual audit services

(ii) Collection of reports

(a) Collection of reports for focused verification

The Basic Plan for Examinations states that, from the viewpoint of encouraging the appropriate establishment of audit quality control, based on the quality control reviews conducted by JICPA, the CPAAOB focuses on reviewing the establishment and management of the quality control systems of audit firms, such as those noted as having a wide range of deficiencies in quality control, or those for which voluntary improvements need to be encouraged. Based on this policy, the CPAAOB has selected audit firms and collected reports from them.

In FY2012, despite its limited resources, the CPAAOB collected reports from more audit firms than usual to verify the establishment and management of their quality control systems. It also expanded the range of reports to be collected to find facts about issues to be addressed across the audit industry (transfer of duties upon the replacement of accounting auditors, communication between accounting auditors and audit & supervisory board members, etc.) (in October 2012).

(b) Collection of reports for fact finding

The CPAAOB shall, as specified in the basic policy on examinations, “conduct effective examinations as to cross-sectional topics surrounding the audit profession, by such means as identifying groups of audit firms with common issues and the areas and matters to be reviewed.” Under the policy, the CPAAOB has conducted examinations to precisely grasp the risks of audits firms and individual audit services.

In FY2012, as another new effort in the collection of reports, the CPAAOB collected reports from audit firms other than those from which it did so for focused verification as specified above in paragraph (a), so as to find facts about issues to be addressed across the audit industry (transfer of duties upon the replacement of accounting auditors, communication between accounting auditors and audit & supervisory board members, etc.) (in October 2012).

History of Collection of Reports for Focused Verification and Fact Finding

	Record of Report Collection in FY2012					Record of Report Collection in FY2011		
	No. of firms undergoing report collection (a)		No. of firms undergoing QC reviews in FY2011 (b)	Report collection ratio a/b	No. of firms undergoing report collection (focused verification) (c)	No. of firms undergoing QC reviews in FY2010 (d)	Report collection ratio c/d	
	Focused verification	Fact finding						
Audit firms	58	51	7	86	67.4%	31	99	31.3%
Audit firms	50	43	7	66	75.8%	23	52	44.2%
Sole practitioners(see Note)	8	8	0	20	40.0%	8	47	17.0%

(Note) Including CPA joint office

(c) Collection of reports following notification of inspection results

Under the basic policy for examinations, the CPAAOB shall, “if it considers it necessary, require reports to be submitted on an audit firm’s state of quality control in order to ascertain the audit firm’s subsequent response, etc. for problems notified as part of inspection results.” Based on this, the CPAAOB has selected and collected reports from audit firms.

In FY2012, the CPAAOB collected reports from five of the nine audit firms that it notified of inspection results in FY2011. As another new effort, the CPAAOB also expanded the range of reports to be collected, including by requesting audit firms to report on what they had to do to address issues identified through inspections, and issues across the audit industry (transfer of duties upon the replacement of accounting auditors, communication between accounting auditors and audit & supervisory board members, etc.).

(iii) Deliberation

Based on the results of examinations of quality control reviews, the CPAAOB deliberates on conducting inspections of audit firms. Also, based on the results of inspections of audit firms, the CPAAOB shall deliberate on recommending administrative actions and other measures to the Commissioner of the FSA.

In FY2012, the CPAAOB deliberated on the FY2011 quality control reviews (of 86 audit firms), and inspected 10 audit firms. It also deliberated on the results of the collection of reports based on FY2010 quality control reviews, and as a flexibly response thereto, inspected one audit firm. It also made recommendations to the Commissioner of the FSA regarding two audit firms (two related to a FY2011 quality control review).

Status of Deliberation on Quality Control Reviews by JICPA (as of March 31, 2013)

	FY2011	FY2012
i. Deliberations related to quality control reviews (see Note)	99	86
ii. Decisions to conduct inspections of audit firms	9	10
iii. Decisions to recommend administrative actions or other measures to the Commissioner of the FSA	2	2

(Note) In principle, deliberations are carried out on quality control reviews that were conducted in the previous fiscal year.

2.3.3 Status of *Inspections to Audit Firms*

In FY2012, under the “FY2012 Basic Plan for Examinations and Inspections,” the CPAAOB inspected 10 audit firms, in relation to the FY2011 quality control review and one in relation to the FY2010 review.

2.3.4 *Recommendations to the Commissioner of the Financial Services Agency (FSA)*

As a result of inspection on two certified public accountants of Hanshin CPA Office, the CPAAOB found that the two CPAs performed their services in a grossly inappropriate manner. Pursuant to the provisions of Article 41-2 of the CPA Act, the CPAAOB recommended on November 22, 2012, that the Commissioner of the FSA take administrative actions and other measures against the two CPAs, as follows:

- (i) The CPAs’ inadequacies have been pointed out by JICPA in their audit commission risk assessment and an improvement report has been submitted stating that when commissioning audit services, they will carefully assess audit commission risks with recognition of the need to do so. Even after submission of the report, the CPAs still continue to commission post-balance sheet date or interim audit services, which are expected to carry high audit risks attributable to, for example, client-predecessor auditor disagreements and predecessors' disclaimers of opinion. However, the CPAs remain significantly inappropriate and of insufficient caliber for the commission of such audit services. In fact, before commissioning, they do not identify audit contract risks that may be expected from the facts found through questioning their predecessor auditors.
- (ii) Despite receipt of repeated recommendations from JICPA to correct flaws in audit evidence provided, the CPAs do not adequately understand the intent of the improvement recommendations. They have yet to appropriately develop and take any measures necessary to correct such flaws.

Also, the CPAs, as professional experts, neither pay due attention nor take a skeptical viewpoint in performing audit services. When auditing sales and accounting estimates of, and revising the going-concern assumption of their clients, the CPAs accept what their clients insist, without critically reviewing it.

In addition, the CPAs do not adequately verify with each other the applicability of audit opinions given and the sufficiency and appropriateness of audit procedures performed by other controllers of audit. Also, they do not take any measures to maintain and improve audit quality. For example, they do not take measures to receive valid examinations on the sufficiency and appropriateness of the audit procedures they perform, without specifically explaining the details of the procedures using audit working papers to the external CPAs whom they contract to examine the procedures.

Given these facts, the CPAs are deemed not to perform a wide range of audit services according to the audit procedures in compliance with audit standards. They do not develop an appropriate audit plan based on risk approach. They do not obtain sufficient and appropriate audit evidence during important audit procedures, including sales and audit estimate audits, and going-concern assumption reviews.

- (iii) The CPAs' audit firm has a significantly inappropriate and insufficient quality control structure. The firm lacks awareness of securing audit quality through the proper maintenance and operation of its quality control system. Although it has internal quality control regulations in place, the regulations are only for form's sake. The firm is deemed inadequate in quality control; it does not check independence in the operation of all of the regulations on an annual basis and does not perform effective routine monitoring and periodic verification.

2.3.5 Dissemination of Information

- (i) Preparation and publication of the "Case Report: Audit Firm Inspection Results"
From the viewpoint of securing and improving the levels of audit quality of audit firms, the CPAAOB yearly reviews and revises the Case Report, which was published in February 2008. In FY2012, the CPAAOB published a revised version thereof in August 2012 by adding or deleting certain examples of issues to incorporate the issues identified in inspections conducted up to FY2011 and to reflect the revisions of accounting standards, etc. The English version was similarly revised and published at around the same time (see Annex 2).
This revised version is divided into the quality control and individual audit services sections, from the viewpoint of "presenting its level of expectation" and

“providing reference information for directors and audit & supervisory board members of listed companies, etc., and general investors and other market players,” in addition to “helping audit firms make voluntary efforts for maintaining and improving the quality of their audits.” The version newly contains inspection standpoints, summarized inspection results, and actions to be taken by audit firms, and its title is renamed from “Case Report: Deficiencies in Audit Quality Control” to “Case Report: Audit Firm Inspection Results.”

(ii) Lectures, etc., on inspection results (Case Report)

The CPAAOB actively participates in workshops organized by JICPA or other relevant organizations to lecture on inspection results so as to help perform appropriate audit procedures.

In FY2012, the CPAAOB delivered six lectures for certified public accountants at five workshops hosted by JICPA across Japan from October to December 2012, to promote voluntary activities aimed at securing and improving audit quality.

The CPAAOB also delivered two lectures for audit & supervisory board members at the Japan Audit & Supervisory Board Members Association (JASBA) in November 2012. It lectured for listed company executives at seminars hosted by the Tokyo Stock Exchange and the Osaka Stock Exchange in February and March 2013.

In addition, the CPAAOB gave wide publicity to the inspection results, such as by printing the Case Report in the bulletins and other publications of relevant organizations, so that audit firms, etc., can actively use them for reference purposes.

(iii) Cooperation with JICPA and other relevant organizations

In order to stimulate further improvement of the functions of quality control reviews conducted by JICPA from a public-interest standpoint, the CPAAOB conducts examinations and inspections, and for the purpose of improving audit quality control, the CPAAOB is engaged in sharing information and strengthening cooperation with JICPA, for instance, by conducting discussions with the JICPA Chairperson, other executives and reviewers about problems identified through examinations and inspections.

Furthermore, since the mission of the CPAAOB is to improve the fairness and transparency in Japan's capital markets by securing the reliability of audits through inspections, etc., the CPAAOB cooperated with JICPA, relevant FSA divisions and securities exchanges, etc., such as by actively exchanging views on industry-wide issues related to audits which were identified from the results of inspections, etc.

2.3.6 Framework for Inspections and Oversight on Foreign Audit Firms, etc.

(i) Notifications of foreign audit firms, etc.

When providing services deemed to correspond to the audit attestation services prescribed in the CPA Act, for financial statements submitted by foreign companies, etc. under the Financial Instruments and Exchange Act, foreign audit firms, etc., shall notify the Prime Minister (who shall delegate his/her authority to the Commissioner of the Financial Services Agency under the CPA Act) in advance. (As of March 31, 2013, 79 audit firms from 29 countries)

(ii) A framework for Information requirements and Inspections on foreign audit firms, etc.

In relation to the treatment of foreign audit firms, etc., the CPAAOB and the FSA prepared and published "A Framework for Inspection/Supervision of Foreign Audit Firms, etc." in September 2009, based on the "FY2009 Basic Plan for Examinations and Inspections."

In view of "A Framework for Inspection/Supervision of Foreign Audit Firms, etc.," the CPAAOB also published the "Basic Guidelines on Information Requirements and Inspection on Foreign Audit Firms etc. by the CPAAOB" in January 2010. The Guidelines establish basic procedures and points to be considered regarding inspections and the information gathering from foreign audit firms, etc.

With respect to information requirements and inspections regarding foreign audit firms ("firms"), etc., the FSA and the CPAAOB will, in principle, rely on such actions by the competent authorities of the firms' home jurisdictions ("foreign competent authorities"), instead of seeking to obtain information from or conducting inspections

on firms themselves, provided (a) audit and public oversight systems in the firms' home jurisdictions are equivalent to those of Japan, (b) necessary information can be provided from the foreign competent authorities through appropriate arrangements of information exchange, and (c) reciprocity is ensured in the Framework and Guidelines.

(iii) Exchange of letters on cooperation in the area of audit oversight

Currently, the FSA and the CPAAOB are in negotiations with the foreign audit oversight authorities on cooperation in the area of audit oversight, including information sharing. The CPAAOB concluded an information exchange agreement and exchanged letters on cooperation in the area of audit oversight with the Malaysian Audit Oversight Board (AOB) on October 3, 2012, and the Netherlands Authority for the Financial Markets (AFM) on March 26, 2013.

(Reference) Past Exchange of Letters

- On October 6, 2011, with the Public Company Accounting Oversight Board (PCAOB)
- On March 23, 2012, with the Canadian Public Accountability Board (CPAB)

(iv) Information requests to foreign audit firms

In October 2012, based upon the CPA Act, the CPAAOB requested 23 foreign audit firms—of those having notified the FSA—from six jurisdictions of which the foreign audit oversight authorities were not expected to be relied on by the FSA and the CPAAOB regarding inspection and oversight, to submit information concerning operation, etc. of the firm, the quality control system of the firm and results of the latest inspection/review conducted by the supervisory authority, etc.

Notifications from Foreign Audit Firms, etc. (as of March 31, 2013)

	Number of countries/regions	Number of audit firms, etc.
North America	2	7
Central & South America	3	9
Europe	13	37
Asia and Oceania	10	25
Middle East	1	1
Total	29	79

2.4 Future challenges

(i) Further improvement of the functions of quality control reviews by JICPA

With the aim of stimulating further improvement of the functions of quality control reviews conducted by JICPA from a public-interest standpoint, since FY2004, the CPAAOB has continued to review the appropriateness of quality control review systems and operations and to conduct two-way discussion with JICPA. Given that the present framework has been one where the results of inspection are reported to JICPA via audit firms, any problems identified through examinations and inspections are being shared with JICPA in a more concrete form, and efforts are being made to share a sense of the issues surrounding quality control reviews through the bilateral exchange of views with JICPA.

With regard to the quality control reviews conducted by JICPA, given that nine years have passed since their legislation following the May 2003 revision of the law, and five years since the April 2007 introduction of the registration system for listed company audit firms, JICPA is in discussion on the improvement of the quality control review system. The CPAAOB believes it necessary to strongly promote a framework whereby feedback on CPAAOB activities is given directly and indirectly to JICPA through the exchange of views and results of inspections, etc.

(ii) Strengthening of information collection and analysis systems

The CPAAOB receives quality control reviews conducted by JICPA, and then uses a variety of information to conduct examinations and inspections. In order to conduct more efficient and effective examinations and inspections, the CPAAOB needs to strengthen its systems for information collection and *ex ante* and *ex post facto* information analysis.

For this reason, the CPAAOB believes it necessary to proactively collect information on audit firms, etc., and markets, as well as quality control review reports, so as to further promote cooperation with JICPA, relevant FSA divisions and other relevant organizations.

The CPAAOB also believes it important to strengthen both the quality and quantity aspects of its information collection and analysis systems, such as by further enhancing and strengthening report collection and through close

cooperation with supervisory authorities after the notification of inspection results.

(iii) Improving inspection functions

The CPAAOB believes that an important issue with regard to large audit firms is to obtain important information on the quality control and the individual audit services of audit firms, and in light of past inspection results and the monitoring activities of overseas alliance partners, etc., to focus on the risks of individual audit services, accurately analyze where those risks are, and by narrowing down the review items, effectively and flexibly conduct well-balanced inspections focused on the essential problems in business operations.

The CPAAOB also believes that, for audit firms of other sizes, an important issue is to conduct inspections paying attention to problems, such as the responsibility for business operations and quality control, which arise due to the structures observed in small- and medium-sized audit firms, which includes audit firms now subject to quality control reviews.

Furthermore, the CPAAOB believes it important to identify industry-wide problems through the inspections and to share information through exchange of views on such problems with JICPA, relevant FSA divisions, and other relevant organizations.

(iv) Strengthening the dissemination of information

To help audit firms make voluntary efforts for maintaining and improving the quality of their audits, the CPAAOB disseminates a variety of information, such as by collating problem areas in audit firms identified through inspections and publishing them in the Case Report, and by holding briefing sessions on the Case Report as part of the training at JICPA.

Other than just voluntary improvements at audit firms, the CPAAOB believes that an important issue with regard to problem areas in audit firms identified through examinations and inspections is to get an overall picture, conducting analyses in a way so as to extract cross-sectional industry-wide problems from the inspection results and, through the exchange of views, making suggestions to JICPA, relevant FSA divisions and other relevant organizations.

Furthermore, the CPAAOB also believes it important to revise the Case Report taking into account the standpoint of providing market practitioners with reference information, and to actively disseminate information through briefing sessions on the Case Report.

(v) Enhancing the structure for addressing problems concerning accounting audits

Japan has a variety of considerations concerning accounting audits, including the application of new legal standards, the establishment of standards for addressing fraud risks in audit and the revision of Company Law, in addition to the application of the revised operational guidelines based on the Clarity Project of the International Auditing and Assurance Standards Board (IAASB). Outside of Japan as well, cooperation with various overseas authorities is progressing, such as the exchange of letters with the US PCAOB, Canadian CPAB, Malaysian AOB and Dutch AFM regarding cooperation in the area of audit oversight. Given these circumstances, in addition to enhancing training programs continuing to keep in mind system revisions and international trends, the CPAAOB believes it important to provide effective training programs that allow participation by JICPA reviewers. Furthermore, it believes it still important to enhance the procurement of personnel to further strengthen the cooperation with overseas authorities, in order to address this situation and for inspections to be carried out appropriately.

3 Cooperation with Relevant Organizations in Other Jurisdictions

3.1 *Outline*

Triggered by accounting scandals such as at Enron and WorldCom in the United States (US), the need to secure and improve the quality of accounting audits was recognized, and since 2002, audit oversight institutions independent from the accounting profession have been established in jurisdictions throughout the world.

Amid such circumstances, the first unofficial meeting of audit oversight institutions was held in Washington DC, organized by the Financial Stability Forum (FSF) (see Note), for the purpose of sharing information among each country's audit oversight institution. The meeting was attended by nine jurisdictions: Japan, U.S.A., Britain, Germany, France, Italy, Canada, Australia, and Singapore. Subsequently, a series of further informal meetings was held. Momentum gathered for the establishment of a permanent international meeting, and at the fifth meeting of audit oversight institutions held in Paris in September 2006, formal approval was given for the establishment of the International Forum of Independent Audit Regulators (IFIAR). Its first plenary meeting was held in Tokyo in March 2007, hosted by the CPAAOB, and was attended by the audit oversight authorities of 22 jurisdictions. Since then, 12 meetings have been held, with membership as of March 31, 2013, having grown to 44 jurisdictions.

In addition to cooperating with the audit oversight authorities of each country through actively participating in the activities of the IFIAR, by exchanging views individually with the audit oversight authorities of each country, the CPAAOB is also making efforts to establish and enhance international cooperative relationships aimed at securing and improving the quality of audits.

(Note) In light of the declaration of the second meeting of the heads of state, held in April 2009 for the discussion of financial markets and the world economy (London Summit), the FSF was reorganized into the Financial Stability Board (FSB), as an organization with a stronger organizational base and with greater capacity.

3.2 International Forum of Independent Audit Regulators (IFIAR)

3.2.1 Organization

(i) Goals

The IFIAR's Charter specifies the following as the goals of its activities:

- i To share knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on the inspections of auditors and audit firms;
- ii To promote collaboration and consistency in regulatory activity; and
- iii To provide a platform for dialogue with other organizations that have an interest in audit quality.

(ii) Organization

The IFIAR is made up of the audit oversight authorities of various jurisdictions that have membership, and decisions are, in principle, made at the plenary meetings at which all member authorities participate. Individuals serve as the Chairperson and Vice-Chairperson to facilitate the activities of the IFIAR, and an Advisory Council providing support and advice to the Chairperson and Vice-Chairperson has been established. The Advisory Council comprises six jurisdictions, and together with Abu Dhabi, Canada, Germany, the Netherlands and Spain, Japan has been elected as a member of this Council.

Currently, there are six working groups established in the IFIAR, the goals of which are described below.

(a) Global Public Policy Committee (GPPC) Working Group

The aim of this working group (WG) is to exchange views with six large audit networks (see Note) on the quality control of global audits. The WG maintains dialogue with each network on such topics as the quality control systems of global audit networks, and shares information between authorities on improvements in quality control and on the organizational expansion of each network.

(Note) The six large audit networks are comprised of Deloitte Touche Tohmatsu, Ernst & Young, KPMG, PricewaterhouseCoopers, BDO and Grant Thornton.

(b) Standards Coordination Working Group

The aim of this WG is to exchange views on such topics as the setting of international auditing standards at the International Auditing and Assurance Standards Board (IAASB) and on cooperation with bodies that set standards related to audit services.

(c) Inspection Workshop Working Group

This WG plans, coordinates and conducts *ex post facto* evaluations of IFIAR inspection workshops. These workshops have been established for the purpose of skills training for inspectors and to share inspection methods and experiences, and are held every year.

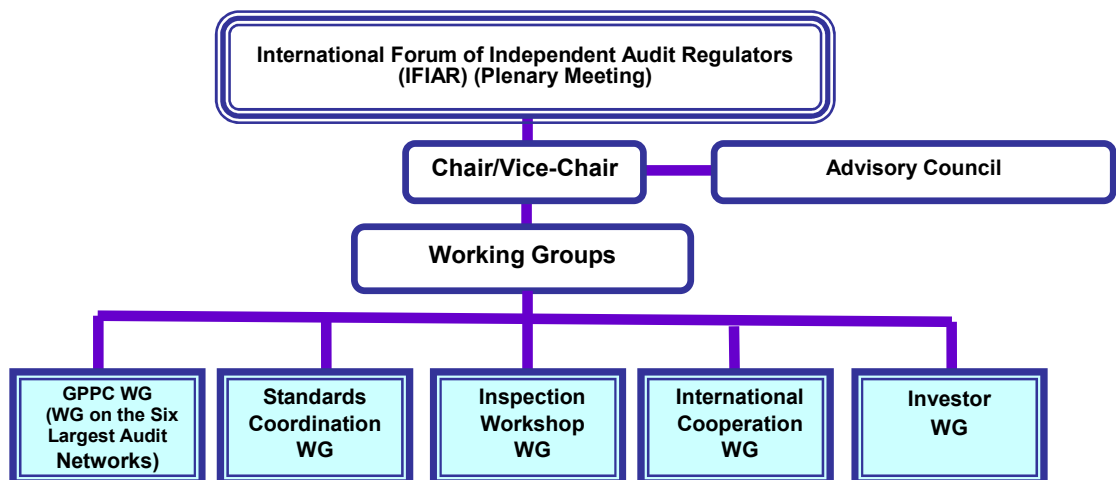
(d) Investor Working Group

The aim of this WG is to engage in dialogue with investors—the users of audit reports—on the quality of audits and how audit reports ought to be. The WG also plans and coordinates the exchange of views with investor representatives at the IFIAR plenary meetings.

(e) International Cooperation Working Group

The aim of this WG is to promote the practical exchange of information on regulation and inspections between supervisory authorities.

IFIAR organization chart



3.2.2 *Activities*

(i) Plenary meetings

(a) Eleventh meeting (Pusan)

The eleventh meeting was held in Pusan from April 16 to 18, 2012, and was hosted by the South Korean Financial Supervisory Service (FSS) and the Financial Services Commission (FSC).

In March 2012, the Financial Stability Board (FSB) requested the IFIAR to strengthen the effectiveness of audit oversight on external audits of financial institutions for improving the quality of audits globally.

At this plenary meeting, in response to the request, a work plan for the future was approved. Agreement was also made on priorities regarding efforts to enhance domestic and international communications. In addition, the proposed the IFIAR charter amendment requiring the holding of the IFIAR meetings once a year was officially approved (ratified) under the charter.

(b) Twelfth meeting (London)

The twelfth meeting was held in London from October 1-3, 2012, and was hosted by the Financial Reporting Council (FRC). At this plenary meeting, in relation to the request from FSB, agreement was made to resolve on the establishment of a new task force. The meeting also confirmed that discussions should be held on the reform of the IFIAR organization including the establishment of a permanent the IFIAR secretariat.

Past IFIAR plenary meetings

	Dates	Venue	Participating audit oversight authorities
First	March 22-23, 2007	Tokyo, Japan	22 jurisdictions
Second	September 24-25, 2007	Toronto, Canada	21 jurisdictions
Third	April 9-11, 2008	Oslo, Norway	22 jurisdictions
Fourth	September 22-24, 2008	Cape Town, South Africa	21 jurisdictions
Fifth	April 27-29, 2009	Basel, Switzerland	30 jurisdictions
Sixth	September 14-16, 2009	Singapore	29 jurisdictions
Seventh	March 22-24, 2010	Abu Dhabi, UAE	30 jurisdictions
Eighth	September 27-29, 2010	Madrid, Spain	37 jurisdictions
Ninth	April 11-13, 2011	Berlin, Germany	34 jurisdictions
Tenth	September 26-28, 2011	Bangkok, Thailand	29 jurisdictions
Eleventh	April 16-18, 2012	Pusan, South Korea	32 jurisdictions
Twelfth	October 1-3, 2012	London, UK	39 jurisdictions

(ii) Inspection workshops

At the first IFIAR plenary meeting in Tokyo, it was agreed that inspection workshops would be held, led by the inspectors of the IFIAR members, for the purpose of sharing information on the inspection methods of audit oversight authorities and on issues related to inspections, as well as providing skills training for inspectors. Since then, the workshops have been held every year, with planning and coordination provided by the Inspection Workshop Working Group.

This fiscal year, the workshop was held between March 4 and 6, 2013, and was organized by the Federal Auditor Oversight Authority (FAOA) of Switzerland.

118 inspectors and others participated from 38 jurisdictions, including those dispatched from Japan. At the meeting, 13 individual sessions, etc. were set up. At the session titled “Common elements of Risk-Based Inspection Approach,” the Japanese inspectors introduced considerations, etc. for inspections in Japan, contributing to the workshop. They also participated in other sessions to collect information regarding the use of information technology experts in and methods of inspections in other participating jurisdictions.

Past IFIAR inspection workshops

	Dates	Venue	Participating audit oversight authorities
First	May 30-31, 2007	Amsterdam, Netherlands	22 jurisdictions
Second	January 29-30, 2008	Berlin, Germany	20 jurisdictions
Third	February 11-13, 2009	Stockholm, Sweden	25 jurisdictions
Fourth	February 9-12, 2010	Paris, France	31 jurisdictions
Fifth	February 23-25, 2011	Washington DC, US	30 jurisdictions
Sixth	March 5-7, 2012	Abu Dhabi, UAE	32 jurisdictions
Seventh	March 4-6, 2013	Zurich, Switzerland	38 jurisdictions

3.3 Other

3.3.1 Exchange of views with foreign audit oversight authorities

In light of the globalization of corporate activities, ensuring the quality of audit procedures that cross national borders, such as using the audit results of overseas audit firms in the audit of consolidated financial statements, has become more important than ever before. Moreover, enhancing cooperation with foreign audit oversight authorities, etc. has become indispensable for building audit oversight that is globally efficient and effective. Through participation in the IFIAR plenary meetings, the GPPC Working Group and the IFIAR inspection workshop working group, the CPAAOB is actively strengthening its cooperation and exchanging information with foreign audit oversight authorities. In addition to activities at the IFIAR, for the purpose of sharing information on internationally active audit firms and issues pertaining to audit inspections, the CPAAOB is also constantly exchanging views and experience with audit oversight

authorities and other organizations from various jurisdictions on a bilateral basis and is striving to build and enhance its relationships of cooperation with foreign audit oversight authorities.

The CPAAOB and the FSA also exchanged letters on cooperation in the area of audit oversight with the Malaysian Audit Oversight Board (AOB) on October 3, 2012, and the Netherlands Authority for the Financial Markets (AFM) on March 26, 2013. This exchange of letters has enabled them to exchange information for audit oversight more smoothly.

The CPAAOB also strives to disseminate information, such as by exchanging views with international industry groups and by presenting Japan's audit oversight system and overview of recent inspection results.

3.3.2 Participation in seminars

Seminars for the purpose of sharing inspection experiences and issues on audit inspections are organized by audit oversight institutions overseas, and the CPAAOB sends inspectors from the viewpoint of enhancing cooperation with foreign authorities and collecting information on audit inspections.

This fiscal year, in addition to sending inspectors to the International Auditor Regulatory Institute (November 5-7, 2012), which was organized by the US PCAOB, the CPAAOB also contributed to workshops by dispatching inspectors as speakers to the second ASEAN Audit Regulators Inspection Workshop (January 14-16, 2013) organized by the AOB.

3.4 Future challenges

(i) Strengthening cooperation with foreign audit oversight authorities

Given that the globalization of corporate activities has resulted in the advance of cross-border audit services, such as using the audit results of overseas audit firms in the audit of consolidated financial statements of internationally active enterprises, a new challenge has been ensuring the quality of those audits that cross national borders. Attention also needs to be paid to the effects that the global economic and financial situation has on the quality of audits.

Based on such perspectives, the enhancement of Japan's presence in IFIAR and cooperation with foreign audit oversight authorities is becoming increasingly important to ensure the quality of international audits. The CPAAOB needs to not only continue to actively participate in the IFIAR activities, but also to use international conferences and working group meetings to actively exchange views regarding concerns of Japan and awareness of issues of foreign audit oversight authorities and to provide useful information obtained through the CPAAOB's activities. It is also necessary to promptly share the results of view exchanges with parties concerned and actively use such results in the clerical work of the CPAAOB.

While actively proceeding with negotiations toward developing (bilateral) frameworks for the exchange of information between audit oversight authorities, the CPAAOB believes that an important issue is the further strengthening of cooperation by communicating closely with foreign audit oversight authorities to put developed frameworks into specific use.

(ii) Response to international trends in accounting and audit systems

Regarding international trends in international discussion on accounting and audit systems, the CPAAOB needs to collect and promptly share information in a timely manner, through cooperation, with a wide range of relevant organizations, including the FSA divisions concerned, JICPA, and securities exchanges. The CPAAOB also believes it important to take necessary action properly in a timely manner, including analyzing and considering the potential impact of discussion results on audit firm activities and the CPAAOB operations, and measures to be taken, and translating such results into examinations and inspections on audit firms.

**List of Members of
Certified Public Accountants and Auditing Oversight Board
(CPAFOB)
(As of March 31, 2013)**

Chairperson (full-time)	Yoshimasa Tomosugi	Former Professor WASEDA Graduate School of Accountancy
Commissioner (full-time)	Toshiro Hiromoto	Former Professor Graduate School of Commerce and Management, Hitotsubashi University
Commissioner (part-time)	Yasuyoshi Ichikawa	Partner Deloitte Touche Tohmatsu LLC
Commissioner (part-time)	Mami Indo	Senior Managing Director Consulting Division Daiwa Institute of Research Ltd.
Commissioner (part-time)	Michiyoshi Sakamoto	Certified Public Accountant
Commissioner (part-time)	Hisakatsu Sakurai	Professor Graduate School of Business Administration, Kobe University
Commissioner (part-time)	Yuko Tashima	Lawyer Outside Director Meiji Yasuda Life Insurance Company
Commissioner (part-time)	Naoko Nemoto	Managing Director Financial Services Ratings Standard & Poor's
Commissioner (part-time)	Yasuyuki Fuchita	Executive Fellow Nomura Institute of Capital Markets Research
Commissioner (part-time)	Kazunori Yagi	Advisor Yokogawa Electric Corporation Outside Corporate Auditor Yokogawa Bridge Holdings Corp. Outside Director JSR Corporation

Case Report from Audit Firm Inspection Results

August 2012
Certified Public Accountants and Auditing Oversight Board

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Introduction

Since its establishment in April 2004, the Certified Public Accountants and Auditing Oversight Board (CPAAOB) has been performing inspections of Japanese audit firms from the viewpoint of enhancing the quality of audit in Japan, securing public interests, and protecting investors.

In the course of those inspections, the CPAAOB identified various deficiencies in audit firms concerning matters pertaining to audit quality control, such as management systems of audits, professional ethics and independence, acceptance and continuance of engagements, performing of audit engagements, audit documentation, engagement quality control review, and monitoring of quality control systems. From the perspective of promoting voluntary efforts by audit firms to maintain and improve their audit quality, the CPAAOB has been issuing, since February 2008, a Japanese version of the “Case Report: Deficiencies in Audit Quality Control,” a compiled list of examples of deficiencies identified through the most recent inspections.

In the 2012 Case Report, the following revisions have been made from the perspective of promoting voluntary efforts to maintain and improve audit quality, presenting the standards expected by the CPAAOB, and providing reference information to directors and statutory auditors of listed entities, etc. and to market players including public investors, etc., with the content divided into two parts: “Quality Control System” and “Individual Audit Engagements” (note 1).

- In the Quality Control System part, examples of identified deficiencies are introduced in detail for each quality control item, with descriptions of points of focus in inspection, outline of inspection results, (outline of examples that are considered highly useful in addressing identified deficiencies and/or improving quality control) and expected response by audit firms.
- In the Individual Audit Engagements part, the points of focus in inspection, etc. are described with a particular focus on the areas where many deficiencies were identified: the planning an audit based on a risk approach, audit for accounting estimates, and audit of internal control over financial reporting. In addition to the examples of identified deficiencies, the points to note in performing audit procedures are appended.

The CPAAOB hopes that this Case Report will be actively used as a reference document by audit firms as they strive to establish and maintain better quality control systems, and be widely referenced by capital market players, including statutory auditors of entities, in order for them to understand the actual conditions of the external audits (note 2).

Note 1: In introducing the examples of identified deficiencies, in addition to the revisions described in the main text, as much background information behind and causes of such identified deficiencies is provided as possible. In addition, regarding the matters specific to individual audit firms, etc., expressions are partially modified.

In consideration of the fact that most audit guidelines, etc. in accordance with the new draft policy are already applied at the time when this Case Report is issued, the old standards, etc., which were effective and applied at the time when the inspections were performed, are, as a general rule, replaced with new standards, etc. when they are quoted. In cases where there are multiple applicable provisions in the standards, etc., which serve as a basis for the deficiency identification, only the principal provisions are quoted. Furthermore, the name has been changed from “Case Report: Deficiencies in Audit Quality Control” to “Case Report from Audit Firm Inspection Results.”

Note 2: Examples of identified deficiencies in the quality control reviews performed by the Japanese Institute of Certified Public Accountants are introduced in the “Outline of Recommendation Reports Issued, etc.” section in the Annual Report of the Quality Control Committee; please refer to those examples along with this Case Report. In addition, it is recommended that statutory auditors, etc. of entities make efforts to understand the actual conditions of the quality control of audit firms, by, for example, using the notice from audit firms of matters related to the execution of duties prescribed in Article 131 of the Company Accounting Ordinance and/or other relevant documents.

Definition of terms

- The term “Act” refers to the Certified Public Accountants Act.
- The term “Ordinance” refers to the Cabinet Office Ordinance for Enforcement of the Certified Public Accountants Act.
- The term “audit firm” refers to an audit corporation or a sole practitioner.
- The term “local office” refers to a secondary office of an audit firm.
- The term “CPE” stands for Continuing Professional Education.
- The term “JICPA” stands for Japanese Institute of Certified Public Accountants.

Quality Control System

1. Management Systems

(1) Basic Policy and Plan on Inspection

Point of focus

In the inspection of the CPAAOB, the management system of audits of audit firms, particularly the status of establishment and maintenance of quality control systems, is considered as one of the most important inspection items; and the inspection is performed from the following perspectives:

- Whether quality control systems have been established and maintained in order to reasonably ensure that audit firms and engagement team perform audit engagements in compliance with the professional standards and laws and regulations, etc. and issue appropriate auditor's reports;
- Whether appropriate policies and procedures have been specified in order to promote an internal culture recognizing that quality is essential in performing engagements;
- Whether the CEO is fulfilling his/her duties as the ultimately responsible person for the quality control systems of the audit firm;
- Whether the audit firm has specified policies and procedures for ensuring that the person in charge of quality control has sufficient and appropriate experience and ability, and necessary authority to assume his/her responsibility; and
- Whether the person in charge of quality control is fulfilling his/her duties as a person responsible for the establishment and maintenance of quality control systems.

Outline of inspection results

The results of inspections of the status of quality control systems at each audit firm showed that there are audit firms that are actively working to maintain and improve quality control systems by, for example, appointing a full-time person in charge of quality control (partner).

On the other hand, as shown in the Case Example section below, there are audit firms, primarily small and medium-sized audit firms, where the measures to establish and maintain their quality control systems are insufficient, and where the CEO, the person in charge of quality control, or other responsible persons are not fully performing the duties related to quality control.

Expected response

It is necessary for audit firms to review the way audit engagements are performed and to promote an internal culture recognizing that quality is essential in performing engagements, for example, building a structure where the CEO, the person in charge of quality control, and other responsible persons are actively involved in the appropriate establishment and maintenance of quality control systems.

Case Examples

Case 1: Establishment of quality control systems

The CEO did not fully recognize the need for the establishment of management systems of audits. It was left to each personnel and their conscience as to the compliance with rules on professional ethics, the establishment of professional capabilities, and the appropriate performance of audit engagements. These facts indicated that a systematic control was not fully functioning.

In addition, the partners manage their own accounting firms and some live in distant locations, making it difficult for them to be fully involved in audit engagements. Sufficient time was not spent on the establishment of management systems of audits, and sufficient personnel were not made available.

Furthermore, although the CEO and the person in charge of quality control were aware that the audit firm's internal rules are not consistent with actual audit engagement conditions, the rules had not been revised. They were also aware that sufficient engagement team members are not made available and assigned to ensure appropriate performance of audit engagements; however, they did not take adequate corrective actions. These facts indicated that they had not properly established and maintained quality control systems. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 2: Establishment of quality control systems

Matters to be resolved by the board of partners, such as the acceptance and continuance of audit engagements, were implemented without discussion or approval of the board of partners. A system in which each partner monitors and examines other partners' performance, to ensure, collectively as an organization, the appropriate performance of audit engagements had not been established.

In addition, although many deficiencies were pointed out in the JICPA quality control review regarding the performance of individual audit engagements, no action was taken to understand and examine the implementation status of corrective actions in a concrete manner. This indicated the audit firm as a whole had not established a system to maintain and improve audit quality.

Furthermore, the CEO, who has the ultimate responsibility for the quality control system, just entrusted a partner in charge of quality control with the quality control-related duties, and did not properly understand the conditions of quality control at the audit firm or secure the necessary personnel, etc. required to perform the quality control-related duties.

In addition, the person in charge of quality control did not understand, as a person in charge of quality control, the contents of duties to be performed in a concrete manner or spend sufficient time on the quality control-related duties. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 3: Quality control systems at local office

The audit firm had not specifically prescribed policies and procedures for grasping the operational condition of the quality control system at the local offices, which resulted in insufficiency in the understanding of the following matters:

- Status of risk assessment concerning the acceptance and continuance of audit engagements at local offices and the actual condition of acceptance and continuance of engagements;
- Whether or not an engagement quality control review was performed on those engagements that are under the supervision of local offices and the results thereof, and the status of issuance of auditor's reports; and
- Monitoring of the results of quality control system at local offices.

(Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

Case 4: Quality control-related responsibilities of CEO, etc.

In the situation where the person in charge of quality control could not spend sufficient time on the establishment and maintenance of quality control systems, he/she did not properly divide the quality control-related work into two parts: work to be done by himself/herself, and work to be done by other partners. Regarding the work to be done by other partners, clear instructions were not provided before the work, and no examination was performed after the work. In addition, the CEO had not clearly defined the authority given to the person in charge of quality control, did not understand the actual condition of work performed by the person in charge of quality control, and did not provide specific instructions to ensure the appropriate establishment and maintenance of quality control systems.

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 15 through 18)

(2) Initiatives to Improve Performance

Point of focus

In the inspection of the CPAAOB, which is performed based on the reports of the JICPA quality control review, the CPAAOB inspects particularly the improvement status of deficiencies identified in the quality control review performed at audit firms. Specifically, as a general rule, it selects multiple individual audit engagements, and inspects, for each item, the improvement status of deficiencies identified in each individual audit engagement. In the case where the improvement is deemed insufficient, the CPAAOB seeks to identify the operational and structural problems that may be the cause of such insufficiency.

Outline of inspection results

The results of inspections of the status of initiatives to improve performance at each audit firm showed that there are audit firms at which most of the deficiencies identified in the JICPA quality control review have been sufficiently and properly remedied. Such improvement is deemed a result of initiatives in which the audit firms established specific improvement measures for each case in accordance with the unique characteristics, etc. of the entity based on the improvement plan submitted to the JICPA, and the status of such improvement measures was examined in a timely manner by the engagement partner and the quality control review partner, etc. of the corresponding individual engagement.

On the other hand, as shown in the Case Example section below, there are audit firms where initiatives to improve the deficiencies identified in the quality control review have not been sufficiently undertaken, and insufficient or no improvement has been made regarding multiple identified deficiencies.

Expected response

It is necessary for audit firms to improve the overall performance of audit engagements, by examining whether improvements have been made regarding the deficiencies identified in the quality control review, particularly from the perspective of whether or not the improvement is merely superficial; for example, the improvement measures are undertaken only for the individual audit engagements related to the identified deficiencies.

Case Examples

Case 1: Establishment of specific policies and procedures for improvement, etc.

The CEO and the person in charge of quality control had not established specific policies and procedures for the implementation of the improvement plan to address the deficiencies identified in the JICPA quality control review, and did not grasp the implementation status of improvement measures. (Fiscal 2010 Inspection)

Case 2: Review of status of improvement

Although many deficiencies were pointed out in the past JICPA quality control reviews, and the action under Article 131 of the JICPA Rules (note), etc. was ordered, the CEO left the engagement partner to implement improvement measures, and did not review the status of improvement. In addition, the engagement partner had not taken necessary improvement measures. (Fiscal 2011 Inspection)

Note: An action that is ordered to urge the improvement, etc. of the condition of audit quality control, when substantial suspicions are raised concerning the condition of an audit firm's audit quality control during JICPA quality control review.

Case 3: Initiatives for improvement

Partners, including the CEO and the person in charge of quality control, viewed that the deficiencies identified in the quality control review were caused by something unique to the reviewed audit

engagement; as a result, they did not examine the root cause of the identified deficiencies. This indicated that the audit firm did not undertake sufficient initiatives to improve their overall audit engagements, and did not take action to understand and examine the implementation status of corrective actions in a concrete manner. (Fiscal 2011 Inspection)

(3) Establishment, Dissemination, and Implementation of Internal Rules

Point of focus

It is expected that audit firms, in order to reasonably secure the audit quality, document policies and procedures for the establishment and maintenance of quality control systems in the internal rules, etc., disseminate them to engagement team, and ensure their compliance with them.

Outline of inspection results

The results of inspections of the status of establishment, dissemination, and implementation of internal rules at each audit firm showed that there are audit firms at which internal rules for quality control had been established using a template in the JICPA's "Rules for Quality Control of Audit" as a base, and by reflecting the actual condition of the audit firm; and also audit firms at which thorough compliance with internal rules is ensured by, for example, assigning a dedicated person and establishing a workflow for each quality control-related task.

On the other hand, as shown in the Case Example section below, there are audit firms where deficiencies relating to the establishment, dissemination, and implementation of internal rules were identified, including those where the above-mentioned template in the "Rules for Quality Control of Audit" was adopted, as it is, as their internal rules without performing a necessary review to reflect the actual condition of the audit firm.

Expected response

It is necessary for audit firms to perform a sufficient examination and review as to whether engagements are performed in accordance with the internal rules, and to establish a management system concerning the appropriate establishment, dissemination, and implementation of internal rules by, for example, establishing a workflow in accordance with the actual condition of the individual audit firm.

Case Examples

Case 1: Implementation of internal rules (operation of Board of Partners, etc.)

The CEO, etc., in managing the operation, did not sufficiently consult the internal rules, including the articles of incorporation, the rules for quality control of audit, etc., and did not review, as necessary, the internal rules to reflect the actual condition of the operation. This resulted in a situation where the acceptance and continuance of audit engagements, and the evaluation and determination of

compensation for personnel, which are matters to be resolved by the board of partners under the internal rules, were performed without referring such matters to the board of partners.

In addition, although it is prescribed in the articles of incorporation that an engagement partner shall be appointed by the unanimous agreement of all partners, engagement partners were assigned for the audit engagement of some listed entities without obtaining an agreement from a partner who was absent from the board of partners' meeting, and engagement partners were assigned for the audit engagement of unlisted entities without the unanimous agreement of all partners. (Fiscal 2011 Inspection)

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

Case 2: Establishment of internal rules (review when laws and regulations, etc. are revised)

The person in charge of quality control, etc. was not aware of the revisions made to laws, regulations, and professional standards; as a result, the cabinet office ordinances, which were already repealed, were quoted in the internal rules. (Fiscal 2011 Inspection)

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

Case 3: Establishment of internal rules (review when JICPA Rules are revised)

Although, under the JICPA Rule, the number of required units of Continuing Professional Education (CPE) that each personnel should undertake during one business year was changed to two units in professional ethics, and six units in audit quality control, the person in charge of quality control, etc. had not made revisions to the internal rules accordingly. (Fiscal 2011 Inspection)

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

Case 4: Establishment and dissemination of internal rules

The majority of the internal rules are created by the CEO and the person in charge of quality control without consulting the board of partners, and other personnel were not aware of the existence of such rules. (Fiscal 2011 Inspection)

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

Case 5: Dissemination of internal rules

Part-time personnel were not provided with an internal rules booklet when they were newly employed, and were not provided with explanations, etc. about changes in the internal rules when such changes were made. (Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 16)

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

Point of focus

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

Outline of inspection results

The results of inspections of the status of compliance with applicable laws, regulations, and professional standards at each audit firm revealed that, as shown in the Case Example section below, there are audit firms where deficiencies were identified relating to the provision of services not stated in the articles of incorporation, prohibition of the concurrent provision of services, non-compete obligation by partners, restriction on appointment of retired engagement partners, matters stated in the business report, notification of a change to the articles of incorporation, etc.

Expected response

It is necessary for audit firms to establish appropriate management systems for compliance with laws, regulations, and professional standards by identifying the operations where it is required to check the status of compliance with laws, regulations, and professional standards, and by assigning persons in charge for each such operation.

Case Examples

Case 1: Provision of services not stated in the Articles of Incorporation

Although it is stated in the articles of incorporation that the audit firm performs only audit and attestation services, it also provides non-audit and attestation services. (Fiscal 2010 Inspection)
(Article 34-5 of the Act)

Case 2: Prohibition of the concurrent provision of services

The audit firm, as an organization, did not check or examine whether or not their services violated Article 34-11-2 of the Act, which prohibits concurrent provision of audit services and non-audit services, by leaving such judgment to the partner who was to start providing audit services or non-audit services as an individual. (Fiscal 2009 Inspection)
(Article 34-11-2, paragraph (1) of the Act)

Case 3: Non-compete obligation by partners

Certain partners, as individuals, accepted non-audit service engagements that are included in the scope of business of the audit firm, without obtaining approval from all other partners. (Fiscal 2008 Inspection)

(Article 34-14, paragraph (2) of the Act)

Case 4: Non-compete obligation by partners

No measure was taken to grasp and control as to whether or not there is business competition between partners as individuals and the audit firm. (Fiscal 2010 Inspection)

(Article 34-14, paragraph (2) of the Act)

Case 5: Restriction on appointment of retired engagement partners

Regarding the restriction on appointment of retired engagement partners in the position of director, statutory auditor, etc., no measures, such as obtaining written pledges, were taken. (Fiscal 2010 Inspection)

(Articles 28-2 and 34-14-2 of the Act)

Case 6: Matters stated in business report

A centralized system had not been established for gathering and managing information to be stated in business reports; the CEO, who is in charge of report preparation, wrote reports, and nobody else other than himself/herself verified the accuracy of the reports. This resulted in errors in the description of “status of partners, employees, etc.,” “status of cyclical inspection of audit engagements,” etc. of the submitted business report. (Fiscal 2011 Inspection)

(Article 34-16 paragraph (2) of the Act; Article 38 of the Ordinance)

Case 7: Notification of changes to the Articles of Incorporation

The audit firm just entrusted the CEO with the duties of submitting various notifications, etc. and did not take any measures to manage and verify the submission status of legally required notifications. This resulted in a failure to submit a notification of changes to the Articles of Incorporation by the legally required due date. (Fiscal 2011 Inspection)

(Article 34-10 paragraph (2) of the Act)

(5) Information Security

Point of focus

Certified public accountants are in a position where they might be often exposed to the confidential information of entities, etc. in the course of performing their duties. Particularly in recent years, as pointed out in the “Guidelines for Information Security in the Services of Certified Public Accountants” (IT Committee Statement No.4), certified public accountants, in the daily performance of their duties, carry around personal computers and exchange business information with their clients, etc. through e-mails (refer to “I. Introduction of the said statement). In such circumstances, audit firms are required to establish and maintain information security systems that fully and appropriately meet the sensitive needs of the IT environment, etc.

In consideration of the above, in the inspections, the CPAAOB inspects the status of establishment and maintenance of the information security systems of audit firms, from such perspectives as whether or not audit firms properly assess the risk of information leakage by, for example, analyzing the type of information, etc. held by the audit firms, and whether security policies, etc. have been established and maintained in accordance with such risk.

Outline of inspection results

The results of inspections of the status of establishment and maintenance of the information security systems at each audit firm showed that there are audit firms which, for reducing the risk of information leakage, had implemented the following measures:

- Prohibiting, as a general rule, carrying a PC, on which data obtained from entities, etc. is stored;
- Preparing a self-check list for information security in accordance with the IT Committee Statement No.4; and required full-time and part-time personnel to go through the checklist for the information devices, such as PCs used for their audit engagements.

On the other hand, as shown in the Case Example section below, there were deficiencies identified, including a case where, although internal rules concerning information security were in place, preventive measures against information leakage set forth in the said internal rules were not implemented.

Expected response

It is necessary for audit firms to fully understand the damage, etc. that may occur in the event of information leakage, and establish information security systems in accordance with how information devices are used at each audit firm.

Case Examples

Case 1: Monitoring of the operation of information security systems, etc.

Although the internal rules concerning information security specify the implementation of periodic

training, and the monitoring of the condition of password setting and management, as well as the operation of information security systems, the specified monitoring was not performed for some business use PCs, including the checking of whether the passwords are changed periodically, and whether the antivirus program is updated.

In addition, some personnel did not set a password for their business use PCs. (Fiscal 2011 Inspection)

(Article 27 of the Act; IT Committee Statement No.4, IV5 and V3)

Case 2: Monitoring of the condition of electronic data storing, etc.

Monitoring of the condition of electronic data storing, etc. was not performed for PCs provided for use by full-time personnel, etc., or for PCs personally owned by part-time personnel and used for audit engagements of the audit firm. (Fiscal 2010 Inspection)

(Article 27 of the Act; IT Committee Statement No.4, IV5)

(6) Prevention of Insider Trading

Point of focus

Certified public accountants, who for serve the public good to ensure the fairness and transparency of the market, should never ever be involved in insider trading, that is, they should never take advantage of the insider information obtained through their engagement activities. It is expected that audit firms constantly implement highly effective measures in order to prevent insider trading by their members.

Outline of inspection results

The results of inspections of the status of establishment and maintenance of the systems to prevent insider trading at each audit firm showed that most of the audit firms had established and implemented rules for preventing insider trading that contain provisions relating to, for example, the prohibition of trading of specified securities issued by the entities to which services are provided, ensuring a thorough notification of entities to which services are provided, and obtaining written pledges, by using, as a base, such materials as a template “Rules for Preventing Insider Trading” provided at the JICPA’s training program. In addition to the measures mentioned above, the following measures were also undertaken:

- Periodically collecting from members records of transactions relating to specified securities, etc. to check the conditions concerning the holding and transactions of specified securities, etc.;
- Take measures including imposing a certain level of restrictions on the trading of specified securities other than those issued by the entities to which services are provided.

On the other hand, as shown in the Case Example section below, there were small and medium-sized audit firms that only prepared internal rules by using the template “Rules for Preventing Insider Trading” as a guide,

and never implemented the insider trading preventive measures specified in such rules.

Expected response

It is necessary for audit firms to carefully study the “Q&A concerning insider trading” issued by JICPA (September 2, 2008), etc., re-examine the conditions of establishment, dissemination, and implementation of the rules for preventing insider trading, and consider whether or not the strengthening of systems to prevent insider trading is required.

Case Examples

Case 1: A notification of entities to which services are provided, etc.

It is specified in the rules for preventing insider trading that a list of entities to which services are provided shall be distributed to members in order to provide a warning about insider trading, and that members shall submit written pledges to the effect that they will not carry out any transactions for themselves to buy/sell specified securities issued by the entities to which services are provided; however, a list of entities to which services are provided had not been prepared, and part-time personnel had not been requested to submit written pledges.

(Fiscal 2010 Inspection)

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

Case 2: A thorough notification regarding entities to which services are provided

When accepting engagements (audit services and non-audit services), notification was not given to members regarding entities to which services are provided. (Fiscal 2009 Inspection)

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

Case 3: List of entities to which services are provided

In the list of entities to which services are provided, which is distributed to members as part of measures to prevent insider trading, a list of entities to which non-audit services are provided was not included. (Fiscal 2010 Inspection)

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

2. Professional Ethics and Independence

Point of focus

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

In consideration of the above, in its inspections, the CPAAOB inspects the appropriateness of the procedures for confirming the satisfaction of independence requirements mainly from the following perspectives:

- Whether or not audit firms obtain, at least once every year, confirmation letters concerning compliance with policies and procedures for the maintenance of independence from all engagement team members who are required to maintain independence;
- Whether or not all persons who are subject to the independence confirmation procedures are covered; and
- Whether or not, regarding the independence confirmation procedures, the most recent information is provided concerning subsidiaries, etc. of the entity.

Outline of inspection results

The results of inspections of the appropriateness of independence confirmation procedures, etc. at each audit firm revealed that, as shown in the Case Example section below, there are audit firms where deficiencies were identified, including cases where the independence confirmation procedures specified in the internal rules, etc. were not implemented and where the independence confirmation procedures were not implemented for non-audit and attestation services.

Expected response

It is necessary for audit firms to establish a system to implement procedures for confirming the independence in a timely and sufficient manner in order to ensure the reliability of audits.

Case Examples

Case 1: Procedures for independence confirmation

Although it is specified in the internal rules that personnel shall annually submit an independence checklist for the confirmation of their independence, the person in charge of quality control did not request personnel to submit an independence checklist. (Fiscal 2010 Inspection)

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

Case 2: Procedures for independence confirmation, etc. for some personnel

On the part of the person in charge of quality control, etc., due to the insufficient consideration of the scope of targets and method of investigation regarding the maintenance of independence, the following deficiencies were identified concerning the independence confirmation procedures:

- In the annual independence confirmation procedures, “checklists for accounting firms in the Ethics Rules section,” and “checklists for audit firm partners in the Laws and Regulations section” were not obtained from the audit firm and the partners;
- The annual independence confirmation procedures were not performed for those personnel who are not partners; and
- The independence confirmation procedures were not performed for some affiliated entities of the audit firm.

(Fiscal 2011 Inspection)

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

Case 3: Procedures for independence confirmation, etc. for some personnel

Due partially to the fact that the audit firm leaves the maintenance of independence to each personnel and his/her self-discipline, the following deficiencies were identified concerning the independence confirmation procedures:

- The person in charge of quality control did not implement the independence confirmation procedures for some newly joined partners at the time of joining as well as of annual implementation;
- Although the person in charge of quality control indicated that he/she verbally provided information to part-time personnel about audit engagements performed by the audit firm at the time of conclusion of the employment agreement and that he/she confirmed independence using an independence checklist, he/she did not notify the said personnel of the names, etc. of affiliates of the entities;
- As the person in charge of quality control was not aware that the “Independence checklist for auditors” (Ethics Committee Statement No. 1) had been recently revised, the old independence checklist was used for the confirmation of independence; and
- In the independence confirmation procedures for partners, the person in charge of quality control distributed independent checklists with “NO” already checked for all items.

(Fiscal 2011 Inspection)

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

Case 4: List of entities

Due partially to the fact that the person in charge of quality control did not take measures to centrally collect the most recent information of entities, etc. and reflect such information in the “List of

entities” that is distributed at the time of annual independence confirmation, some entities were omitted from the “List of entities” that was distributed at the time of independence confirmation procedures. (Fiscal 2011 Inspection)

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

Case 5: Procedures to confirm independence until the date of auditor’s report

The engagement partner did not confirm, in the confirmation procedures of compliance with independence requirements by personnel, whether there was no change in interest in the relationship with entities, etc. during the period from the time of implementation of annual independence confirmation procedures until the date of the auditor’s report or whether there were no problems concerning the maintenance of independence. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 220, paragraph 10)

3. Acceptance and Continuance of Engagements

Point of focus

In order to reasonably secure audit quality, it is necessary that audit firms carefully assess potential risks involved in the acceptance and continuance of engagements, by collecting information regarding the integrity, etc. of the entity from a wide range of sources, before the acceptance or continuance of engagements. If an insufficient consideration is given in the process of risk assessment regarding the conditions of entities or if a judgment as to whether or not audit engagement should be accepted, etc. is made based on a wrong understanding of the audit performance system, it would most likely result in the situation where auditors cannot fully execute their responsibilities, such as not expressing the auditor's opinion. It is therefore evidently required that careful judgment based on properly collected, sufficient information is required in accepting or continuing audit engagements. In addition, it is necessary to perform such audit engagements taking into consideration the risk assessment and the information regarding entities, etc., which was obtained in the course of making such a judgment.

Outline of inspection results

The acceptance and continuance of audit engagements is a central matter in the audit firm's managerial judgment; however, in reality, as shown in the Case Example section below, there were deficiencies identified, including the cases where internal procedures relating to the acceptance and continuance of audit engagements were not executed, where proper risk assessment was not performed, and where records of matter handed over were not properly kept.

Expected response

It is necessary for audit firms, in consideration of the importance of the policies and procedures relating to the acceptance and continuance of audit engagements, to re-examine the status of establishment and implementation of such policies and procedures from the perspective of whether or not the procedures for risk assessment, etc. implemented at the time of acceptance and continuance of engagements have lost their substance, and to enhance and strengthen the risk assessment procedures at the time of acceptance and continuance of engagements.

(1) Execution of Internal Procedures, etc.

Point of focus

In accepting or continuing audit engagements, audit firms are required to meet all of the following conditions:

- That the audit firm is competent and has necessary capabilities, including time and human resources, to

perform audit services;

- That the firm is capable of complying with relevant ethical requirements; and
- That the audit firm examines the integrity of the entity and does not identify any matter that would have a significant negative effect on the acceptance and continuance of engagements.

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

Outline of inspection results

The results of inspections of the execution status, etc. of the internal procedures relating to the acceptance and continuance of engagements at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies in the internal procedures relating to the acceptance and continuance of engagements and in the risk assessment procedures. There were also deficiencies identified, such as the case where, at the time of continuing audit engagement, in-depth risk assessment was not performed; instead, only check marks indicating “no problems found” were placed in the check boxes of the checklist that is specified in the internal procedures.

Expected response

It is necessary for audit firms to re-examine whether or not the policies and procedures relating to the acceptance and continuance of audit engagements have been properly established and implemented.

Case Examples

Case 1: Implementation of internal procedures

The engagement partner (prospective) considered that, regarding the acceptance and continuance of audit engagements, decisions could be made in consultation with the CEO or the person in charge of quality control on an as needed basis; as a result, the acceptance and continuance of audit engagements, which is a matter to be resolved by the board of partners under the internal rules were performed without holding board of partners’ meetings. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 25)

Case 2: Implementation of risk assessment procedures

When accepting or continuing audit engagements, risk assessment based on the “Checklist when accepting audit engagement” or “Checklist when continuing audit engagement,” which are specified in the internal rules, was not performed. (Fiscal 2010 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 25)

Case 3: Documentation of risk assessment results

The engagement partner (prospective) considered that it was not necessary to document the assessment results, etc. in the cases of juridical persons other than listed entities and SPCs, as audit risk involved in such cases is minimal. As a result, the assessment results, etc. of matters that would significantly affect the judgment on the acceptance and continuance of engagements were not recorded. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 220, paragraphs 11 and 23)

Case 4: Documentation of consideration process of identified problems

The engagement partner, who was aware of the fact that the entity (listed entity) became insolvent as of the end of the fiscal year and that its shares were designated as shares subject to a grace period leading to insolvency, did not record the process of consideration of this matter in the “Checklist when continuing audit engagement.”

(Fiscal 2011 Inspection)

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

Case 5: Documentation of consideration process of identified problems

The engagement partner, who was aware that there were events or circumstances that pose a significant uncertainty regarding the going concern assumption, including the fact that the entity reported operating losses and net losses in consecutive years, did not record the process of consideration of these matters when the audit engagement was continued. (Fiscal 2011 Inspection)

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

(2) Communications between Predecessor and Successor Auditors

Point of focus

In cases where auditors change, the information collected and obtained by the predecessor auditor in the course of performing audit engagements is extremely important. The predecessor auditor and successor auditor are therefore required to ensure the following are addressed:

- The predecessor auditor must carry out the communications in a timely and adequate manner in order to provide the successor auditor with useful information that can be used when the successor auditor makes a judgment as to whether or not the audit engagement should be continued and when the successor auditor performs the audit engagement; when inquired by the successor auditor, the predecessor auditor must provide

information with integrity in an articulate manner. Especially in the case where the predecessor auditor is aware of information or circumstances concerning significant fraud in the financial statements that affected or would affect the auditor's opinion, the predecessor auditor must provide such information to the successor auditor, and

- The successor auditor must communicate with the predecessor auditor regarding the handover of the audit engagement, by making inquiries, reviewing audit working papers, and other means; and the results must be properly documented. In addition, the successor auditor must, in order to make a proper judgment as to whether or not the audit engagement should be accepted, inquire of the predecessor auditor at least the following matters:
 - (i) Whether there is any concern about the integrity of the management;
 - (ii) The predecessor auditor's opinion regarding the change of auditor;
 - (iii) Whether there are major differences of opinions regarding the accounting, presentation, and audit procedures;
 - (iv) Whether there is any fraud by management or significant fraud by any employee, or any signs of such fraud;
 - (v) Whether there are any significant unlawful acts or acts suspected to be unlawful;
 - (vi) Whether there are any significant contingent liabilities or events that would possibly become significant contingent liabilities;
 - (vii) Whether there are any significant deficiencies regarding the internal control of financial reporting;
 - (viii) Whether there are any events or circumstances that would pose significant uncertainty regarding the going concern assumption;
 - (ix) In the event of a change during the fiscal year, whether there are any uncorrected misstatements that have been already identified; and
 - (x) Whether there were any misstatements that were identified and eventually corrected in the course of past audits.

Outline of inspection results

The results of inspections of the status, etc. of communications between predecessor and successor auditors at each audit firm showed that, in the case of change during the fiscal year, there were cases where the predecessor auditor passed on to the successor auditor detailed information regarding the condition of the entity obtained in the course of audits, including the provision of an explanation about the content of notification, etc. issued to the entity pursuant to Article 193-3 of the Financial Instruments and Exchange Act.

On the other hand, as shown in the Case Example section below, there were deficiencies, such as the case where inquiries to and responses from the predecessor auditor were not documented, and the case where there was concern about the scope and accuracy of the information provided to the successor auditor.

Expected response

The predecessor auditor needs to understand that it is necessary to provide the information relating to the audit

risk of the entity, etc. obtained in the course of performing audit engagements to the successor auditor in a sufficient and accurate manner. In addition, the predecessor auditor needs to establish a system in which the information relating to the audit risk of the entity, etc. obtained from the predecessor auditor in the process of communications between auditors, etc. is properly documented and fully used in the audit engagements.

Case Examples

Case 1: Documentation of content of inquiries, etc. to the predecessor auditor

The successor auditor indicated that, in accepting audit engagements, he/she inquired of the predecessor auditor the matters listed in the Auditing Standards Committee Statement No. 33 (before amendment), paragraph 13 and obtained responses; however, the content of such inquiries and responses was not documented. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; No. 230, paragraph 7 of the same Statement)

Case 2: Documentation of content of inquiries, etc. to the predecessor auditor

Under the internal rules, it is required: (i) to comply with the Auditing Standards Committee Statement No. 33 (before amendment), paragraph 13; and (ii) for the person in charge of quality control to confirm whether or not the communication is performed in compliance with the policies and procedures specified by the audit firm; however, there were audit engagements, with which the documentation of content of inquiries to and responses from the predecessor auditor was not properly performed. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 900, paragraphs 8 and 9; No. 230, paragraph 7 of the same Statement)

Case 3: Documentation of procedures to assess reasonableness of evaluation of beginning of the year balance, etc.

The engagement team indicated that they inquired of the predecessor auditor whether or not there were significant unrealized losses, in order to assess the reasonableness of the evaluation of the beginning of the year balance for the accounts associated with accounting estimates; however, the performed audit procedures and the results were not documented in the audit working papers.

Moreover, in some cases, regarding the accounts associated with accounting estimates and the liability items, which were significant in monetary terms, the substantiality, etc. of the beginning of the year balance was not verified; instead, they were only checked against the trial balance, etc.

(Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 510, paragraph 5; No. 230, paragraph 7 of the same Statement)

4. Employment, Education and Training, Evaluation, and Assignment

(1) Education and Training

Point of focus

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

- Whether or not the audit firm emphasizes the importance that personnel receive continuous training, and maintains and develops the personnel's necessary competence and capabilities by providing necessary training opportunities; and
- Whether or not the audit firm properly manages and supervises the status of participation in the CPE program and the units earned by the personnel

Outline of inspection results

The results of inspections of the status, etc. of implementation and management of education and training at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies identified, including the case where the status of participation in the CPE program was not properly managed.

Expected response

It is necessary for audit firms to maintain and develop the personnel's necessary competence and capabilities by providing personnel with appropriate training opportunities, and by properly managing and supervising the status of participation in the CPE program.

Case Example: Management of participation status in the CPE program

As a result of the audit firm not properly confirming the status of participation in the CPE program and units earned, there was a case where personnel had not earned necessary units of the compulsory training subjects. (Fiscal 2010 Inspection)

(Item 116 of the JICPA Rules; No. 230, Article 6 of the Rules for Continuing Professional Education)

(2) Evaluation, Compensation, and Promotion

Point of focus

Audit firms are expected to set out appropriate policies and procedures for evaluation, compensation, and promotion to ensure that a culture is cultivated that places a high priority on audit quality. In the inspection, the CPAAOB inspects the conditions of establishment and implementation of procedures for the evaluation,

compensation, and promotion of personnel, from the following perspectives:

- Whether or not the attitude of placing a high priority on audit quality is reflected in the policies and procedures relating to personnel affairs; and
- Whether or not the procedures for evaluation, compensation, and promotion are implemented in such a way that efforts and performance to maintain and enhance capabilities and to comply with professional ethics by personnel are fairly evaluated, and such efforts and performance are sufficiently rewarded.

Outline of inspection results

The results of inspections of the status, etc. of establishment and implementation of the procedures for evaluation, compensation, and promotion of personnel at each audit firm revealed that there are audit firms, regardless of the size, that implement such evaluation procedures in which the quality of audits performed by personnel are regularly evaluated according to the evaluation items specified by the audit firm, and the results of such evaluation are communicated to the personnel.

On the other hand, at some small and medium-sized audit firms, as shown in the Case Example section below, there were deficiencies identified, including a case where specific policies etc. had not been established as to how the audit quality should be reflected in the performance evaluation of personnel.

Expected response

It is necessary for audit firms to establish and implement the policies and procedures to evaluate the personnel's efforts and performance to maintain and enhance professional capabilities and to comply with professional ethics, taking into consideration the size and personnel structure of each audit firm, etc.

Case Example: Policies and procedures for evaluating personnel

Although it is specified in the internal rules that the evaluation of personnel shall be performed by paying attention to the audit quality and the status of compliance with professional ethics, the compensation of each personnel was determined in a situation where there are no specific policies or procedures established as to how the capability of personnel and quality of audits performed by them should be evaluated and how the results of such evaluation should be reflected in their compensation and promotion. (Fiscal 2011 Inspection)

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

(3) Assignment

Point of focus

Audit firms must establish policies and procedures for the assignment of personnel, and must assign personnel who are independent and have the ability and experience to properly perform audits in accordance with the business of the entities, etc. and who can spend sufficient time on audit engagements. In addition, in assigning

personnel, the engagement partner is expected to confirm that the members of the engagement team are independent and have the necessary ability and experience to perform audit engagements, and that they can spend sufficient time on audit engagements.

In consideration of the above, in the inspections, the CPAAOB inspects the appropriateness, etc. of the assignment of engagement team from the following perspectives:

- Whether or not the audit firm, regarding the assignment of engagement team (including the engagement partner), has specified policies and procedures to ensure the assignment of engagement team who have the required competence and capabilities; and
- Whether or not, when assigning engagement team, proper and sufficient examinations had been made for each engagement team regarding the time that can be spent on audit engagements, understanding of professional standards and applicable laws and regulations, practical experience, ability to exercise judgment, etc.

Outline of inspection results

The results of inspections of the appropriateness, etc. of the assignment of engagement team at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies, including the case where the engagement partner, etc. were not properly assigned.

Expected response

It is necessary for audit firms to assign engagement team who have professional knowledge, practical experience, ability to exercise judgment, etc. required in accordance with the size and business of entities, and to establish a system for properly carrying out engagements to ensure such engagement team can spend sufficient time on audit engagements, for example, by monitoring the work load.

Case Examples

Case 1: Assignment of engagement partner

A partner who lives in a distant place from the audit firm and the entity, and mainly performs operations other than the operations of the certified public accountant, was assigned as the engagement partner. The said partner performs substantially no audit procedure other than visiting the entity once every quarter and is thus deemed not to spend sufficient time on audit engagements.

(Fiscal 2011 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 29)

Case 2: Assignment of engagement team

The audit engagement team for a listed entity consisted, in reality, of three persons: the engagement partner and two junior accountants. Moreover, despite lacking sufficient capabilities and experience to perform the audit the junior accountants were assigned to a task related to significant items. These

facts indicated that sufficient time and human resources were not spent in light of the audit risk involved. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 30)

5. Audit Documentation

(1) Preparation and Review of Audit Documentation

Point of focus

Audit documentation provides evidence to show that an auditor obtained a basis for issuing an auditor's report and that the auditor performed an audit in accordance with audit standards, etc. Thus, the audit documentation serves as evidence to directly and specifically show the content of the audit procedures performed by engagement team. On the other hand, especially in the cases of audit procedures for making an important judgment, if the content of procedures, etc. is not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanation, etc. by the engagement team who, according to his/her words performed the procedures) cannot serve as solid and reliable evidence. Auditors, as professionals, must pay full attention to this matter.

In consideration of the above, in its inspections, the CPAAOB inspects the status of the preparation and review of audit documentation from the following perspectives:

- Whether or not audit documentation was prepared in such a way that an experienced auditor, who had not been involved in that audit, can understand the status of compliance with audit procedures, timing and scope of implementation of audit procedures, the conclusions reached, etc.;
- Whether or not the engagement partner confirmed that sufficient and appropriate audit evidence had been obtained to support the conclusions reached and auditor's opinion through the review of audit documentation and discussions with the engagement team; and
- Whether or not more experienced members of the engagement team properly reviewed the audit documentation performed by less experienced members.

Outline of inspection results

The results of inspections of the status, etc. of preparation and review of audit documentation at each audit firm revealed that, as shown in the Individual Audit Engagements part of this Case Report (page 31 ff), there were deficiencies, including the case where audit procedures which were said to be performed, the extent of procedures subject to audit sampling, obtained audit evidence, process of judgment, conclusions, etc. were not recorded in the audit documentation. In addition, as shown in the Case Example section below, there were other deficiencies identified, including the case where the reasons, etc. for omitting audit procedures were not recorded in the audit documentation.

Expected response

It is necessary for engagement team to ensure that more experienced members of the engagement team properly review audit documentation, and provide instruction and supervision, etc. to less experienced members; and to record necessary and sufficient information regarding the performed audit procedures.

Case Examples

Case 1: Statement of reasons for omitting audit procedures, etc.

Regarding the audit procedures listed in the statement of auditing procedures, engagement team neglected to perform a part of the procedures; however, the reasons for neglecting such audit procedures, and a statement to the effect that the engagement partner approved the neglecting of such procedures were not included in the audit documentation. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 2: Statement of cross-referencing working papers, etc.

The relationship between accounts in the financial statements and the audit working papers in which the content of discussion on each account is stated is not made clear by putting the reference working paper numbers, etc. As a result, the corresponding relationship between the amounts of subject-to-audit accounts and the amounts of accounts in the audit working papers, which contain audit evidence, is unclear. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

Case 3: Statement of engagement team members, etc.

Names of engagement team members and reviewers, and dates of review were not stated in the audit documentation. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 230, paragraph 7)

(2) Retention of Engagement Documentation

Point of focus

Audit firms are expected to pay sufficient consideration to the retention of audit working papers prepared by auditors. For this reason, in the inspection, the CPAAOB inspects the status of retention of audit working papers from the perspective of whether or not the policies and procedures for the management of audit working papers to ensure their confidentiality, safe custody, integrity, accessibility, and retrievability are properly established and implemented.

Outline of inspection results

The results of inspections of the status of retention of audit working papers at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies concerning the retention of audit working papers.

Expected response

It is necessary for engagement team to re-examine the status of management and retention of audit working papers and to implement full-scale measures to prevent the occurrence of loss of audit evidence, leakage of confidential information, etc. resulting from the loss, etc. of audit working papers.

Case Example: Retention of audit working papers

The following deficiencies were identified concerning retention of audit working papers.

(Quality Control Standards Committee Statement No. 1, paragraph 45)

- The implementation procedures, the person in charge of implementation, and other specific matters regarding the completion of audit files and the retention of audit working papers were not specified (Fiscal 2011 Inspection);
- The number of audit files, year prepared, retention period, etc. were not recorded and managed (Fiscal 2011 Inspection);
- Only the names of entities, business year, and the number of audit files were recorded in the register; however, the serial numbers placed on each audit file and brief explanations of the content were not included (Fiscal 2009 Inspection); and
- Some of the audit working papers were not managed in the audit firm; instead, they were placed in the home-cum-office of the engagement partner. (Fiscal 2009 Inspection)

6. Engagement Quality Control Review

Point of focus

Auditors, before expressing an opinion, must undertake engagement quality control review (“EQCR”) concerning the expression of the opinion in order to confirm that their opinion is appropriate and is in accordance with generally accepted auditing standards. In addition, audit firms are expected to establish policies and procedures setting out the nature, timing and extent of EQCR, and to require, in the said policies and procedures, that the engagement report not be dated until the completion of the EQCR.

In consideration of the above, in its inspections, the CPAAOB inspects the appropriateness of review performed by the persons in charge of EQCR from the following perspectives:

- Whether or not reviews are performed at an appropriate time for the planning an audit, significant audit judgment, and expression of audit opinion;
- Regarding significant judgments and audit opinions made by engagement team, whether or not communications with the engagement partner, review of audit working papers, evaluation of audit opinions, review of financial statements and proposed report, etc. are performed;
- Whether or not the appropriateness is examined regarding the evaluation of the engagement team members’ independence, the necessity of seeking expert opinions and the conclusion reached, and records of significant judgments in audit working papers; and
- Whether or not the facts are properly documented, that procedures required in the review policy of the audit firm were performed, that the review was completed before the date of auditor’s report, and that the quality control reviewer did not determine the significant audit judgments and conclusions reached to be inappropriate.

Outline of inspection results

The results of inspections of the implementation status, etc. of reviews at each audit firm revealed that, as shown in the Case Example section below, there were deficiencies, including the case where the deficiencies in the audit procedures were not identified in the review.

Expected response

It is necessary for audit firms to re-examine whether or not the review system is fully functioning as originally intended (in other words, function to confirm, from an independent standpoint from the engagement team, that the audit opinion is appropriate and is in accordance with generally accepted auditing standards). In addition, it is necessary for the quality control reviewer to perform effective reviews, with a full understanding of the importance of his/her responsibility.

Case Examples

Case 1: Review of planning an audit

Effective reviews of planning an audit were not performed, including the case where the risk of material misstatement and responses to address such risk were not discussed. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 19)

Case 2: Timing of review of planning an audit

Reviews of the planning an audit for the financial statement and the internal control were performed concurrently with the review of forming the auditor's opinion under the Companies Act. (Fiscal 2010 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 35)

Case 3: Examination and evaluation of audit procedures (going concern assumption)

In the reviews of planning an audit and forming the auditor's opinions, the quality control reviewer performed reviews only on matters related to the going-concern assumption, and did not examine other risks that required special consideration. As a result, many deficiencies were not identified in the audit procedures performed by the engagement team. Moreover, regarding the examination of the going-concern assumption, although the engagement team failed to record the process of examination, etc. of the business plan, which was submitted from the entity, in the audit working papers, the quality control reviewer overlooked that deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 4: Examination and evaluation of audit procedures (revision of materiality level)

Although the figures of financial statements, which served as a basis of calculation of the performance materiality, significantly changed, the engagement team did not consider the necessity of revising the materiality in forming the auditor's opinion. The quality control reviewer overlooked the above-mentioned deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 19)

Case 5: Examination and evaluation of audit procedures (summary of exceptions)

The quality control reviewer overlooked the fact that the engagement team failed to assemble exceptions, which should be summarized as uncorrected misstatements. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraphs 19 and 20)

Case 6: Examination and evaluation of audit procedures (internal control audit)

Regarding the internal control audit, the engagement team did not sufficiently record the audit procedures relating to the understanding of the flow of transactions and understanding of the accounting process, management's judgment on the appropriateness of identified control, and need for and extent of the use of work of internal auditors in the audit working papers. However, the quality control reviewer did not examine the sufficiency of the above-mentioned audit procedures, and as a result, overlooked the said deficiency. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 220, paragraph 20)

Case 7: Documentation of review

The quality control reviewer, who is required to record the conclusions of the EQCR regarding auditor's opinion in the audit working paper in accordance with the policies and procedures specified by the audit firm, did not state in the audit working paper his/her agreement or disagreement with the engagement team's audit opinion. (Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 41; Auditing Standards Committee Statement No. 220, paragraph 20)

Case 8: Management of auditor's report issuance

The person in charge of quality control, etc. considered that they could grasp the progress of all audit engagements, as the number of audit engagements is small. Because of this, a system had not been established to confirm the completion of review at the time of auditor's report issuance.
(Fiscal 2011 Inspection)
(Quality Control Standards Committee Statement No. 1, paragraph 35)

7. Monitoring the Firm's Quality Control Policies and Procedures

Point of focus

The monitoring of the quality control system plays an important role in the maintenance and improvement of audit quality as a process to voluntarily identify and understand problems relating to the quality control system and to address such problems. For this reason, audit firms are expected to perform ongoing monitoring of the quality control system to ensure the sufficient and appropriate establishment and implementation of policies and procedures relating to the quality control system; and to perform cyclical inspections of completed audit engagements at least once in a specified period for each engagement partner.

In consideration of the above, in its inspections, the CPAAOB inspects whether or not such monitoring is effectively functioning, mainly from the following perspectives:

- Whether or not a person with sufficient and appropriate experience for the role is assigned as the person responsible for the monitoring of the quality control system, and whether or not the assigned person is vested with sufficient and appropriate authority;
- Whether or not a person with sufficient and appropriate experience is assigned as the person in charge of monitoring; and
- Whether or not the impact of identified deficiencies is evaluated, and appropriate corrective actions are taken in accordance with the results of impact evaluation.

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

- Whether or not the person in charge of cyclical inspections performs effective inspections by, for example, making inquiries of engagement team and reviewing audit working papers and other documents; and
- Whether or not the person in charge of cyclical inspections evaluates the impact of deficiencies identified as a result of inspections and ensures the relevant engagement partner, etc. take appropriate corrective actions.

Outline of inspection results

The results of inspections of the implementation status, etc. of ongoing monitoring and cyclical inspections at each audit firm revealed that there are audit firms at which full monitoring functions are exercised at high levels, including the case where partners other than those who are assigned as the persons in charge of quality control objectively examine the appropriateness, etc. of quality control related operations; and as a result, multiple deficiencies related to such operations were voluntarily identified and corrected.

On the other hand, as shown in the Case Example section below, there are audit firms at which deficiencies were identified concerning the competence of the person in charge of monitoring quality control system and the depth, etc. of inspections. There are also audit firms at which monitoring was performed with an assumption that no particular deficiency exists in the quality control system; and the primary function of monitoring the quality control system, which is to voluntarily identify and correct deficiencies, was not fully exercised.

Expected response

It is necessary for audit firms to establish and maintain a system in which the primary function of monitoring the quality control system, which is to voluntarily identify, understand, and correct problems, can be fully exercised.

Case Examples

Case 1: Establishment of procedures, etc. for ongoing monitoring

Regarding the ongoing monitoring, specification of the procedures, scope, and criteria for each monitoring item was not carried out, and the content of implementation procedures, the implementation results, etc. were not documented or communicated to the CEO, etc. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraphs 47, 52, and 56)

Case 2: Competence of the person in charge of performing ongoing monitoring

The person in charge of quality control, who is virtually the only person to perform the quality control related duties and concurrently serves as the person in charge of performing ongoing monitoring, is not in a position to objectively identify deficiencies and matters that must be corrected in the quality control related operations. As a result, multiple deficiencies in the quality control system were overlooked. (Fiscal 2011 Inspection)

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

Case 3: Competence of the person in charge of performing cyclical inspection

Partners involved in the performance and examination of audit engagements performed the cyclical inspections of the said audit engagements, which resulted in such cyclical inspections not being objective. (Fiscal 2011 Inspection)

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

Case 4: Depth of cyclical inspection

The person in charge of cyclical inspection, when performing cyclical inspection, did not examine audit working papers; instead, he/she checked the audit procedures only through verbal discussion with the engagement team. (Fiscal 2009 Inspection)

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

Case 5: Response to deficiencies identified in cyclical inspection

Although deficiencies were identified, during the cyclical inspection, in the planning an audit based on a risk approach, etc., the content of such deficiencies was not communicated to engagement

partner, etc. (Fiscal 2010 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 49)

Case 6: Checklists for cyclical inspection

The checklist used for cyclical inspection did not contain items related to the new accounting standards and audit guidelines, including the accounting standards for asset retirement obligations.

(Fiscal 2011 Inspection)

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

8. Joint Audit

Point of focus

In the case of joint audit with other audit firms, audit firms are also required to reasonably secure the audit quality. For this reason, in the inspections, the CPAAOB inspects the cases of joint audit from the perspective of whether or not the audit firms confirm that the quality control system of the joint auditor is one that can reasonably secure the audit quality.

Outline of inspection results

The results of inspections of the status of implementation and management of joint audits at each audit firm revealed that there were deficiencies, including a case where the results of review of the joint auditor's quality control system were not recorded in the audit working paper.

Expected response

It is necessary for audit firms to secure the quality of joint audits by, for example, reviewing the other audit firm's quality control system.

Case Example: Review of joint auditor's quality control system

Although it was indicated that a confirmation was made that the joint auditor's quality control system is one that can reasonably secure the quality of joint audit, the content and conclusions of such confirmation were not recorded in the audit working papers. (Fiscal 2009 Inspection)

(Quality Control Standards Committee Statement No. 1, paragraph 61)

Individual Audit Engagements

Audit Engagement Performance

Outline

In the inspection of the CPAAOB, many deficiencies were still identified, primarily in the following items: the planning an audit based on a risk approach and the audit procedures to be performed; audit for accounting estimates; and audit of internal control. In the Individual Audit Engagements part, the CPAAOB introduces examples from the CPAAOB inspections, focusing on these items. The perspective of the CPAAOB inspections and points to note are also described. Please use them as a reference hereinafter.

In addition, other than the deficiencies mentioned above, there were many cases where the results of audit procedures implementation and the obtained audit evidence were not recorded in audit working papers. As described on page 26 in the section “5. Audit Documentation” of the Quality Control part of this Case Report, audit working papers must be prepared in such a way that experienced auditors, who had not been involved in the particular audit engagement, can understand the status of such audit engagement, and evidence other than the audit working papers, such as oral explanation, cannot serve as solid and reliable evidence of audit procedures.

It should be especially noted that identified deficiencies in documentation included not only those related to simple failure to record in audit working papers, but also those pointed out from the perspective of whether or not required audit procedures had been performed.

(1) Planning an Audit Based on Risk Approach and the Audit Procedures to be Performed

Point of focus

The planning an audit based on a risk approach, and the audit procedures to be performed, are particularly important procedures in the performance of audit engagements. In its inspections, the CPAAOB performs examinations mainly from the following perspectives:

- In the planning an audit, whether or not the audit procedures to be performed are planned based on effective risk assessment, which includes the full understanding of the actual condition of the entity and a proper understanding of potential risks involved; instead of preparing an audit plan just by filling out forms provided by the audit firm or the JICPA, etc.; and
- Regarding fraud in an audit of financial statement, whether or not necessary risk assessment procedures and the audit procedures to be performed are implemented throughout the entire audit process, regardless of the auditors' past experiences regarding the honesty and integrity of the management, etc., being aware of the potential risks of material misstatement due to fraud.

Expected response

It is necessary for engagement team to realize again the importance of keeping records in audit working papers. They should record in the audit working papers their understanding of the entity and its environment, including the entity's internal control, and the implemented risk assessment procedures and the results of such assessment; such records will serve as a basis for identifying and assessing the risks of material misstatement when planning an audit based on a risk approach. Particularly in dealing with fraud in an audit of financial statement, engagement team needs to perform their audit engagements, always with professional skepticism.

(a) Identifying and Assessing the Risks of Material Misstatement and Designing the Responses to Assessed Risks

Case 1: **Identifying and assessing the risks of material misstatement**

The engagement team considered that it was not necessary to identify the risks of material misstatement (risk that requires special audit consideration) due to fraud in revenue recognition, based on the facts that: the entity operates a restaurant business, and most sales are settled in cash, etc., which is common in this industry and type of business; that the entity checks its cash holding against the sales record on a daily basis; and that, after such checking, cash is transferred to and managed by an external security entity. However, the engagement team failed to identify possible fraud that could arise in the entity's sales transactions, and did not perform procedures to assess such risk. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 25 and 26)

Case 2: **Assessing the risks of material misstatement**

Because of the fact that the entity, in the past, made a correction of accounting errors after the account closing date due to a large amount of sales return, the engagement team, when planning an audit, considered the possible overstatement of sales as a risk that requires special audit consideration. However, the engagement team did not understand the internal control and the related control activities of the process of sales return, in which such risk was identified. (Fiscal 2011 Inspection) (Auditing Standards Committee Statement No. 315, paragraph 28)

Points to note:

In addition to the above-mentioned cases, there were many deficiencies identified in the CPAAOB's inspections, as described below.

- When assessing the risk of revenue recognition, the sales transactions of the entity were not divided into separate classes of transactions for risk assessment at the assertion level; instead, the risk was assessed only for the entire balance amount of sales.
- The engagement team did not sufficiently assess as to whether or not relevant risks fall under the category of the risk that requires special audit consideration.

In the identification and assessment of the risks of material misstatement, it is required: to (1) identify the risks of material misstatement by understanding the entity and its environment and by examining the classes of transactions, account balances, disclosures, etc.; (2) assess as to whether or not the identified risk is related more pervasively to the financial statements as a whole and potentially affects many assertions; (3) associate the said risk with different types of potential misstatement risks at the assertion level; and (4) assess the likelihood of occurrence of misstatements and the extent of impact of potential misstatements. Especially when identifying and assessing the risks of material misstatement, a judgment needs to be made regarding the probability of fraud-risk occurrence, as to what kind of revenue, transactions, and assertions are associated with such fraud risk. In addition, the judgment as to whether or not the identified risks of material misstatement falls under the category of risk that requires special audit consideration needs to be made in consideration of the qualitative aspect, such as the relationship with fraud risk, complexity of transactions, extent of subjectivity in judgment, etc.

Case 3: **Designing the audit procedures to be performed**

In the planning of the audit based on a risk approach, although significant accounts had been selected, identification and assessment of the risk of material misstatement for some of such accounts were not performed, and the corresponding designing of the audit procedures to be performed was not performed. (Fiscal 2011 Inspection) (Auditing Standards Committee Statement No. 300, paragraph 8)

(b) Fraud in Financial Statement Audits

Case 1: **Discussions among the engagement team**

In the planning of the audit, although it was indicated that the team discussed the possibility of risks of material misstatement due to fraud, there was no item related to the risks of material misstatement due to fraud recorded in the agenda list or a minute of discussion on such an item. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 14 and 43; No. 315, paragraphs 9 and 31 of the same Statement)

Case 2: Inquiries of management

Although it was indicated that the engagement team made inquiries of the management in order to identify the risks of material misstatement due to fraud, there was no recording of responses to the inquiries related to fraud in audit working papers. Moreover, there was no understanding about the assessment of the management regarding the risks of material misstatement due to fraud, and a series of management processes established by the management for the identification of and response to fraud risk. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 16 and 43)

Case 3: Audit Procedures Responsive to Risks Related to Management Override of Controls

In the audit procedures responsive to risks related to management override of controls, the adjusting journal entries were merely scanned over; and the examination was not performed as to whether or not there is a possibility that the management is biased toward making material misstatements by fraud concerning the test of appropriateness of journal entries recorded in the general ledger and concerning accounting estimates. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 240, paragraphs 31 and 44)

Points to note:

In addition to the above-mentioned cases, there were many cases identified in the CPAAOB inspections where there were concerns about the maintaining professional skepticism as described below.

- Fraud-related inquiries of management and discussions among the engagement team members were only carried out as a matter of formality, and such discussions, etc. were not deemed to be meaningful.
- In the audit procedures responsive to risks related to management override of controls, journal entry testing was performed as a matter of formality without fully taking the fraud risk into consideration.

Although the fundamental responsibility to prevent fraud lies with the management, considering the situation where many fraud cases have occurred at entities, it is necessary to perform audit engagements with a sufficient understanding of auditors' responsibilities and with professional skepticism throughout the entire audit process.

(c) Analytical Procedures

Case 1: **Planning an audit**

Analytical procedures, which should be performed in the planning stage of audit as procedures for risk assessment, were not performed. Extraordinary transactions and tendencies that require special consideration in the audit were not identified; instead, the engagement team only compared the figures of the previous fiscal year and those of the first quarter, and stated in the audit working paper: “for reasons for increase/decrease, see the Summary of Financial Results for the First Quarter.”

(Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 315, paragraph 5)

Points to note:

The analytical procedures in the planning stage of audit are performed for the purpose of obtaining a basis for planning and implementing the audit procedures to be performed through the assessment of the risks of material misstatement.

For this reason, in performing the said procedures, auditors need to identify extraordinary or unexpected relationships and the conditions of the entity that were not identified before.

Case 2: **Substantive procedures**

In the substantive analytical procedures for sales and selling, general and administrative expenses, the engagement team only compared the figures with those of the previous fiscal year and identified changes; and did not develop the expectation, investigate and assess the significant differences, or perform further investigations. (Fiscal 2011 Inspection)

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

Points to note:

The substantive analytical procedures are performed for the purpose of obtaining audit evidence that substantiates specific assertions related to accounts or transactions. For this reason the following steps need to be taken: (1) develop an expectation and assess the level of its precision; (2) determine the amount of difference from the expected amount that can be accepted in audit; (3) calculate the difference in amount or ratio between the expected values and the recorded amount; and (4) investigate and assess the significant differences that are beyond the acceptable range (including obtaining appropriate audit evidence regarding the inquiries of and responses from the management, and performing other audit procedures).

Case 3: **Forming an overall conclusion of audit**

In the analytical procedures in the forming an overall conclusion of audit, the engagement team only calculated, for each account, the difference between the figure as of the end of the previous fiscal year and that as of end of the current term; and did not perform analytical procedures required to form an overall conclusion. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 520, paragraph 5)

Points to note:

The analytical procedures in the completion stage of audit are performed for the purpose of forming an overall conclusion regarding the consistency between the auditor's understanding of the entity and its financial statements. It is therefore necessary to conclude, in these procedures, as to whether or not sufficient and appropriate audit evidence has been obtained in the overall financial statements, and for the identified extraordinary items or relationships, during the course of audit.

(d) Revision of Performance Materiality

Case 1: Revision of performance materiality

In determining performance materiality in the planning an audit, the amount of total assets had been selected as an appropriate index, and calculation had been performed using the relevant amounts in the financial statements of the previous fiscal years. Although the amount of total assets significantly decreased in the current year as a result of a sale of a subsidiary and business divestitures, and a huge gap was created between the current and past figures of the financial statements, no revision was made to the performance materiality. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 320, paragraph 11; No. 450, paragraph 9 of the same Statement)

Case 2: Change to planning decisions during the course of the audit

Although a revision was made to the performance materiality, consideration was not given as to whether any change in the planning an audit is necessary, including the corresponding revisions to the scope of examinations, etc. (Fiscal 2008 Inspection)

(Auditing Standards Committee Statement No. 320, paragraph 12)

(e) Evaluation of IT Control Risk

Case 1: General assessment of IT control

In the general assessment of IT control in the planning an audit the assessment of the previous fiscal year was re-posted as it was in the current term's planning an audit, including the overview of IT infrastructure and configuration of application systems, without examining whether any changes had been made to the information systems. (Fiscal 2011 Inspection)

(IT Committee Practical Guideline No. 6, paragraph 4)

Case 2: Control activities (examination of spreadsheets, etc.)

Regarding the general control of IT-based information systems, the engagement team failed to

examine the accuracy of calculation results made by the financial reporting related material spreadsheet and user-developed program. Although the engagement team was aware that the entity did not have a design for control to ensure security, they failed to perform alternative examination procedures for that. (Fiscal 2008 Inspection)

(Auditing Standards Committee Statement No. 500, paragraph 8; Auditing and Assurance Practice Committee Statement No.82, paragraphs 175 and 176)

Case 3: Control activities (assessment and evaluation of general controls)

The entity uses financial accounting, purchasing, and payroll systems with a cost accounting function added. Although this does not fall under the case where the potential risk of material misstatement from using IT systems is considered to be sufficiently low, the engagement team did not perform the assessment and evaluation of general IT controls. The engagement team chose to omit part of the procedures for assessing risk from the use of IT, in consideration of the facts that the degree of using IT is low, that the stability level of information systems is high, and that there had been no significant changes in the information systems since the previous year. In addition, although audit procedures were performed using IT application controls in the procurement process, the assessment and evaluation of IT general controls were not performed for the relevant procurement process. (Fiscal 2008 Inspection)

(IT Committee Practical Guideline No. 6, paragraphs 5 and 46)

Case 4: Control activities (evaluating operating effectiveness of controls)

Regarding the sales process of the software download sales business (in which sales are recognized at the time when electronic data that enables use of software posted on the Internet is sent to the customer), the procedures for assessing operating effectiveness were performed only for the manual controls regarding the cross-checking between the sales details and the total amount of sales data, which is performed on a monthly basis. However, such procedures were performed without understanding the part of controls that have been automated. (Fiscal 2009 Inspection)

(IT Committee Practical Guideline No. 6, paragraph 17)

Case 5: Confirmation of accuracy and completeness of the information generated from IT system

In performing audit procedures relating to the valuation of delinquent accounts receivable and inventories, the engagement team used information generated from the entity's IT system. However, the team failed to obtain the audit evidence concerning the accuracy and completeness of such information (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 500, paragraph 8; IT Committee Practical Guideline No. 6, paragraph 41; IT Committee Research Report No 42, Q17)

Points to note:

In addition to the above-mentioned cases, there were still many cases identified in the CPAAOB inspections where information obtained from entities was used as it was without confirming the accuracy and completeness of such information. When using information provided by the entities as audit evidence, auditors must sufficiently examine the reasonableness of the provided information, regardless of whether or not such information was generated from IT systems.

(2) Auditing Accounting Estimates

Point of focus

Accounting estimates often involve subjective assessment by management, and are often based on complex assumptions and a variety of information sourced from inside and outside entities. For this reason, the degree of estimation uncertainty eventually affects the risks of material misstatement of accounting estimates, because they are likely to be affected by the nature and reliability of assumptions, management's bias, and other factors.

In consideration of the above, in its inspections, the CPAAOB performs examinations mainly from the following perspectives:

- In the evaluation of the degree of estimation uncertainty, whether or not sufficient and appropriate audit evidence to support estimates had been obtained, instead of just obtaining the results of estimation from the management, and whether or not critical examination of such evidence was performed; and
- When using the work of experts in the process of auditing accounting estimates, whether or not the required audit procedures were performed.

Expected response

Auditing accounting estimates are extremely important procedures that are also required to be performed as fraud-related procedures in an audit of financial statement. For this reason, when obtaining sufficient and appropriate audit evidence concerning estimates by the management, and recording performed procedures in the audit working papers, auditors must exercise due professional care, and perform such activities with professional skepticism.

(a) Securities

Case 1: When a need for impairment of shares of an insolvent subsidiary was discussed, the entity insisted that the impairment was not necessary, because the amount of net assets of the subsidiary could recover, according to the subsidiary's business plan, to the acquisition cost within the next four years. The engagement team considered that the assessment of the entity was appropriate. Under the subsidiary's business plan prepared by the entity, a huge sales increase was anticipated from an introduction of a new product into the market; and the subsidiary's business was anticipated to turn profitable. However,

due to the nature of the industry in which the subsidiary operates, it is difficult to forecast the sales of new products. Moreover, the subsidiary has consistently posted losses since its incorporation, and never achieved budgeted targets. Even in such a case, the engagement team did not obtain sufficient audit evidence to support the reasonableness of the subsidiary's business plan. (Fiscal 2011 Inspection) (Accounting System Committee Statement No. 14, paragraphs 92 and 285; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 2: In making a judgment about the need for impairment of shares in a subsidiary, the engagement team determined it was not necessary to record an impairment loss, because of the fact that, when comparing the amount of net assets per share, which was calculated based on the non-consolidated financial statements of the subsidiary, and the acquisition price of the share, the former was not significantly smaller than the latter. On the other hand, the entity posted, in consolidated accounts, additional promotion expenses for long-held inventories by the subsidiary, which would have a negative impact on the financial position of the subsidiary. However, the engagement team failed to take this matter into consideration and did not calculate the amount of net assets per share accordingly, when they made the judgment regarding the need for impairment. (Fiscal 2011 Inspection) (Accounting System Committee Statement No. 14, paragraph 92; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(b) Recoverability of Deferred Tax Assets

Case 1: In making a judgment about the recoverability of deferred tax assets, the engagement team determined that the entity is an entity that falls under the proviso to paragraph 5 (1) (iv) of the Audit Committee Statement No. 66, because the entity recorded a significant tax loss in the current period, which was carried forward. The entity incurred a tax loss, not only in the current period, but also in the previous fiscal year.

In this situation, the engagement team determined that the entity falls under the category of an entity that generates taxable income in every period, only because the amount of tax loss incurred in and carried forward from the previous period was not significant. In addition, regarding the cause of the significant tax loss incurred in and carried forward from the current period, the engagement team was simply told by the entity that "the loss incurred due to a significant decrease in sales and fluctuations in foreign exchange." They did not consider whether or not the cause falls under an "unusual and special cause" listed in Audit Committee Statement No. 66. (Fiscal 2011 Inspection) (Audit Committee Statement No. 66, paragraph 5 (1); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 2: The entity recorded deferred tax assets for the deductible temporary differences related to unrealized

losses on investment securities, such as listed stocks, considering that they are projected to be sold over a long period of time, and it is possible to perform scheduling. The engagement team failed to examine the probability of the sale of such stocks. (Fiscal 2011 Inspection)

(Audit Committee Statement No. 66, paragraphs 4 and 5 (1); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

Case 3: In making a judgment about the recoverability of deferred tax assets, the engagement team obtained a five-year business plan from the entity. However, they failed to check whether the business plan was one approved by the board of directors, etc. (Fiscal 2011 Inspection)

(Audit Committee Statement No. 66, paragraph 5 (3); Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(c) Impairment

Case: When a need for impairment of fixed assets was discussed, the entity insisted that, regarding the business locations at which signs of impairment were identified, impairment of property was not necessary, because, under the business plans for the relevant business locations, sufficient future cash flows can be expected due to a performance recovery resulting from relocations of their stores. The engagement team considered that the judgment of the entity was appropriate. However, in the process of drawing such a conclusion, the engagement team did not examine the reasonableness of the business plans, including the examinations of planners of such business plans, process of approval, specific content of improvement measures, and appropriateness of assumptions that form a basis, for each of the business locations at which signs of impairment were identified. (Fiscal 2011 Inspection)

(Application Guidelines for Accounting Standards No. 6, paragraph 36; Auditing Standards Committee Statement No. 540, paragraphs 11, 12, and 17)

(d) Reserve for Employees Retirement Benefits

Case 1: In the calculation of retirement benefit obligations, the engagement team used as audit evidence, a calculation results report of retirement benefit obligations, etc., which was prepared by a pension actuary. However, they failed to evaluate the necessary competence, capabilities and objectivity of the actuary. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 620, paragraph 8)

Case 2: In the calculation of retirement benefit obligations, the engagement team failed to examine the appropriateness of the base data, which was submitted from the entity to the pension actuary, concerning the completeness of employees' data of calculation and the accuracy of the base amount for calculation of retirement benefits, etc. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 620, paragraph 11)

Points to note:

In the auditing accounting estimates, there are cases where works of experts (such as pension actuary, lawyer, and real estate appraiser) are used when specialized skills or knowledge are required in making judgments on matters that could have a significant impact on the financial statements. Since there were cases identified in the CPAAOB inspections where works of experts were used without sufficiently performing the procedures required for such usage, engagement teams must ensure that the required audit procedures are performed.

(3) Audit of Internal Control over Financial Reporting

Point of focus

Regarding the audit of the internal control over financial reporting, which was introduced in business years beginning on or after April 1, 2008, the CPAAOB examines, in the inspections, management's assessment of internal control from the perspectives of whether or not auditors performed sufficient and appropriate examinations and whether or not required procedures were performed relating to the use of work of internal auditors.

Expected response

It is necessary for engagement team to re-examine the scope and depth, etc. of required audit procedures, and to ensure sufficient and appropriate implementation of audit procedures and their documentation.

(a) Evaluation of Significance of Deficiencies

Case 1: Performance materiality

The guideline for determining the materiality of internal control deficiencies should be the same as that for determining materiality in the financial statement audit, because it eventually affects the reliability of financial statements. However, the engagement team failed to examine the reasonableness of the performance materiality in the audit of internal control, although it was different from that in the audit of consolidated financial statements. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 188)

Case 2: Determination of material weakness

In the evaluation of significance of internal control deficiencies, although the entity considered that the misstatement identified in the audit of financial statement was caused by deficiencies in internal control; the entity determined that it had no significant impact on the financial reporting, as its quantitative materiality was low. However, the engagement team did not examine whether or not the

significance of such internal control deficiencies constitutes a material weakness by taking into consideration the qualitative materiality, compensating control, potential quantitative impact of deficiencies and likelihood of having an actual impact and other factors. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 42 and 190 through 211)

(b) Evaluation of the Scope of Assessment

Case: The entity uses sales before elimination of inter-company transactions as criteria for selecting significant locations or business units, since it is difficult to accurately determine the sales after elimination of inter-company transactions for each component. However, the engagement team did not examine whether or not such criteria are appropriate. In addition, when the sales before elimination of inter-company transactions is used as criteria for selecting significant locations or business units, it is possible that the locations or business units with more inter-company sales would be ranked higher. However, the engagement team did not examine whether or not all significant locations or business units that should be selected were selected. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 91)

(c) Evaluation of Assessment of Internal Control

Case 1: **Assessment of Company-Level Internal Controls**

In the evaluation of assessment of the status of establishment and implementation of company-level internal controls, the engagement team failed to examine whether or not the assessment items adopted by the management are appropriate in light of the conditions of the entity, by referring to the assessment items shown in Exhibit 1 of the “Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting.” (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 124)

Case 2: **Evaluation of assessment of internal control**

In the assessment of company-level internal controls and period-end financial reporting processes of consolidated subsidiaries, according to the engagement team, they obtained the results of assessment performed by consolidated subsidiaries and examined their appropriateness. However, the performed procedures and conclusions were not recorded in the audit working papers. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 125, 130 and 251;
Auditing Standards Committee Statement No. 230, paragraph 8)

Case 3: **Sampling**

In implementing procedures for the assessment of internal control operations, engagement team failed to record, in audit working papers, the population, scope and period of sampling, sampling method,

etc. which were specified by them. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 251; Auditing Standards Committee Statement No. 230, paragraph 8)

Case 4: Roll-forward procedures

In the assessment of the company-level internal controls and the internal controls over period-end financial reporting processes, according to the engagement team, they, in order to confirm whether or not the internal control was effective until the fiscal year end date, obtained a report relating to changes in such internal controls from the entity, and checked the content of the changes by inquiring. However, a review of relevant records, monitoring, etc. were not performed for that purpose. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraph 131)

(d) Using the Work of Internal Auditors, etc.

Case: In the procedures for evaluating business process operations in the audit of internal control, auditors fully utilized the work results of internal auditors, etc., instead of performing sampling themselves. However, engagement team did not examine the objectivity and capabilities of internal auditors, etc., and the degree of use of internal auditors, etc. (Fiscal 2011 Inspection)
(Auditing and Assurance Practice Committee Statement No.82, paragraphs 228 through 243)

(4) Other Audit Procedures

(a) Communication with Those Charged with Governance

Case: Although the engagement team insisted that they communicated with those charged with governance about the matters which the team noted as important from the perspective of those charged with governance's performing its duties, the team failed to document such communication in the audit working papers. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 260, paragraphs 14 and 21)

(b) Evaluation of Compilation of Audit Results

Case: In the situation where works of component auditors were utilized in the audit of consolidated subsidiaries; and where an uncorrected misstatement of the financial statements was reported by the component auditors, the group engagement team failed to examine the following regarding the said uncorrected misstatement:

- In expressing an audit opinion, the amounts of financial statement items and the quantitative and

qualitative impact on overall financial statements, linking with subtotal or total amounts as necessary;

- Whether or not the said uncorrected misstatement was caused by, or possibly caused by fraud; and
- The impact of the said uncorrected misstatement on the audit of internal control. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 450, paragraph 10)

(c) Physical Observation

Case: In performing physical observation of on-site inventory taking, the engagement team did not examine, in advance, the entity's inventory taking plan. In addition, in selecting locations for the physical observation, the team did not consider the types of inventories held, their quantitative materiality, etc. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 501, paragraph 3)

(d) External Confirmations

Case 1: Regarding the deposit balance of the overseas subsidiaries, the engagement team performed external balance confirmations as of the term-end date with overseas financial institutions; and they had not received balance confirmation letters from some of those financial institutions. However, they did not perform alternative procedures. (Fiscal 2011 Inspection)

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

Case 2: Regarding the balance confirmation of accounts receivable and notes receivable, although some confirmation letters were received by facsimile, the engagement team did not request for original letters. There was also a case where only the personal seal of the person in charge of confirmation was affixed on a received confirmation letter, and the engagement team failed to examine the reliability of the confirmation letter by, for example, contacting the relevant office. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 505, paragraph 9)

Case 3: In the analysis of exceptions in outstanding balance of receivables and payables, the engagement team only obtained the results of exception analysis performed by the entity. They failed to examine the reasonableness of such analysis results. (Fiscal 2011 Inspection)

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

Case 4: In the confirmation of outstanding balance of receivables and payables, the engagement team selects, by means of sampling, parties to which confirmation letters are sent. In this situation, regarding some

identified exceptions, the engagement team failed to investigate the details and causes of such exceptions, deeming that the amount was insignificant. Moreover, the team failed to examine their impact on the purposes of audit procedures and on other audit areas, etc. The team also failed to make an estimate of the amount of misstatement in the entire population based on the amount of error identified in the sample population. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 505, paragraph 13; No. 530, paragraphs 11 and 13 of the same Statement)

Case 5: In the confirmation of the outstanding balance of accounts payable, although the base date for confirmation is set to be before the term-end date, substantive procedures were not performed for the remaining period from the base date to the term-end date. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 21)

(e) Related Party Transactions

Case 1: In the procedures for related party transactions, the engagement team failed to examine the internal control regarding the approval and/or records of related party transactions. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 550, paragraph 13)

Case 2: The engagement team failed to examine the completeness of information regarding related parties by, for example, obtaining a list of names of all identified related parties from the entity. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 550, paragraph 12)

Points to note:

Related party transactions are possibly subject to a greater risk of material misstatement of the financial statements compared with third-party transactions, because the related party transactions are complex, reflecting the breadth and complexity of their relationships, and because there are cases where terms and conditions of such transactions are different from normal market transactions. In addition, fraud activities become easier when there is a collusion, etc. between the entity and related parties

In the implementation of risk assessment procedures and audit procedures to be performed, it is necessary to obtain sufficient and appropriate audit evidence, paying careful attention to these characteristics of related-party transactions.

(f) Going Concern

Case: The entity recorded a significant sales decrease and a large amount of loss in the current period, which the engagement team considered as an event or condition that may cast significant doubt on the

entity's ability to continue as a going concern. While the entity plans to undertake measures to solve or improve such event or conditions, including a review of sales mix, cost reductions and improvement of financial position, the team judged that material uncertainty regarding the going concern assumption still exists, and put a note accordingly under the section of "Matters Related to Going Concern Assumption" of the Annual Securities Report.

Under these conditions, the engagement team failed to perform the following evaluations regarding the audit procedures related to going concern assumption.

- Evaluating Management's Assessment

Recognizing this significant uncertainty related to the going concern assumption as a risk that requires special audit consideration, the engagement team obtained, from the entity, a budget statement, a cash flow forecast, and statement of related assumptions as part of audit procedures to address this issue. Although the team indicated that they would examine the feasibility of the plans to be taken, they failed to examine the significant assumptions that form a basis of forecast financial information or the reliability of the financial information by comparing the past year's forecast and actual figures, etc.

- Discussion with the management

The engagement team insisted that, at the times of planning an audit and year-end audit, they discussed with the management regarding the going concern assumption. However, in the minutes of the discussions held on those dates, there were only records of the business overview, but there was no mention on the going-concern assumption.

- Subsequent events

The entity's business plan was revised down by the resolution of the board of directors meeting which was held on or after the date of the auditor's report, under the Companies Act. As a result, a significant gap was created between the content of the budget statement obtained in the audit procedures concerning the going-concern assumption and that of the revised business plan.

However, the engagement team was not aware of this situation until the time of expressing an audit opinion based on the Financial Instruments and Exchange Act; and they did not examine the impact of this situation on the financial statements. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 570, paragraph 15)

Points to note:

Management's assessment regarding the going-concern assumption involves a judgment, made at a certain point of time, about the uncertainty of a future outcome relating to events or conditions. Therefore, when examining the management's assessment, it is necessary to sufficiently examine the obtained audit evidence from a critical perspective, instead of just obtaining assessment results.

(g) Audit of an Entity using a Service Organization

Case 1: The entity outsources some of its payroll operations, including salary calculation, etc. to a third-party organizations. However, in the planning the audit, the engagement team failed to consider the effect of applying the operations provided by the service organization to the design and implementation of internal control of the entity, which is a service organization. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 402, paragraphs 8 and 9)

Case 2: The engagement team used the service auditor's report in order to ascertain the status of design and implementation of internal control of the organization. However, the engagement team failed to check whether or not there had been any changes to its internal control from the auditor's report date to the financial year end of the entity. (Fiscal 2010 Inspection)
(Auditing Standards Committee Statement No. 402, paragraph 16)

Points to note:

In cases where an entity outsources aspects of their business to a third-party organization, the user auditor needs to understand the operations provided by the organization as well as the internal control of the user entity. In addition, for the understanding of internal control, an engagement team must assess the effect of applying the operations, including internal control, provided by the organization to the design and implementation of the entity's internal control. It should be noted that these procedures need to be performed not only in the financial statement audit, but also in the audit of internal control over financial reporting.

(h) Audits of Group Financial Statements

Case 1: In the audit of overseas consolidated subsidiaries, the group engagement team naturally considered that the component auditors performed audit setting a materiality level lower than the performance materiality for the consolidated financial statements. As a result, the group engagement team did not notify the component auditors of the materiality for the component, or the standard for determining the amount of misstatement that cannot be deemed as insignificant in the group financial statements. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 600, paragraph 39)

Case 2: The engagement team only obtained, from the entity, documents which show the calculations of the amounts of journal entries. The team failed to check the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances. (Fiscal 2011 Inspection)
(Auditing Standards Committee Statement No. 330, paragraph 19; No. 500, paragraph 8 of the same Statement)

Case 3: In the audit procedures for the consolidated statement of cash flows, as the consolidated statement of cash flows was generated by the consolidated accounting system, the engagement team only confirmed that the amounts in the cash flow worksheet produced by the system match the amounts in the consolidated statement of cash flows. They did not examine the consistency with other financial statements or the appropriateness of the journal entries related to the consolidated statement of cash flows. (Fiscal 2010 Inspection)

(Auditing Standards Committee Statement No. 330, paragraph 39)

Case 4: In the situation where the component auditor reported to the group engagement team that there were retirement benefit obligations that the entity, the parent company, was not aware of, and that there were loan guarantees provided to non-consolidated subsidiaries, the engagement team failed to perform additional audit procedures to address such reported matters. (Fiscal 2011 Inspection)

(Auditing Standards Committee Statement No. 600, paragraphs 41 and 42)

(i) Presentation and Disclosure of Financial Statements

Case 1: In the case where the provisions for environmental measures are recorded in the financial statements, the engagement team overlooked the fact that the said provisions were not recorded under the list of allowances, provisions and reserves in the supplemental schedule to the Annual Securities Report.

(Fiscal 2011 Inspection)

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

Case 2: The engagement team overlooked the fact that, regarding a non-consolidated subsidiary not accounted for by the equity method, a note explaining the reason for excluding the subsidiary from the scope of consolidation was not included in the scope of equity method section under the Significant Accounting Policies of the Annual Securities Report. (Fiscal 2011 Inspection)

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

Case 3: The engagement team overlooked the fact that, regarding the difference in valuation of investment securities for which the entity determined not to record deferred tax assets because scheduling was deemed impossible, the total amount of deferred tax assets and valuation allowance was not presented in the Notes to Income Tax of the Annual Securities Report.

(Fiscal 2011 Inspection)

(Accounting System Committee Statement No. 10, paragraph 31; Auditing Standards Committee Statement No. 330, paragraph 23)