

# **Responses to the Certified Public Accountants and Auditing Oversight Board's Report Entitled "Proposal for Further Improvements to the Quality Control Review – Assessment of and Recommendations Pertaining to the Quality Control Review System of the Japanese Institute of Certified Public Accountants"**

February 17, 2005

The Japanese Institute of Certified Public Accountants

## **I. Our Approach to the Proposal**

Since fiscal 1999, the Japanese Institute of Certified Public Accountants (JICPA) has conducted quality control reviews of audit practices performed by audit firms in order to enable audit firms to maintain and improve the quality of their audit practices because JICPA is a self-regulatory body. These quality control reviews are also designed to ensure the reliability of financial information, and thereby to ensure public trust in audits. The quality control review, which was first implemented as a self-regulatory procedure by JICPA, was later legally required under the Certified Public Accountants Law (CPA Law), as amended in June 2003. Since April 1, 2004 when the amended CPA Law became effective, the quality control review has been subject to monitoring by the Certified Public Accountants and Auditing Oversight Board (CPAFOB), which was established within the Financial Services Agency.

The quality control review is conducted by quality control reviewers who work for JICPA on a full-time basis. JICPA adopted this system judging that it is more effective than the firm-on-firm peer review system. Since fiscal 1999, JICPA has been working to fully implement the system. JICPA amended its Constitution and related rules and revised quality control review standards and procedures during fiscal 2003 in order to prepare for the smooth enforcement of the amended CPA Law beginning April 2004.

Recently, the CPAFOB assessed the quality control review system for the period when the amended CPA Law was not effective, from April 1999 to March 2004, and issued a report entitled "Proposal for Further Improvements to the Quality Control Review – Assessment of and Recommendations Pertaining to the Quality Control Review System of the Japanese Institute of Certified Public Accountants."

As a self-regulatory body, JICPA takes the CPAFOB's assessments and recommendations seriously and plans to actively further improve the quality control review system with a view to ensuring public trust in audits. It is also taking other measures, such as improving audit practices by increasing audit hours spent, developing and/or amending accounting and auditing practical guidelines and the Code of Ethics, enriching the continuing professional education program, and strengthening its review of individual audit engagements to determine whether audit firms are performing their audits properly.

## **II. Our Response to the Proposal**

### **1 . Quality Control Review System and Organization**

#### **(1) Strengthening of the Quality Control (QC) Review Team**

In fiscal 2004, quality control reviews were conducted by a QC review team consisting of ten QC reviewers. This team, however, should be strengthened to respond to future needs.

Given the performance of quality control reviews conducted as a self-regulatory measure since fiscal 1999, JICPA recognizes the necessity to further strengthen the quality control review system. JICPA will double the number of QC reviewers in fiscal 2005 in order to cope with the increase in the number of audit firms to be reviewed. This increase of approximately 200 firms is due to the new requirements of the amended CPA Law.

Quality control reviews of small audit firms are conducted by one QC reviewer. However, it is deemed necessary to change this practice in order to ensure the objectivity and reliability of the quality control review.

Having one QC reviewer do the review of a small audit firm is common practice in other countries as well. The QC reviewers who conduct these quality control reviews of small audit firms are all senior QC reviewers who have sufficient and appropriate experience. JICPA ensures the objectivity and reliability of these QC reviewers by requiring that their review working papers be examined by the QC reviewer's supervisor and by the QC Committee.

In order to further improve the objectivity and reliability of the QC review, JICPA will respond flexibly, taking into account the efficiency of the system as a whole and the size of the reviewed firm.

#### **(2) Cooperation with Other Functions within JICPA Related to Quality Control**

##### **i. The Quality Control Committee (QC Committee)**

It is necessary for the QC Committee to clearly document its decision-making process in its minutes, evaluation records and review working papers so that the CPAAOB can monitor the appropriateness of this process.

JICPA will clarify the documentation requirements of the QC Committee's evaluation records and minutes, thereby ensuring the transparency of the decision-making process of the QC Committee when the CPAAOB monitoring takes place.

ii. The Quality Control Oversight Board (QCOB)

Activities of the QCOB should be improved and revitalized, and certain activities should be changed to enhance transparency.

As the QCOB is an independent organization consisting of external knowledgeable persons, JICPA is not in the position to determine the frequency of QCOB meetings or the contents of its recommendations. JICPA will try, however, to explore possible measures to improve and revitalize the activities of the QCOB, and increase transparency, by taking the recommendations proposed by the CPAAOB into account. In response to one CPAAOB recommendation, the QCOB meetings, which were held twice a year in the past, have been doubled from fiscal 2004 ending March 31, 2005.

It should be noted that the QCOB is an independent body that advises JICPA on quality control review from a broader perspective, and it is not responsible for making specific recommendations to an individual audit firm.

**(3) The Scope of the Quality Control Review System**

The present quality control review emphasizes the quality control system of audit firms, but does not evaluate how the audit opinion was formed on individual audit engagements. This approach may cause some misgivings about whether this kind of quality control review system truly serves to improve audit quality. It is necessary that the quality control review evaluate how audit opinion is formed. For example, the quality control reviews should determine what kinds of processes were carried out to form an audit opinion based on the audit evidence obtained, and confirm whether there is high probability that such audit evidence leads to the audit opinion reached.

In the quality control review, the QC review team examines (i) whether the firm's process of forming an opinion is in compliance with auditing standards, and (ii) whether the firm's system is in compliance with the firm's quality control policies and procedures. The quality control review is designed to evaluate whether the reviewed audit firm's quality control policies and procedures are properly designed and adequately implemented. The QC review team monitors compliance by reviewing audit working papers on an individual audit engagement. Specifically, the QC review team evaluates (i) whether sufficient and appropriate audit procedures were performed, (ii) whether an audit opinion was properly supported by audit evidence obtained, and (iii) whether the firm's concurring reviewer ensured that accounting and auditing issues were adequately addressed and that an audit opinion was appropriately formed in compliance with auditing standards and the firm's policies and procedures.

In the "Evaluation of a Process to Form an Audit Opinion," the CPAAOB demands that JICPA evaluate the appropriateness of an individual audit opinion. This requires, for example, that the QC review team determine whether auditors have properly evaluated the appropriateness of

accounting estimates, which means whether such estimates have been developed in compliance with accounting standards and are, therefore, appropriate. The review procedures the QC review team applies, however, are significantly limited compared to the audit procedures auditors generally apply. The QC review team (i) reviews audit working papers prepared by the auditors, (ii) communicates only with them, not accessing directly their clients, and thereby (iii) assesses significant matters essential in arriving at an audit opinion, including appropriateness of accounting estimates. This means that the review opinion is drawn solely from audit evidence gathered and documented by the reviewed firm's auditors. Since the QC review team does not re-perform an audit of the reviewed firm's client, it is not easy to conclude that the assessment of the auditors is inappropriate even when the opinion of the QC review team is somewhat different. It should be noted that the quality control review does not replicate audit procedures performed by auditors.

When the QC review team finds something that implies that an audit opinion has not been properly formed, this matter is reported to the Chairman of JICPA. The Chairman then delegates further investigation to appropriate organizations such as the Audit Practice Review Committee. If certain improvements to quality control review procedures are found necessary as a result of such investigation of the Audit Practice Review Committee, JICPA will respond proactively. Since fiscal 2004, the QC review team obtains information on accounting estimates in the course of its review. In addition, JICPA intends to further expand the scope of information to be obtained by the QC review team, and at the same time, to encourage audit firms to perform sufficient and appropriate procedures in the course of their audit.

#### **(4) Disclosure of the Results of the Quality Control Review**

Disclosure of the results of the quality control review should be improved to include statistical information on recommendations made to the reviewed firms and the review results of the firms that did not conform to laws and/or regulations, which were identified by the QC review team.
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Currently the annual report of the QC Commission is disclosed to JICPA members only, not to the public, because the quality control review is intended to educate and advise auditing firms. In the near future, however, JICPA will consider what parts of the annual report should be disclosed and how, taking the risk of public misunderstanding into account.

The Chairman of JICPA is informed of which audit firms received adverse review reports, rejected quality control review, or failed to respond to the recommendations. Then an appropriate organization, such as the Audit Practice Review Committee, which is responsible for monitoring an individual audit engagement, investigates further for disciplinary proceedings.

## **2 . Quality Control Review Standards and Procedures**

### **(1) Consistency of Evaluation Standard in the Quality Control Review Reports**

It is necessary to include the evaluation standard in the review procedures so that the QC Committee and the QC review team can make their decisions objectively and consistently. This standard must address a variety of cases, such as making a final judgment about a reviewed firm, expressing a qualified opinion, or making other recommendations for improvements. In certain areas where it is difficult to develop a detailed evaluation standard, JICPA must still develop an operations manual that includes a uniform terminology and procedures for individual reviewers to use to document evidence pertinent to the formulation of their judgment.

Obviously, it is desirable to develop an effective standard that can be implemented in order to make each evaluation consistent. However, since the companies' businesses and the internal/external environments in which they operate differ, in practice it is difficult to set a uniform evaluation standard. Therefore, often the QC Committee and QC review team have to make decisions for each individual case. In cases like these, the QC Committee and QC review team will document evidence pertinent to the formulation of their judgment. JICPA will actively research the possibility of developing an evaluation standard by accumulating review experiences.

### **(2) Quality Control System of an Audit Firm**

Currently audit corporations are required to implement their own quality control systems, while small audit firms that don't have their own systems are allowed to engage independent contractors (outside reviewers) for concurring review. Since all audit firms should implement appropriate quality control systems, JICPA should encourage them to implement effective systems through the quality control review.

JICPA agrees that in order to maintain and improve the quality of an audit, every audit firm should implement an appropriate quality control system. Although quality control in small audit firms has been improved significantly, JICPA will promote further improvements through the quality control review.

The Auditing and Assurance Practice Committee of JICPA will amend and issue the “Practice Manual for Using an Independent Contractor for Concurring Review.” The amended manual will require additional information to be reviewed, including documents concerning audit planning and the result of audit risk assessment in the process of forming an audit opinion. JICPA plans to offer seminars to its members so that the amended manual will be understood thoroughly.

### **3 . Implementation of the Quality Control Review**

#### **(1) Compliance with Auditing and Accounting Standards**

In order to improve effectiveness of the quality control review, (i) the QC review team should evaluate whether the process of forming an audit opinion is in compliance with auditing and accounting standards by examining whether the opinion is well supported by audit evidence obtained; and (ii) the review report and the recommendations should include such findings as noncompliance, if suspected by the QC review team and the QC Committee concurs as such.

The QC review team evaluates the process of forming an audit opinion as described in II. 1. (3); if the team concludes that an audit opinion is virtually not supported by audit evidence, the reviewed firm needs to respond to the recommendation of the QC review team and take corrective actions.

If any noncompliance with auditing and accounting standards is suspected, and the noncompliance relates to the reviewed firm's quality control policies and procedures, the QC Committee will express a qualified opinion. If the reviewed firm's quality control policies and procedures are not appropriate and significant noncompliance with auditing and accounting standards is identified, an adverse opinion will be expressed, and the existence of such significant noncompliance will be mentioned in the quality control review report.

#### **(2) Audit Planning and Audit Procedures Based on Risk-based Approach Methodologies**

As for risk-based approach methodologies in audit practices, the QC review team should not only (i) evaluate how the reviewed audit firm included in the audit plan its assessment of the client's internal control and the audit procedures that it planned to perform, but also refer to possible consequences that may result from an inadequate audit plan; and (ii) focus on the scope of an audit engagement and/or level of substantive testing in an engagement when they do not satisfy requirements imposed by auditing standards due to inappropriate application of risk-based approach methodologies, and issue the recommendations.

In planning an audit using risk-based approach methodologies, audit firms assess various types of risk and develop materiality thresholds based on the understanding of the business environment and other relevant information. As a result, audit firms determine the nature of audit procedures to be performed and the extent of evidence to be obtained. This means that if this kind of assessment and/or decision is not properly documented, those who are not associated with the engagement cannot tell how the auditor developed the audit plan or whether the audit was performed as planned. Audit planning is especially important when risk-based approach methodologies are used, and an appropriately documented audit plan helps ensure quality control in assigning and supervising audit assistants in the engagement. Therefore, JICPA strives to further improve the quality of an audit by:

\* making recommendations to audit firms when their documentation is inadequate,

- \* advising audit firms to develop an audit plan that is logical and consistent, and
- \* advising audit firms to perform audit work based on that audit plan.

**(3) Selection Policy of Audit Engagements to be Reviewed**

In general, the total audit hours spent and the audit fee are important indicators of the quality of an audit and of the auditor's independence. The current format of the public company list prepared by the reviewed firm does not include this information. Therefore, the format should be improved to include this information so that audit engagements to be reviewed can be selected taking these factors into account. It is also necessary to review any successor auditor's new engagements that predecessor auditors refused to continue due to high risk.

As audit hours and audit fees affect the quality of an audit as well as an auditor's independence, JICPA will improve the current format of the public company list to include this information so that audit engagements to be reviewed can be selected taking these factors into account.

Furthermore, as is seen in the recent cases reported in the media, a change of auditors may involve fraudulent accounting; therefore, a review sample should include engagements whose auditors were changed without justifiable reason.

**(4) Review Procedures on the Process of Forming an Audit Opinion**

Documentation on the process of forming an audit opinion by taking materiality thresholds and scope limitations into account is an important audit procedure, which should be thoroughly enforced.

Furthermore, in their review working papers, QC reviewers should clearly describe review procedures performed based on the quality control review standards.

An auditor is required to examine whether audit procedures have been completed and whether materiality thresholds and scope limitations have been taken into account before expressing an opinion. At present QC reviewers already ensure that auditors have documented the evaluation processes, taking into consideration materiality thresholds and audit scope limitations. JICPA plans to further strengthen these review procedures.

JICPA plans to ensure that review procedures prescribed in the quality control review standards are adequately documented in the QC reviewer's working papers.

**(5) Timing of the Concurring Review and the Quality Control Review**

The date of an audit report is important because it relates to the extent of an auditor's responsibility. However, the revised Auditing Standards do not specifically prescribe which date should be used. The date of an audit report is affected by several factors, such as laws and regulations concerning financial statement disclosure and the definition of substantial completion of an audit. The Auditing Committee Report No. 75 prescribes that a statutory audit report under the Commercial Code must be dated when an auditor completes the fieldwork, which has led to wide interpretations regarding when a concurring review should be conducted. The dating of the audit report may pose problems for the quality control review. JICPA, together with other relevant organizations, should discuss this issue and take appropriate measures.

In the International Standards on Auditing, the date of an audit report should be the day on which audit work is complete, and a concurring review should be conducted before issuing an audit report. In auditing practices in the U.S. and other countries, the date of an audit report is the day on which field work is complete, and an audit report is signed and issued after confirming that all other required procedures, such as an audit working paper review by engagement partners and a concurring review by concurring review partners, are complete. JICPA believes that current quality control review practice in Japan, which requires confirming whether a concurring review is complete before issuing an audit report under the Commercial Code, is consistent with these foreign practices.

Furthermore, JICPA agrees to further examine the issue, cooperating with other relevant organizations to improve the practice.

**(6) Follow-up Actions to the QC Reviewer's Recommendations**

The QC Committee Rule, as amended following the amendment of the CPA Law, prescribes that an audit firm is to report the status of the implementation of quality control procedures to the QC Committee annually. This gives the QC Committee a way to monitor improvements of an individual firm's quality control system. However, the QC Committee is not required to confirm whether the quality control procedures have in fact been implemented by the reviewed firm. In order to ensure appropriate follow-up actions, field reviews should be conducted where appropriate.

JICPA recognizes that follow-up actions to the recommendations should be conducted where appropriate. JICPA will decide whether to conduct field reviews, which are conducted at reviewed audit firms' offices, based on the analysis of status reports submitted by reviewed firms. At the same time, JICPA will report to and consult with the QCOB about the result of the analysis of status reports submitted by the reviewed firm and examined by the QC Committee.

**4 . Independence of Auditors**

**(1) Independence of Auditors**

Independence of auditors is fundamental to maintain and enhance public trust in audits. Therefore, the quality control review should specifically address this issue by incorporating an appropriate system for monitoring and supervising the independence of auditors. Therefore, review procedures and review tools should be improved.

JICPA fully understands the importance of the independence issue. As independence requirements become more stringent under the amended CPA Law, JICPA has been working to promote the awareness of audit firms regarding independence issues in the amended CPA Law. The Ethics Committee will issue a checklist of procedures that satisfy independence requirements under the amended CPA Law. In addition, the QC Committee plans to revise the review procedures and review tools.

**(2) Financial Independence**

The Code of Ethics, self-imposed regulations of JICPA that prescribe the financial independence of auditors, should be thoroughly disseminated and rigorously enforced. Therefore, review procedures to monitor auditors' independence related to fees received should be included in the review tools.

JICPA has been working on the review of compliance with the Code of Ethics by the reviewed firm. JICPA will continue to work to improve review tools, including procedures to monitor the reviewed firm's policies and procedures for assuring independence of auditors as required under the amended CPA Law.

**5 . Improvements to the Quality Control Review System**

In order to further improve the quality control review, effective collaboration of the QC Committee and the Audit Practice Review Committee should be promoted.

JICPA plans to promote such collaboration by sharing relevant information, including information that the Audit Practice Review Committee identifies in the course of its monitoring of specific audit engagements and, where appropriate, information the Audit Practice Review Committee gathers from public sources.

Appendix

**JICPA's Quality Control Review System**

