金融監督管理委員會
Financial Supervisory Commission

2012 CPA Firms Inspection

General Inspection Report

Financial Supervisory Commission, Taiwan

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This is an English translation version of the original Traditional Chinese text. In the event of any inconsistency between this translation and the original text, the latter version shall prevail for all purposes.

I. Introduction

Article 19 of the Certified Public Accountant (CPA) Act provides as follows: "In order to safeguard the interests of the general public and promote the good of society, the competent authority may dispatch personnel to inspect the operations and operations-related financial status of a CPA firm that has been approved to provide attestation services to public companies. A CPA firm may not avoid, impede, or refuse to cooperate with such an inspection." Inspectors from the Financial Supervisory Commission (FSC) conducted inspections on six joint CPA firms[1] during 2012. The purpose of an inspection is to improve audit quality, to ensure a CPA firm's quality control system is working properly, and to prevent the potential risk of audit failure. Additionally, the goal is to promote high-quality audits by exercising public supervision. Ultimately, what we want to do is not so much to impose punishments on auditors, as to enhance public confidence in financial statements and CPA audit opinions.

II. Domestic CPAs and CPA Firms:

(I) At the end of April 2013, there were 1,786 CPA firms, including 1,393 sole practitioner CPA firms, 346 joint CPA firms, and 47 co-location CPA firms (approximately 78%, 19.37%, and 2.63% of all firms, respectively).

(II) At the end of April 2013, there were 6,265 licensed CPAs, of whom 2,854 were registered with the National Federation of CPAs Associations in Taiwan. Among registered CPAs, there were 744 who were authorized to audit public companies' financial statements, and 2,110 CPAs who were not.

III. Inspection Principles, Focal Points, and Methods

(I) **Inspection Principles:** The FSC has adopted the supervisory model and uses a risk-based approach to inspect CPA firms. To the extent possible, the FSC provides guidance to help CPA firms establish and implement an internal quality control system that conform with regulations and generally accepted auditing standards (GAAS). When an FSC inspection reveals quality control deficiencies, the FSC requires the CPA firm to take necessary corrective remedies to

[1] A "joint CPA firm" is a firm established by 2 or more CPAs acting together as partners in organizing a joint CPA firm to engage in CPA practice under Article 20 of the CPA Act.

improve audit quality.

(II) **Focal Points of Inspections:**

1. **Review of Quality Control System:** An inspection of a firm's quality control system is carried out in accordance with the requirements of the Taiwan Statement of Auditing Standards No. 46 "Quality Control for Firms" ("SAS No. 46"). The purpose of an inspection procedure is to understand and to assess the effectiveness of the firm's quality control system. The inspection focuses on:

   (1) Leadership responsibility for quality control within the firm (tone at the top)

   (2) Independence

   (3) Acceptance and continuance of client relationships and specific engagements (risk management mechanism)

   (4) Human resources (partner evaluations, compensation and promotion actions, the appointment of the engagement team, and continuing professional development)

   (5) Engagement performance (engagement quality control review, consultation, and differences of opinion)

   (6) Monitoring (to check the CPA firm's internal inspection program and see how well it communicates on deficiencies, addresses them, and carries out ongoing monitoring)

2. **Review of Audit Engagements:**

   (1) To check the CPA firm's internal inspection program and see how well it communicates on deficiencies, addresses them, and carries out ongoing monitoring.

   (2) Audit engagements were selected for review using methods defined by the FSC. The CPA firms could not affect or limit which audit engagements were selected by the FSC for review.

(III) **Inspection Methods:**

1. **Review of Quality Control System**

(1) Understand the CPA firm's quality control policies and procedures through interviews and related documents.

(2) Evaluate the design of the inspected CPA firm's internal quality control system.

(3) Conduct appropriate compliance tests to assess the effectiveness of the quality control system.

2. **Review of Audit Engagements**

(1) Interview the engagement partner and the engagement team manager to understand the risk assessment, audit focus, and audit method.

(2) Review the working papers to examine whether the audit is in conformity with the "Regulations Governing Auditing and Attestation of Financial Statements by CPAs" and the Taiwan SAS.

(3) Use each review to examine the implementation of the CPA firm's quality control system.

IV. **About the Inspection Results:**

(I) Due to various factors (e.g. the joint CPA firm's size and characteristics, the nature of its clientele, and its risk management strategies), different firms used different approaches to achieve compliance with laws and regulations and fulfill their professional responsibilities.

(II) This general inspection report published by the FSC should not be regarded as an endorsement of a CPA's audit, nor should it be regarded as assurance that audited financial statements are free of any deficiencies, even if there was not any deficiency noted in the inspection report.

V. **Inspection Findings:**

(I) **Review of the Audit Engagements**:

1. <u>Failed to Properly Audit the Write-off of Accounts Receivable:</u> In one case, the auditor's procedure on "subsequent cash collection of accounts receivable" only documented the subsequent reconciling to the General Ledger Account, but the auditor failed to verifying the effectiveness of "subsequent cash

collection" and to examine whether accounts receivable were offset against the same parties to which the sales were made. Thus, the auditor failed to comply with Article 20, subparagraph 3.7 of the "Regulations Governing Auditing and Attestation of Financial Statements by Certified Public Accountants" (referred to as "*the Regulations*" hereinafter) in force at the time of the audit.

2. <u>Failed to Properly Assess the Presentation of Accounts Receivable</u>: In one case, for "Related-party Receivables" with a repayment period longer than the normal three months, the auditor did not assess whether those receivables should be reclassified as "Other Receivables" as required under Interpretation No.167 issued on July 9 2004 by the Accounting Research and Development Foundation (Taiwan's accounting standards setting organization).

3. <u>Failed to Properly Perform Procedure of Audit Sampling</u>: Article 20, subparagraph 3.1 of *the Regulations* provides that the auditor shall include "any sales customer newly listed during the present period as one of the top ten sales customers" in the audit sample, to identify whether any irregularity exists in the transactions. However, in one case, the auditor did not comply with this requirement.

4. <u>Failed to Properly Evaluate Internal Control System</u>: In one case, the auditor did not evaluate the system of internal controls over "Financial Assets/Liabilities at Fair Value Through Profit or Loss" and "Long-Term Equity Investments under Equity Method" to verify the reliability and completeness of the classification, calculation, and recording. Thus, the auditor violated Article 20, subparagraphs 2.1 and 8.1 of *the Regulations.*

5. <u>Failed to Properly Perform Confirmation Procedures</u>:

    (1) In one case, when performing confirmation of "related party transactions," "accounts receivable," and "long-term equity investments," the auditor failed to adequately document the audit trail showing the preparing, sending, and receipt of replies to the confirmation requests. Thus, the auditor violated Article 22 of the Regulations and Article 29 of Taiwan SAS No. 38 "External Confirmations."

(2) In one case, for responses to "Accounts Receivable Confirmations" which did not match with book balance, the auditor only obtained the reconciliation sheet provided by the client. The auditor did not verify or audit the items of reconciliation, in violation of Article 35 of Taiwan SAS No. 38..

(3) In one case, the auditor received responses to "Accounts Receivable Confirmations" by fax without verifying their reliability or veracity. Thus, the auditor violated Article 33 of Taiwan SAS No. 38.

6. Failed to Properly Assess Impairments on Assets: In one case, for "fixed assets, intangible assets, long-term equity investments, and invested companies with an operating loss," the auditor did not ascertain whether there was any indication that any of those assets may be impaired, nor did the auditor document the analysis with supporting materials. Hence, the auditor did not comply with Article 20, subparagraphs 8.12 and 9.17, or with Article 22 of *the Regulations.*

7. Failed to Properly Audit Physical Inventory Observation or Inventory Ownership:

(1) In one case, the auditor did not ascertain the ownership of any inventory in transit and not document the audit results. Thus, the auditor violated Article 20, subparagraph 5.12 of *the Regulations.*

(2) In one case, when observing physical inventory, the auditor did not document the sampling ratio and checking records. This was a violation of Article 22 of *the Regulations.*

8. Failed to Properly Evaluate the Work of Another Auditor:

(1) In one case where the financial statements of a subsidiary had been audited by another CPA, the principle auditor failed to obtain a written declaration of impartiality and independence from the subsidiary's CPA as required by Taiwan SAS No.15. Hence, the auditor did not comply with Article 8 of *the Regulations.*

(2) In one case where Long-Term Equity Investments under

Equity Method had been audited by another CPA, the engagement team stated that it had evaluated the other auditor's work in the manner required under Article 5 of Taiwan SAS No. 15 "Using the Work of Another Auditor" and Article 7, paragraph 3.2.3 of the "Regulations Governing the Preparation of Financial Reports by Securities Issuers," but the engagement team did not document the audit process with relevant audit evidence or prepare audit working papers on the basis thereof. That was a violation of Article 22 of *the Regulations.*

8. Others matters:

(1) In one case, the auditor did not ascertain whether the audited entity had substantive control over investee companies in which it held an equity stake of more than 50%. Hence, the auditor did not comply with Article 22of *the Regulations.*

(2) In one case, for the accounting treatment of revenue recognition, the auditor did not document the determination basis, which was a violation of Article 20, subparagraph 3.4 of *the Regulations.*

(3) In one case, for "financial assets measured at cost –non current," amounts shown in the audit working papers did not match with those in the accounting items on financial statements, but the auditor did not effectively audit the above difference. Thus, the auditor did not comply with Article 2 of Taiwan SAS No.1.

(4) In one case, the auditor did not ascertain whether the audited entity had complied with statutory provisions as well as the established operating procedures for client's endorsements and guarantees. Hence, the auditor violated Article 20, subparagraph 20.1 of *the Regulations.*

(II) **Review of the Quality Control System:** After evaluating the overall audit quality of the inspected CPA firms, the FSC inspection team found the following defects in the firms' quality control systems:

1. Leadership Responsibility For Quality Control Within the Firm

(1) Within the firm's policies and procedures for quality

control, rules pertaining to the establishment of performance evaluation criteria failed to give consideration to the responsibility of personnel for the firm's quality control system. The firm also failed to document its partner evaluation system. These deficiencies constituted violations of Article 11 of SAS No. 46.

(2) The firm did not use training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda to convey to employees the fact that its quality policies and procedures recognize and reward high-quality work. This was a violation of Article 59 of SAS No. 46.

2. **Ethical Requirements**

(1) The firm did not establish policies and procedures regarding consideration of the impact of self-interest, self-review, advocacy, familiarity, and intimidation on independence, as required under Articles 8 to 10 of the "Norm of Professional Ethics for Certified Public Accountant of the Republic of China, No.10." Thus, the firm did not comply with Article 15 of SAS No. 46.

(2) The firm did not establish policies and procedures with specific mechanisms for the scrutiny of staff independence. Neither did the firm implement any audit procedure to ascertain auditors' independence. Hence, the firm violated Article 16 of SAS No.46.

(3) Article 20 of SAS No.46 requires an audit firm to adopt criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time. However, the firm did not comply with this requirement.

(4) The firm did not hold education and training activities to reinforce the fundamental principles of professional ethics. Hence, the firm did not comply with Article 64 of SAS No.46.

(5) Article 68 of Taiwan SAS No. 46 requires that the engagement auditors of listed companies should be rotated within a certain number of years (normally no more than 7 years), and that they cannot resume work for a listed company until after a certain cooling off period (normally no more than 2 years). The firm failed to establish the policies or procedures regarding this requirement.

(6) The firm failed to include the subject of independence in its educational material and personnel evaluation checklists, thereby violating the firm's own policies and procedures.

3. **Acceptance and continuance of client relationships and specific engagements**

(1) The firm did not include the relevant evaluation forms for acceptance and continuance of engagements (such as client acceptance evaluation forms and audit engagement continuance evaluation forms) in its quality control policies and procedures. Hence, the firm did not comply with Article 21 of SAS No. 46.

(2) The firm did not effectively assess the acceptance and continuance of engagements, nor did it consider the possible effects of identified issues. Thus, the firm did not comply with Article 24 of SAS No. 46.

(3) In its "new client acceptance evaluation form," the firm did not list client integrity among the items to be considered. Hence, the firm failed to implement Article 24 of SAS No. 46.

(4) The firm did not establish policies and procedures regarding withdrawal from an engagement or from both the engagement and the client relationship. The firm did not document significant matters, consultations, conclusions, or the basis for the conclusions when withdrawing an engagement. Thus, the firm violated Article 73 of SAS No.46.

4. **Human resources**

(1) The firm did not establish the specified evaluation procedures regarding professional competence and capabilities, so as to reasonably verify that the firm had sufficient personnel. Thus, the firm did not comply with Article 26 of SAS No.46.

(2) The firm's human resources policies and procedures did not include qualification requirements for prospective employees. Hence, the firm did not comply with Article 74 of SAS No.46.

(3) The firm did not establish policies and procedures to require each partner and staff member to take a minimum number of annual training hours, nor did it enforce the system. Thus, the firm violated Article 76 of SAS No.46.

(4) The firm set out policies and procedures for partner evaluations in its "Partnership Contract," but did not establish a direct connection between promotion to partner and engagement quality .Hence the firm did not comply with Article 77 of SAS No.46.

5. **Engagement Performance**

(1) The firm's quality control material (e.g. audit manual, standardized forms, checklists, and questionnaires) was not updated or revised in line with the newly issued Taiwan Statements of Auditing Standards, or with IFRSs. The firm also failed to keep an audit trail of its revisions or updates. Hence, the firm did not comply with Articles 29 and 82 of SAS No. 46.

(2) The firm did not set out criteria regarding whether or not to perform engagement quality control (EQC) reviews for the audits of financial statements of unlisted companies. Thus, the firm violated Article 32 of SAS No. 46.

(3) In one case, the EQC review report was dated after the audit report date, which was a violation of Article 32 of SAS No. 46.

(4) The firm failed to set out time limits for completion of the assembly of final engagement files, thereby violating Articles 43, 102, and 103 of SAS No. 46.

(5) The firm did not establish policies and procedures for maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of working papers. Thus, the firm failed to comply with Article 44 of SAS No. 46.

(6) The firm did not conduct the EQC review in a timely manner at appropriate stages during the engagement. Thus, the firm violated Article 93 of SAS No. 46.

(7) The firm's EQC review policies and procedures permit members of senior management at the level of deputy assistant general manager or higher to be an EQC reviewer for an audit of the financial statements of a listed company, which was in violation of Article 95 of SAS No. 46.

(8) The firm did not adopt policies and procedures to avoid the unauthorized alteration or loss of working papers. Accordingly, the firm failed to comply with Article 105 of SAS No. 46.

6. **Monitoring**

(1) The firm failed comply with the Article 46 and 47 of SAS No. 46, as follows:

A. It failed to monitor the operation of each element of the firm's quality control system, or to perform an inspection per year.

B. It only inspected selected local offices of the firm, without inspecting the firm-wide quality control system.

C. Those performing EQC reviews were found involved in monitoring of the engagements.

(2) The firm failed to communicate at least annually the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm. Thus, the firm did not comply with Article 52 of SAS No. 46.

(3) The firm did not document its response to complaints and allegations, thereby violating Article 56 of SAS No.

46.

(4) The firm did not specify a monitoring cycle that spans a certain number of years, thereby violating Article 114 of SAS No. 46.

7. **Documentation of the Quality Control System**

(1) The firm failed to comply with Articles 57 and 58 of SAS No. 46, as follows:

A. It failed to document the monitoring of the elements of the quality control system.

B. It failed to appropriately document its operation of each of the elements of the quality control system.

C. It failed to document its retention period policies.

D. It failed to perform monitoring procedures.

(2) The firm did not appropriately document either the monitoring of its quality control system, or the measures that it took to address deficiencies. Thus, the firm did not comply with Article 121 of SAS No. 46.

V. This general inspection report is a summary of the major deficiencies observed during the FSC's inspection conducted in 2012. This purpose of this report is to alert CPA firm to these deficiencies, and to spur the firms to effectively establish internal quality control systems that are in conformity with regulations and the GAAS. The FSC expects that its annual inspections will prompt each CPA firm to inspect its own internal audit quality control system and take it upon itself to improve its internal quality control system. We expect that this would enhance the quality of CPA audits and bolster public confidence in audit quality and capital market transparency.

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The Financial Supervisory Commission (FSC, Taiwan) was established on 1 July 2004 as the competent authority responsible for development, supervision, regulation, and examination of financial markets and financial service enterprises in Taiwan. The FSC seeks to ensure safe and sound financial institutions, maintain financial stability, and promote the development of our financial markets. Since its establishment, the main goals of the FSC have been to: create a sound, fair, efficient, and internationalized environment for financial industry, strengthen safeguards for consumers and investors and help financial industry achieve sustainable development.