



**金融監督管理委員會**  
**Financial Supervisory Commission**

2010 CPA Firms Inspection

# General Inspection Report

**Financial Supervisory Commission, Taiwan**

July 2011

*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 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 three medium-sized joint CPA firms<sup>1</sup> during 2010. 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 May 2011, there were 1,481 CPA firms, including 1,114 sole practitioner CPA firms (approximately 75% of all firms), and 313 joint CPA firms (approximately 21% of all firms). Among these firms, 83 were authorized to provide attestation services to public companies.
- (II) At the end of May 2011, there were 5,765 licensed CPAs, of whom 2,793 were registered with the National Federation of CPAs Associations in Taiwan. Among registered CPAs, there were 725 (299 at the big-four firms and 426 CPAs at other firm) who were authorized to audit public companies' financial statements, and 2,068 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).

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<sup>1</sup> 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.

When an FSC inspection reveals quality control deficiencies, the FSC requires the CPA firm to take necessary corrective remedies to 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 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:** Inspection procedures for each engagement are determined on a case-by-case method. The FSC annually sets the focal points of inspections and uses a risk-based approach to select which audit engagements are to be reviewed.

**(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. Inspection Findings:**

- (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. The FSC's inspection procedures mainly included: (1) a review of selected audit engagements to evaluate how the firm conducts audits; and (2) a review of the operation of the firm's quality control system.

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

1. 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.
2. 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
3. The FSC inspection team identified the following major audit deficiencies:

**Failure to Properly Perform Confirmation Procedure**

- (1) In one case, the auditor failed to document the review process, or confirmations collected by fax from export

customers were not recorded in the working papers. The auditor also sometimes failed to provide any evidence to show how he or she verified the reliability of the confirmations, as required by the Taiwan SAS No. 38 "External Confirmations."

- (2) In one case, when performing confirmation procedures, the auditor failed to maintain control over the process of selecting those to whom a request would be sent, the preparation and sending of confirmation requests, and the responses to those requests. The auditor did not contact those who failed to respond, or perform alternative audit procedures where no responses were received to a positive external confirmation request. Thus, the firm violated the Article 29 and 31 of the Taiwan SAS No. 38.
- (3) In one case, the auditor performed the Account-Receivables Confirmation via email, but violated the Article 33 of the Taiwan SAS No. 38 by failing to document the evaluation of the reliability of those confirmations in the working papers.
- (4) Article 20, subparagraph 12.2 of the "Regulations Governing Auditing and Attestation of Financial Statements by Certified Public Accountants" (referred to as "*the Regulations*" hereinafter) provides that the auditor shall perform the audit procedures to confirm the borrowing balances, interest rates, repayment periods, amounts, material covenants, and the collateralization status, but in one case the auditor did not conduct those required audit procedures.

#### Failed to Properly Audit Long-Term Equity Investments

- (5) Article 7, paragraph 3.2.3 of the "Regulations Governing the Preparation of Financial Reports by Securities Issuers" provides that when investment gain or loss is recognized, if the financial reports of an invested company have not been prepared in accordance with Taiwan GAAP, those financial reports shall first be adjusted to achieve conformance before they may be used to recognize investment gain/loss. In one case, the Long-Term Equity Investments under Equity Method was used to recognize

the investment gain/loss from the invested company's financial statements audited by the other CPA, but the FSC staff found that the engagement team failed to comply with the above Regulations. The working papers did not document the performance of the evaluation on: [a] whether the invested company's financial reports prepared under Taiwan GAAP; [b] its differences; and [c] whether it would affect the audited company's financial report.

- (6) In one case, when the firm conducted an on-site inventory of securities acquired by subsidiaries or through investments accounted for using the equity method, the firm only checked some investment items to the count-sheet without fully physical counting/inspecting the original copy of the physical securities certificates and source documents. The firm also failed to ascertain whether those securities were provided as security, pledged, or otherwise subject to any restriction or limitation. Those audits were thus in violation of Article 20 subparagraphs 8.3 and 8.5 of *the Regulations*.
- (7) In one case, the auditor's assessments on "whether the audited entity had substantive control over the invested company or related party to prepare the consolidated financial statements, lost significant influence, and whether the subsidiaries had a significant effect on the audited entity," were not documented in the working papers. The auditor thus violated the Article 20, subparagraphs 8.6 and 8.7 of *the Regulations*.
- (8) In one case, the auditor did not document the difference between the physical count and book balance of the audited entity's stocks or alternative audit procedure, did not completely fill in the confirmation-control-sheet of the long-term equity investments, and did not document the audit process of the long-term equity investment, including whether those with significant influence were valued by the equity method, whether the audited entity had substantive control over invested company or related party to prepare the consolidated financial statements. In short, the auditor failed to compile the record together

with relevant audit evidence obtained, into working papers, thereby violating Article 22 of *the Regulations*.

#### Failed to Properly Audit Operating Revenues

- (9) In one case, the auditor failed to incorporate in the audit sample any new sales customer from the present period that was a related party and had entered into any transaction of a material amount with the audited entity, or any sales customer newly listed during the present period as one of the top 10 sales customers, to identify whether any irregularity exists in the transactions. Thus, the auditor did not comply with Article 20, subparagraph 3.1 of *the Regulations*.
- (10) In one case, the audited entity recognized sales revenues when the goods were delivered to the consignment company, but its risk and rewards were not transferred. Moreover, the auditor did not verify whether the timing of the recognition of sales revenues complied with Section 13 of the Taiwan Statement of Financial Accounting Standards (SFAS) No. 32 "Accounting for Revenue Recognition." The auditor failed to ascertain the appropriateness of the book balance and classification of the operating revenues. Additionally, when the auditor performed substantive audit procedures, the auditor did not follow Article 20, subparagraph 3.4 of *the Regulations*, which provides that the auditor shall ascertain whether the audited entity recognized sales as required in SFAS No.32.
- (11) In one case, the auditor did not conduct a further audit when sales returns showed different amounts from the evidence of different sources. In other words, the firm violated Article 10 of Taiwan SAS No.4 "Audit Evidence."
- (12) For sales to a substantively related party, in one case the auditor did not conduct adequate audit procedures such as using the external confirmation on the information and account of the related party transactions, thereby failing to obtain sufficient and appropriate audit evidence to verify whether those transactions with the related party were properly recorded and disclosed. In other words, the

auditor did not follow Article 13 and 14 of Taiwan SAS No. 6 "Related Parties."

Failed to Properly Audit Account Receivables

- (13) In one case, when performing the substantive test, the auditor did not verify whether material accounts receivable were offset against the same parties to which the sales were made. This audit violated the Article 20 paragraph 3.7 of *the Regulations*.
- (14) In one case, the working papers did not document the audit procedure of the physical count on Note Receivables on hand and bank notes for collection and of the verification on the supporting documents for such bank collections. Thus, the auditor did not comply with Article 20, subparagraph 3.8 of *the Regulations*.
- (15) In one case, when performing the audit on the adequacy of the "allowance for account receivables" (hereafter, "allowance"), the auditor did not effectively check the amount of the "Accounts Receivable Aging Schedule" to ascertain the appropriateness of the manner and amount of the allowance, thereby violating Article 20, subparagraph 3.11 of *the Regulations*.
- (16) Article 20, subparagraph 3.14 of *the Regulations* provides that the auditor shall ascertain whether there is any note or account receivable due from a related party or investee company that exceeds the normal loan term and that is required to be reclassified under "other receivables". However, in one case, the auditor failed to document the related audit procedure.
- (17) In one case, for the audit of the "write-off of material accounts receivable," the aggregate figure for write-offs obtained through the sample audit was below determined materiality for the company's financial statements as a whole, but the auditor failed to consider the audit risk for particular classes of account balances or transactions and use the findings as the basis for determining materiality. This failure was a violation of Article 22 of Taiwan SAS No. 24 "Materiality and Audit Risk."



### Failed to Properly Audit Inventory

- (18) Article 20, subparagraph 5.7 of *the Regulations* provides that the auditor shall select two time periods, one before and one after the balance sheet date, and check all supporting source documents for each period, to ensure that there has been a proper cut-off of operating overhead. However, In one case, the auditor failed to effectively implement this requirement.
- (19) In one case, the auditor failed to design the audit plan and program of observing physical inventory before conducting the physical count, thereby violating Article 4 of Taiwan SAS No. 9 "Physical Inventory Observation" (hereinafter, "SAS No. 9").
- (20) In one case, for inventories held by outside custodians, the auditor did not send out confirmations to the custodians, thereby violating Article 12 of SAS No. 9.

### Other matters

- (21) Article 20, subparagraph 2.7 of *the Regulations* provides that the auditor shall ascertain whether the audited entity has evaluated financial assets for possible impairment on the balance sheet date, and evaluate the appropriateness of the estimation of the recoverable amount of such an asset, and of the corresponding accounting treatment, by the audited entity. However, in one case, the auditor failed to effectively implement this requirement.
- (22) Article 20, subparagraph 9.1 of *the Regulations* provides that, if due to statutory restrictions the title to any particular asset is not registered under the name of the audited entity for the time being, the auditor shall ascertain whether any safeguards are in place and whether a proper explanation has been provided in a footnote. In one case, the auditor found that the title to one audited entity's farm was registered under the name of the entity's chairman of the board of directors, but the auditor failed to ascertain this asset with proper safeguards, thereby violating this requirement.

- (23) In one case, the auditor failed to ascertain whether the audited entity's "loans to and endorsements/guarantees for others" had been handled in compliance with statutory provisions as well as the established operating procedures. Thus, the auditor violated Article 20, subparagraphs 4.3 and 20.1 of *the Regulations*.
- (24) In one case, the audited entity had collected endorsement and guarantee income from wholly-owned subsidiaries, but its auditor did not "analyze any income and expense items that were material in amount or unusual in nature and ascertain the status of all supporting source documents and how they have been recorded," as required in Article 20, subparagraph 22.2 of *the Regulations*.
- (III) **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 audited entities' quality control systems:
- 1. Leadership Responsibility For Quality Control Within the Firm**
- (1) The firm's highest decision-making body was the Partners Committee, which met only once a year. Clearly, this Committee was not the highest decision-making unit in terms of day-to-day operations.
- (2) The firm's quality control manual required that the performance of the firm's quality control system be given due consideration in personnel performance evaluations, compensation, and promotions. However, the firm did not actually accord this factor independent consideration, and it failed to incorporate it into either personnel performance evaluations or compensation and promotion actions. The firm also did not establish a partner evaluation system in documentation, thereby violating Article 11 of SAS No. 46.
- (3) The firm did not document that the responsible person for the firm's quality control system (i.e. the firm's president) regularly reviewed the relevant units' operation of the firm's quality control system.

## 2. Independence

- (1) The firm did not specify the ethical requirements of partners, and did not specify the policies and procedures a follow-up monitoring mechanism after the emergence of independence issues with respect to a particular auditor. Neither did the firm establish rules governing the actions to be taken to resolve such situations when notified of breaches of independence requirements. This was a violation of Article 18 of SAS No. 46.
- (2) The CPA firm only required the signature of a "declaration of impartiality and independence" every year, and failed to carry out any audit procedure to ascertain the adequacy of the declaration.
- (3) The CPA firm only required the signature of a "declaration of impartiality and independence" every year, and failed to carry out any audit procedure to ascertain the adequacy of the declaration.
- (4) The audited entity did not observe the required format in disclosing the audit fee in the annual report of the shareholder's meeting, and the auditor did not discover the deficiency and ask for correction. This was a violation of the "*Regulations Governing Information to be Published in Annual Reports of Public Companies.*"

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

- (1) The firm did not conduct an assessment before accepting a new client or continuing an existing client, nor did the firm consider the internal control system and the integrity of the client. This was a violation of Article 21, subparagraph 1 of SAS No.46.
- (2) Article 21, subparagraph 2 of SAS No.46 requires an audit firm to consider whether it has the competence, time, and resources to undertake a new engagement from a new client, whether it can handle the specific requirements of the review, and whether it has sufficient staff. However, the firm failed to abide by this requirement.

- (3) The firm did not consider whether it was appropriate to accept the engagement when a potential conflict of interest would arise from the existing client. Hence, the firm did not effectively implement Article 23 of SAS No.46.
- (4) The firm did not establish policies and procedures governing withdrawal from an engagement or from both the engagement and the client relationship. This was a violation of Article 73 of SAS No.46.
- (5) The firm's policy stated that for financial statement audits of listed companies, the engagement partner shall be rotated at least once every 5 years, which was found different from the 7-year rotation period set out in the engagement documents. Also, the firm did not establish a control procedure to govern the rotation of the in-charge auditor and engagement partner.
- (6) Regarding evaluations on whether to continue client relationships, the quality control manual requires the firm to consider the statutory agent and lawsuits. However, the firm did not include that consideration in its "working paper documenting the assessment of the acceptance of engagements."
- (7) The firm's quality control manual specified the withdrawal procedure and matters to be considered in connection therewith. However, the firm did not document the assessment process in its "Withdrawal Form."

#### **4. Human resources**

- (1) The firm required auditors and staff to take a certain minimum number of annual hours of professional training, but failed to enforce the system.
- (2) The firm did not establish policies and procedures governing the assignment of engagement teams, thereby violating Articles 27 and 28 of SAS No. 46.

#### **5. Engagement Performance**

- (1) The firm did not define the nature and scope of consultations, nor did it establish policies and procedures

regarding consultations on contentious matters. This was a violation of Articles 31, 87, 88, and 89 of SAS No. 46.

- (2) The firm's Quality Control Manual adopted rules regarding matters that must be considered by engagement quality control (EQC) reviewers, but the firm's EQC review checklist did not fully match its requirements. This was a violation of Articles 36, 92, and 94 of SAS No. 46.
- (3) The firm did not adopt policies and procedures for the replacement of an EQC reviewer whose ability to perform a review is impaired. Hence, the firm violated Articles 37, 39, and 96 of SAS No. 46.
- (4) The firm's policies and procedures for documentation of the EQC review failed to require documentation that "the reviewer was not aware of any unsolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate," and the date when the firm completed the EQC review was after the audit report date. These deficiencies constituted violations of Article 40 of SAS No. 46.
- (5) The firm failed to establish policies and procedures for "dealing with and resolving differences of opinion between the engagement team and the reviewer." This was a violation of Articles 41, 42, 100, and 101 of SAS No. 46.
- (6) The firm neither established policies and procedures for "completing assembly of the final engagement file," nor practically addressed it. Hence, the firm did not comply with Articles 43, 102, and 103 of SAS No. 46.
- (7) The firm failed to establish policies and procedures regarding the retrieval period of engagement documentation (i.e. working papers), related control procedures, or control measures to prevent unauthorized alteration or loss of working papers. Thus, the firm violated Articles 44, 105, 106, 107, 109, 110, and 111 of SAS No. 46.

- (8) The firm failed to establish policies and procedures regarding the retention period for documentation of the operation of each element of its quality control system. This was a violation of Article 58 of SAS No. 46.
- (9) The firm adopted a rule requiring that "the EQC review must be conducted in a timely manner at appropriate stages during the engagement to allow significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction before the date of report," but did not effectively implement it on certain engagements. In one case, the firm conducted the EQC review after the date on which the engagement partner finished the audit working papers and the audit report. Hence, the firm did not comply with Article 93 of SAS No. 46.
- (10) The firm's EQC review policies and procedures required that manager/assistant manager must be eligible to be an Engagement Quality Control Reviewer for an audit of the financial statements of a listed company, which was in violation of Article 95 of SAS No. 46.
- (11) The firm's working papers were primarily in hardcopy form. In order to comply with Article 105 of SAS No.46, the firm needed to design and implement policies and procedures designed to avoid unauthorized alteration or loss of the working papers and maintain their confidentiality, safe custody, integrity, accessibility, and retrievability. As for high risk engagements (such as those under investigation by the law enforcement authorities), the firm failed to establish risk control policies and procedures regarding the confidentiality, safe custody, integrity, accessibility, and retrievability of their working papers.
- (12) The firm's policies did not specify the frequency of EQC reviews at public companies.

## 6. **Monitoring**

- (1) The items of the firm's engagement monitoring checklist did not cover enough of the elements in its quality control system. Additionally, one of the firm's stated criteria for

selection of individual engagements for monitoring put emphasis on the selection of "case with high inherent risk," but the firm failed to effectively implement it.

- (2) The firm did not adopt policies and procedures regarding appointment of the person in charge of the monitoring process, nor did it assign responsibility for the monitoring.
- (3) The firm failed to comply with its established policies and procedures for monitoring.
- (4) The firm failed to take follow-up procedures to address engagement deficiencies discovered during the monitoring process.
- (5) The firm failed to establish policies and procedures designed to provide reasonable assurance that it had dealt appropriately with complaints and allegations, as required by Articles 54 through 56 of SAS No. 46.

V. This general inspection report is a summary of the major deficiencies observed during the FSC's inspections conducted in 2010. The purpose of this report is to alert CPA firms 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.