Review Engagement of Interim Financial Information in Japan

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I. Introduction

Under Japan's Financial Instruments and Exchange Act, for the fiscal years beginning on or after April 2008, it is mandatory for all listed companies to disclose not only their annual financial statements in the form of Securities Report but also their quarterly financial statements in the form of quarterly reports. Apart from Japan, such quarterly disclosure systems are required by law only in the United States, Canada, and some countries of the European Union. However, in the United States, quarterly financial statements serve as an interim process or a provisional value for annual financial statements because quarterly reports are based on estimates. In Japan, we have adopted a quarterly report system based on actual values. This is because when the introduction of a quarterly report system was being considered here, the interim financial statements that were being used as interim reports had made a transition from being based on earlier estimates to being based on actual values. For this reason, we took cue from Canada where quarterly reports were prepared on the basis of actuals.

Hence, although some interim accounting procedures as well as disclosures were being acknowledged, it posed a huge burden on finance and accounting section in companies that made the quarterly account statements because they had to indicate their final financial values for each quarter. As a result, measures were taken to ease the burden and they were implemented from financial year 2011 onward. These measures were administered by modifying quarterly accounting standards and required just 25% of the companies to disclose their cash flow statement for the first and the third quarters. Even so, it was found that steps such as streamlining the disclosure or notes in the summary of financial reports did not necessarily permeate across the board because companies feared criticism for retracting their stance on disclosure (Ernst & Young ShinNihon LLC, 2011).

As far as the issue of guaranteeing the credibility of the quarterly financial statements is concerned, the framework of the quarterly report system in Japan as well as some other countries requires such statements to be reviewed by an external auditor. In Japan, this review is called the *quarterly review* and is carried out as one of the *audit certification*

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activities under Article 193-2 Section 1 of the Financial Instruments and Exchange Act. This quarterly review has been conducted for a long time in various countries as the main certification activity provided by certified public accountants. Even in the International Auditing and Assurance Standards Board (IAASB), which serves as the basis for the quarterly review standards in Japan, International Standard on Review Engagements (ISRE) 2400 *Engagements to Review Financial Statements* and ISRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* have been made public. The same holds true for the Statement on Standards for Accounting and Review (SSARS) and Statements on Auditing Standards (SAS) 100 *Interim Financial Information* by the American Institute of Certified Public Accountants. The latter in each of these are similar to Japan, whereby these are review engagements stipulated for financial information made public during the period, based on auditing of annual financial statements; however, a general review engagement standard on the lines of ISRE 2400 or SSARS, which presume the existence of independent contracts, is not available in Japan. This is because no such actual practices came to be fostered in Japan and the Japanese Institute of Certified Public Accountants introduced the review engagement for quarterly financial statements (legal disclosure documents) as a legal system without setting out a code of practice.

Even though the quarterly review in Japan is no different from that in other countries as far as using the general procedure of utilizing Inquiries and Analytical Procedures as the principal process for review engagements is concerned, there are some strict requirements that are not present in other countries. Apart from the obligation to submit a report and public declaration, along with following the quarterly review procedures, these requirements also include certain procedures regarding the going concern assumption.

Therefore, from the viewpoint of the international comparability of quarterly financial reports, it is important to demonstrate the kinds of actual engagements being carried out in Japan where the origin and characteristics of the quarterly review differ from those of other countries. Particularly, in the case of Japan, it is being pointed out that comparatively low audit fee make it difficult to secure audit time; and even internal control evaluation or certification procedure, which should be carried out during the annual audits, is being conducted within the time allocated for quarterly reviews. It is also necessary to appropriately comprehend such a reality as a problem faced during actual engagement in current circumstances.

Furthermore, there is a trend in Europe these days to abolish the mandatory quarterly report and legal system as well as listing regulations, as can be seen in a report known as the *Kay Review* (2012) by Professor John Kay of England. In Japan, the Ministry of Economy, Trade, and Industry has initiated a similar investigation since July 2013 under the *Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors* project. Thus, it can be said that Japan too is in the midst of reconsidering the quarterly report system from a critical perspective.

Against this background, this study is an attempt to investigate the true picture of the quarterly review system being implemented in our country, from the perspective of audit and guarantee engagement.

II. Previous Studies on Quarterly Review

From the standards and codes of practice for quarterly reviews in Japan, a number of studies have illustrated the discrepancies in the content and level of assurance in audit and review for quarterly reviews held as part of annual audits (Matsumoto, 2005; Inoue, 2009; Kojima, 2009). Furthermore, there is a study by Naito (2008), which examines the level of assurance from the IAASB *International Framework for Assurance Engagement* (IAASB, 2003) and the *Opinion on the Framework of Assurance Engagement of Financial Information* (Business Accounting Council, 2004) in Japan, and a study by Matsumoto, Machida, and Sekiguchi (2011), which verified the contents of reviews and quarterly reviews by comparing the systems in different countries. Among studies conducted abroad, the one by Wiedman (2007) investigated the legalization of quarterly review engagement as a system in Canada.

Apart from conceptual and comparative studies based on such standards and codes of practice, there is also an empirical study by Sakuma (2012) using our archival data (mainly public declaration of financial and other data). This empirical analysis is based on a comparative study of the cumulative abnormal return (CAR) of both interim audit and quarterly review to find out whether the capital market correctly grasps the assurance level in the quarterly review.

On the other hand, a research named “A Study of the Current State of Quarterly Information Disclosure in Japan” was carried out under the *Research Project on the Design for the Optimum Disclosure System* by the Research Institute of Economy, Trade, and Industry. This study used a survey to find out how (1) listed companies creating the quarterly financial statements, (2) auditors providing assurance in the form of audit certificates for such financial statements, and (3) analysts using such certified financial statements differentiate between audit certification from annual audits and audit certification from quarterly audits, and how they create, assure, and use information. Especially, the study made a concrete survey on “what kind of auditors” does “what kind of procedures” for “how many hours.”

As a result, it was found that as far as the companies were concerned, all child companies were preparing individual financial statements as required by quarterly accounting standards (Accounting Standards No. 12, “Standards of Quarterly Financial Statements”); based on these statements, the companies were preparing a combined quarterly financial statement. Thus, it was clear that in this way, they were using a fundamental process to prepare the financial statements and compiling a combined quarterly financial statement in a very short period of time. Moreover, it was found that the hourly cost of this process for preparing the statements had doubled compared to earlier days when quarterly reports had not been systemized yet, and more than half of this increased hourly cost was incurred in "dealing with the auditors."

It was also found that the analysts consider the quarterly financial statements (summary of financial statements and quarterly reports) useful for gathering information about decision making in the companies, and more than 80% of analysts expect a relatively huge involvement by the auditors in the quarterly summary of financial statements. With such expectations in the background, it is assumed that the accounting heads in the companies have some explicit and implicit demands, which in turn leads to an increase in the hourly cost of accounting engagements.

And it became clear that although the quarterly review procedure mainly comprises inquiries and analytical procedures by the auditors, more than half of them were carrying out substantive procedures during quarterly reviews instead of annual audits. For the auditors, this led to more than half of the rise in hourly cost.

Moreover, it was found that both analysts and auditors (users) consider the assurance level for quarterly reports to be 60–80% (mean 66.0%; median 60.0%; standard deviation 14.9%) and there is an established common social understanding (IAASB, 2002) with regard to a *moderate level* of the quarterly review standard.

In this study, we will focus on auditors and investigate the problems that have not yet been solved in previous studies – for example, why auditors conduct substantive procedures during quarterly reviews.

III. Overview of the Survey and Research Model

We conducted an experimental survey based on a hypothetical case. The survey was conducted with the cooperation of many (major and midsized) auditing companies and involved certified public accountants with hands-on experience of quarterly review engagements and at a position where they could formulate engagement plans for quarterly reviews. For the survey, we created concrete models for a bad and good company based on the quarterly financial statements of real companies. A bad company is one where there is a relatively high possibility of material misstatement hidden in the statements due to low performance, resulting in poor financial conditions. In other words, the risk of material misstatement is relatively high in the case of these bad companies. Good companies are the ones where the risk of material misstatement in the same category is relatively low. Based on these models, we asked the subjects to respond to the following points, keeping in mind their experiences during actual quarterly review engagements.

1. How do you set the materiality threshold while formulating a quarterly review plan?
2. How much credibility do you think you have secured in the limited assurance level attached to quarterly financial statements through quarterly reviews?

3. Which accounts of financial statements do you think are at a high risk of material misstatement while formulating a quarterly review plan?
4. What are the mandatory procedures for validation, and which points would you like to assert through such procedures for each of these accounts?
5. For these accounts, which of the quarterly review procedures would you implement as (a) mandatory procedures, (b) additional procedures, and (c) further procedures to be implemented when there is scope to do so?

This survey was carried out from December 20, 2012 to March 20, 2013, and the subjects of the survey were certified public accountants from major and midsized auditing companies who were at a position to formulate engagement plans for quarterly reviews. The attributes of the subjects in their company—*type of industries engaged*, *years of experience*, and *occupational position*—are shown in figures 1, 2, and 3 respectively. In this

[Figure 1] Industries engaged

01: Fishery/agriculture and forestry 4	02: Mining 1	03: Construction industry 50	04: Food products 34
05: Textile goods 14	06: Pulp/paper 5	07: Chemistry 20	08: Medical goods 19
09: Petroleum and coal products 3	10: Rubber goods 7	11: Iron and steel 10	12: Glass/earth products
13: Nonferrous metals 6	14: Metal goods 17	15: Machinery 37	16: Electronic goods 24
17: Transport equipment 11	18: Precision machines 11	19: Other goods 25	20: Electricity/gas industry 5
21: Land transport industry 15	22: Shipping industry 9	23: Aviation industry 3	24: Warehousing/ transportation 16
25: Information/communication 52	26: Wholesale business 51	27: Retail industry 60	32: Real estate 48
33: Service industry 64	99: Others { } (Please write in detail) 28 entries, of which 18 were engaged in the finance industry		

※ Multiple responses allowed

[Figure 2] Years of experience

	Years of experience	Number of Responses
1.	Less than 5 years	1
2.	5–10 years	38
3.	10–15 years	52
4.	15–20 years	27
5.	More than 20 years	17

n=135

[Figure 3] Occupational position in the audit firm

	Occupational position	Number of responses
1.	Representative partner	14
2.	Employee	24
3.	Manager	92
4.	Senior	3
5.	Junior	0

n=133

survey, we were able to get a total of 170 responses.

IV. Research Results

The responses to the questions and the results of the survey are summarized below.

IV-1. The materiality level in the quarterly review

The materiality level in the quarterly review should be set to a value equal to or slightly lower than the materiality level in the annual financial statement audit. We attempted to understand the real set up of the materiality level, using the following question.

[Question]
"How do you set the materiality level while formulating a quarterly review plan? If it is the same as the plan for annual financial statement audit, mention that as well."

As shown in [Figure 4], many of the subjects responded that the materiality level in the quarterly review was the same as the annual audit. Then again, there were cases where an adjustment in the ratio was being made with the annual value as the upper limit.

[Figure 4] The materiality level in the quarterly review

Response	Number of responses
Same as previous year	110
Upper limit for the financial year	4
1/2 or 3/4 of the financial year, or multiplying certain percentage with the financial year	9
Response on hold	11
No response	36

n=170

The materiality level and how it is to be broken down to the materiality in the assertions as mentioned in the Auditing Standards Committee Report 320 (ISA 320) and 450 (ISA 450) differs, depending on the audit firm or the common manual used by the network group to which the audit firm belongs. In this research, we have not analyzed each firm separately, but there is scope for further investigation about the impact of the method of dealing with importance on audit judgment.

IV-2. Assurance level in the quarterly review

Next, we prepared multiple options (assurance level scale) by dividing the assurance level provided by the quarterly review into portions of 5% each, starting from 0% to 100%, and posed the following question.

[Question]
"How much credibility do you think you have secured in the limited assurance level attached to the quarterly financial statements through the quarterly reviews? Please select the appropriate value."

According to [Figure 5], on one hand, there were subjects who thought that they were unable to secure the systematically estimated assurance level while carrying out the quarterly review in reality. On the other hand, there were subjects who thought that they were able to secure an assurance level which is similar to that of the audit. However, since the mean is 64.5% (median 70%), it can be concluded that majority of the auditors considered themselves to be unable to secure the assurance level that was systematically estimated. In addition to this, if we consider the remarks made in the comments section, it may be assumed that the subjects who selected an assurance of low level considered the current quarterly review procedures to be inadequate to gain confidence in auditors.

[Figure 5] Level of assurance through the quarterly review

Item	Response (%)
Mean	64.5
Standard deviation	14.70
Maximum	90
Minimum	20
Median	70

n=129

IV-3. Risk evaluation in the quarterly review

In the quarterly review, it is not mandatory for auditors to differentiate or specify the material misstatement risks for each account of financial statements/assertion level in the independent quarterly review while formulating the plan. However, we decided to go a step ahead and ask the following question so as to experiment:

[Question]
"Which accounts in the financial statements do you think are at a high risk of material misstatement while formulating a quarterly review plan? List up the name of five items and rank them from 1 to 5."

[Figure 6] shows the financial statement items which the auditor selected for the good and bad companies. We carried out the Chi-square test for the top three responses and the results are shown in [Figure 7]. The *p*-value was 0.586, which means that there was no significant difference between good companies and bad companies at the significance level

[Figure 6] Accounts in the financial statements with high risk of material misstatement

Good company (includes multiple answers)		
	1st position	1st–3rd position
Sales	89	114
Notes and accounts receivable	29	107
Merchandise and finished goods	7	60
Inventory	5	27
Cost of sales	2	15
Bad company (includes multiple answers)		
	1st position	1st–3rd position
Sales	75	105
Notes and accounts receivable	25	92
Merchandise and finished goods	10	44
Cost of sales	9	29
Inventory	5	33
GC item	4	4

[Figure 7] Chi-square test for the top 3 answers in [Figure 6]

	Good company	Bad company	Total
Sales	89	75	164
Notes and accounts receivable	29	25	54
Merchandise and finished goods	7	10	17
Total	125	110	235

χ^2-value 1.068
p-value 0.586

of 0.05 (5%). From this result, it can be concluded that the auditors selected pre-determined items from the financial statements, irrespective of whether the performance or financial condition of the company was good or bad. This is because these items are almost regularized in the manuals and other documents used for financial statement items during the quarterly reviews.

IV-4. Mandatory quarterly review procedure

We asked the following question about the mandatory quarterly review procedures for both good and bad companies in order to find out how assertions are determined and how quarterly review procedures are selected to cater for such assertions.

[Question]
“What are the (1) mandatory examination procedures and (2) which points would you like to assert through such procedures while formulating the quarterly review plan?” (Multiple selection possible)

Here, we assumed that the quarterly review was part of the annual audit and the quarterly review plans were made in such a manner that they can be used to tentatively evaluate the material misstatement risk together with the annual audit. Among the responses to this question, [Figure 8] shows those “procedures and assetrtions which were mandatory and those which were selected first.” It is also clear from this figure that the auditors were carrying out some substantive procedures in the quarterly review, although this was not mandatory in the quarterly review standards and the basic procedure to be implemented, such as analytical procedures and inquiries/inspections procedures set in ISRE 2410 and SAS 100, irrespective of the company’s attribute (whether good or bad).

The next question aims to find out whether the procedure of the quarterly review varies depending on the attributes of the company (performance, financial condition), even after it is evident that auditors implement complementary substantive procedures along with the basic procedures such as analytical procedures, inquiries, and inspections. To understand this, we set up the following null hypothesis and alternative hypothesis.

[Null hypothesis]
In selecting the procedures for the quarterly review, the auditors carry out the same procedures that are specified in the standard quarterly review, irrespective of the client’s conditions (performance, financial conditions, cash flow conditions).

[Alternative hypothesis]
In selecting the procedures for the quarterly review, the auditors carry out procedures different from those specified in the standard quarterly review. The procedures depend on the client’s conditions (performance, financial conditions, cash flow conditions). They

[Figure 8] Response distribution for mandatory procedures (assertions) in the quarterly review

Panel A (frequency)

	Good company			Bad company		
Assertions	Analytical Procedure	Inquiry/ Inspection	Substantive Procedure	Analytical Procedure	Inquiry/ Inspection	Substantive Procedure
Existance	56	17	37	54	20	24
Occurrence	9	5	9	12	4	4
Cutoff	26	11	38	24	7	19
Revenue recognition	4	0	1	1	0	1
Appropriateness of evaluation	19	8	16	20	12	21
Accuracy	8	5	9	8	2	8
Completeness	6	2	3	7	5	6
Others	2	0	2	3	2	3
Presentation/disclosure	0	0	0	1	3	0
Total	130	48	115	130	55	86

Panel B

		Analytical Procedure/ Inquiry/Inspection [basic procedure]	**Substantive Procedure [complementary procedure]**	**Total**
Good company	Frequency	178	115	293
	%	60.75	39.25	100%
Bad company	Frequency	185	86	271
	%	68.27	31.73	100%
Total		363	201	564

p-value 0.038

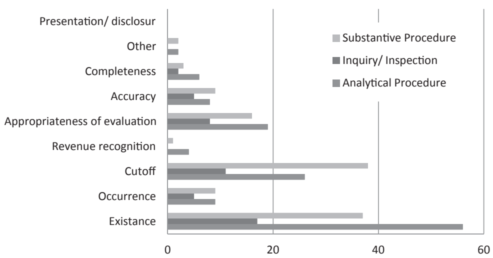
select more substantive procedures for good companies and more basic procedures for bad companies.

We chose to set up a one-sided test for the alternative hypothesis because it can be assumed that the choice of quarterly review procedures differs according to the conditions of the client, and in the case of good companies, there will be a trend to select more substantive procedures than in the case of bad companies. On the contrary, in the case of bad companies, there will be a trend to select more basic procedures. In other words, the control risk (CR) will be lower in the case of good companies because inherent risk (IR) is lower, and there is a higher possibility of better management and operation of internal control. However, the risk of material misstatement (RMM), which is a combination of these two, is lower, as there is a lower possibility of material misstatement in the financial statements of good companies. Since the quarterly review is carried out as part of the annual audit, its characteristics as part of the annual audit are stronger, and the auditors allocate more resources to it in the form of substantive procedures, keeping annual audit under consideration. In case of bad companies, there is the possibility of IR and CR becoming high. So, the auditors cannot ignore the RMM in the quarterly financial statements, and allocate sufficient resources and importance to basic procedures that are mandatory according to the standards of the quarterly review procedure. Thus, it can be said that only the remaining resources will be allocated to the substantive procedures, which are complementary.

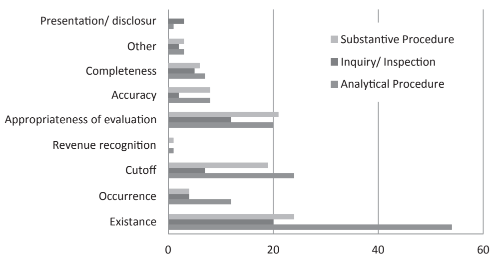
Panel B in [Figure 8] shows the results of the Fisher's exact test carried out after dividing the procedures into two groups – basic procedures and substantive procedures.

[Figure 9] Difference in quarterly review procdure and assertions: The first mandatory procedure

Good Company				Bad Company			
Assertions	Analytical Procedure	Inquiry/ Inspection	Substantive Procedure	Assertions	Analytical Procedure	Inquiry/ Inspection	Substantive Procedure
Existance	56	17	37	Existance	54	20	24
Occurrence	9	5	9	Occurrence	12	4	4
Cutoff	26	11	38	Cutoff	24	7	19
Revenue recognition	4	0	1	Revenue recognition	1	0	1
Appropriateness of evaluation	19	8	16	Appropriateness of evaluation	20	12	21
Accuracy	8	5	9	Accuracy	8	2	8
Completeness	6	2	3	Completeness	7	5	6
Other	2	0	2	Other	3	2	3
Presentation/ disclosur	0	0	0	Presentation/ disclosur	1	3	0



Good Company



Bad Company

Basic procedures are in the form of analytical procedures, inquiries, and inspections for both good and bad companies, while substantive procedures are implemented as complementary procedures. The *p*-value in Panel B is 0.038. Thus, the null hypothesis, which has is rejected (at the significance level of 0.05 (5%),) in favor of the alternative hypothesis. In other words, this shows that auditors, during the quarterly reviews, change the combination of basic and complementary procedures depending on the attributes of the company. The results confirmed that the auditors select more substantive procedures for good companies, and more basic procedures for bad companies. This fact is represented in a visual form in [Figure 9].

IV-5. Additional procedures and others

IV-5-1. Additional procedures

We used the following question to confirm if there are any additional procedures and assertions, apart from the mandatory procedures that the auditors must implement.

[Question]
"While planning the quarterly review, in addition to the mandatory procedures, (1) mention whether there are additional assertions to be investigated due to occupational skepticism, and (2) select such procedures." (multiple selection possible)

[Figure 10] shows the results of the chi-square test to determine whether there is a difference in procedures (assertions) selected depending on the attributes of the company, similar to mandatory procedures. Here, the *p*-value is 0.021. Hence, in the case of additional procedures as well, the null hypothesis is rejected at the significance level of 0.05 (5%), and it is found that there is a difference between the procedures selected by the auditors in good and bad companies. At the same time, it is also found that in the case of good companies, similar to mandatory procedures, relatively more substantive procedures

[Figure 10] Comparison of additional procedures according to company attributes

		Analytical precedure/ inquiry/inspection [basic procedure]	**Substantive procedure [complementary procedure]**	**Total**
Good company	Frequency	132	259	391
	%	33.76	66.24	100%
Bad company	Frequency	151	209	360
	%	41.94	58.06	100%
Total		283	468	751

χ^2-value 5.347
p-value 0.021

[Figure 11] Comparison of extra procedures according to company attributes

		Procedure of division / question/reference [basic procedure]	Verification procedure [complementary procedure]	Total
Good company	Frequency	53	169	222
	%	22.87	76.13	100%
Bad company	Frequency	49	120	169
	%	28.99	71.01	100%
Total		102	289	391

χ^2-value 1.305
p-value 0.253

are carried out, while in the case of bad companies, more basic procedures are selected.

IV-5-2. Additional procedures that are implemented when there is scope to do so

Moreover, we asked the auditors to tell us about preliminary procedures, other than the mandatory and additional procedures specified in the process of the quarterly review, which may be implemented if there is time and money to do so.

[Question]
"While planning the quarterly review, if there is more time and money, (1) mention assertions that are considered good for adding to the examination process, and (2) select such procedures." (Multiple selection possible)

[Figure 11] shows the results of the chi-square test to determine whether there is a difference in procedures (assertions) selected by the auditor when there is money and time available, depending on whether the company is good or bad. In Figure 11, the p-value is 0.253. Hence, the null hypothesis cannot be rejected and we cannot conclude that there is any difference in the selected procedures for the two types of companies. Therefore, there is a possibility that the company attributes are not taken into consideration when selecting extra procedures, unlike in the case of mandatory and additional procedures.

V. Conclusion

In this study, we examined how the quarterly review is planned in reality as part of the actual annual audit; in other words, how assertions and review procedures are determined, based on the data of good companies and bad companies. As concluded in Matsuda (2011), in this study, the substantive procedures are carried out during the quarterly review to find out how the attributes of a company (good or bad performance and financial conditions) affect the selection of procedures.

In formulating the plan, be it the important step of setting up the materiality level, or the selection of assertions through the evaluation of risk of material misstatement, we could not find a significant difference in the way companies with different attributes are treated. In fact, we could assume a lot of formalization in the selection of assertions and procedures because the auditors depended on manuals to implement the review.

Furthermore, even though it seems that there is not necessarily any consensus in the assurance level in the quarterly review, if we still consider the mean (median value), we find that there is 60–80% assurance, as indicated in IAASB (2002) and Matsumoto and Machida (2011).

Moreover, as far as the selection of review procedures is concerned, we found from the responses to our survey that the mandatory procedures are implemented first in the quarterly review and assertions by the auditors, the additional procedures and assertions are to be carried out next, and the extra procedures and assertions are to be implemented if there is scope for time and money.

As a result, in the case of the most important mandatory procedures and additional procedures, relatively more basic procedures were implanted for the former and many more substantive procedures were carried out for the latter. Thus, the trend for selecting procedures was found to be common for both – companies with good performance and financial conditions as well as companies with bad performance and financial conditions.

However, if we investigate the relation between the performance and financial conditions of a company and the selection of basic procedures and substantive procedures, we are able to confirm that basic procedures involving analytical procedures, inquiries, and inspections are relatively more in the case of companies with bad performance and financial conditions, than in the case of companies with good performance and financial conditions. In the case of companies with good performance and financial conditions, the auditors choose more substantive procedures.

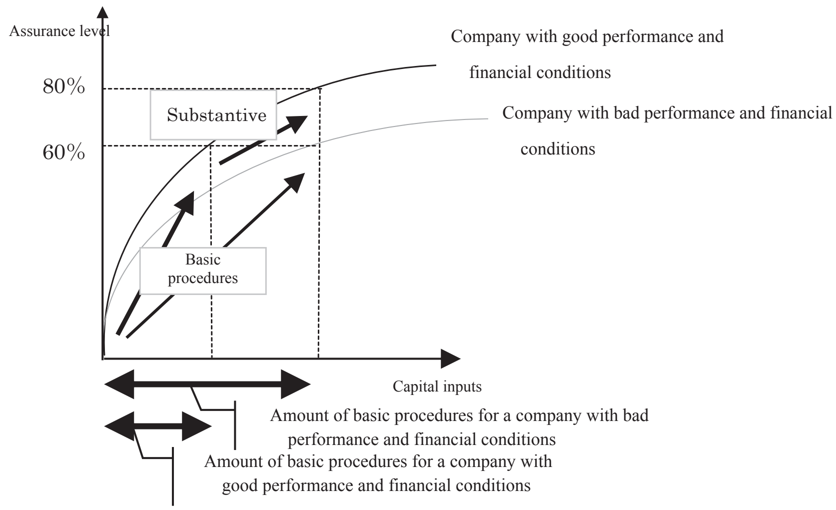
If we consider the relation of this fact with the assurance level, we can say that the auditors mainly focus on the allocation of resources to basic procedures such as analytical procedures, inquiries, and inspections, until the minimum level of assurance, i.e., 60% is reached during the quarterly review. Once the 60% level is achieved, they aim at the minimum level of assurance (80%) necessary for the annual audit and carry out additional substantive procedures in the quarterly review, which is part of the annual audit. As a result, it can be concluded that they keep the range of the assurance level and the level of confidence between 60% and 80% for the quarterly review.

As per the experimental investigation carried out in this study, the auditors focus on allocating resources to more basic procedures in order to bring the companies with good performance and financial conditions to the minimum assurance level of 60% in the short period of the quarterly review. They allocate the remaining resources to substantive procedures in companies with good performance and financial conditions because these companies are easily able to reach the minimum assurance level of 60%.

With this understanding, we can reach the conclusion shown in [Figure 12] (cf. Matsumoto [2005]). Whereas, if we look at this process from the viewpoint of the annual audit, we can say that as part of the annual audit, there is a possibility that the quarterly review serves the role of complementing the procedures and time that may be insufficient during the annual audit.

[Figure 12] shows that because the general assurance level of the review is set to 60–80%, the auditors are working to achieve a minimum confidence level (assurance level) of 60% by focusing on the implementation of the basic procedures that are considered necessary for the quarterly review. The auditors achieve the 60% level with few basic procedures in the companies with excellent performance and ideal financial conditions because the IR and CR of these companies are low, and the auditors allocate the remaining time and resources to substantive procedures that can also be used in the annual audit. This strategy helps the auditors achieve an assurance level close to 80% in these companies. By contrast, in the companies with poor performance and unfavorable financial conditions, many basic procedures have to be carried out to reach the 60% level. Thus, the auditors (1) expand the quarterly review and (2) complement or reuse the evidence in the annual audit, among other strategies, to reach a level higher than the minimum confidence level by undertaking those substantive procedures that can be used in the annual audit.

It is difficult to investigate the assurance level of the review engagement and the procedures required for it in Japan separately from each other. It is also difficult to perform an in-depth study of the assurance level and procedures of the quarterly review because they



[Figure12] Relation between assurance level and review procedures

are actually part of the annual audit. At the very least, we can achieve higher effectiveness in the audits through the annual audits, which are meant to be realized from the quarterly review standard and the mutual use of evidence based on the quarterly reviews. However, the quarterly review is, at best, a derivation of the individual contracts of review engagement; we must not overlook the fact that sufficient audit time should be secured for the annual audits. To this end, it is necessary to reconsider the content that should be implemented as part of the quarterly review through individual review engagement standards and establishment of their code of practice.

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