Recommendations on Audits (Special Edition)

Auditor's Response to Fraud in Audit of Financial Statements
-Not to Overlook Material Misstatements due to Fraud-

January 27, 2016

The Audit Practice and Review Committee

Introduction

On January 27, 2016, the Japanese Institute of Certified Public Accountants ("JICPA") issued a Chairman and President Statement (No. 1, 2016) entitled "Commitment to High-Quality Audit to Restore Public Confidence."

Several accounting scandals uncovered in recent years have undermined public confidence in audit. It is an urgent issue for each JICPA member to think back on his/her attitude toward audit and make an effort to restore public confidence.

Fraud is an intentional action to deceive others and is usually accompanied by concealments. Especially in the case of a fraud committed by management (hereinafter referred to as "management fraud"), it is more difficult for the auditor to detect material misstatements because management overrides controls using its unique position. Therefore, based on the past fraud cases, generally accepted auditing standards, including the "Standard to Address Risks of Fraud in an Audit," contain many points that the auditor should keep in mind in each phase of the audit, such as risk assessment, response to assessed risks, and formation of an audit opinion, in order not to overlook material misstatements due to fraud.

The Audit Practice and Review Committee believes that every auditor may face management fraud cases and that lessons learned from such cases can provide auditors with an opportunity to think back on their own behavior in an audit. Auditors should conduct audits rigorously, recognizing their own responsibility as professionals and not making excuses for difficulties in responding to management fraud. This is what the public expects of auditors. Thus, the Committee has published these "Recommendations on Audits (Special Edition)" to once again remind auditors of what they should keep in mind in order not to overlook material misstatements due to management fraud.

The "Recommendations on Audits (Special Edition)" do not constitute auditing standards.

Contents

1. **Professional skepticism** 1
   (1) Professional skepticism 1
   (2) The reliability and integrity of management 1
2. **Risk assessment procedures and related activities** 1
   (1) Understanding the entity and its environment 1
   (2) Assessment of corporate governance 2
   (3) Assessment of internal controls over financial reporting 2
   (4) Group audit 3
3. **Identification and assessment of significant risks** 3
4. **Auditor's responses to assessed fraud risk** 4
   (1) Audit approach 4
   (2) Further audit procedures to address risks 5
   (3) Strengthening communication within the audit team 5
5. **Risks related to management override of controls** 5
   (1) Discussion with management 5
   (2) Assessment of risks related to management override of controls 6
6. **Engagement quality control review** 7
7. **Audit time and reasonable period of work** 7

1. Professional skepticism

(1) Professional skepticism

- The auditor is required to maintain professional skepticism at every phase of the audit. In particular, the auditor needs to reaffirm that he/she is required to exercise his/her professional skepticism for the proper identification and assessment of any risk of material misstatement due to fraud (risk of fraud), especially management fraud.
- It would be inappropriate for the auditor to presume that fraud exists only in limited entities. The auditor should recognize that the risk of fraud can exist in any entity.
- Audit team members who are involved in an audit of an entity over a long period of time may believe that they already understand the entity and its business well, which may undermine their exercise of professional skepticism. As the business models of entities may change at any time, the auditor should conduct an audit with a fresh mind in every period.

(2) The reliability and integrity of management

- The auditor should maintain his/her neutral position on the integrity of the entity's management.
- When understanding the entity and its environment in the risk assessment process, the auditor should consider whether management has an adequate understanding of financial reporting and auditing.
- When the entity strongly requests the auditor to provide the entity with the auditor's report before its earnings release, the so-called "*Kessan Tanshin,*" the auditor may face time pressure. In particular, when the entity plans its reporting schedule so tightly that misstatements identified by the auditor are likely to remain uncorrected, the auditor needs to pay attention to the presence of fraud risk factors (i.e., pressure).
- When evaluating the reliability and integrity of management, the auditor may need to consider what kind of pressure each management member faces, based on discussions with not only top management, but also managers positioned at an appropriate level who have material influence on the entity's activities, including executive officers and division heads.
- If management is not cooperative with the auditor and its explanations and/or rationale for an accounting treatment are unclear, the auditor needs to carefully consider whether there are any indications that a fraud risk factor is present.

2. Risk assessment procedures and related activities

(1) Understanding the entity and its environment

- When assessing risks, the auditor should understand the situation of the entity with professional skepticism in the context of the overall environment and the trends of the

industry in which the entity operates. The auditor also needs to recognize that the environment could change during the period. In addition, the auditor needs to keep in mind that management is always under the pressure of achieving its performance targets.

- Adverse changes in the business environment and the entity's performance have influences on accounting estimates such as impairment of fixed assets. The auditor needs to consider what kinds of fraud could occur as a result of these influences.
- Although it is beneficial to have experience in auditing other entities in the same industry, every entity is different. The auditor needs to enhance its understanding of the entity's business without any bias.

(2) Assessment of corporate governance

- It is essential to assess with professional skepticism whether the corporate governance (including the board of directors and those charged with governance ("TCWG")) is functioning sufficiently when understanding the control environment. The auditor needs to keep in mind that it would be impossible to assess the effectiveness of corporate governance simply by understanding the legal structure of governance and reading the minutes of the board of directors and/or other management board.
- The auditor should assess whether TCWG, who usually consist of external and internal Kansayaku, are performing their oversight function against top management, by considering whether sufficient information is provided to the external *Kansayaku* on a timely basis and what career the internal *Kansayaku* had before his/her appointment to the position.
- The auditor may obtain important information by reading the materials reviewed by TCWG in addition to the minutes of the meeting of TCWG. TCWG may not necessarily communicate information regarding inappropriate accounting to the auditor even if they have obtained such information. The auditor needs to build a constructive relationship with TCWG, considering their integrity.
- Two-way communication with TCWG is necessary. In the communication, it is not sufficient to receive an answer from TCWG to the effect that no fraud risk has been identified. The auditor needs to discuss with TCWG the process they performed in reaching their conclusion that there is no fraud risk.

(3) Assessment of internal controls over financial reporting

- It has been pointed that there are cases where internal controls are assessed superficially. It is necessary to revisit whether the control assessments are appropriately performed in conformity with the objectives of the *Standards and Practice Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting* and its practice statements.
- When reviewing the description of internal controls prepared by the entity, it is important for the auditor to inquire what action is taken by whom and who approves non-routine

transactions, matters that may be left unexplained in the entity's description of internal controls.

- When assessing the internal controls, the auditor needs to confirm whether the assumptions and conditions explained in the description of internal controls are relevant in the current period.
- The auditor can obtain a deeper understanding as to how transactions are processed and reflected in the financial statements, by inquiring about the process of non-routine transactions and performing walk-throughs in various scenarios. Understanding the entity's business is essential to understanding its internal controls. Simply confirming that there is an approval signature is inadequate as evidence of effective performance of a control.
- There are some cases where the auditor selects significant locations or business units mechanically using only quantitative criteria such as coverage of consolidated revenue. The auditor needs to determine the scope by considering the possibility of risk of fraud.
- At an insignificant location or business unit, it is not uncommon for fraud to remain undetected for a longer period. The auditor may ask management to pay attention to the design and operation of the controls to prevent and detect fraud in an insignificant location or business unit. It may point out, among other things, the need to reconsider the segregation of duties, periodic personnel rotation, and monitoring activity (including the use of internal audits) in the group.

(4) Group audit

- If there is a complicated transaction within the group, the auditor needs to understand the whole picture of the transaction, paying attention to the audit results of the component auditor, even if the transaction is to be eliminated as an intra-group transaction.
- For the group audit, a fraud occurring in a component that is not significant could result in a material misstatement of the consolidated financial statements. The auditor needs to pay attention to the existence of any risk of material misstatement in the group's financial statements while considering the entity's control systems (such as its personnel rotation system).
- The auditor needs to critically evaluate the audit evidence obtained from the component's auditor, and to exercise professional skepticism. The auditor also needs to consider changes in the component's performance and the professional competence of the component's auditor.

3. Identification and assessment of significant risks

- When the auditor identifies a significant risk, he/she needs to appropriately determine the relevant accounts and assertions that relate to the risk and perform appropriate audit procedures to address the risk. The auditor needs to deliberately consider the

linkage between the risk and the procedures at the assertion level on relevant accounts.

- It has been observed that the auditor identifies a risk of fraud related to revenue recognition, but the audit procedures in response to this risk are not effective in detecting the possible fraud in some cases. The auditor needs to appropriately identify risks by the types of revenue transactions or assertions and consider what kind of fraud could occur in order to design audit procedures responsive to those risks.
- For significant risks, especially for fraud risks, directions, instructions and the audit program that specifically address the risk are especially important. Also, sharing them within the audit team is important.

4. Auditor's responses to assessed fraud risk

(1) Audit approach

- In conducting an audit, the auditor is required to determine the locations where various audit procedures are performed, including significant components for the group audit, significant business locations for the internal control audit, branches and factories for interim visits, and the locations for inventory observation. Each basis for the selection could differ for rational reasons. The auditor needs to design an effective and efficient audit plan considering the relationship between the audit procedures performed during the interim period at each location and the audit procedures performed after the period ends. The auditor also needs to evaluate whether audit evidences obtained at each location are sufficient and appropriate for the purposes, and to properly follow up the results of those procedures during the course of the procedures performed after the period ends.
- The auditor needs to update its knowledge of the entity's business, including the flow of goods/services and related accounting information, every year with a fresh eye.
- If the audit team member who initially performs procedures recognizes no risk arising from an unusual transaction, it may cause a delay in the detection of any material misstatement. The professional competence and capabilities of audit team members are extremely important. Audit team members with less experience should also keep in mind that they are audit professionals. Appropriate OJT and training programs are needed, as limited experience could be one of the factors for a lack of professional skepticism.
- In some cases, audit procedures for the parent company's financial statements are not sufficiently performed for intercompany transactions within a group, as those transactions are eliminate in the consolidated financial statements. The auditor should perform appropriate audit procedures to express an opinion on the parent company's unconsolidated financial statements.
- The auditor determines materiality for the financial statements as a whole and performance materiality in light of the auditor's understanding of the entity's business, the nature and amount of misstatements identified in the previous audits, and expected

misstatements in the current period. The entity's environment keeps changing year by year. Thus, the materiality also needs to respond to the changes.

(2) Further audit procedures to address risks

- To recognize the risk arising from unusual transactions, it is important to stand back and understand the whole picture of the transactions. The auditor needs to understand the whole picture of a series of interrelated transactions and the entity's role and intention in the context of the entity's business by analyzing relevant accounts or the entity's customers and checking the involvement of the entity's affiliates. Simply investigating the accounts assigned or selected samples is insufficient for this purpose.
- The auditor needs to evaluate the economic and business rationale for unusual significant transactions such as intercompany transactions, large sales occurring at or near the year-end, or large investments in other entities that have unclear connections with the entity's business objectives. The auditor needs to critically evaluate audit evidence obtained and determine whether it is sufficient and appropriate.

(3) Strengthening communication within the audit team

- The audit team should conduct its team meetings without presupposing that the management and TCWG are honest and have integrity.
- Different team members may be assigned to perform the procedures on the same account and/or class of transactions in an interim period and after the year-end at the headquarters and its branches or at the parent company and its subsidiary. All relevant information should be communicated with appropriate team members. There are cases where fraud could have been detected if the team members had recognized the existence of an unusual transaction at an interim visit to a branch or factory. Staff who are assigned to an engagement for only a short period of time should also keep in mind that they are audit professionals and are expected_to communicate unusual, significant accounting or audit issues to other more experienced team members as soon as possible when they find such issues.
- The audit team needs to consist of not only those who have knowledge about the entity based on a long-term relationship with the entity, but also those who are able to challenge those members critically. The auditor should recognize that an understanding based on past experience shared by the engagement team could bias the audit team.

5. Risks related to management override of controls

(1) Discussion with management

- Management is in a unique position in an organization. When management is involved in a fraud, it is often the case that inquiries addressed directly to the management itself are ineffective. However, discussion with the appropriate level of management, such as

general managers and branch managers, may provide the auditor with information about the pressures facing management and changes in the management's attitudes.

- In order to make a discussion with management meaningful, it is essential for the auditor to sufficiently understand the entity, its environment, and its business. Without sufficient understanding, necessary information cannot be obtained from management.

(2) Assessment of risks related to management override of controls

- The risk related to management override of controls is present in all entities. Regardless of the level of the risk, the following three further audit procedures should be performed at minimum: journal entry testing, examination of any indication of management bias related to accounting estimates, and examination of significant unusual transactions.
- Furthermore, the auditor needs to determine whether those three procedures are sufficient to deal with the risk related to management override of controls.
- In assessing the risk related to management override of controls, the auditor needs to take account of the overall situation the entity faces. This may include, for example, the entity's ability to meet financial covenants or listing rules. If the execution of a certain transaction inflates the entity's reported income, the auditor needs to consider its effect on the entity's ability to meet financial covenants or listing rules.

① Journal entry testing

- The auditor should consider various possible fraud scenarios relevant to the assessed risk and design testing to obtain sufficient and appropriate audit evidence. Management fraud cannot be detected by simply reviewing journal entries.
- It is crucial for the auditor to have the competence (experience) to find out unusual matters when setting up parameters and testing specific selected items.
- If the auditor sets adequate parameters, it is likely that the selected items will show indications of fraud. It is essential to carefully examine whether any "material misstatement due to fraud" is included in the selected items by obtaining sufficient and appropriate audit evidence.

② Examination of management bias related to accounting estimates

- Even if the management's judgments and decisions related to individual accounting estimates are reasonable, material misstatements could exist in the financial statements as a whole. Therefore, it is essential to assess in a comprehensive manner whether management bias leads to any risk related to management override of controls.
- In order to assess management bias, the auditor should perform a retrospective review of the management's assumptions and judgments reflected in the financial statements of the prior year.

③ Examination of significant unusual transactions

- Even if some transaction is unusual in general, industry practices may excuse the unusual aspect. Auditors should not be satisfied with the explanation that a transaction is acceptable under industry practices, but carefully observe the reality of the transaction with professional skepticism.

6. Engagement quality control review

- The engagement quality control review is a process designed to provide an objective evaluation of the audit procedures performed, the significant judgments made, and the audit opinion formed by the engagement team. The engagement quality control reviewer needs to reaffirm that it is not sufficient only to follow the explanation provided and the procedures performed by the engagement team.
- The engagement quality control reviewer needs to apply professional skepticism and review work papers relating to significant transactions from a critical point of view, including transactions relating to the engagement team's identification of and responses to significant risks.

7. Audit time and reasonable period of work

- In some cases, time constraints limit the auditor's focus to evidences that support management's assertions and prevent the auditor from sufficiently considering information that contradicts the management's assertions, because the auditor needs to complete the audit before the due date for the entity's earnings release. The auditor may need to reconsider the existing audit schedule and behavior.
- If the auditor foresees difficulties in completing the audit by the date planned for the auditor's report because of newly arising issues (for example, a new risk of material misstatement is identified), the auditor needs to immediately communicate with the entity and request an extension of the due date.
- Statistics indicate that more than 40 percent of the listed companies in the fiscal year ended 31 March 2015 received an auditor's report under the Companies Act before their earnings releases were announced. In principle, any misstatements detected by an auditor should be corrected even if they are below the materiality threshold as a whole. However, there are some cases where misstatements detected by an auditor were not corrected because of limitations in the entity's ability to issue its financial reporting in a timely manner. The auditor needs to discuss the time schedules of the entity's financial reporting and audit with the management and to seek the management's understanding that adequate time for auditing and a reasonable period for work is essential for enhancing the reliability of the financial statements.

This English version is not translated word for word. The original text prepared in the Japanese language is available on the following website:
http://www.hp.jicpa.or.jp/specialized_field/main/post_1844.html