Chairman and President Statement (No.1, 2016)

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The Japanese Institute of Certified Public Accountants
Kimitaka Mori, Chairman and President

Commitment to high quality auditing to restore public confidence

Auditors are required to perform audits rigorously in order to contribute to the sound development of capital markets. Regrettably, several accounting scandals uncovered in recent years have undermined public confidence in audit. To restore public confidence, I urge all members of the JICPA to pay particular attention to the following points in performing their audits in accordance with generally accepted auditing standards.

1. Risk assessment as part of a risk-based audit

If the auditor identifies and assesses the risks of material misstatement inappropriately, the effectiveness of the entire audit could be affected, both in the planning and the performance of the audit procedures, which could cause the auditor to overlook material misstatements in the financial statements. Auditors are therefore required to reaffirm the key importance of appropriate risk assessment based on an adequate understanding of the entity and its environment.

In assessing the risks of material misstatement, including fraud risks, the auditor should obtain an appropriate understanding of the entity's business and its internal controls, notwithstanding the auditor's past experience of the integrity of the entity's management and social prestige of the entity or management.

2. Professional skepticism

The auditor should maintain and exercise professional skepticism throughout the audit, in particular paying close attention to the following:

- Risk assessment: When assessing risk, the auditor should recognize that a material misstatement due to fraud or error can exist in any entity. The auditor should also carefully revisit whether the risk assessment needs be revised during the course of the audit, given that the risk of material misstatement may change in the evolving business environment.
- Effectiveness of controls: Considering the linkage between the risk of material misstatements and the relevant controls, the auditor should carefully evaluate whether control objectives are effectively achieved. The auditor should perform tests of controls with an appropriate understanding of the purpose of the test. Simply confirming there is an approval signature is inadequate as evidence of the effective

performance of a control. Specifically, the auditor should carefully revisit whether entity-level controls (including the control environment) are appropriately evaluated, as those controls are often tend to be evaluated by a check-box approach.

・Sufficiency of audit evidence from substantive procedures: The auditor should not simply rely on an entity's explanation without any verification. The auditor should keep a skeptical mindset and obtain sufficient appropriate corroborative audit evidence to support an entity's explanation.

3. Risk related to management override of controls

When management is involved in intentional material misstatements (hereinafter referred to as "management fraud"), its attitude significantly affects the entire entity. In such a case, management may use its position to override controls and leverage various interrelated factors to achieve it aims, such as the characteristics of its business model or recent changes in its environment. Therefore, the auditor should be aware that management fraud can result in material misstatements that may not be detected for a longer period of time.

The risk related to management override of controls is present in all entities. It is inappropriate for an auditor to assess the risk of management override of controls as low based on the assumption that the management of the entity keeps the integrity. The auditor should exercise professional skepticism to critically assess the risk of management override of controls. When designing and performing audit procedures relating to the risk of management override of controls (for example, testing the appropriateness of journal entries, reviewing accounting estimates for biases, and evaluating the business rationale of significant unusual transactions), the auditor should consider various possible fraud scenarios so as to design and perform the appropriate procedures in the circumstances.

4. Auditing accounting estimates

When reviewing management's method used to develop accounting estimates and the data on which the estimates are based, the auditor cannot simply rely on the entity's explanations. The auditor should keep a skeptical mindset and challenge the explanations in light of information obtained during the course of audit and cumulative knowledge within the engagement team.

When evaluating the reasonableness of an accounting estimate, the auditor should obtain sufficient appropriate audit evidence, which should include a retrospective review of the estimate in the prior year financial statements with the actual amount or an updated estimate in the current year financial statements.

5. Communication within the engagement team

Timely discussion among the engagement team members is necessary to share information and knowledge obtained during the course of the audit. The engagement partner is responsible for providing a team environment where less experienced team members can report to or consult with more experienced team members without difficulty. At the same time, each team member needs to be fully aware of his or her own responsibility to act as a professional and fulfill his or her duty within the team.

6. Engagement quality control review

The engagement quality control reviewer is responsible for objectively evaluating the significant judgements the engagement team made and the conclusions it reached. The engagement quality control reviewer should perform an objective evaluation with professional skepticism from a viewpoint outside of the engagement team, when reviewing selected audit documentation related to significant judgements made by the engagement team and the conclusions reached.

7. Ensuring adequate audit time and reasonable period of work

As described in Japan's Corporate Governance Code, ensuring adequate audit time is one of the critical factors in conducting a high-quality audit. Auditors should continuously strive to have the management understand that adequate audit time and the reasonable period of work after the date of financial statements are critical factors to enhance audit quality.

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Auditors should stand strong in conducting audits. An audit is performed in the public interest. In other words, the audit is performed for the users of the auditor's report, including shareholders and investors of the audited entity. With this in mind, I urge all of our members to stand back and ask themselves seriously whether they are conducting their audits with the appropriate professional skepticism to avoid more accounting scandals that may undermine confidence in audit in the future.

The original texts are prepared in the Japanese language, which is available on the following website:
http://www.hp.jicpa.or.jp/ippan/jicpa_pr/news/post_20160124.html