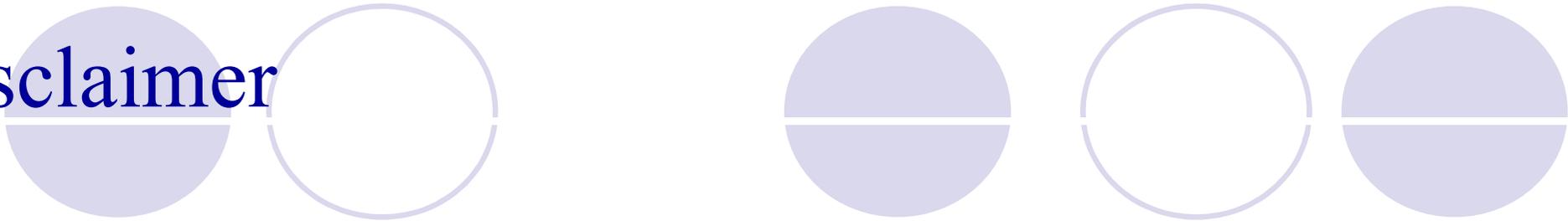


The Issue of Professional Skepticism and Standard to Address Risks of Fraud in Japan

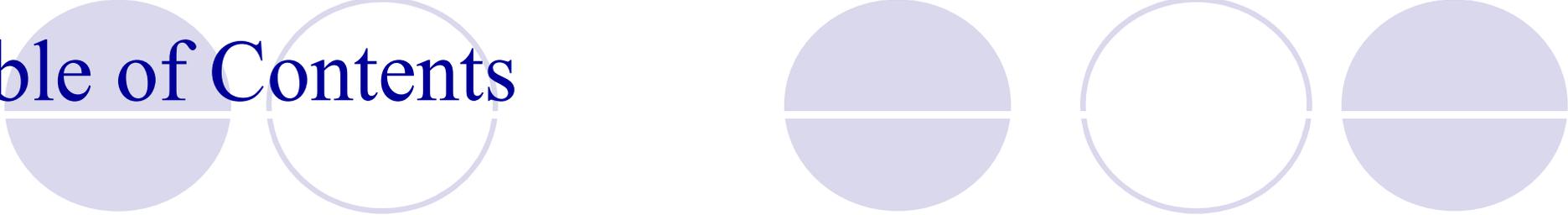
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Disclaimer



- This presentation is prepared under the sole responsibility of the presenter.
- The views expressed are solely on my own and do not necessarily reflect those of FSA Japan.

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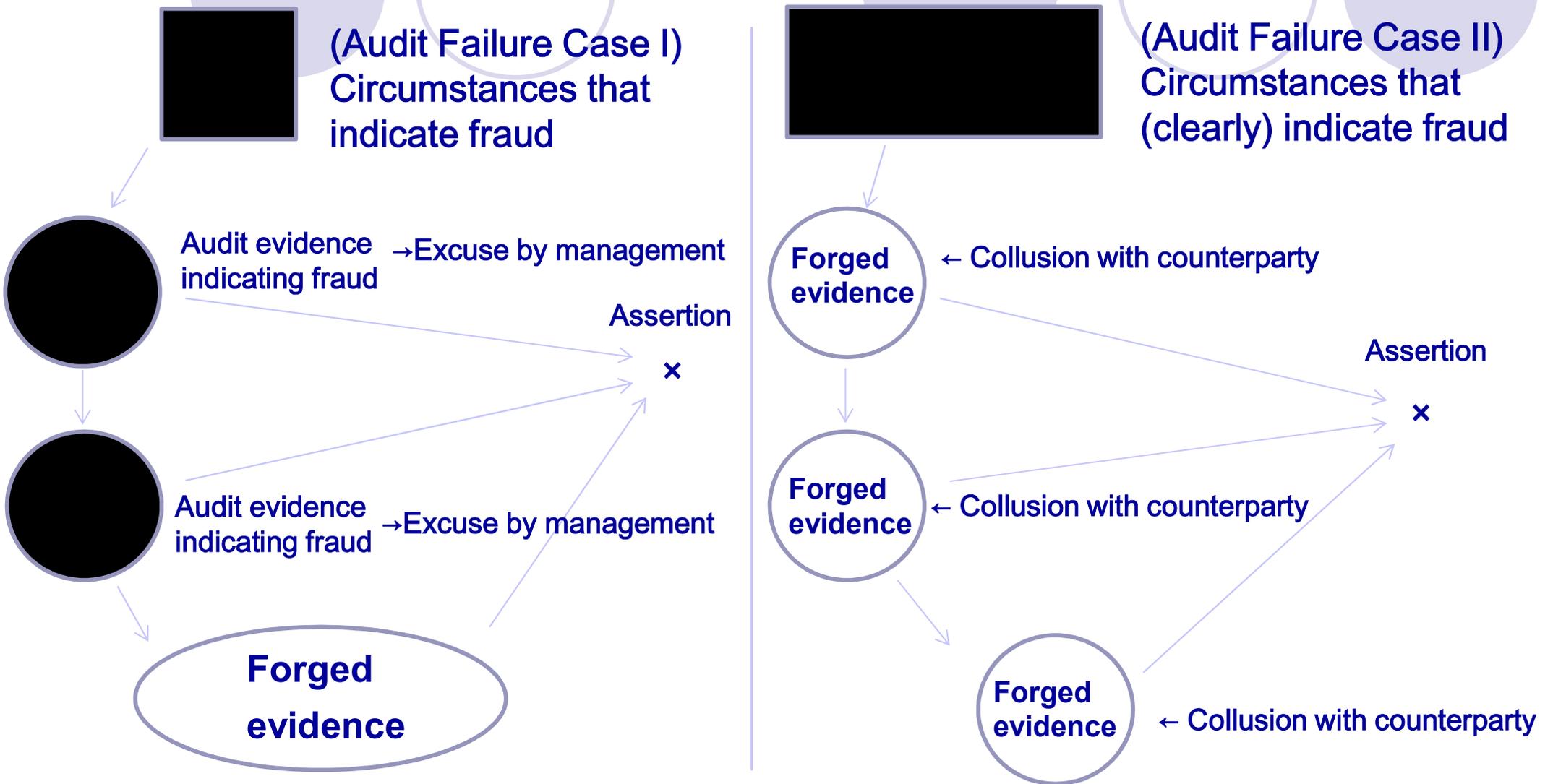
1. The Issue of Professional Skepticism
2. The Issue of Auditors' Resignation
3. Standard to Address Risks of Fraud in Japan
4. Other Regulatory Changes

The Issue of Professional Skepticism

- It is internationally pointed out that auditors do not always exercise sufficient level of professional skepticism.
- There have been certain changes in an auditing environment which would affect auditors' professional skepticism:
 - Businesses and transactions have become more complicated
 - Accounting standards have introduced more managements' judgments
 - Auditors are increasingly under pressure to pursue efficiency

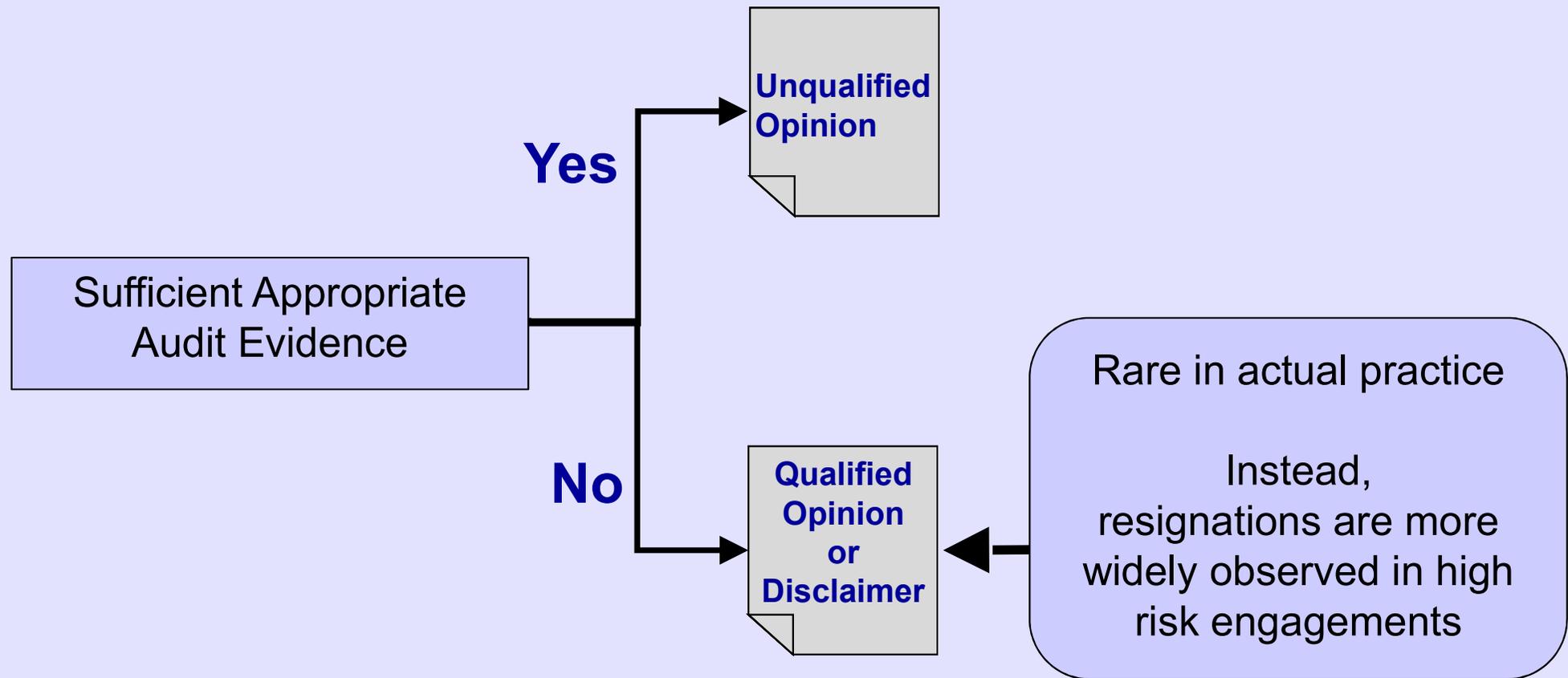
- Do auditing standards sufficiently address the challenges auditors face?
- Are there any areas in which auditing standards should be revised?

The Issue of Professional Skepticism



- Do auditors critically assess inconsistency in the circumstances, management's assertion and audit evidence, especially in the critical circumstances?
- In other words, do auditors exercise sufficient level of professional skepticism?

The Issue of Auditor's Resignation



- Is communication between predecessor and successor auditors always sufficient?

Standard to Address Risks of Fraud in Japan

- In March 2013, FSA Japan issued “Standard to Address Risks of Fraud in an Audit (hereafter, the Japanese Fraud Risk Standard).”
- The standard follows basic concepts of ISA 240, however, new requirements are also introduced:
 1. Appendix: Examples of circumstances that indicate the possibility of a material misstatement due to fraud
 2. “A Suspicion of Material Misstatement Due to Fraud”
 3. Communication between predecessor and successor auditors
 4. Others

Appendix: Circumstances that Indicate the Possibility of a Material Misstatement Due to Fraud (1/4)

- ISA 240 Appendix 3 “Examples of Circumstances that Indicate the Possibility of Fraud” present circumstances where auditors should exercise professional skepticism, however, auditors are not explicitly required to respond to the circumstances described in the Appendix.

*PCAOB AS 14 explicitly requires auditor’s responses in the same appendix

- The Japanese Fraud Risk Standard incorporated explicit requirements for auditors
 - to ask for explanation from management
 - to perform additional audit procedures

Appendix: Circumstances that Indicate the Possibility of a Material Misstatement Due to Fraud (2/4)

- Recent fraud cases are reviewed for the circumstances in which auditors should have exercised professional skepticism → Examples are added to the Appendix.

1. Information in Relation to Fraud

- Through the whistle-blowing system, the audited entity has received information which is deemed to have a material effect on the financial statements and disclosed the information to the auditor.
- * Employees of the audited entity, counterparties or others have provided information relating to the possibility of fraud to the auditor (including information provided through the whistle-blower channel of the audit firm).

Appendix: Circumstances that Indicate the Possibility of a Material Misstatement Due to Fraud (3/4)

2. Unusual Transactions, etc. to be Considered

(1) Circumstances that indicate the possibility of improper revenue recognition

- * Significant transactions that are outside the normal course of business of the entity, for which the business rationale appears unclear.

- * Significant and unusual transactions in light of the auditor's understanding of the entity and the environment surrounding the industry in which it operates, for which the business rationale appears unclear.

Appendix: Circumstances that Indicate the Possibility of a Material Misstatement Due to Fraud (4/4)

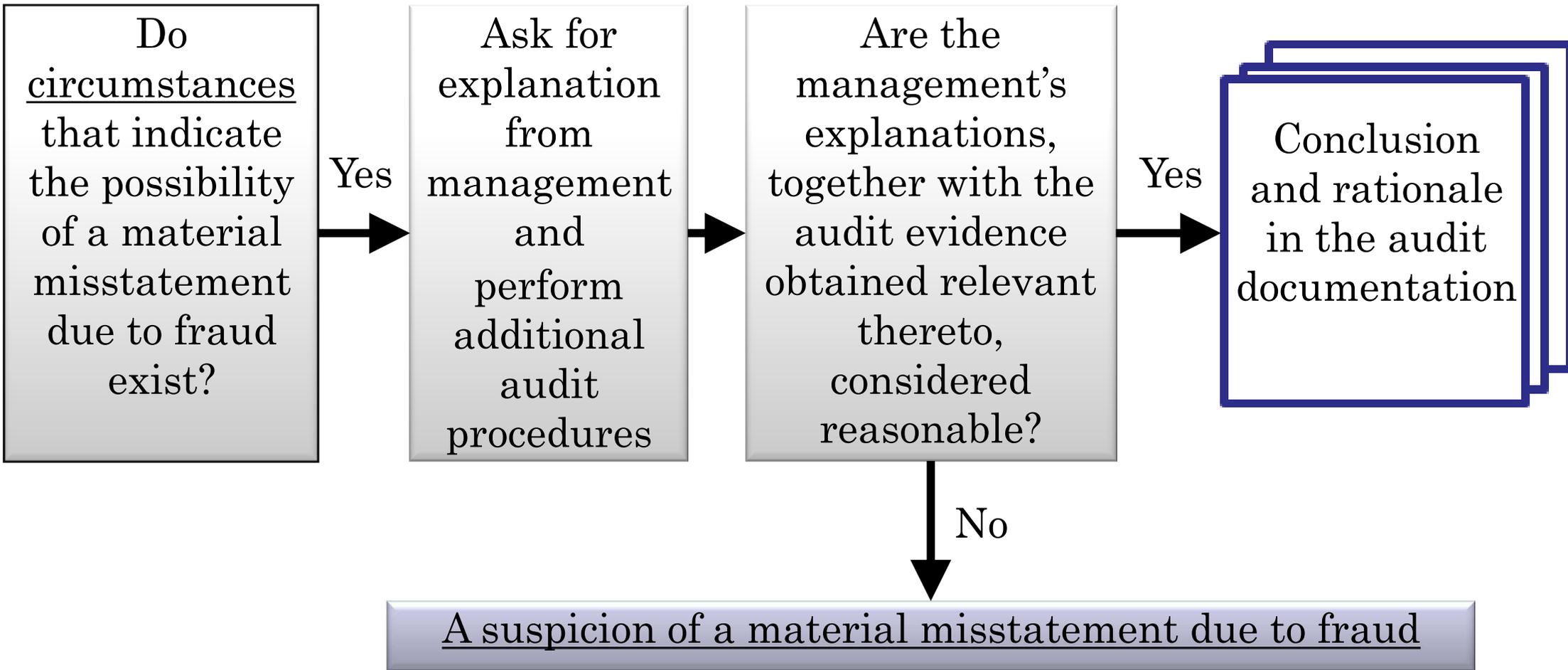
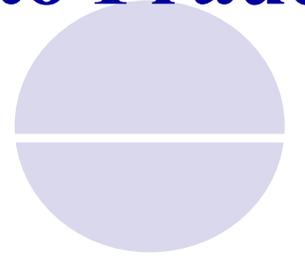
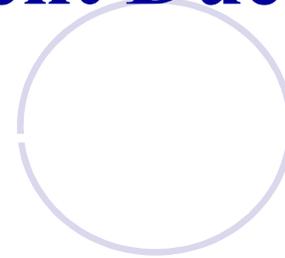
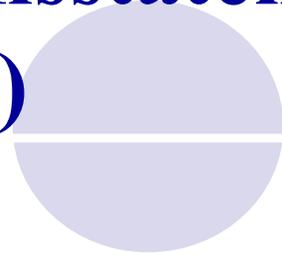
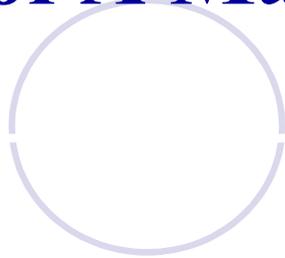
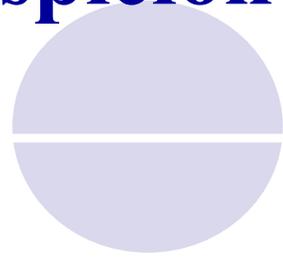
2. Unusual Transactions, etc. to be Considered

(2) Circumstances that indicate the possibility of off-balance transactions, such as fictitious cash disbursement and reimbursement.

* Acquisition of significant assets or a business, significant new investments or significant expenses which are not directly related to the entity's business activities or for which the business rationale appears unclear.

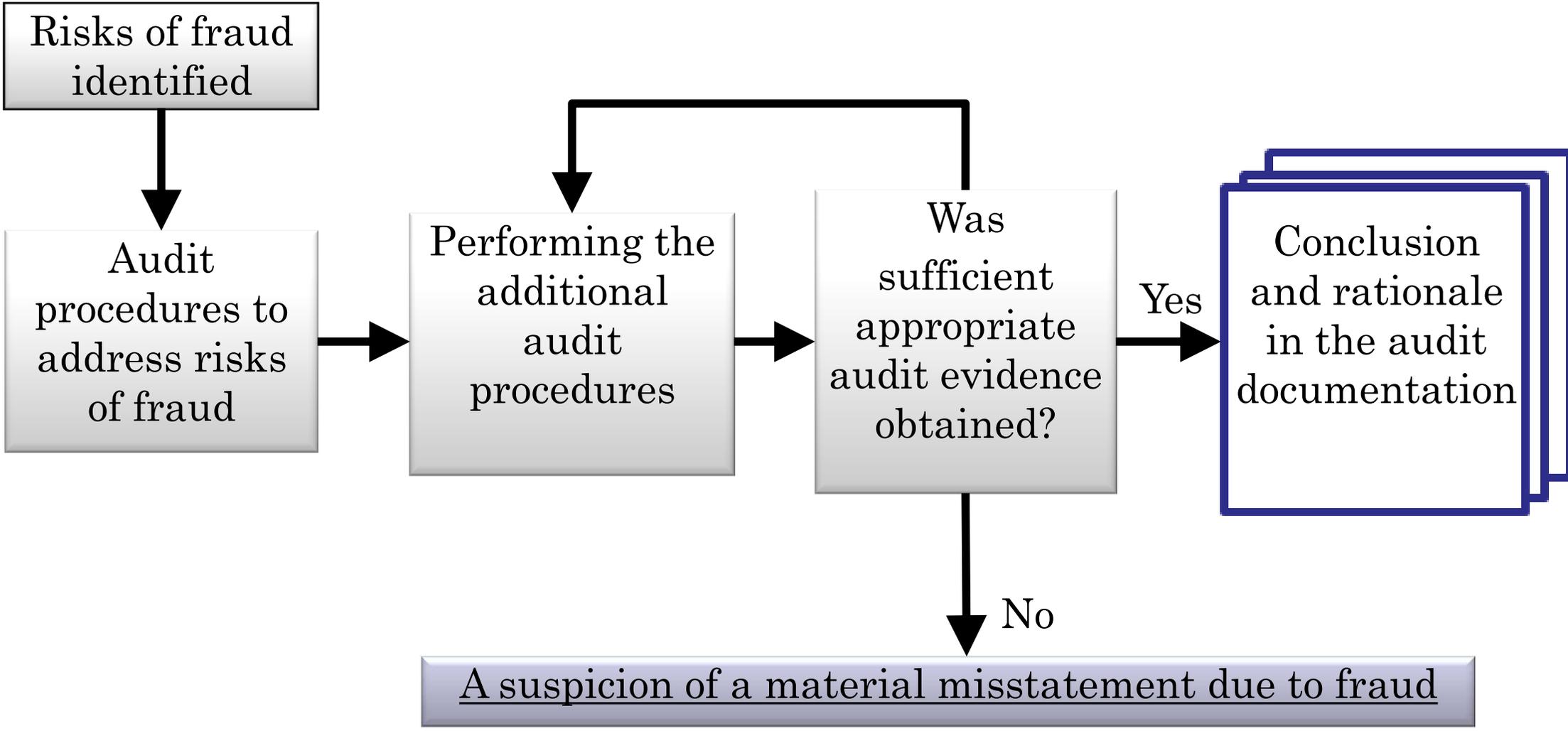
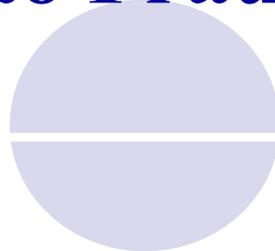
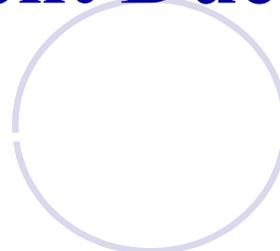
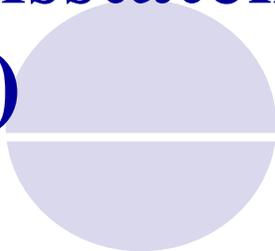
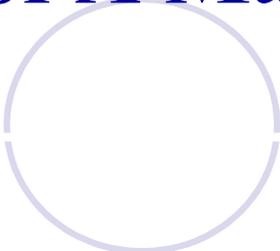
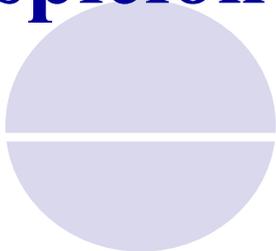
A Suspicion of A Material Misstatement Due to Fraud

(1/4)



A Suspicion of A Material Misstatement Due to Fraud

(2/4)



A Suspicion of A Material Misstatement Due to Fraud

(3/4)

Requirements for auditors when an auditor concluded that a “suspicion of a material misstatement due to fraud” exists.

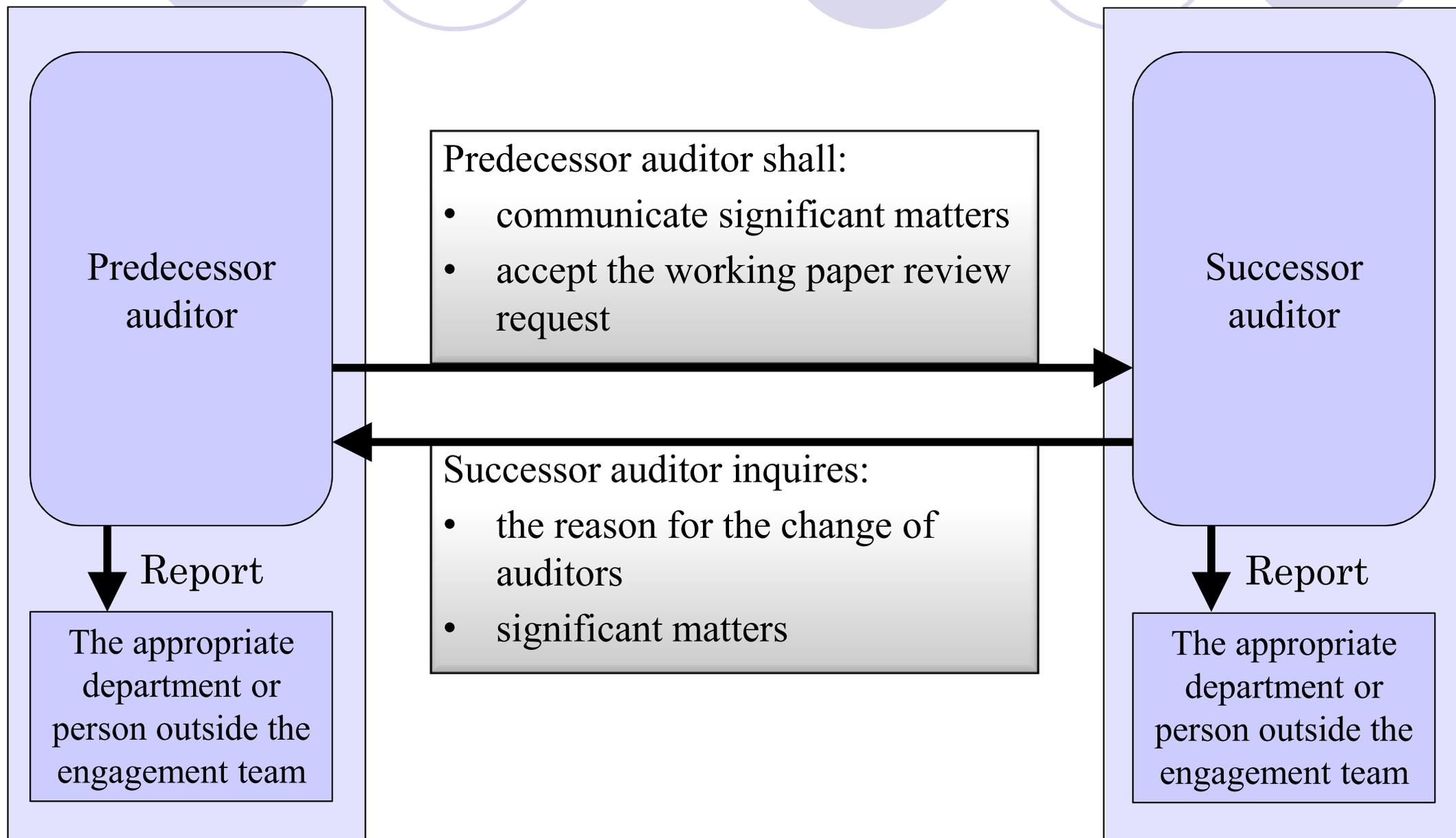
- The auditor shall modify the audit plan to include audit procedures that are specifically responsive to the types of possible fraud (including sufficient investigation related to such suspicion, in order to obtain sufficient appropriate audit evidence)
- The enhanced engagement quality control review (the Enhanced EQCR) is required, in regard to the auditor’s responses to the “suspicion of a material misstatement due to fraud”
- The auditor shall not express an audit opinion until the Enhanced EQCR is completed

A Suspicion of A Material Misstatement Due to Fraud

(4/4)

Types of EQCR	Engagement	EQCR reviewer	Scope of review
EQCR	<ul style="list-style-type: none">•Pursuant to ISQC1 (including all audit engagements of listed entities)	<ul style="list-style-type: none">•Pursuant to ISQC1 (Typically, conducted by a partner in the same office.)	<ul style="list-style-type: none">•Pursuant to ISQC1 (including significant matters and judgments)
Enhanced EQCR	<ul style="list-style-type: none">•Engagement identified “Suspicion of Material Misstatement Due to Fraud.”	<ul style="list-style-type: none">•Qualified Enhanced EQCR reviewer (including a team made up of qualified individuals)•Sufficient and appropriate experience, authority and other qualifications that is responding to the relevant suspicion. (For large audit firms, typically conducted by the head office.)	<ul style="list-style-type: none">•Appropriateness of modified audit plan and audit procedures.•Sufficiency and appropriateness of audit evidence obtained.

Communication between Predecessor and Successor Auditors



Other Changes (1/3)

■ Other changes that were incorporated in the Japanese Fraud Risk Standard include:

Topics	ISAs	The Japanese Fraud Risk Standard
Understanding of instances of fraud and business practices	<ul style="list-style-type: none">•ISA 315 requires an understanding of the entity and its environment in general.•ISA 240.15 also requires engagement team discussion on how and where the financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.	<ul style="list-style-type: none">•The auditor shall obtain an understanding of:<ul style="list-style-type: none">• the typical instances of fraud which have been made public (including inspection reports of the audit regulator)•general and industry-specific business practices that are likely to be used for fraud.

Other Changes (2/3)

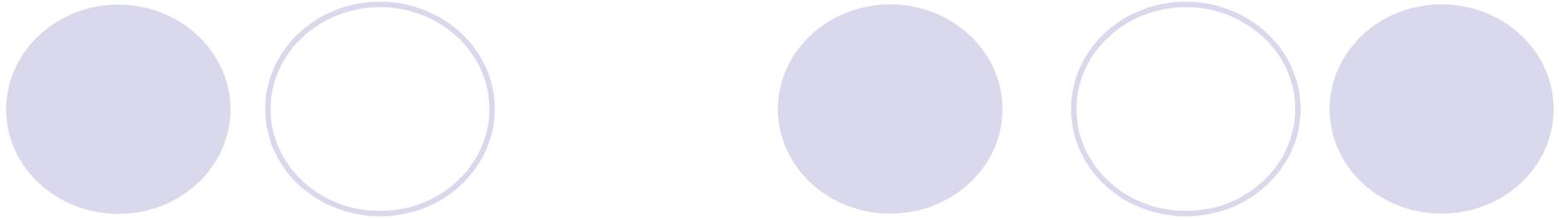
Topics	ISAs	The Japanese Fraud Risk Standard
<p>Report obligation to engagement partner</p>	<ul style="list-style-type: none"> •No explicit requirement for the engagement partner to direct team members to bring matters to senior staff’s attention. •However, ISA 220.15-18 establish responsibilities on the engagement partner for supervision, review and consultations, including review of documentation and discussion with engagement team about adequacy of evidence and <u>being satisfied that there has been appropriate consultations within the engagement team.</u> 	<ul style="list-style-type: none"> •<u>The engagement partner shall direct engagement team members to bring matters arising during the audit to the attention of the engagement partner and more experienced engagement team members:</u> <ul style="list-style-type: none"> •matters could be significant accounting and auditing issues such as unusual transactions that raise questions about the business rationale

Other Changes (3/3)

Topics	ISAs	The Japanese Fraud Risk Standard
Use of expert	<ul style="list-style-type: none"> •The auditor shall assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor’s assessment of the risks of material misstatement due to fraud for the engagement; •The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement. ※ ISA540 “Auditing accounting estimate, including fair value accounting estimate and related disclosure” does have explicit obligation for use of expert. 	<ul style="list-style-type: none"> •The auditor <u>shall determine</u> whether the skill and knowledge of an expert is needed during the audit, according to the nature and significance of the risks of fraud. •For example, <ul style="list-style-type: none"> •to perform assessments of risks of fraud •to perform audit procedures •to evaluate audit evidence (An expert includes the specialist for valuation of financial instruments, corporate valuation, real estate valuation, forensic, or IT)

Other Regulatory Changes

- Other regulatory changes include a change in the filing requirement.
 - When an auditor finds a suspicion of fraud, it takes time to determine if it really is fraud or not.
 - At the same time, the jurisdictional filing requirement sets a deadline for annual filing and an auditor is under pressure to conclude their audit by the deadline, otherwise the audited company would be delisted due to a violation of filing requirements.
 - FSA introduced a special extension of the filing period when an auditor encounters a suspicion of fraud, so that the auditor can spend enough time to work on a suspicion of fraud.



Thank you!

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Government of Japan**

<http://www.fsa.go.jp/en/index.html>