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The IAASB

Dear Sir/Madam,

Enhancing Audit Quality in the Public Interest:
A focus on professional skepticism, quality control and group audits

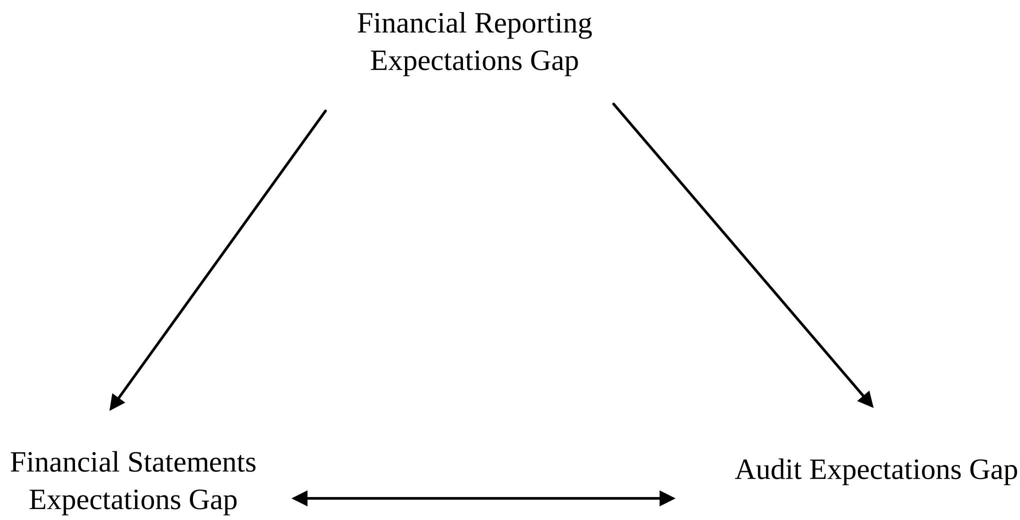
I am writing in response to your request for comments on the above document. My interest is primarily in professional skepticism and therefore my response will be limited to this topic and the general questions. In 2010, I responded to the APB's Discussion Paper: *Auditor scepticism: Raising the bar*. I questioned whether skepticism was enough and offered Critical Thinking as an alternative – sadly the APB did not seem to be interested in this suggestion.

Response to G1b
Both accounting and auditing are often considered to be technical subjects – with technical problems and technical solutions. I would suggest that the perception of technical precision tends to undermine the complexities of external reporting, underplays the subjective nature of the financial statements, and the impact of the motivations of management on the financial statements. I would suggest that external auditing should be viewed in terms of the audit of management's motivations (Higson, 2003). Management's motivations provide the driving force behind the way the financial statements are prepared and presented. These motivations may range from the meeting of profit targets (so as to satisfy City expectations or the achievements of personal bonuses) to ensuring the survival of the business. Motivational aspects permeate the whole production of the financial statements. If management intends to smooth profits, this is something which it is very difficult for auditors to detect. This raises the question as to the role of the auditor in relation to management bias: whether it is to eliminate bias, to minimise bias or to examine the reasonableness of management's justifications for their representations - auditors seem to prefer to view themselves as being required to examine management's justifications for their representations (Higson, 2003, pp.140-141). However, at what point does bias become fraud? The dividing line between the two, in certain circumstances, may at the very least be very fine.

Therefore, I believe the under-appreciation of the impact of management's motivations on the financial statements is one impediment to the full application of professional skepticism.

Response to G2
Whilst a lot of effort has been put into tackling the audit expectations gap, I have long argued that this is part of a much wider expectations gap, namely the financial reporting expectations gap comprising the audit expectations gap and a financial statements expectations gap.

The Financial Reporting Expectations Gap



As far back as 1974, Liggio (p.28) was concerned about the interpretation of the accounting numbers in the financial statements:

> "Users view the financial statements, because of the use of numbers, as having a degree of exactness and certitude which, in fact, they do not have. From our earliest days in grammar school we are taught that two plus two equals four - an unalterable conclusion. Mathematics (and accordingly numbers) is scientific. Numbers are exact, precise and without error. Therefore, logically the reader (or user of financial statements) infers that they have that precision, accuracy and definitiveness."

Liggio (1974, p.29) went on to cite the concerns of Philip Loomis (a commissioner of the SEC) about the "widespread public misunderstanding of the function and limitations of accounting", and Liggio considered that "[i]t is not fair to blame only the user of the financials for this misunderstanding – for the expectation is aided and abetted by the profession". I would suggest that one way the Accountancy profession has "aided and abetted", and is continuing to do this, is through the standard-setters' inability to clearly specify the objective of the financial statements. At the moment, it appears that the accounting standard-setters believe the objective of the financial statements is to enable users to predict the future, take decisions, judge the stewardship of management and assess the performance (past and potential) of the reporting entity (Higson, 1997). The implications for the external auditors of this confusion is, one presumes, that the audit report implies that the financial statements are "fit for purpose" – but what is the purpose? The fact that the financial statements appear to be all things to all people, has done nothing to enhance the status of the Accountancy profession, and if users have unrealistic expectations of the financial statements, no wonder they are often disappointed with the work of the external auditors.

Response to G3
Some of my work that may be of interest:

My response to the APB's 2010 audit skepticism paper:
http://www.frc.org.uk/Our-Work/Publications/APB/Discussion-Paper-Auditor-Scepticism-Raising-the-Ba/Responses-to-Discussion-Paper-Auditor-Scepticism-R/Dr-Andrew-Higson.aspx

My academic paper on skepticism presented at the BAFA Annual Conference at Aston University in 2011:
file:///C:/Users/msawh/Downloads/AUD__Higson__Is%20scepticism%20enough%23-The%20application%20of%20%23critical%20thinking%23%20to%20the%20external%20audit%20(1).pdf

My book, based around the idea of a financial reporting expectations gap: *Corporate Financial Reporting: Theory & Practice*, and Chapter 6 relates to the audit of motivations.

Response to PS1
I have nothing to add to your definition of professional skepticism, but I think it is unlikely that increased audit skepticism alone is enough to tackle the problems facing the external auditors.

Response to PS2
As I stated in response G1, both accounting and auditing are often considered to be technical subjects and I would suggest that this tends to undermine the complexities of external reporting. Key to this is the impact of management's motivations on the preparation and presentation of the financial statements. For this reason I have argued that external auditing should be viewed as the audit of management's motivations.

In PS1 I stated that I do not think that skepticism alone is enough. I have argued that the profession should consider Critical Thinking. Kurfiss (1988, p.2) defined Critical Thinking as "an investigation whose purpose is to explore a situation, phenomenon, question, or problem to arrive at a hypothesis or conclusion about it that integrates all available information and that can therefore be convincingly justified" – doesn't this sound exactly like external auditing?

Huffman et al. (1995, pp.xxix-xxxi) categorized the main elements of Critical Thinking into three main components:

- Affective Components – these comprise "the emotional foundation" which enable or limit an individual's ability for Critical Thinking. These components were "valuing truth above self-interest", "accepting change", "empathizing", "welcoming divergent views", "tolerating ambiguity" and "recognizing personal biases".

- Cognitive Components – these are the thought processes used in Critical Thinking: "thinking independently", "defining problems accurately", "analyzing data for value and content", "employing a variety of thinking processes in problem solving", "synthesizing", "resisting overgeneralization" and "employing metacognition" (reflective thinking – thinking about one's own thought processes).

- Behavioral Components – actions needed to achieve Critical Thinking: "delaying judgment until adequate data is available", "employing precise terms", "gathering data", "distinguishing fact from opinion", "encouraging critical dialogue", "listening actively", "modifying judgments in light of new information" and "applying knowledge to new situations".

From this, it would seem to be highly appropriate to apply Critical Thinking to external auditing and the use of the above three components may help to explain the problems faced by the external auditors and provide a basis for tackling these problems. In my academic paper, I applied these components to the external audit as follows:

Affective Components	→	The auditor's background
Cognitive Components	→	Professional education and training
Behavioural Components	→	Conducting the audit

The Application of Critical Thinking to External Auditing

- The "affective components" are probably imbedded in a person's background – and it may mean that everyone is not capable of Critical Thinking. Therefore, when audit firms are recruiting, they need to consider whether potential candidates are capable of approaching a problem with an open mind. Recruiters look at candidates' qualifications and achievements (and not just academic) but whether they consider a person's ability to be critical may be open to question.

- The "cognitive components" of Critical Thinking are probably impacted upon by professional education and training given to auditors. Whilst auditors are being encouraged to have greater skepticism, there is a danger that financial reporting standards, auditing standards, and firms' audit methodologies may actually reduce that individual auditor's ability to think critically. In order to qualify as an accountant, students have to learn the financial reporting and auditing standards –

usually uncritically. Firms' audit methodologies set out the approaches taken during the audit. Whilst this produces consistency, it could adversely impact on a person's ability to think independently – one of the cognitive components needed for Critical Thinking. Shaub and Lawrence (1999) reported that someone who was new to auditing demonstrated a greater level of skepticism than their superiors – thus implying that there may be pressures to conform.

- The "behavioral components" of Critical Thinking are likely to be employed during the actual conduct of the audit. Time pressures may reduce an auditor's ability to employ Critical Thinking during the audit. Even if an auditor does apply Critical Thinking, consideration has also to be given to the implications for the individual. Someone that is more critical, or reflective, than others may take too much time on the audit and thus not be promoted within the audit firm (Ponemon, 1992) or have to leave the firm (Harrison and Carroll, 1991).

I think I would view audit skepticism as a subset of Critical Thinking. The advantage of Critical Thinking is that it emphasizes not everyone may have the ability to be critical, that the professional training undertaken by auditors may reduce their ability to be critical, and that time pressures to finish the audit / keep within budget may mean that individuals see their careers suffer if they take time to be critical.

Response to PS3
I would like your work on professional skepticism to be expanded to include Critical Thinking. I think you also need to consider the potential implications for the external auditors of a financial reporting expectations gap.

Response to PS4
I am not sure whether your work on quality control and group audits will improve the application of professional skepticism because of the points I have made in response to PS3.

Response to PS5
I think educators need to be stressing:

- the impact of management's motivations of the preparation and presentation of the financial statements,
- the subjective nature of the financial statements,
- the potential usefulness of Critical Thinking in external auditors' professional education and development, and
- the potential impact of the financial reporting expectations gap both for users and external auditors.

I hope these comments are of interest. If you require clarification of any of the above points, please do not hesitate to contact me.

Yours faithfully,

Dr Andrew Higson

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