



International Federation of Accountants

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Committee: IAASB Consultative Advisory Group

Meeting Location: Prague

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Professional Skepticism

Objective of Agenda Item

1. To explore and share viewpoints on the topic of professional skepticism in the context of audits of financial statements.

Background

2. Professional skepticism is a fundamental tenet of any audit. Together with professional judgment it is an important input to audit quality.
3. Professional skepticism is therefore a central theme that underlies the suite of clarified International Standards on Auditing (ISAs). ISA 200¹ explicitly requires auditors to maintain professional skepticism throughout the planning and performance of the audit, and provides guidance to assist in appropriately applying the concept. The concept is further reinforced in other clarified ISAs where it is of particular importance. Examples include the ISAs dealing with fraud, auditing accounting estimates (including fair value accounting estimates), and auditing related party transactions and relationships. In many jurisdictions around the world the clarified ISAs are now beginning to be implemented.
4. The importance of professional skepticism has been the center stage in many recent public statements by regulators and others since the global financial crisis. Many have asserted that, in their view, auditors should be exercising increased levels of professional skepticism in performing audits. For example, they believe that auditors should be actively challenging management assumptions and judgments and forming independent views rather than being satisfied with evidence that supports management's views. Recent inspection reports from various jurisdictions have also observed that audit firms could improve by promoting a culture that fosters increased levels of professional skepticism.
5. Others note however that some of the criticism arises from the fact that auditing inherently is not an entirely transparent process (i.e., regulators conducting inspections after the completion of audit engagements do not have direct insight into the audit process) and that audit documentation cannot fully capture the way in which auditors apply professional skepticism. Additionally, it has been noted that the evolution in International Financial Reporting

¹ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

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Standards (IFRS) and other accounting frameworks to a fair value model has introduced greater measurement uncertainty and that, while some may see the role of auditors to promote a bias of prudence in financial reporting, the financial reporting frameworks are premised on neutrality. Furthermore, the revised ISA on auditing accounting estimates, including fair values, that provides more comprehensive and robust requirements on how auditors should approach auditing estimates with significant measurement uncertainty only became effective for recent audits.

6. Nevertheless, concerns over insufficient auditor skepticism have resulted in questions being raised as to the role of professional skepticism in an audit, and whether its application in practice could be improved and thereby further enhance audit quality.
7. Attached to this Agenda Item is a briefing paper on the topic of professional skepticism. It has been prepared by IAASB staff at the request of the CAG to facilitate further discussion on the topic.

Discussion

8. This session is an open discussion facilitated by the IAASB CAG Chairman and IAASB Technical Director.
9. The CAG Representatives are asked to share their views on the topic of professional skepticism in auditing. The following initial questions are meant to help stimulate discussion:
 - (i) What do you understand professional skepticism to mean? What do you believe it *should* mean? In this regard, do the auditing standards appropriately articulate the concept of professional skepticism and the requisite auditor behavior expectations?
 - (ii) What are significant threats to professional skepticism and its proper application? To what extent have the clarified ISAs, specifically those that reinforce the concept of professional skepticism (explained in this briefing paper), safeguard against such threats? How might the exercise of professional skepticism be further promoted in audits?
 - (iii) How could the level of professional skepticism applied in an audit be better evidenced and reviewed? Are there other considerations or challenges that might factor into the achievement of a common understanding of what is meant by professional skepticism within the global context? What are those, and what can be done to overcome such challenges?
 - (iv) What role if any, is there for others (e.g., management, audit committee, and regulators) in promoting and supporting professional skepticism in auditors?

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Briefing Paper: Professional Skepticism

This briefing paper provides background on the topic of professional skepticism, how it is addressed in the clarified ISAs, and an overview of recent developments. The paper has not been approved or otherwise acted upon by the IAASB. This paper is structured in four sections. Sections I – III describes what skepticism is, why it is important, and how auditor skepticism is addressed in the ISAs. The last section of the paper discusses developments that provide further insight on the topic.

I. What Is Skepticism?

1. The word skeptic is rooted in ancient philosophy and has been variously defined as “a person who questions the validity or authenticity of something purporting to be factual” or “a person who maintains a doubting attitude, as toward values, plans, statements, or the character of others.” Skepticism is therefore a behavioral trait, one that manifests through mindset and attitude.
2. In auditing, the term “professional skepticism” is used and dates back to 1977.² Professional skepticism is integrally linked to the fundamental principles of independence and objectivity, and, as such, the term is descriptive of the auditor’s expected mindset in performing an audit. Personal behavioral traits influence an auditor’s exercise of skepticism, as does the professional auditor’s knowledge, training and experience.
3. There is no consensus in academic literature on the definition and measurement of professional skepticism in the context of an audit. However, conceptually what is meant and understood by skepticism can be thought of along a spectrum. On one end, a *presumption of management’s good faith*: one in which the auditor presumes that management prepares the financial statements in good faith unless evidence is obtained to suggest otherwise. In the middle, there is a *neutral mindset*: one in which the auditor attempts to be unbiased in forming his or her beliefs, and takes neither a positive (trusting), or negative (suspicious) position. On the other end, there is *presumptive doubt*: a mindset where some level of dishonesty by management is assumed until evidence indicates otherwise, similar to the view as used in forensic audits. The objective of a forensic audit is different from the objective of a financial statement audit.³
4. The application of professional skepticism is critical for auditors; however, it has to be practical. By its nature, most audit evidence is persuasive rather than conclusive.⁴ However, if an auditor is expected to obtain all available evidence and question the reliability of all evidence obtained, the costs involved would be significant. In doing so, auditors would be continuing to doubt long after a reasonable person would be persuaded by the evidence at

² Quadackers, Luc. *A Study of Auditors’ Skeptical Characteristics and Their Relationship to Skeptical Judgments and Decisions*. 2009.

³ In an audit of financial statements, the auditor’s overall objective is express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. However, in a forensic audit, the objective is to uncover asset-theft fraud.

⁴ ISA 200, paragraph A45

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hand. This level of “skepticism” would not service practical interests. The following quote from the publication *The Philosophy of Auditing* is stimulating: “[The auditor] should be hard to convince, but not impossible. All evidence should be examined critically and some of it may have to be rejected. None of it should be rejected, however, merely because it is not conclusive.”⁵

II. Why Is Auditor Skepticism Important?

5. Professional skepticism is particularly important when auditors are faced with limited independent evidence (for example in determining a fair value measurement) or possibly contradictory evidence. Increasing complexity of business transactions products and structures, the demand for information that is more relevant to users (e.g., fair values), and the time frame in which financial statements need to be prepared and reported on, have resulted in more accounting methods that involve complex calculations and greater estimation. This in turn has resulted in an increased need for judgment, management estimation and measurement uncertainty in the financial statements. It has become even more important and frequent for auditors to make subjective and judgmental decisions in performing audits of financial statements.

6. The 2010 FSA/ FRC Discussion Paper⁶ provides a useful example:

In the case, for example, of a complex financial instrument that is not traded on an exchange, applying fair value will often necessitate using valuation techniques that involve models to derive values. Where there are significant unobservable inputs, it is likely that there will be a variety of assumptions and possible techniques that could result in a range of estimates for those fair values. The auditor then has to assemble evidence and may need to use experts. Assessing whether the inputs, models, assumptions, range of estimates, and the particular estimate used by their client is appropriate demands a high degree of professional skepticism.

The auditor’s objective is to evaluate whether management have made a reasonable and unbiased valuation consistent with the requirements of the accounting framework and with their approach to valuing other similar instruments, based on what could be a myriad of inputs. It is not sufficient to simply conclude that the valuation is acceptable just because it falls within a range of values that valuation experts would generally consider plausible. The auditor also has to evaluate whether management have provided sufficient appropriate disclosures of the key estimates and assumptions. In some areas, the accounting standards may not specify disclosures and in such circumstances the auditor needs to evaluate whether additional disclosures may be necessary to give a true and fair view. This means it is necessary for the auditor to challenge management’s accounting estimates and the appropriateness of their disclosures. A skeptical mindset, combined with the audit firm’s knowledge of the range of possible approaches to accounting estimates and disclosures, should give the auditor a sound basis to do this.

7. In exercising professional judgment, an appropriate level of professional skepticism is needed by auditor throughout the audit to determine whether sufficient appropriate audit evidence has

⁵ Mautz, R.K & Sharaf, H.A. *The Philosophy of Auditing*. American Accounting Association. 1997.

⁶ Financial Services Authority and Financial Authority & Financial Reporting Council, *Enhancing the Auditor’s Contribution to Prudent Regulation*. June 2010. p. 19.

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been obtained to support the audit opinion. In doing so, it is necessary to be alert for contradictory audit evidence and question the reliability of documents, responses to inquiries, and other information obtained from management and those charged with governance.⁷

III. How Is Professional Skepticism Addressed in the ISAs?

Definition and References to Professional Skepticism

8. Since their codification in the 1990s, the ISAs have included a requirement for the auditor to plan and perform an audit with professional skepticism. The concept was further reinforced in the development of ISA 240,⁸ in addressing fraud in an audit.
9. As part of the Clarity Project, ISA 200⁹ was revised to give more prominence to the term professional skepticism and introduced the following definition:

Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

10. In addition to continuing to explicitly require auditors to maintain professional skepticism throughout the planning and performance of the audit, the clarified ISA 200 provides guidance to further assist in appropriately applying the concept. ISA 200 states the following:¹⁰

The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example: audit evidence that contradicts other audit evidence obtained; information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence; conditions that may indicate possible fraud; and circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of: overlooking unusual circumstances; over generalizing when drawing conclusions from audit observations; or using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used

⁷ ISA 200, paragraph A20

⁸ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

⁹ ISA 200, paragraph 13(l)

¹⁰ ISA 200, paragraphs 15 and paragraphs A18-A22

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as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

11. The Appendix to this paper lists other references in the ISAs to the term professional skepticism.

ISA Requirements and Guidance that Drive Skeptical Behavior

12. In addition to explicit references to professional skepticism, the concept of professional skepticism is further reinforced in the clarified ISAs, through requirements and guidance, where it is of particular importance.
13. Generally speaking, the ISAs can be seen to stimulate skeptical behavior in a variety of ways depending on the subject. For example, in some cases the ISAs require the auditor to take a "presumptive doubt" stance. In other cases, the requirements stress the importance of being alert to factors or other matters that should raise caution and, as appropriate, cause the auditor to reassess whether the auditor's risk assessment and related responses remain appropriate. Further, the ISAs also include requirements and guidance directed specifically at challenging the appropriateness of actions of management.
14. Examples of such requirements and guidance (paraphrased) include the following:
 - Engagement team discussion on the susceptibility of the entity's financial statements to material misstatement, including material misstatement due to fraud, setting aside beliefs that the engagement team may have that management and those charged with governance are honest and have integrity.¹¹
 - Evaluation of unusual or unexpected relationships identified in performing analytical procedures, and evaluation of fraud risk factors.¹²
 - Presumption of risks of fraud in revenue recognition.¹³
 - Treatment of risks of management override of controls as a significant risk and required testing of the appropriateness of journal entries, review of accounting estimates for management biases, and evaluate of whether the business rationale of transactions (or

¹¹ ISA 315, paragraph 10 and ISA 240, paragraph 15

¹² ISA 240, paragraphs 22 and 24

¹³ ISA 240, paragraph 26

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lack thereof) suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.¹⁴

- Evaluation of the implications on the audit where there is inconsistency in, or doubts over reliability of, audit evidence.¹⁵
- Evaluation of validity and reasonableness of management's refusal to allow the auditor to send a confirmation request, and the implications of such refusal on the auditor's assessment of risks and nature, timing and extent of audit procedures.¹⁶
- Evaluation of the implications on the audit where factors give rise to doubts about the reliability of a response to a confirmation request.¹⁷
- Determination of whether changes in accounting estimates or in the method of making them from the prior period are needed and are appropriate in the circumstances; for example, if management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to change in the environment or circumstances affected the entity (e.g., if management changes the basis of making an accounting estimate from a market-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances).¹⁸
- Review of judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias, and, as appropriate, consideration of whether such indicators may affect the auditor's conclusion as to whether the auditor's risks assessment and related responses remain appropriate and the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.¹⁹
- Further substantive procedures for accounting estimates that give rise to significant risks, including evaluation of how management has considered alternative assumptions or outcomes and why it has rejected them, and further action where, if in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty of an accounting estimate that gives rise to significant risks.²⁰
- Procedures in relation to identification of related party relationships or transactions that management has not previously identified or disclosed to the auditor, and reconsideration

¹⁴ ISA 240, paragraph 32

¹⁵ ISA 500, *Audit Evidence*, paragraph 11

¹⁶ ISA 505, *External Confirmations*, paragraph 8

¹⁷ ISA 505, paragraphs 10 and 11

¹⁸ ISA 540, paragraphs 8(c)(v), 12(b) and A37

¹⁹ ISA 540, paragraphs 21 and A124

²⁰ ISA 540, paragraphs 15 and 16

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of risks in cases where the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor.²¹

- Re-evaluation of the integrity of management and other actions where management does not provide one or more requested written representations.²²
- Evaluation of the adequacy of disclosure of estimation uncertainty for estimates that give rise to significant risks in the context of the applicable financial reporting framework, in addition to obtaining sufficient appropriate audit evidence about whether disclosures are in accordance with the requirements of the framework.²³

15. In addition, ISQC 1 requires audit firms to establish policies and procedures that are designed to promote an internal culture that recognizes and rewards audit quality.²⁴ ISQC 1 notes that the promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures, and the requirement to perform work that complies with professional standards. ISQC 1 notes further that actions and messages that encourage a culture that recognizes and rewards high-quality work may be communicated by, but are not limited to, training seminars, meetings, formal or informal dialogue, mission statements, newsletters or briefing memoranda. It also includes the establishment of policies and procedures that address performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, in order to demonstrate the firm's overriding commitment to quality.
16. More generally, there are matters that may cut across several aspects of an audit where skepticism is important. An example is auditing significant unusual and or highly complex transactions. The September 2010 IAASB Staff Questions and Answer publication, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions*,²⁵ highlights considerations in the ISAs that are relevant to auditing such transactions, noting that their nature may give rise to risks of material misstatement of the financial statements and, accordingly, may merit heightened attention by auditors.

IV. What Developments Provide Further Insights on the Topic?

Policy Debates

17. The subject of professional skepticism has been raised by regulators and others in the wake of the global financial crisis. Sources of commentary include, amongst others:

²¹ ISA 550, *Related Parties*, paragraphs 15 and 22

²² ISA 580, *Written Representations*, paragraph 19

²³ ISA 540, paragraphs 19 and 20

²⁴ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements*, paragraphs 18, A4 and A5

²⁵ Available at <http://web.ifac.org/publications/international-auditing-and-assurance-standards-board/practice-alerts-and-q-as>

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- The 2008 Final Report of the Advisory Committee on the Auditing Profession (ACAP) to the U.S. Department of Treasury, which recommended among other things, the “[development] of training materials to help foster and maintain the application of healthy professional skepticism...” as a way of improving the sustainability of the public company auditing profession.²⁶
- The UK Financial Services Authority (FSA) and UK Financial Reporting Council (FRC) issued a discussion paper in June 2010 titled *Enhancing the Auditor’s Contribution to Prudent Regulation* that raised several questions regarding the role of audit and assurance, including a question on how professional skepticism and its application in practice can be enhanced in audit areas. A summary of the 22 responses to this discussion paper notes widespread recognition that the application of professional skepticism is fundamental to the audit process.²⁷
- The European Commission (EC) published a Green Paper in 2010 titled *Audit Policy: Lessons from the Crisis* that raised several questions, in the aftermath of the financial crisis focused at financial market regulatory, about several matters including the role of the auditor and the scope of the audit. In the Green Paper, the EC made a case for “going back to basics with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work.” The Green Paper also included a discussion on auditor behavior which stated that:

Whilst the primary responsibility for delivering sound financial information rests with the management of the audited entities, auditors could play a role by actively challenging management from a user’s perspective; it could be critical to exercise ‘professional scepticism’ vis-à-vis the audited entity. Such skepticism could also be exercised with regard to key disclosures in the financial statements and may also result in an appropriate ‘emphasis of matter’ in the audit report.

In a February 2011 Feedback Paper the EC summarized responses on the Green paper from approximately 700 respondents. All investor and public authority representatives agreed that professional skepticism should be reinforced. Some respondents suggested that audit committees should also be in a position to assess the professional skepticism applied by auditors.²⁸

²⁶ ACAP Final Recommendation VIII:19. The Treasury Department established ACAP to examine the sustainability of a strong and vibrant auditing profession. ACAP adopted a Final Report containing more than 30 recommendations to improve the sustainability of the public company auditing profession. More information about ACAP and its recommendations are available at: <http://www.treasury.gov/about/organizational-structure/offices/Pages/acap-index.aspx>.

²⁷ The Financial Services Authority (FSA) and Financial Reporting Council (FRC), *Enhancing the auditor’s Contribution to prudent regulation*. (June 2010) and *Feedback Paper*, (March 2011). Available at: <http://www.frc.org.uk/publications/pub2302.html>

²⁸ The European Commission Green Paper. *Audit Policy: Lessons from the Crisis*. (October 13, 2010) and *Feedback Paper* (February 2011). Available at:

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- The final March 2011 report by the UK House of Lords, Select Committee on Economic Affairs, *Auditors: Market Concentration and their Role*, also included a recommendation that the “profession, regulators and the Government should all seeks ways to defend and promote the exercise of auditor’s traditional, prudent scepticism.”²⁹
 - The Public Company Accounting Oversight Board (PCAOB) recently issued for public comment a concept release that explores the matter of mandatory auditor rotation and among other things, its potential implication on professional skepticism. The deadline for providing comments on the concept release is December 14, 2011.³⁰
 - Public statements by regulators and others have also included a call for increased levels of professional skepticism. For example, in a recent speech the PCAOB Chairman stated that “to assure that reported financial and economic successes are not illusory – auditors must approach their jobs with independence and skepticism.”³¹ Similarly, the Chief Executive of the FRC stated in a recent speech to the EC Conference on Financial Reporting and Auditing that “we need an audit profession ...that is not afraid to challenge management. One that is sceptical of assertions made without apparent good foundation – that does not see its role as confirming management’s view, but identifying the truth.”³²
18. A theme noted in some of the above, including audit inspection reports, relates to active “challenging of management” as a feature of professional skepticism. Those reports are not explicit in what is meant by the term “challenging of management.” Conceivably the term could mean asking tougher questions of management, second guessing or supplanting management’s judgments or assertions, or re-performance.

Audit Inspections

19. Recent inspection reports in various jurisdictions cite specific examples where auditors could enhance professional skepticism include the work the auditors performed in auditing fair value measurements, impairment calculations, related party transactions and going concern

http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm

²⁹ UK House of Lords, Select Committee on Economic Affairs, 2nd Report of Session 2010-11. *Auditors: Market Concentration and their Role*, (March 2011) Available at:

<http://www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf>

³⁰ Additional information regarding the PCAOB concept release is available at:

http://pcaobus.org/News/Releases/Pages/08162011_OpenBoardMeeting.aspx

³¹ James Doty. SEC and Financial Reporting Institute 30th Annual Conference. *Rethinking the Relevancy, Creditability and Transparency of Audits*. Pasadena, CA (June 2, 2011). Available at:

http://pcaobus.org/News/Speech/Pages/06022011_DotyKeynoteAddress.aspx

³² Stephen Hadrill. European Commission Conference on Financial Reporting and Auditing, A Time for Change? Brussels. (February 10, 2011).

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assessments.³³ For example, in its Activity Report for 2010, the International Forum of Independent Audit Regulators (IFIAR) included concerns with the exercise of professional skepticism as an engagement level inspection findings that that IFIAR members identified.³⁴ More specifically the FRC's 2009/2010 Inspection report identified instances where there was:

- Insufficient evidence to support the appropriateness of key assumptions such as growth rates and discount rates;
- Use of assumptions that were inconsistent with those used in valuing other balances in the financial statements; no consideration of revisions to forecasts;
- Insufficient sensitivity analysis; and
- Insufficient consideration of the adequacy and appropriateness of the disclosures in the financial statements relating to impairment testing;

as areas where auditors could have increased the level of professional skepticism applied.

20. Some regulators have noted in their inspection reports that audit firms could improve by promoting a culture that fosters increased levels of professional skepticism.

UK Auditing Practices Board (APB) Discussion Paper

21. The APB in August 2010 issued for public comment a discussion paper, *Auditor Skepticism: Raising the Bar*,³⁵ that focused on the degree of skepticism that auditors should apply in conducting an audit. It also addressed and raised questions about whether sufficient skepticism was demonstrated during the banking crisis.
22. In March 2011, the APB issued a Feedback Paper that summarized the comments received in response to the discussion paper. The Feedback Paper incorporated relevant feedback regarding profession skepticism that was received in response to the FSA/ FRC discussion paper, *Enhancing the Auditor's Contribution to Prudent Regulation* (see paragraph 17 above).
23. There were 27 responses to the APB's discussion paper from various stakeholders. The feedback received from users of financial statements, regulators and others continued to suggest that an increased level of auditor professional skepticism is needed. Audit firms on the other hand were of the view that auditors are sufficiently skeptical in performing audits. Some respondents to the discussion paper noted that documenting the level of professional

³³ For example, PCAOB Report on the PCAOB's 2004, 2005, 2006, and 2007 Inspections of Domestic Annually Inspected firms. December 5, 2008; U.K. Audit Inspection Unit, 2009/10 Annual Report 4 July 21, 2010; AFM, Report on General Findings Regarding Audit Quality and Quality Control Monitoring 13-14 Sept. 1, 2010; Australian Securities & Investment Commission, Audit Inspection Program Public Report for 2009-2010 June 29, 2011.

³⁴ International Forum of Independent Audit Regulators, Activity Report 2010. Available at: <https://www.ifiar.org/reports/index.cfm>

³⁵ The Auditing Practices Board, *Auditor Skepticism: Raising the Bar* (August 2010) and Feedback Paper (March 2011). Available at: <http://www.frc.org.uk/apb/publications/pub2343.html>

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skepticism exercised in an audit is challenging because audit working papers are designed to support the auditor's opinion on the financial statements and do not always involve documentation of all aspects of the audit team's thought process throughout the audit. Those respondents also noted that the new auditing standards (ISAs UK & Ireland), particularly those relating to auditing accounting estimates, are more rigorous and already require increased levels of auditor professional skepticism.

24. Other respondents to the APB paper, including preparers, supported the view that there is a sufficient level of professional skepticism being applied by auditors in performing audits. Additionally, they expressed concern that increased levels of skepticism in audits might result in increased costs of audits, and may result in the relationship between the entity and the auditor becoming too confrontational, which could delay the audit process.
25. The APB has formed a working group and has agreed on a project plan that will undertake work in the following areas regarding professional skepticism:
 - Ensuring that there is a consistent understanding of the nature of professional skepticism and its role in the conduct of an audit,
 - Reviewing auditing standards for possible ambiguities in relation to the nature and importance of professional skepticism, and proposing changes as may be needed,
 - Reviewing the audit quality standard to ensure that it has sufficient requirements and guidance relating to the need for firms to have appropriate policies and procedures for promoting the competencies that underlie professional skepticism,
 - Considering how the application of skepticism can be made more transparent, and
 - Considering, with other parts of the FRC, whether there is a need for guidance on the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been the subject of significant challenge by auditors.

International Education Standards Board for Accountants (IESBA) Standards

26. Professional education plays a critical role in equipping auditors with the skills needed for exercising professional skepticism. It is also a means by which the proper application of professional skepticism can be continually reinforced. The International Education Standards (IESs), which are developed by the IAESB, identify requirements for professional skills, general education, and competence for audit professionals. Audit professionals are typically responsible for making significant judgments in a financial statement audit. IES 8³⁶ requires that the skills requirement within the education and development program for audit professionals should include developing the following professional skills in an audit environment:³⁷
 - (a) Applying relevant audit standards and guidance;

³⁶ IES 8, *Competence Requirements for Audit Professionals*

³⁷ IES 8, paragraph 42

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- (b) Evaluating applications of relevant financial reporting standards;
- (c) Demonstrating capacity for inquiry, abstract logical thought, and critical analysis;
- (d) Demonstrating professional skepticism;
- (e) Applying professional judgment; and
- (f) Withstanding and resolving conflicts.

The IAESB is currently undertaking a project to revise IES 8 and an exposure draft of the proposed revised standard is expected in Q4 2011.

IAASB Project on Audit Quality

27. The appropriate level of auditor skepticism is a vital input to audit quality. The IAASB has commenced work on the development of a consultation paper on framework for audit quality. The draft paper notes that demonstrating professional skepticism is an important mindset for making professional judgments. The draft consultation paper emphasizes that unless auditors are prepared to challenge management's assertions, they will not act as a deterrent to fraud nor be able to conclude, with confidence, that an entity's financial statements are fairly presented. See CAG Agenda Item B.1, section 4.2, for further discussion on the topic.

Academic Research

28. Researchers of auditor behavior have observed and concluded that, while less skeptical auditors may be better at identifying factual errors, through focusing on the details of the audit, more skeptical auditors are better at identifying situations containing contradictory information and adopting a holistic view of audit evidence. Some studies also indicate that increased auditor knowledge (subject matter expertise) does not always result in increased skepticism.
29. Researchers also indicate that auditor skepticism is impacted by the following incentive factors: opportunities for additional services and revenue generation; the nature of review and performance appraisal in the firm and related revenue recognition reward; and regulatory inspection and threats to reputation. The research suggests that increased skepticism is exhibited where concern for reputation and exposure to client litigation is greater rather than concern for firm revenue or the potential loss of a client. Some researchers suggested that professional skepticism, which is fostered through independence, is incompatible with the client/auditor relationships. Researchers also observed that personal attributes and traits, including trust, also influence the degree of skepticism exhibited by auditors.
30. Though most of the research on skeptical behavior has been focused on the individual auditor, studies suggest the following as ways that audit firms could enhance professional skepticism:
- Recruitment process that include assessment of real attributes;
 - Training in error recognition and in negotiation;
 - Performance evaluation and promotion systems that reward appropriate professional skepticism;

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- Review processes that are structured to favor professional skepticism;
 - Decision aids such as checklists and procedural documentation requirements; and
 - Incentives that promote challenge in the audit process.
31. Researchers have noted that further research on the behavioral elements that may compromise professional skepticism among auditors despite standards, regulation and related oversight and enforcement regimes may be useful.

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Appendix

References to the Term “Professional Skepticism” in the ISAs

Para. Ref.	Text from ISA
ISA 200, <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>	
7	The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things...
13(l)	Professional skepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
A16	In the case of an audit engagement it is in the public interest and, therefore, required by the IESBA Code, that the auditor be independent of the entity subject to the audit. The IESBA Code describes independence as comprising both independence of mind and independence in appearance. The auditor’s independence from the entity safeguards the auditor’s ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor’s ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.
A18	Professional skepticism includes being alert to, for example: <ul style="list-style-type: none"> • Audit evidence that contradicts other audit evidence obtained. • Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. • Conditions that may indicate possible fraud. • Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.
A19	Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

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	<ul style="list-style-type: none">• Overlooking unusual circumstances.• Over generalizing when drawing conclusions from audit observations.• Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.
A20	Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.
A21	The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. ¹³ In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.
A22	The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.
A43	Detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as: <ul style="list-style-type: none">• adequate planning;• proper assignment of personnel to the engagement team;• the application of professional skepticism; and• supervision and review of the audit work performed, assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might

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	select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.
A69	In using the objectives, the auditor is required to have regard to the interrelationships among the ISAs. This is because, as indicated in paragraph A53, the ISAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this ISA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each ISA. At a more detailed level, ISA 315 and ISA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An ISA dealing with specific aspects of the audit (for example, ISA 540) may expand on how the objectives and requirements of such ISAs as ISA 315 and ISA 330 are to be applied in relation to the subject of the ISA but does not repeat them. Thus, in achieving the objective stated in ISA 540, the auditor has regard to the objectives and requirements of other relevant ISAs.
ISA 220, <i>Quality Control for an Audit of Financial Statements</i>	
A13	<p>Direction of the engagement team involves informing the members of the engagement team of matters such as:</p> <ul style="list-style-type: none"> • Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by ISA 200.6 • Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement. • The objectives of the work to be performed. • The nature of the entity's business. • Risk-related issues. • Problems that may arise. • The detailed approach to the performance of the engagement. <p>Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.</p>
ISA 230, <i>Audit Documentation</i>	
A7	Audit documentation provides evidence that the audit complies with the ISAs. However, it is neither necessary nor practicable

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	<p>for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:</p> <ul style="list-style-type: none"> • ... • In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file: <ul style="list-style-type: none"> ○ For example, there may be no single way in which the auditor’s professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor’s exercise of professional skepticism in accordance with the ISAs. Such evidence may include specific procedures performed to corroborate management’s responses to the auditor’s inquiries. ○ Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the ISAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner’s timely involvement in aspects of the audit, such as participation in the team discussions required by ISA 315.
<p>ISA 240, <i>The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements</i></p>	
8	<p>When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.</p>
12	<p>In accordance with ISA 2005, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance. (Ref: Para. A7–A8)</p>
13	<p>Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)</p>

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A7	Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor’s professional skepticism is particularly important when considering the risks of material misstatement due to fraud.
A8	Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity’s management and those charged with governance, the auditor’s professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.
A9	An audit performed in accordance with ISAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication. ¹⁵ However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include: <ul style="list-style-type: none"> • Confirming directly with the third party. • Using the work of an expert to assess the document’s authenticity
A17	Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management’s responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.
A33	Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through: <ul style="list-style-type: none"> • Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions. • Increased recognition of the need to corroborate management explanations or representations concerning material matters. It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph29, which are discussed below.
ISA 250, <i>Consideration of Laws and Regulations in an Audit of Financial Statements</i>	
8	The auditor is required by this ISA to remain alert to the possibility that other audit procedures applied for the purpose of

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	forming an opinion on financial statements may bring instances of identified or suspected noncompliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by ISA 200, ³ is important in this context, given the extent of laws and regulations that affect the entity.
ISA 300, <i>Planning an Audit of Financial Statements</i>	
Appendix	<p>Considerations in Establishing the Overall Audit Strategy</p> <p><i>Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements</i></p> <p>The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.</p>
ISA 330, <i>The Auditor's Responses to Assessed Risks</i>	
A1	<p>Overall responses to address the assessed risks of material misstatement at the financial statement level may include:</p> <ul style="list-style-type: none"> • Emphasizing to the audit team the need to maintain professional skepticism. • ...
ISA 540, <i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>	
A40	The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
ISA 550, <i>Related Parties</i>	
7	Planning and performing the audit with professional skepticism as required by ISA 2006 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

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A9	<p>Matters that may be addressed in the discussion among the engagement team include:</p> <ul style="list-style-type: none">• ...• An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.• ...
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