

**PROFESSIONAL SKEPTICISM IN AN AUDIT OF FINANCIAL STATEMENTS*****Foreword from IAASB Chairman***

The public places value on the independent financial statement audit because it enhances the degree of confidence of intended users in the financial statements. A high-quality audit features the exercise of professional judgment by the auditor and, importantly, a mindset that includes professional skepticism throughout the planning and performance of the audit.

The need for professional skepticism in an audit cannot be overemphasized. Professional skepticism is an essential attitude that enhances the auditor's ability to identify and respond to conditions that may indicate possible misstatement. It includes a critical assessment of audit evidence. It also means being alert for audit evidence that contradicts other audit evidence or that brings into question the reliability of information obtained from management and those charged with governance (TCWG). This critical assessment is necessary in order for the auditor to draw appropriate conclusions.

The IAASB's International Standards on Auditing (ISAs) explicitly recognize the fundamental importance of professional skepticism. Nevertheless, adopting and applying a skeptical mindset is ultimately a personal and professional responsibility to be *embraced* by every auditor. It is an integral part of the auditor's skill set and is closely interrelated to the fundamental concepts of auditor independence and professional judgment and contributes to audit quality.

Professional skepticism is also influenced by personal behavioral traits, including motivation, and competencies. Thus auditor education, training and experience are important. Audit firms themselves therefore have an important role to play in cultivating a skeptical mindset in auditors. This includes designing and implementing policies and procedures that promote an internal culture recognizing that skepticism is essential in performing audit engagements.

Today's financial reporting seeks to address information that is more relevant to users. As a result, more judgment and increased subjectivity is involved in management's accounting and reporting decisions (for example in relation to some fair value measurements). Also, many entities today face difficult economic conditions that give rise to unique financial reporting and auditing challenges. These developments heighten the importance of professional skepticism by auditors, especially in areas of financial reporting that are complex or highly judgmental.

In the aftermath of the 2008–2009 global financial crisis, recent audit inspection reports in various jurisdictions have noted areas, such as fair values, related party transactions, and going concern assessments, where regulators and oversight bodies believe that auditors should have more clearly demonstrated professional skepticism. It is therefore in the public interest to re-emphasize to both auditors and others the important role that professional skepticism has to play in audits of financial statements. The attached IAASB Staff Questions & Answers (Q&A) publication has been developed for this purpose.

The following Q&A focus on considerations in the ISAs and the IAASB's quality control standard that are of particular relevance to the proper understanding and application of professional skepticism during an audit of financial statements. I trust that firms and auditors of entities of all sizes will find these Q&A helpful. They may also be useful to users of financial statements, in particular TCWG and regulators and oversight bodies, in their efforts to challenge and question the application of professional skepticism in audits.



Prof. Arnold Schilder, IAASB Chairman

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## Questions and Answers

### Q1. *What is professional skepticism?*

The ISAs define professional skepticism as “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.”<sup>3</sup> They explicitly require the auditor to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.<sup>4</sup>

Like other concepts fundamental to auditing, it is difficult for a single definition to capture fully the meaning of professional skepticism. Further, there is no single way in which professional skepticism can be demonstrated. Nevertheless, the ISA definition describes important elements that help in the understanding of what professional skepticism means.

As an attitude, professional skepticism is fundamentally a mindset. A skeptical mindset drives auditor behavior to adopt a questioning approach when considering information and in forming conclusions. In this regard, professional skepticism is inseparably linked to the fundamental ethical principles of objectivity and auditor independence.<sup>5</sup> The auditor's independence enhances the auditor's ability to act with integrity, be objective and maintain an attitude of professional skepticism.<sup>6</sup>

Professional skepticism also includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence. Further, it includes being alert to conditions

<sup>1</sup> ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

<sup>2</sup> While certain ISA and ISQC 1 requirements and application and other explanatory material are highlighted, this publication does not reproduce all of the ISA and ISQC 1 provisions that are relevant to the auditor's responsibility to plan and perform an audit with professional skepticism.

<sup>3</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(l)

<sup>4</sup> ISA 200, paragraph 15

<sup>5</sup> The International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), paragraph 290.6, explains that independence comprises both independence of mind and independence in appearance. In relation to independence of mind, it is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

<sup>6</sup> ISA 200, paragraph A1

that may indicate possible fraud, and circumstances that suggest the need for audit procedures in addition to those required by the ISAs.<sup>7</sup>

Professional skepticism also includes a critical assessment of audit evidence, which comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. Applying professional skepticism in this regard means questioning and considering 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.<sup>8</sup> In cases of doubt about the reliability of information or indications of possible fraud, the ISAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.<sup>9</sup> The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.<sup>10</sup>

While the auditor cannot be expected to disregard past experience with management and those charged with governance (TCWG), a belief that they are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.<sup>11</sup>

## **Q2. Why is professional skepticism important in audits of financial statements?**

Professional skepticism plays a fundamentally important role in the audit and forms an integral part of the auditor's skill set.<sup>12</sup> Professional skepticism is closely interrelated with professional judgment.<sup>13</sup> Both are essential to the proper conduct of the audit and are key inputs to *audit quality*. Professional skepticism facilitates the appropriate exercise of professional judgment by the auditor, particularly regarding decisions about, for example:

- The nature, timing and extent of audit procedures to be performed.

<sup>7</sup> ISA 200, paragraph A18

<sup>8</sup> ISA 200, paragraph A20

<sup>9</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 13 and ISA 500, *Audit Evidence*, paragraph 11

<sup>10</sup> ISA 200, paragraph A48

<sup>11</sup> ISA 200, paragraph A22

<sup>12</sup> The International Accounting Education Standards Board's International Education Standard 8, *Competence Requirements for Audit Professionals*, paragraph 42, in particular requires the skills requirement within the education and development program for audit professionals to include, amongst other matters, developing professional skills at an advanced level in an audit environment. These skills include applying relevant audit standards and guidance; evaluating applications of relevant financial reporting standards; demonstrating capacity for inquiry, abstract logical thought, and critical analysis; demonstrating professional skepticism; applying professional judgment; and withstanding and resolving conflicts.

<sup>13</sup> ISA 200, paragraph 13 (k), defines professional judgment as "the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement."

- Whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the ISAs.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.<sup>14</sup>

The application of professional skepticism enhances the effectiveness of an audit procedure and of its application and reduces the possibility that the auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.<sup>15</sup>

**Q3. *What can be done by audit firms and auditors to enhance the awareness of the importance of professional skepticism and its application?***

Professional skepticism is influenced by personal behavioral traits (i.e., attitudes and ethical values) as well as the competence level (i.e., knowledge) of the individuals undertaking the audit. These, in turn, are influenced by education, training and experience. Professional skepticism within the engagement team is also influenced both by the actions of the firm's leadership and the engagement partner, and by the culture and business environment of the firm. The ISAs and ISQC 1 include requirements and guidance designed to help create an environment at both the firm and engagement levels in which the auditor can cultivate appropriate professional skepticism.

*Firm Level*

The firm's leadership and the examples it sets significantly influence the internal culture of the firm.<sup>16</sup> Accordingly, the "tone at the top" and continual reinforcement of the importance of professional skepticism on audit engagements are important influences on individuals' behavior.

Opportunities for the firm to set expectations regarding, and to emphasize the importance of, professional skepticism include, for example, when:

- Establishing policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements.<sup>17</sup>
- Promoting a quality-oriented internal culture through clear, consistent and frequent actions and messages from all levels of the firm's management. This may be communicated by, but not limited to, training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. Such actions and messages encourage a culture that recognizes and rewards high-quality work, and may be incorporated, for example, in the firm's internal documentation and training materials and in partner and staff appraisal procedures

<sup>14</sup> See ISA 200, paragraph A23.

<sup>15</sup> See ISA 200, paragraph A43.

<sup>16</sup> ISQC 1, paragraph A4

<sup>17</sup> ISQC 1, paragraph 18

such that they support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.<sup>18</sup>

- Establishing policies and procedures designed to provide the firm with reasonable assurance that it has sufficient personnel with the necessary competence, capabilities and commitment to ethical principles.<sup>19</sup> In this regard, promoting an internal culture based on quality may be achieved through the establishment of policies and procedures that address performance, evaluation, compensation, and promotion (including incentive systems), that give due recognition and reward to the development and maintenance of competence.<sup>20</sup>
- Developing and implementing internal training and continuing education programs for all levels of the firm's personnel. This may be achieved through, for example, work experience, on the job training, coaching by more experienced staff (for example, other members of the engagement team), and independence education. It is noted that the continuing competence of firm personnel depends to a significant extent on an appropriate level of continuing professional development.<sup>21</sup>

### *Engagement Level*

At the engagement level, the engagement partner is required to take responsibility for the overall quality on each audit engagement to which that partner is assigned.<sup>22</sup> The actions of the engagement partner and appropriate messages to the other members of the engagement team emphasize that quality is essential in performing audit engagements and the importance to audit quality of, for example, the engagement team's ability to raise concerns without fear of reprisals and in issuing auditor's reports that are appropriate in the circumstances.<sup>23</sup>

An ideal opportunity to address and emphasize with the engagement team the importance of maintaining professional skepticism throughout the audit is during the discussion by the engagement partner and other key engagement team members of the susceptibility of the entity's financial statements to material misstatement. This discussion includes the application of the applicable financial reporting framework to the entity's facts and circumstances, and places particular emphasis on how and where the financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur (setting aside beliefs that the engagement team members may have that management and TCWG are honest and have integrity). This discussion also provides a basis upon which engagement team members communicate and share new information that may affect risk assessments or the audit procedures performed.<sup>24</sup>

<sup>18</sup> See ISQC 1, paragraph A4.

<sup>19</sup> See ISQC 1, paragraph 29.

<sup>20</sup> See ISQC 1, paragraphs A5 and A25-A28.

<sup>21</sup> See ISQC 1, paragraphs 29 and A25-A26.

<sup>22</sup> ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 8

<sup>23</sup> See ISA 220, paragraph A3.

<sup>24</sup> See ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraphs 10 and A14, and ISA 240, paragraph 15.



Further opportunities for the engagement partner to set expectations regarding, and to emphasize the importance of, professional skepticism include, for example, when taking responsibility for:

- The direction, supervision and performance of the audit engagement.<sup>25</sup>
- Reviews of work performed. In this regard, the engagement partner, in particular, has much knowledge and experience to impart in helping less experienced team members develop a critical and questioning mind through review of, among other matters, critical areas of judgment and significant risks. Timely reviews also allow significant matters (for example, critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement) to be resolved on or before the date of the auditor's report.<sup>26</sup>
- The engagement team undertaking appropriate consultation on difficult or contentious matters and that the conclusions reached from such consultations have been implemented.<sup>27</sup>

While activities at the firm level and engagement level contribute to the mindset of professional skepticism, it is nevertheless the responsibility of each individual auditor to maintain an attitude of professional skepticism. Like professional judgment, professional skepticism needs to be exercised throughout the audit.

Maintaining professional skepticism throughout the audit enables the auditor 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.<sup>28</sup>

#### **Q4. *At what stage in the audit process is professional skepticism necessary?***

Professional skepticism is relevant and necessary throughout the audit, even though reference to it is not repeated within each ISA.<sup>29</sup> For instance:

- Engagement acceptance – For example, when considering matters such as the integrity of principal owners and management.<sup>30</sup>
- Identifying and assessing risks of material misstatement – For example, when:
  - Performing risks assessment procedures (including the engagement team discussion on the susceptibility of the entity's financial statements to material misstatement, as discussed in Q3 above).
  - Revising the auditor's assessment of the risks of material misstatement and modifying the further planned audit procedures accordingly – as appropriate, for example, as a

<sup>25</sup> See ISA 220, paragraph 15.

<sup>26</sup> See ISA 220, paragraphs 16 and A18.

<sup>27</sup> ISA 220, paragraph 18

<sup>28</sup> ISA 200, paragraph A19

<sup>29</sup> See ISA 200, paragraph A69.

<sup>30</sup> ISA 220, paragraph A8

result of new information that is inconsistent with the audit evidence on which the auditor originally based the assessment, or through being alert to changes in circumstances, new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.<sup>31</sup>

- Designing the nature, timing and extent of further audit procedures that are responsive to assessed risks of material misstatement, and evaluating audit evidence – For example, when:
  - Considering, for areas of higher assessed risks, the need to increase the quantity of evidence or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or obtaining corroborating evidence from a number of independent sources.<sup>32</sup>
  - Designing and performing substantive analytical procedures, including when evaluating the reliability of data from which the auditor's expectation is developed, and when identifying and investigating fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.<sup>33</sup> The auditor's expectations serve an important role when evaluating the results of analytical procedures and challenging management's explanations for deviations from expected results.
  - Addressing circumstances such as when management refuses to allow the auditor to send a confirmation request.<sup>34</sup>
- Forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the application financial reporting framework – For example, when:
  - Concluding about whether reasonable assurance was obtained and whether sufficient appropriate audit evidence was obtained to support such conclusion.<sup>35</sup>
  - Considering the implications for the opinion where the auditor is unable to gather necessary audit evidence.<sup>36</sup>
  - Evaluating whether financial statements that are prepared in accordance with a fair presentation framework achieve fair presentation, considering both (i) the overall presentation, structure and content of the financial statements and (ii) whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieve fair presentation.<sup>37</sup>

<sup>31</sup> See ISA 315, paragraph 31, and ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 12 and A13.

<sup>32</sup> See ISA 330, *The Auditor's Responses to Assessed Risks*, paragraphs 7 and A19.

<sup>33</sup> See ISA 520, *Analytical Procedures*, paragraphs 5 and 7.

<sup>34</sup> See ISA 505, *External Confirmations*, paragraph 8.

<sup>35</sup> See ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph 11.

<sup>36</sup> See ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph A124.

<sup>37</sup> See ISA 700, paragraph 14.



**Q5. *How does professional skepticism relate to the auditor's responsibilities with respect to fraud?***

Due to the characteristics of fraud, including the fact that fraud may include sophisticated and carefully organized schemes designed to conceal it or may involve collusion, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

ISA 240 places special emphasis on professional skepticism. Among other matters, it includes requirements specifically addressing the need to 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 TCWG.<sup>38</sup> It also requires the auditor to investigate further where 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.<sup>39</sup>

ISA 240 notes that maintaining professional skepticism in audits requires an ongoing questioning of whether the information and audit evidence obtained by the auditor suggests that a material misstatement due to fraud may exist. This includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant.<sup>40</sup> ISA 240 also recognizes the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. Accordingly, the requirements of ISA 240 are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing further procedures.<sup>41</sup>

In some cases, the ISAs require the auditor to make presumptions about risks of fraud, the assessment of risks of material misstatement, or specify procedures that are required to be performed. They do so recognizing the importance of professional skepticism in areas where it has been demonstrated that they are more susceptible to misstatement, including misstatement due to fraud. Examples include the required presumption that there are risks of fraud in revenue recognition,<sup>42</sup> the treatment of risks of management override as a risk of material misstatement due to fraud and thus a significant risk,<sup>43</sup> and required procedures addressing the review of accounting estimates for biases.<sup>44</sup>

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<sup>38</sup> ISA 240, paragraph 12

<sup>39</sup> ISA 240, paragraph 13

<sup>40</sup> ISA 240, paragraph A7

<sup>41</sup> ISA 240, paragraph 8

<sup>42</sup> See ISA 240, paragraphs 26-27.

<sup>43</sup> See ISA 240, paragraph 31.

<sup>44</sup> See ISA 240, paragraph 32(b).

Determining overall responses to address 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. ISA 240, for example, includes specific examples of how the conduct of the audit might reflect increased professional skepticism, including:

- Increased sensitivity in the selection of the nature and extent of entity documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.<sup>45</sup>

The ISAs note that the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.<sup>46</sup> In this regard, the ISAs:

- Indicate that evaluating management's responses to inquiries with an attitude of professional skepticism may need to include corroboration of management's responses to inquiries with other information.<sup>47</sup>
- Where responses to inquiries of management or TCWG are inconsistent, require the auditor to investigate the inconsistencies.<sup>48</sup>
- Require the auditor to reevaluate the prior assessment of the risks of material misstatement due to fraud, the consequential impact on the nature, timing and extent of audit procedures, and the reliability of evidence previously obtained if a misstatement comes to light that it is or may be the result of fraud and that involves management (in particular, senior management) or where circumstances or conditions indicate possible collusion involving employees, management or third parties.<sup>49</sup>

**Q6. *In addition to fraud, are there other aspects of an audit where professional skepticism may be particularly important?***

Professional skepticism is important and necessary throughout the entire audit process. The auditor's professional skepticism becomes particularly important when addressing areas of the audit that are more complex, significant or highly judgmental such as:

- Accounting estimates, including fair value accounting estimates, and related disclosures – For example, when:

<sup>45</sup> ISA 240, paragraph A33

<sup>46</sup> ISA 240, paragraph 7

<sup>47</sup> ISA 240, paragraph A17

<sup>48</sup> ISA 240, paragraph 14

<sup>49</sup> See ISA 240, paragraphs 35-36.

- Evaluating the reasonableness of the significant assumptions used by management for accounting estimates that give rise to risks to significant risks.<sup>50</sup>
- Determining whether changes in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.<sup>51</sup>
- Reviewing the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.<sup>52</sup>
- Going concern – For example, when evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.<sup>53</sup> The December 2011 IAASB release, *Economic Conditions Continue to Challenge Preparers and Auditors Alike; Focus Must Include Going Concern Assumption and Adequacy of Disclosures*, stresses the importance of professional skepticism and judgment in evaluating financial statement disclosures and the implications for the auditor's report when a material uncertainty exists relating to events or conditions that, individually or collectively, may cast doubt on the entity's ability to continue as a going concern. It also references the 2009 IAASB Staff Audit Practice Alert, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, which highlights matters relevant to the consideration of the going concern assumption in the preparation of financial statements.
- Related party relationships and transactions – For example, when remaining alert during the audit for information that may indicate previously unidentified or undisclosed related party relationships or transactions;<sup>54</sup> and in the context of identified significant transactions outside the entity's normal course of business, when evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests.<sup>55</sup>
- Consideration of laws and regulations – For example, when remaining alert while performing other audit procedures for instances of non-compliance or suspected non-compliance with those laws or regulations that may have a material effect on the financial statements or that have a fundamental effect on the operations of the entity causing it to cease operations, or call into question its continuance as a going concern.<sup>56</sup> This may also be relevant in the

<sup>50</sup> See ISA 540, paragraph 15.

<sup>51</sup> See ISA 540, paragraph 12.

<sup>52</sup> ISA 540, paragraph 21

<sup>53</sup> ISA 570, paragraph 16(b)

<sup>54</sup> ISA 550, *Related Parties*, paragraphs 10-11 and 15

<sup>55</sup> See ISA 550, paragraphs 16, A24 and A25.

<sup>56</sup> See ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs 14, 15 and A9.

context of a group audit, for instance, due to business practices and cultures in different jurisdictions.<sup>57</sup>

Another example where professional skepticism is particularly important is in relation to auditing significant unusual or highly complex transactions. The 2010 IAASB Staff Q&A publication, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions*, 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.

In addition, in relation to auditing financial instruments, firms' and auditors' attention is drawn to the IAASB's recently released International Auditing Practice Note (IAPN) 1000.<sup>58</sup> Among other matters, the IAPN re-emphasizes the importance of professional skepticism, in particular in relation to the risks and consequences of management bias.<sup>59</sup>

**Q7. How can the application of professional skepticism be evidenced?**

Professional skepticism is often demonstrated in the various discussions held by the auditor during the course of an audit. For example, the auditor's communication with TCWG includes, where applicable, why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity.<sup>60</sup>

Nevertheless, audit documentation remains critical in evidencing professional skepticism because it provides evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.<sup>61</sup> The ISAs require the auditor to prepare sufficient audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand, among other things, the significant decisions made regarding significant matters arising during the audit, the conclusions reached thereon, and significant judgments made in reaching those conclusions.<sup>62</sup>

The ISAs also require auditors to document discussions of significant matters with management, TCWG, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.<sup>63</sup> Such documentation helps the auditor demonstrate how significant judgments and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriate audit evidence has been obtained.

<sup>57</sup> See ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraphs 19 and 20.

<sup>58</sup> IAPN 1000, *Special Considerations in Auditing Financial Instruments*

<sup>59</sup> IAPN 1000, paragraph 71

<sup>60</sup> ISA 260, *Communication with Those Charged with Governance*, paragraph 16

<sup>61</sup> ISA 230, *Audit Documentation*, paragraph 5

<sup>62</sup> See ISA 230, paragraph 8.

<sup>63</sup> See ISA 230, paragraph 10.

Examples of circumstances in which it is important to prepare audit documentation where the matters and judgments are significant include:

- Significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, and communications about fraud made to management, TCWG, regulators and others.<sup>64</sup>
- Identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, TCWG and other parties outside the entity.<sup>65</sup>
- The basis for the auditor's conclusions about the reasonableness of accounting estimates, and their disclosures that give rise to significant risks, and any indicators of possible management bias.<sup>66</sup>
- Identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, including how such inconsistency was addressed.<sup>67</sup>
- The basis for the auditor's conclusions on the reasonableness of areas of subjective judgments.
- The basis for the auditor's conclusion about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.<sup>68</sup>

Given that professional skepticism is a state of mind, it is sometimes difficult for the auditor's documentation to fully capture how the auditor applied professional skepticism throughout the audit. The ISAs note that there may be no single way in which the auditor's professional skepticism is documented. Nevertheless, audit documentation may 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.<sup>69</sup>

**Q8. *Do regulators and oversight bodies of audit firms and those charged with governance have a role to play in supporting skeptical behavior among auditors?***

The ISAs do not set forth requirements for regulators and oversight bodies of the audit firms, nor for TCWG. However because of the critical role that those stakeholders serve in achieving audit

<sup>64</sup> ISA 240, paragraphs 44(a) and 46

<sup>65</sup> ISA 250, paragraph 29

<sup>66</sup> ISA 540, paragraph 23

<sup>67</sup> ISA 230, paragraph 11

<sup>68</sup> See ISA 230, paragraph A10.

<sup>69</sup> ISA 230, paragraph A7

quality,<sup>70</sup> they are in a position to further challenge auditors to be skeptical through adequate two-way communication and effective oversight and inspection of audits.

Adequate two-way communication between the auditor and TCWG is an essential part of the audit process. The ISAs require the auditor to communicate certain matters about the audit, including the planned scope and timing of the audit as well as significant findings and difficulties encountered during the audit. For example, the required communications include the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.<sup>71</sup> Robust dialogue between the auditor and TCWG about areas of higher assessed risk of material misstatement, particularly critical accounting estimates, and how the auditor responded to those assessed risks, may provide TCWG an opportunity to challenge how the auditor applied professional skepticism in the approach to those areas.

TCWG are in a position to influence and stimulate auditor skepticism by providing feedback on important matters pertaining to the audit. For example, in receiving communications about the planned scope and timing of the audit, TCWG may:

- Discuss issues of risk and the concept of materiality with the auditor;
- Identify any areas in which they may request the auditor to undertake additional procedures; and
- Assist the auditor to better understand the entity and its environment.<sup>72</sup>

Through their monitoring and audit inspections, oversight bodies can also facilitate effective dialogue that contributes to focusing auditors on the importance of professional skepticism and how it can be appropriately applied in financial statements audits. The auditor's documentation is particularly important as it serves, among other purposes, to enable the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.<sup>73</sup>

Auditors often are required to communicate directly with regulators or prudential supervisors, in addition to TCWG.<sup>74</sup> Even in the absence of a requirement, in exceptional circumstances, the

<sup>70</sup> The IAASB's publication, [Audit Quality, An IAASB Perspective](#), discusses the many important influences that contribute to achieving audit quality and the roles that the external auditor and others play in achieving quality financial reporting.

<sup>71</sup> See ISA 260, paragraph 16(a), which also notes that, when applicable, the auditor is also required to explain to TCWG why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be the most appropriate to the particular circumstances of the entity.

<sup>72</sup> See ISA 260, paragraph A11.

<sup>73</sup> See ISA 230, paragraph 3.

<sup>74</sup> For example, ISA 250 requires auditors to determine whether there is a responsibility to report identified or suspected non-compliance with laws and regulations to parties outside the entity. If the auditor identifies or suspects a fraud, ISA 240 requires the auditor to determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. Requirements concerning the auditor's communication to banking supervisors and others may be established in many countries either by law, by supervisory requirement, or by formal agreement or protocol.



auditor may judge it necessary to communicate certain matters directly with regulators or prudential supervisors. However, the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting. Accordingly, the auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances.

There also may be situations for which communication with regulators or prudential supervisors may be useful throughout the audit. For example, in some jurisdictions, banking regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.<sup>75</sup> It also provides an opportunity for constructive dialogue between the auditor and regulators about matters pertinent to the appropriate application of professional skepticism.

### Key Contacts

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<sup>75</sup> See IAPN 1000, paragraph 145.



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