

A collage of business-related images showing people in meetings, working on laptops, and reviewing documents, set against a blue background with a faint globe. The images are tilted and overlapping, creating a dynamic feel. The text 'Enhancing Auditor Professional Skepticism' is prominently displayed in white, bold, sans-serif font on the left side. At the bottom right, the names 'Professors Steven I....' and 'and Douglas...' are partially visible.

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Global Public Policy Committee

November, 2013

Dear Friend of the GPPC,

Professional skepticism is a topic of great importance to the audit profession, audit regulators, audit standard setters and others who work in the audit arena for the benefit of the public interest. The term “professional skepticism” is widely used but may mean different things to different organizations and individuals.

The Standards Working Group (SWG) of the Global Public Policy Committee (GPPC) (comprising BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers) has sought to develop additional thinking and research that contributes to the dialogue on this important topic. Accordingly, the SWG commissioned the enclosed publication “Enhancing Auditor Professional Skepticism”, which was written by Professors Steven M. Glover and Douglas F. Prawitt of Brigham Young University.

The publication considers the importance of developing a shared understanding of what professional skepticism is, how it should be applied, the threats to professional skepticism and the safeguards that may be cost effective. It provides some ideas and recommendations on how the application of professional skepticism might be enhanced by auditors, as well as briefly indicating how other key stakeholders can also contribute to its effective application.

The thoughts in the publication do not necessarily reflect the views of each network in the GPPC and are not intended as recommendations or application guidance; rather, they are intended to provoke further thought and discussion, with the objective of enhancing the consistent, appropriate application of professional skepticism in practice, and, ultimately, improving audit quality. In particular, the GPPC networks do not have a common view on all aspects of the EU audit market proposals.

We would be pleased to meet with you and your colleagues from your organization to discuss this topic and consider how best to take forward further debate and careful consideration of this paper and the general subject of enhancing auditor skepticism. Please contact the secretary of the SWG, Angela Green (angela.m.green@uk.pwc.com) in the first instance and she will forward your inquiry appropriately.

Yours sincerely,

David Devlin
Chair, SWG

Steve Maslin
Chair, GPPC

Executive Summary

The Standards Working Group (SWG) of the Global Public Policy Committee of the six largest global accounting networks is committed to improving the quality of financial statement audits and as such has a keen interest in advancing the understanding and application of professional skepticism. The SWG accordingly commissioned leading academics to produce this thought leadership paper. The purpose of the paper is to facilitate an ongoing discussion between the profession, standard setters, regulators, investors, audit committees, and other interested stakeholders. While the SWG believes this paper accomplishes that objective, not all of the views expressed in this paper necessarily represent the views of individual networks represented in the SWG.

The purpose of the paper is to facilitate an ongoing discussion between the profession, standard setters, regulators, investors, audit committees, and other interested stakeholders.

The application of professional skepticism by auditors is important to audit quality. However, various definitions of, and perspectives on, professional skepticism exist in the auditing literature. To move the dialogue on improving the consistent appropriate application of professional skepticism forward, it is important that a shared understanding be developed regarding what professional skepticism is, how it should be applied and documented in various situations, and how threats to professional skepticism manifest themselves at different structural levels. It is also important to take into account the efforts and safeguards already in place to increase the likelihood that new initiatives will bring incremental improvement and that their benefits will exceed their costs. We propose a “professional skepticism continuum” that acknowledges that the appropriate application of professional skepticism will depend on the risk characteristics of the account and assertion. We also lay out the different structural levels at which professional skepticism is applied and at which threats can arise. We propose that efforts to mitigate threats to the appropriate application of professional skepticism are more likely to be effective if they take into account the distinct nature of the different structural levels. Finally, we provide some ideas and recommendations on how the application of professional skepticism might be enhanced on the part of auditors as well as how other key stakeholders can contribute to its effective application. The thoughts presented for consideration in this paper are not intended as concrete recommendations or specific application guidance; rather, they are intended to provoke further thought and discussion, with the objective of enhancing the consistent, appropriate application of professional skepticism in practice, and, ultimately, improving audit quality.



Definition and Application of Professional Skepticism

Reliable financial information is vital to investor confidence in the capital markets. The financial reporting information chain involves many stakeholders who have responsibilities that promote reliable financial reporting. Independent, external financial statement auditors play an important role in the financial reporting process by providing an independent opinion that financial statements present fairly in all material respects, or give a true and fair view of, the reporting entities' financial position, results of operations, and cash flows, in accordance with an applicable reporting framework. This paper contributes to an ongoing discussion regarding enhancing the professional skepticism of auditors.

Auditors adhere to professional standards while performing financial statement audits. Those standards require that appropriate professional skepticism be applied in the exercise of professional judgment. While a responsibility for appropriate professional skepticism is not the sole domain of financial statement auditors, this paper focuses on professional skepticism applied by auditors in the conduct of a financial statement audit. We note that while the concepts underlying professional skepticism are relatively straightforward, there is a lack of common understanding or practical guidance on what professional skepticism is and how it can be demonstrated and documented. We discuss the reasons for a renewed focus on auditor skepticism, as well as various definitions and meanings of professional skepticism. We propose a "professional skepticism continuum" that recognizes that the appropriate application of professional skepticism will depend on the risk characteristics of the particular account and assertion being audited. We also discuss threats to the consistent application of professional skepticism at various structural levels and steps that can mitigate these threats. Finally, we suggest that auditor professional skepticism can be enhanced through the cooperative efforts of other stakeholders in the financial reporting process, including directors and audit committees, regulators, and standard setters, and we propose specific ideas for advancing such cooperative efforts.

We propose a "professional skepticism continuum" that recognizes that the appropriate application of professional skepticism will depend on the risk characteristics of the particular account and assertion being audited.

Why the Renewed Focus on Professional Skepticism?

The complexity of business transactions and of accounting standards continues to increase. Principles-based accounting standards, expanded use of fair values, and subjective accounting measures and estimates require management to apply greater judgment and discretion in estimating the value of and accounting for important amounts reported in the financial statements. Given increased complexity and subjectivity together with a continued emphasis on reliable financial reporting, a heightened interest in the application of professional skepticism by the auditor and others in the financial reporting information chain is perhaps not surprising.

Some have asserted that factors such as provision of nonaudit services or long audit tenure can threaten audit quality over time by undermining auditor professional skepticism, noting the perception that management assertions are sometimes accepted without sufficient challenge. Such assertions have raised additional questions and intensified a focus on auditors' exercise of professional skepticism.

Inspection reports from regulators around the world often express concern with the application of professional skepticism by auditors. Appropriate professional skepticism is a necessary component of the financial statement audit. However, we suggest that efforts and recommendations to enhance professional skepticism will benefit from an understanding of the concepts that underlie it, a robust dialogue around the numerous factors at different structural levels that both positively and negatively influence it, and recognition of the measures that have already been taken to foster it. Recommendations that overlook important concepts and influences on professional skepticism as well as factors already in place to enhance professional skepticism may not yield incremental improvement in audit or financial reporting quality.

Professional Skepticism: What is it?

The word skepticism is formed from the root "skeptik," which comes from the Greek word "skeptikos," meaning "inquiring or reflective." To inquire is "to seek information by questioning; to ask." The characteristics commonly associated with being a skeptic include questioning and careful observation, probing reflection, looking beyond the obvious, and suspension of belief. Professional skepticism incorporates the attributes commonly associated with being a skeptic in a professional setting that requires a standard of care and due diligence in the context of professional standards, regulation, oversight, litigation, negotiation, evidence collection and evaluation, professional judgment, complex business transactions, varying incentives and motives, rationalization, and so forth.

Are Professional Judgment and Professional Skepticism the Same

Thing? Professional skepticism is necessary for high-quality professional judgment, but it is only one component of what is necessary for the auditor to exercise sound professional judgment. For example, skepticism without requisite accounting and auditing industry expertise is not sufficient to obtain high-quality judgment.

When we examine the definition of professional skepticism in auditing standards and the academic literature, we find related, but different, definitions. For example, both international and U.S. auditing standards stress a questioning mind and a critical assessment of audit evidence.¹ However, terms such as "a questioning mind" and "a critical assessment of audit evidence" are somewhat ambiguous and leave open to interpretation what constitutes appropriate levels of questioning or critical assessment, and how such behavior is demonstrated and documented in settings that present different risks at the account and assertion levels.

¹ IAASB, ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. 2009. New York, NY: IFAC. PCAOB AU 230, *Due Professional Care in the Performance of Work*. 2010. www.pcaobus.org.

The auditing literature has described differing perspectives of professional skepticism. The *presumptive doubt* view seems consistent with the specific requirement in auditing standards to presume that there are significant risks of fraud in revenue recognition regardless of past experience in auditing revenue at an entity and regardless of the assessed competence and integrity of management.² Presumptive doubt assumes some level of carelessness, incompetence, or dishonesty on the part of preparers. Many areas in the auditing standards appear to take a *neutral* perspective. For example, “the auditor neither assumes that management is dishonest nor assumes unquestioned honesty.”³ With such an approach, the auditor evaluates evidence carefully and objectively but without necessarily presuming a high likelihood of management carelessness, incompetence, or fraud. Finally, though not in the professional literature, others have asserted that in some circumstances skepticism can involve a level of trust, accompanied by appropriate verification.

The existence of a range of different perspectives results in varied practices. For example, a recent, widely cited academic paper that comprehensively reviewed the academic and practice literatures on professional skepticism adopted the *presumptive doubt* perspective on the basis that “as a practical matter, auditors should note that regulators appear to take more of a ‘presumptive doubt’ perspective, as they typically refer to professional skepticism as something that was missing when an audit failure has occurred.”⁴ However, the article notes that taking a presumptive doubt approach in auditing all assertions would result in the collection of more evidence than the other perspectives and may not result in an optimal balance of effectiveness and efficiency.

The absence of clear direction and practical application guidance on what behaviors and actions constitute appropriate professional skepticism across a range of risk scenarios for different assertions and accounts has led to different views, applications, and opinions. In such



an environment, reasonable observers, professionals, and regulators might understandably disagree. Each of the different perspectives on the mindset underlying professional skepticism has implications for audit effectiveness and potentially for efficiency. The problem with any particular perspective is that each is incomplete in a practical audit setting—none is necessarily optimal under all circumstances.

Applying Professional Skepticism: A Continuum.

We believe differing views and lack of clear application guidance represent a significant opportunity for the auditing profession, academics, standard setters, regulators, and inspectors, to develop a more comprehensive and practical view of professional skepticism and to fill in the void of practical application guidance. We suggest rather than focus on any one particular perspective, it may be more productive to think of the application of professional skepticism as a continuum related to the risk of material misstatement and other factors. In conceptualizing the application of professional skepticism as a continuum or range, it is important to keep in mind that applying such a continuum takes place *after* a careful and rigorous initial risk assessment, and that the auditor continues to reevaluate risk throughout the audit, to ensure that an appropriate level of skepticism is applied to the collection and evaluation of audit evidence. An illustration of the application of audit procedures and documentation after an appropriate initial risk assessment across a skepticism continuum is provided in Exhibit 1. We note that while the illustration includes a complete behavioral range from complete trust to complete doubt, the exhibit highlights that the application of professional skepticism does not include the area denoted as complete trust.

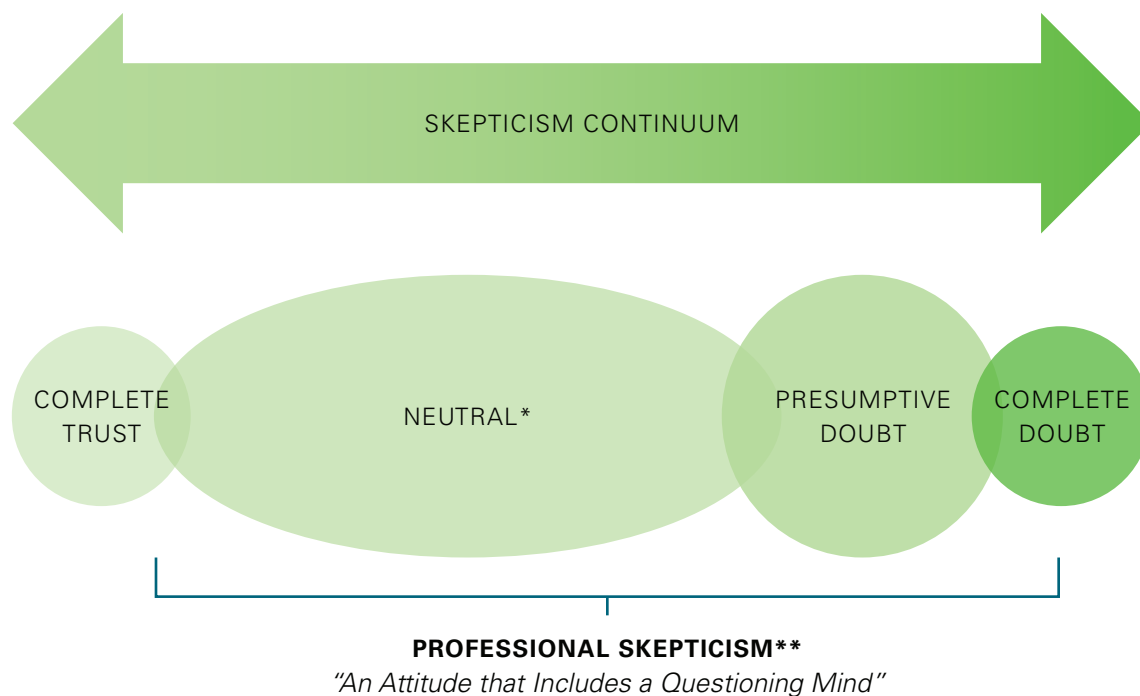
The use of a skepticism continuum makes clear that the appropriate level of skepticism varies depending on the situation. While the exhibit illustrates different levels of professional skepticism, the continuum represents

² ISA 240, *The Auditor's Responsibility Relating to Fraud in An Audit of Financial Statements*. 2009. New York, NY: IFAC.

³ PCAOB AU 230, *Due Professional Care in the Performance of Work*. 2006. www.pcaobus.org.

⁴ Nelson, M.W. 2009. “A model and literature review of professional skepticism in auditing.” *Auditing: A Journal of Practice & Theory* 28 2: 1–34.

Exhibit 1: The Application of Professional Skepticism



FACTORS POTENTIALLY LEADING TO LESS AUDIT EVIDENCE *(after initial appropriate risk assessment procedures)*

- Lower risk and susceptibility of material misstatement
- No indicators of fraud
- No errors detected
- Routine, little judgment required
- Audit evidence consistent with initial risk assessment

FACTORS POTENTIALLY LEADING TO MORE AUDIT EVIDENCE *(after initial appropriate risk assessment procedures)*

- Higher risk and susceptibility of material misstatement
- Fraud indicators present
- Errors detected
- Complex judgment
- Audit evidence inconsistent or contrary to the initial risk assessment

* Neutral—neither assuming management dishonesty nor unquestioned honesty.

** Professional Skepticism does not include the area of the continuum depicted by complete trust; in the area depicted as complete doubt, the auditor will move to a forensic mindset.

a gradation of more or less doubt within and across the categories and not necessarily completely different mindsets at distinct stages of the continuum. Some of the factors leading to a neutral or more doubting attitude, and thus the need for more or less audit evidence, are listed in the exhibit. These factors are primarily based on risk and susceptibility of material misstatement and on indications provided by audit evidence.

The factors leading to the need for additional audit evidence recognize that the complexity of business transactions, expanded use of fair values and subjective estimates, and the move to more principles-based accounting standards all tend to heighten the degree of professional judgment and skepticism auditors need to apply. The boxes listing the factors indicate, as mentioned above, that the continuum focuses on audit strategy, procedures, and documentation *after* an appropriate initial risk assessment for each account and relevant assertion is conducted in accordance with applicable auditing standards. We also acknowledge that an initial risk assessment that leads to a particular skepticism level should be reevaluated and challenged based on evidence obtained throughout the audit to determine if the original assessment is still appropriate.

The exhibit also illustrates that there are instances where the auditor's risk assessment procedures will lead the auditor to the determination that little to no additional audit work, beyond the risk assessment procedures, for an account or assertion is necessary. For example, an asset account balance that is clearly immaterial and presents no risk of material misstatement would not require additional audit work beyond the initial risk assessment. As auditors consider the extent of evidence needed, it is also important to recognize that different forms and nature of audit evidence vary in strength.

It should be noted that maintenance of a questioning mind is associated with the entire range of professional skepticism. For example, for a material account or assertion that is assessed as lower risk, it may be appropriate to apply a neutral perspective in determining the audit evidence needed, but this does not mean that the auditor ceases to be alert for and follow up on indicators of potential issues that may result in the need for more persuasive evidence.



We illustrate four overlapping categories in the continuum and note that the two categories in the middle are the two labels most commonly used in the prior literature. The categories are not used in equal proportion in a financial statement audit. We depict the neutral perspective as covering a larger portion of the continuum to recognize that a majority of assertions will fall in this area and that there will be a substantial range of risk covered by this perspective. In other words, within the neutral range, the level of risk and audit evidence increase moving from left to right. Moving from left to right in the area of professional skepticism increases the level of questioning in the auditor's mind. Evidence of increased questioning might involve a revision of the nature, timing, or extent of testing. For example, the timing of the testing may be closer to period end, the nature of testing may involve additional types of procedures to provide corroborating evidence, or the extent of testing may be increased. Another aspect of an increase in questioning in the application of professional skepticism may be a greater focus on potentially disconfirming evidence and when there are high-risk factors, such as the presence of fraud-risk indicators, it may result in an active search for evidence that has strong potential to contradict or disconfirm management's assertions. An active search for disconfirming information may be facilitated by the auditor designing and carrying out audit procedures to specifically address questions such as "what evidence might support the opposing arguments?" or "what evidence might indicate that management's assumptions do not hold?"

The rightmost category, "complete doubt," is a more skeptical perspective than is "presumptive doubt" and would be appropriate when, for example, audit tests reveal known errors and/or fraud that will likely lead to a material misstatement. Accordingly, when audit testing reveals systematic errors that could lead to a material misstatement, the auditor would search for additional errors or ask the entity to do so and appropriately

follow up on those efforts. When there is evidence of fraud or factual material misstatement, it may well be appropriate to consult with the audit committee, and as appropriate, apply a forensic accounting mindset and procedures. Presumptive doubt, on the other hand, may be appropriate when factors indicate significant risk or susceptibility of material misstatement.

In the absence of known errors, red flags, or other risk conditions suggesting a high risk and susceptibility of material misstatement, always applying a presumptive doubt mindset across all assertions of varying risk may lead to unnecessary cost being imposed on the reporting entity and ultimately on investors. On the other hand, overuse of a neutral approach may result in failure to obtain sufficient appropriate evidence in areas with higher susceptibility to fraud or material misstatement.

We suggest that the consistent application of an appropriate level of professional skepticism could be enhanced if audit firms, standard setters, regulators, and inspectors were to explicitly integrate a skepticism continuum conceptually similar to the one illustrated above, in policies and standards, and then work to provide relevant practical implementation guidance. Such guidance would acknowledge appropriate differences in the application of professional skepticism as well as differences in the nature and extent of audit evidence and documentation across a risk continuum.

Attributes, Skills, Personality. Another aspect of defining skepticism is whether it fundamentally consists of a set of skills and behaviors, or whether it also involves knowledge and expertise or personality traits. While some scholars lean more toward skill and others toward personality trait, we believe ongoing dialogue is best served by considering professional skepticism in terms of a combination of personal traits, knowledge, and skill. A number of personal traits have been described as contributing to the ability of an auditor to exercise appropriate professional skepticism, including a questioning mind, ability to analyze and critically evaluate, problem-solving ability, ethical and moral reasoning, a willingness to suspend judgment, a tendency to search for knowledge, abilities relating to interpersonal understanding, a sense of autonomy, and confidence based in self-esteem.⁵ Recent academic literature also suggests that skepticism involves skills that can be taught.⁶ Thus, while understanding and cultivating the personal traits that drive skepticism in auditors is important, additional opportunities likely exist to develop and implement training in universities and at the professional level designed to enhance skeptical thinking, attitudes, skills, and actions by new and experienced auditors.⁷

⁵ See, for example, Hurtt, K. 2010. "Development of a Scale to Measure Professional Skepticism." *Auditing: A Journal of Practice & Theory* 29 (1): 149-171. The latter three traits may help ensure that the auditor's skeptical mindset will translate into actions by the auditor that are consistent with that mindset. Consistent with the argument for a role for personality traits in exercising skepticism, a book titled *Behind Closed Doors—What Company Audit is Really About* (published by the Institute of Chartered Accountants, 2001) suggests that audit quality depends on audit partner personality traits that have clear implications for skepticism.

⁶ For example, see Plumlee, D., B.A. Rixom, and A.J. Rosman. *Training Auditors to Think Skeptically*. 2011. Working paper, University of Utah.

⁷ Cultural differences around the world likely can affect the exercise of professional skepticism through cultural personality traits or through cultural norms regarding the application of knowledge to question assertions. It is important that cultural characteristics or patterns that have potential to undermine the application of appropriate professional skepticism be identified and addressed so that professional skepticism can be enhanced through training, and encouraged in the field through supervision, mentoring, and review of work performed.



Threats, Mitigating Factors, and Suggestions to Enhance the Application of Professional Skepticism

In this section, we address potential threats to professional skepticism as well as factors that are already in place to foster the consistent, appropriate application of professional skepticism. We also discuss potential opportunities for audit firms and the profession to consider as they work to enhance professional skepticism. Given the scope of this paper, the ideas we offer for enhancing professional skepticism are illustrative—they do not constitute an effort to propose a comprehensive set of solutions nor do we provide in-depth discussion of the appropriateness or potential value of each proposal.

Some regulators have suggested that more appropriate levels of professional skepticism might have avoided alleged audit deficiencies that they have identified, and have conducted outreach and suggested possible measures intended to enhance auditor skepticism.⁸ Our observation regarding efforts to enhance professional skepticism is that before moving ahead with such proposals, stakeholders should take time to fully understand the various factors that influence the application of professional skepticism, including potential threats and measures already in place, and should engage in a full consideration of potential ways to effectively enhance professional skepticism. Any such analysis should consider the full context in which professional skepticism is applied. Otherwise, proposed solutions may have

A key to understanding, evaluating, and appropriately addressing factors that may either threaten or enhance professional skepticism is to recognize that different factors come into play at different structural levels of the professional setting.

⁸ For example, one suggested solution is mandatory audit firm rotation. Both the 2010 European Commission Green Paper “Audit Policy: Lessons from the Crisis” and a 2011 U.S. Public Company Accounting Oversight Board (PCAOB) concept release include discussion of mandatory audit firm rotation. In response to requests to provide feedback as to whether mandatory audit firm rotation would enhance professional skepticism and if so, if it would do so in a cost effective manner, the significant majority of responses (including analyses that exclude responses from the audit profession) were not in favor of mandatory rotation.

associated costs that exceed the benefits, not address actual root causes, fail to improve skepticism at the individual auditor or team level, or even reduce overall audit quality.

While steps can and must be taken to improve auditor professional skepticism in practice, much has been done in current standards, quality control policies and procedures, oversight, and working practices to foster an appropriate level of professional skepticism. New proposals should be carefully considered in the context of these existing measures to assess their potential to provide incremental benefits. Inherent in the nature of an external audit are trade-offs between costs and benefits, efficiency and effectiveness. Accordingly, we suggest that a robust analysis of the potential benefits and costs of proposed actions should include a complete understanding of the nature of threats to skepticism at different structural levels and should carefully take into account the effects of measures that are already in place.

A key to understanding, evaluating, and appropriately addressing factors that may either threaten or enhance professional skepticism is to recognize that different factors come into play at different structural levels of the professional setting. We break these structural levels into the following categories: individual auditor, engagement team, audit firm, and overall audit profession. We suggest that the discussion of actions that may be implemented to improve the consistent and appropriate application of professional skepticism in the financial reporting process will be more productive if it considers the context of each of the structural levels and if it takes into account both the nature of the threats at each level and the mitigating factors that are already in place.

For example, research has identified a number of threats to professional skepticism that occur at the individual auditor level. It follows that if the threat to the exercise of professional skepticism exists at the individual auditor level (e.g., judgment biases), then a solution aimed at the profession or audit firm may not effectively mitigate the threat—the proposed solution may not be aimed at the right problem.

Exhibit 2 illustrates some of the threats to professional skepticism at different structural levels as well as some of the factors that are in place at each level to foster and encourage the consistent and appropriate application of professional skepticism. The purpose of Exhibit 2 is to highlight the importance of considering threats, mitigating factors, and methods to enhance the application of professional skepticism at the different structural levels. Thus, the lists are not intended to be comprehensive; further, *the items listed in each structural level may be appropriately included in or may affect other levels*. While we generally do not repeat threats or mitigating factors listed in one structural level that are also relevant for other structural levels, we do repeat a handful of items that we believe are particularly important across levels. It should also be noted that some of the factors that create the threats noted in the table can also provide positive aspects that encourage the appropriate application of professional skepticism (e.g., dysfunctional tendencies that commonly arise in group decision settings can diminish the effectiveness of group judgment, however judgments made in groups do generally tend to be of higher quality than judgments made by individuals). While the threats and mitigating factors listed in Exhibit 2 are relatively straightforward, we highlight some important points in each of the levels.

Exhibit 2: Illustration of Threats and Factors in Place to Enhance Professional Skepticism by Structural Level



Individual Auditor – Pertains to each individual auditor on any given engagement.

Threats – Some of the potential threats to professional skepticism that may exist at the Individual Auditor level include:

- Judgment traps and biases, lack of knowledge and expertise
- Deadline pressure, inherited preferences and expectations
- Auditor character, and personal and cultural attributes
- Performance and compensation metrics and incentives that do not appropriately encourage professional skepticism

Mitigating Factors – Some of the measures in place to foster and encourage the appropriate application of professional skepticism at the individual auditor level include:

- Professional licensing and continuing education requirements
- Supervision, mentoring, review, and inspection of work and performance evaluations
- Effective planning and audit programs, including expectation setting
- Performance metrics that reward people for high quality work
- Stringent recruiting requirements
- Effective engagement partner and leadership messaging
- Training on core competencies, professional judgment, and other subjects

Engagement Team – Pertains to each engagement team assigned to a specific client.

Threats – Some of the potential threats to professional skepticism that exist at the engagement team level include:

- Client service and business development goals that create conflict of interest
- Inadequate time management, limited resources, ineffective utilization of specialists and experts
- Misaligned inspection influence (e.g., expanded requirements)
- Preferences of management and partner, tone or practices of engagement leadership that do not adequately emphasize professional skepticism
- Apprenticeship model
- Client characteristics (governance structure, tone at the top)
- Familiarity linked to audit tenure
- Potential bias stemming from dysfunctional group decision tendencies

Mitigating Factors – Some of the measures in place to foster and encourage the appropriate application of professional skepticism at the engagement team level include:

- Planning with involvement of engagement leadership
- Industry and client experience
- Fraud brainstorming meetings
- Internal quality performance review programs
- Required upward consultation
- HR and independence policies, including limitations on provision of certain nonaudit services and restrictions on compensation based on such services
- Ethics and compliance hotlines
- Partner rotation requirements
- Engagement quality control review and external inspection programs

Exhibit 2: Illustration of Threats and Factors in Place to Enhance Professional Skepticism by Structural Level *(continued)*

Profession/Audit Firm – Pertains to the external auditing profession; encompasses public accounting firms and the economic and regulatory environment in which they operate.

Threats – Some of the potential threats to professional skepticism that exist at the profession and firm level include:

- Conflicts of interest stemming from payor/selector model
- Insufficient resources devoted to the audit, or competition primarily based on audit fees
- Incentives created by office/regional performance measures and consequences
- Dependency by local office on large client
- Nature or volume of nonaudit services
- Inspection focus that does not fully align with relevant audit risks.
- Audit committees that do not understand oversight role or are aligned too closely with management

Mitigating Factors – Some of the measures in place to foster and encourage the appropriate application of professional skepticism at the profession and firm level include (may differ by jurisdiction):

- Tone at the top encouraging high quality auditing and professional skepticism
- Independence requirements including prohibition on providing certain nonaudit services
- Licensing exams, experience, and continuing education requirements
- Professional accounting and auditing standards
- Audit methodology, templates, tools, and policies, including linkage between assertions and audit procedures
- Quality control policies and procedures, including internal and peer inspections, and independence policies, tracking and enforcement
- Independent regulatory oversight and inspection, and appropriate public reporting of inspection results
- Required upward consultations
- Threat of litigation, sanction, fine
- Quality control, quality reviews, and independence standards
- Required communication with audit committee, audit committee selecting and appointing the auditor, and audit committee approval of nonaudit services

Individual Auditor Level: Threats to the Appropriate Application of Professional Skepticism.

Research has found that auditors' judgments can be flawed because, like all people, sometimes they do not consistently follow a sound judgment process and they fall prey to systematic, predictable traps and biases. People, including experienced professionals such as doctors, attorneys, and accountants, often unknowingly use mental "shortcuts" and simplifying strategies to efficiently navigate complexity. These simplifying shortcuts and tendencies generally serve us very well.

However, because they are shortcuts, situations can arise where they systematically and predictably lead to suboptimal judgments and potentially inhibit the application of appropriate professional skepticism.

Bias-inducing tendencies can lead even the brightest, most experienced professionals, including auditors, to make suboptimal judgments. Understanding where auditors tend to unknowingly take judgment shortcuts and where their motives can subconsciously affect them can facilitate the identification of when the quality of auditor judgments and the application of professional skepticism can be affected by systematic bias. While a complete discussion of unconscious judgment traps

and biases is beyond the scope of this paper and can be found elsewhere, in Exhibit 3 we list and briefly describe four tendencies that have been identified as relevant in auditing: the availability, anchoring, overconfidence, and confirmation tendencies.

Time pressure that affects the engagement team affects the individual auditor as well. Teams and individual auditor evaluations often include performance measures relative to budgeted expectations. This pressure may create incentives for auditors to apply insufficient professional skepticism which could result in insufficient evidence and incentive to obtain evidence that is easier to collect but perhaps less relevant.

Individual auditors' judgment and level of skepticism can be affected by their supervisors' preferences. Since the supervisor ultimately will provide a performance review, the individual auditor has incentives to follow the lead of the supervisor. It follows that unintended negative messages or incentives provided by team leaders can translate into a less-than-ideal level of professional skepticism on the part of the individual auditor as well.

A lack of knowledge and experience can affect the appropriate exercise of professional skepticism. The use of the apprenticeship model in public accounting involves the use of relatively inexperienced staff auditors whose lack of relevant knowledge and process expertise can limit their ability to effectively apply professional skepticism. Junior auditors are typically not responsible for the most complex audit areas, and they can in many instances bring a fresh perspective. However, they might in some circumstances struggle to understand technical accounting and auditing standards, audit firm policies and procedures, jargon, terms, or underlying economics. When substantial cognitive effort is applied to simply understand the issues and apply



Exhibit 3: Common Judgment Tendencies that Can Lead to Bias and Weaken Skepticism

Overconfidence — The tendency of decision makers to overestimate their own abilities to perform tasks or make accurate assessments of risk or other judgments and decisions. Overconfidence can lead to underinvesting in understanding issues and audit objectives; insufficient challenging of management's preferences, views, and reporting choices; limited consideration of the nature of the audit procedure and potential alternatives; or truncating evidence search, all of which can manifest themselves in terms of a suboptimal level of professional skepticism.

Confirmation — The tendency to seek and overweight confirming information in the information-gathering and evaluation steps, and to favor conclusions that are consistent with initial beliefs or preferences. The confirmation tendency can bias a wide variety of auditor judgments, ranging from an auditor only seeking evidence that is consistent with a supervisor's or client's explanation for an unusual pattern in financial data, to placing disproportionate weight on audit evidence that is consistent with a preferred outcome.

Anchoring — The tendency to make assessments in gathering and evaluating information by starting from an initial value and then adjusting insufficiently away from that initial value in forming a final judgment. Anchoring is commonly exhibited when auditors begin the audit of a specific account by viewing the account details from the previous year or by examining unaudited balances. The auditor may be inappropriately influenced by those numbers or the auditor may unknowingly fail to sufficiently adjust away from an initial starting point, resulting in a lack of objectivity in assessing transactions, estimates, and account balances.

Availability — The tendency for decision makers to consider information that is more readily available from memory as being more likely, relevant, or more important for a judgment. The tendency limits alternatives considered or information gathered to those alternatives or information that readily come to mind. Availability can be especially common as auditors typically work with several clients. Information from recent events and audits may be fresh in the mind, and an auditor may unconsciously attempt to apply less relevant information or conclusions from prior situations to the current audit.

an audit methodology, junior auditors may adopt an “understanding mindset” rather than a “challenging” or “questioning” mindset and may have difficulty challenging management’s views and preferences. This threat points to the importance of mentoring junior auditors and maintaining a rigorous level of supervision and review by more experienced auditors.

Individual Auditor Level: Enhancing the Appropriate Application of Professional Skepticism.

Exhibit 2 lists some factors that may already be in place to foster the appropriate application of professional skepticism at the individual level. In this section, we focus on potential opportunities the profession could consider to enhance the application of appropriate professional skepticism. We recognize that some audit firms have already taken at least some of these steps, but firms may find opportunities for further improvement in these areas. We organize our thoughts in three categories: development and application of a good judgment process, proactive framing of issues, and alignment of performance evaluation and incentives at the individual auditor level.

Application of Good Judgment Process: An important way to improve professional skepticism in individual auditors is to accelerate their ability to exercise sound judgment by following a good judgment process and learning to avoid judgment traps and biases. While detailed discussions of steps to mitigate judgment traps and biases can be found elsewhere, a foundational step to mitigate these traps and biases is to train auditors in the steps of a good judgment process.⁹ Such a process provides a consistent, logical approach to ensuring judgments are well considered, and provides a common conceptual framework and shared vocabulary to train and mentor auditors. If auditors understand and follow a good judgment process, many judgment traps and biases can be avoided or mitigated.

A formal judgment process is also useful in providing a context in which to understand where and how traps and biases can undermine judgment and professional skepticism. Once such a process is in place, auditors can be trained to be aware that predictable, systematic judgment traps and biases exist and to understand how they can impact professional judgment and skepticism. Awareness and understanding of traps and biases facilitate common sense mitigation approaches. Prompts built into audit processes and procedures can be effective at helping auditors remember to be aware of judgment traps and tendencies throughout the audit process. Finally, reminding and aligning incentives for auditors, especially specialists and experts, to take time to “make the opposing case” and document accordingly are powerful techniques to mitigate the effects of some of the most pervasive biases, including those that stem from the overconfidence and confirmation tendencies.

Proactive Framing of Issues: Judgment frames are an inherent part of human cognition—they allow us to make sense of the world around us and help us identify what is important and relevant in a given situation. However, people are only able to see the world through one frame at a time, and are typically unaware that they have a frame, much less what the frame is, or what are its implications. By proactively identifying and understanding the frames that they and others are using, and making an effort to understand what issues look like from different frames or perspectives, auditors can improve in their ability to appropriately and effectively question their own or others’ initial conclusions and more effectively challenge client explanations. For example, in considering an entity’s accounting or disclosure choices, it is often helpful to consider the situation from the perspectives of management, regulators, investors, and how the choice might look if reported in the business press in the future in light of different eventualities.

Alignment of Performance Evaluation and Incentives at Individual Auditor Level: A maxim of human behavior is that people respond to how they are evaluated and rewarded. While these are actions that must be taken at the firm and engagement team levels, the ultimate impact of policies and practices that impact evaluation and incentives is on behavior at the individual auditor level. Auditors must be placed in an environment that evaluates positively and rewards appropriate application of professional skepticism over other incentives, such as budget and realization pressures.

⁹ See, for example, Glover, S.M., D.F. Prawitt, and KPMG, 2011, *Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework*. For a more general treatment of the topic of following good judgment processes and avoiding judgment traps and biases, see Bazerman, M.H., and D. Moore. 2009. *Judgment in Managerial Decision Making*, 7th ed. Hoboken, NJ: John Wiley & Sons; also see Hammond, J.S., R.L. Keeney, and H. Raiffa. 1999. *Smart Choices: A Practical Guide to Making Better Decisions* Boston: Harvard Business School Press.

Engagement Team Level: Threats to the Appropriate Application of Professional Skepticism

Pressure to maintain and cultivate client relationships can influence individuals' and teams' ability to exercise sufficient professional skepticism. For example, there is some evidence that teams sometimes believe that exercising too high a level of professional skepticism can be detrimental to their relationship with management.¹⁰ This perception could influence risk assessments such as the assessed risk of error or fraud and lead to insufficient application of professional skepticism.

Budget and time pressures might constrain the motivation or ability of engagement teams to exercise an appropriate level of professional skepticism. Additionally, engagement management issues can discourage the use of fraud experts or other specialists during an audit.

Members of an engagement team are influenced by their supervisor's views and preferences, and engagement teams and their members often mirror the degree of professional skepticism that is exhibited by their superiors. Thus, a threat to professional skepticism can arise if the preferences of the immediate reviewer do not contribute positively to appropriate levels of skepticism.

As noted previously, a threat arises if inexperienced auditors are not properly assigned to tasks or properly mentored. Inexperienced auditors are more vulnerable than are experienced auditors to the pitfall of accepting a plausible management explanation without probing further. More experienced auditors need to recognize junior auditors' limitations in knowledge and experience and identify when a staff member needs help to effectively apply professional skepticism.

"Groupthink" is the term for the tendencies that arise in group or team settings to inhibit optimal brainstorming and judgment processes. For example, in some cases groupthink tendencies can result in group judgments that are more aggressive in terms of risk tolerance than would have been acceptable to any individual member of the group. While a complete discussion of groupthink



tendencies is beyond the scope of this paper, such tendencies can pose a threat to the appropriate exercise of professional skepticism, and should be considered in efforts to enhance skepticism in professional practice.

Engagement Team Level: Enhancing the Appropriate Application of Professional Skepticism

Exhibit 2 highlights factors already in place to foster the appropriate application of professional skepticism at the engagement team level. In this section, we focus on opportunities the profession may consider to enhance the application of appropriate professional skepticism by engagement teams. We recognize that some audit firms have already taken some of these steps, though further improvement may be in order. We organize our thoughts regarding steps that engagement teams can take into four categories: setting the proper tone for the engagement team, managing the limitations of the apprenticeship model, structuring group decisions to avoid groupthink tendencies, and focusing specifically on skepticism in internal oversight/review processes.

Setting the Proper Tone for the Engagement Team:

The tone or direction set by engagement team leadership can be a major factor in the level of professional skepticism exhibited by the engagement team and individual team members. It follows that an emphasis on professional skepticism at the firm level flows down to engagement leaders and if engagement leaders set the appropriate tone, to the engagement team level. If the engagement leader does not set an appropriate tone, or sets one that is muddled by

¹⁰ Nelson, M.W. 2009. "A model and literature review of professional skepticism in auditing." *Auditing: A Journal of Practice & Theory* 28 2: 1–34.

conflicting incentives or messages, the firm level messaging and tone may not be effective. An alignment of incentives together with a clear and consistent message that an appropriate level of professional skepticism is expected and valued is essential at both the firm and engagement leadership level.

Managing the Limitations of the Apprenticeship Model:

As we have previously discussed, there may be times when junior auditors do not have sufficient experience to move beyond an “understanding” mindset to effectively challenge management’s views and preferences. It is important to make assignments within relevant skill sets and to properly mentor junior auditors. Effective review and coaching techniques can assist more experienced auditors to appropriately supervise and mentor. Effective planning can help teams identify situations where threats may arise and how they can be addressed. One of the significant advantages of the apprenticeship model is a regular inflow of bright, energetic, hardworking professionals who bring a fresh perspective. These fresh perspectives may help to offset some of the tendencies that can lead to bias (e.g., overconfidence, confirmation).

Structuring Group Decisions to Avoid Groupthink Tendencies:

Brainstorming is a technique that is sometimes employed to improve professional skepticism. For example, international and U.S. standards require that auditors hold meetings prior to audit testing to discuss potential fraud scenarios in the audit.¹¹ A robust identification of possible fraud schemes can help teams exercise an appropriate degree of professional skepticism with respect to fraud. However, research in psychology suggests that group brainstorming sessions can actually inhibit professional skepticism due to groupthink and other group dynamics. Structuring and conducting brainstorming sessions in ways that mitigate these threats can improve the identification of key fraud risks. For example, brainstorming sessions are likely to be more effective when diversity of thought and discussion among team

members is encouraged, when auditors individually identify risks and potential audit responses prior to the brainstorming session, and when the session is conducted in a systematic and deliberate fashion.¹²

Focusing Specifically on Skepticism in Internal Oversight/Review Processes/On the Job Training:

Professional skepticism can be enhanced through proper high-level internal review and oversight focused specifically on application of skepticism. For example, firms could conduct real-time reviews of ongoing engagements specifically to evaluate the application and documentation of professional skepticism in addition to the EQR process. Firms might also further develop policies around circumstances requiring consultation outside the engagement team. Such consultations might focus not only on technical considerations, but also on whether an appropriate level of professional skepticism is applied by the team’s response to particular circumstances. Finally, incorporating on-the-job auditor training regarding the appropriate application of professional skepticism throughout the supervision and review process will not only improve the exercise of professional skepticism on the specific audit engagement, it will also increase the competence of staff over the long term and serve as a daily reinforcement of the commitment to audit quality.

Profession/Audit Firm Level: Threats to the Appropriate Application of Professional Skepticism

At the profession and audit firm level, the current payor/selector model is widely accepted and carries with it certain inherent advantages and disadvantages relative to alternative models. Fee competition reduces profit margins and, when margins are tight or negative, could lead to insufficient skepticism as auditors feel pressure to reduce time spent on the audit. If professional associations or audit firm leadership do not adequately emphasize, incentivize, and support audit quality; the maintenance of a questioning, objective, probing mindset; and the auditors’ role in the context of the broader capital markets, then engagement teams may fail to exercise sufficient professional skepticism.

¹¹ IAASB, ISA 240, The Auditor’s Responsibility Relating to Fraud in an Audit of Financial Statements. 2009. New York, NY: IFAC. PCAOB AU Section 316, Consideration of Fraud in a Financial Statement Audit. 2010. www.pcaobus.org.

¹² See Brazel, J., Carpenter T., and Jenkins, G. 2010. “Auditors’ Use of Brainstorming in the Consideration of Fraud: Reports from the Field.” *The Accounting Review* 85 4: 1273–1301.

Finally, regulation can threaten skepticism if regulation and/or inspection focus is not properly aligned with relevant audit risks. In other words, if auditors expend effort to manage “inspection risk” in areas that are not sufficiently correlated with risk of material misstatement for a specific engagement, the influence of previous inspections can result in misplaced focus and effort, and potentially less attention to areas that present greater audit risk.

Profession/Audit Firm Level: Enhancing the Appropriate Application of Professional Skepticism

Exhibit 2 highlights factors already in place to foster the appropriate application of professional skepticism at the profession and audit firm level. In this section, we focus on potential areas of opportunity firms may want to consider to enhance the application of appropriate professional skepticism. We recognize that some audit firms have many of these factors already in place and some have begun to take some of these steps, but as with other areas discussed previously, we believe opportunities for improvement exist. Because we believe some of the threats to skepticism at the profession/audit firm level might best be addressed by considering changes that go beyond the control of audit firms, in the next section we consider what other stakeholders in the financial reporting process could do to enhance the appropriate application of professional skepticism by auditors.

Public accounting firms must engage in continuous improvement with respect to the consistent application of appropriate professional skepticism by auditors. We organize our thoughts regarding steps that firms can take into these categories: tone at the top and culture of consultation; development and implementation of a judgment framework; training in skills and processes underlying appropriate application of professional judgment and skepticism; and the development of tools, templates, and technology to monitor and enhance consistent firm-wide application of skepticism.



Tone at the Top and Culture of Consultation: As mentioned in discussing threats to professional skepticism at the engagement team level, the tone at the top of the firm and at the top of local offices likely will permeate to engagement teams and affect attitudes and practices involving the application of professional skepticism. A consistent message from firm and office leadership that a questioning, probing mindset is expected and is encouraged and rewarded above other pressures (e.g., deadlines and budget realization) should be regularly conveyed. Further, audit firms should work to establish a culture of consultation. The appropriate application of professional skepticism is only possible when auditors possess the necessary entity, industry, accounting, and auditing expertise to not only understand the issue, but also to proactively reframe the issue, enabling the auditor to effectively challenge management’s perspective. The firm’s culture should support auditors in obtaining the expertise necessary to exercise adequate professional skepticism—consultation outside the engagement team should be available and encouraged, and in some circumstances required.

Firm Developed and Supported Judgment Process: As indicated previously, one of the most important ways to improve the ability of auditors to exercise professional skepticism is to develop their ability to follow a good judgment process and to avoid judgment traps and biases that can undermine effective application of professional skepticism. Firms should develop and implement a sound audit judgment process and help ensure that auditors understand and implement that process so that it becomes deeply engrained in ongoing firm training and audits. A common conceptual foundation and a shared vocabulary at the firm level can facilitate mentoring, coaching, and review of good judgment processes.

Training in Judgment Processes Underlying Professional Skepticism:

As noted earlier, underlying personality traits likely influence an individual's ability to appropriately apply professional skepticism, but experience as well as a number of recent research studies indicate that knowledge and skills that can enhance auditors' ability to apply professional skepticism can be developed through training. Firms should consider collaborations with researchers and others so that they can better understand and build into their auditor development programs regular, recurring training on the judgment processes underlying professional skepticism (and on the requisite knowledge for the effective application of professional skepticism, discussed next). It is not sufficient to simply tell auditors to be skeptical; they must be trained in the underlying judgment processes, knowledge, attitudes, and skills that will allow them to appropriately and effectively bring professional skepticism to their work. We offer a few examples of approaches that have been shown to be effective in the enhancement of auditors' exercise of professional skepticism and that could be considered for use in firms' training programs:

- Training in the application of various levels of professional skepticism across the skepticism continuum. Earlier we referred to the appropriate application of professional skepticism in response to different circumstances based on risk at the assertion level. Firms adopting such a skepticism continuum would want to develop relevant policies and train auditors in the meaning and appropriate application of professional skepticism in different settings as well as implications of different levels of skepticism for obtaining evidence. For example, as noted in the discussion of the professional skepticism continuum above, as the risk associated with an assertion increases, the level of desired professional skepticism increases. The focus on "making the opposing case" or actively seeking disconfirming evidence likewise would be expected to increase.
- Training in proactive framing. By understanding the frames or perspectives that they and others are using and by making an effort to proactively reframe issues to see different perspectives, auditors can improve in their ability to appropriately and effectively question initial conclusions or more effectively challenge client explanations. These are skills that can be trained, mentored, and practiced.¹³
- Developing auditors' cognitive skills linked to creative problem solving through training on divergent and convergent thinking, on recognizing fraud in evidence patterns through "pre-mortem" processing, and on evaluating and articulating why contrary views may or may not be valid.¹⁴

Training to Boost Professional Judgment As Well As Fundamental and Specialized Knowledge, Enabling Enhanced Professional Skepticism:

In addition to developing the judgment skills underlying the exercise of professional skepticism, firm training can enhance auditors' professional skepticism abilities by boosting their knowledge in specific areas relevant to the audits to which they will be assigned. We offer a few illustrative examples, acknowledging that some firms already incorporate many of these in their training:

- Training specific to industry, operations, valuation methodologies, IT controls, and accounting. Obtaining knowledge and an understanding of the current environment for the client's industry, operations, and accounting helps auditors better identify risks.
- Training about the importance of setting independent expectations of unaudited account balances prior to focusing on the client's recorded amounts. Auditors may sometimes base expectations on client-provided evidence, including the company's unaudited financial results.

¹³ For example, see Glover, S.M., D.F. Prawitt, and KPMG, 2011, *Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework*.

¹⁴ Plumlee, D., B.A. Rixom, and A.J. Rosman. Training Auditors to Think Sceptically. 2011. Working paper, University of Utah. Pre-mortem thinking involves imagining a bad outcome in the future when faced with an unusual evidential pattern, and then thinking backward to consider why that bad outcome "was" realized (Trotman, K.T., R. Simnett and A. Khalifa. 2009. "Impact of the type of audit team discussions on auditors' generation of material frauds." *Contemporary Accounting Research* 26 (4), 1115-42. Also see Carpenter, T. and J.L. Reiners, Professional Skepticism: The Effects of a Partner's Influence and the Presence of Fraud on Auditors' Fraud Judgments and Actions. 2009. Working paper, University of Georgia.

- Enhanced fraud training. Given the low base rate of fraud, it is not surprising that auditors sometimes fail to recognize it when it exists. Prior experience with fraud (and with indications of errors in certain kinds of evidence) can make auditors more skeptical in future scenarios where similar evidence is present. Since the base rate of fraud is low, regular hands-on fraud training may serve to facilitate an appropriate level of professional skepticism. Fraud training that involves exposure to specific fraud schemes in various areas, particularly when the training provides simulated exposure to fraud cues in a realistic audit setting, likely has particular potential to be impactful.
- Training in conflict resolution and difficult conversations. For example, enhanced ability to identify and hold to predetermined limits and “non-negotiable” issues might help prevent or mitigate the effects of situations requiring a choice between exercising appropriate professional skepticism and damaging client relationships.

Tools, Templates, and Technology to Enhance and Evidence the Application of Professional Skepticism:

Tools and templates can encourage the consistent, appropriate application of professional skepticism as well as assist the auditor to properly evaluate and document both confirmatory and disconfirmatory evidence, thereby demonstrating the application of professional skepticism. Monitoring technology and electronic workpapers can be used to track when critical judgments are made relative to the audit and to monitor reporting deadlines to consider whether deadline

pressure might impair the appropriate application of professional skepticism. For example a tracking schedule of critical estimates and underlying methods and key assumptions in a level 3 fair value assessment can facilitate the team’s assessment of the reasonableness of the approach, including the development of the most effective testing strategy, and facilitate appropriate supervision and review by the senior team members and engagement quality reviewer. Monitoring technology could also highlight situations where a real-time or “hot review” of audit engagements may be warranted. For example, if audit risk assessments and underlying financial statements are analyzed at the national level through monitoring software, this could facilitate more precise involvement in known problem areas (e.g., entities with exposures to certain risks such as subprime securities or foreign investments).



What Can Other Stakeholders in the Financial Reporting Process Do to Enhance Auditor Professional Skepticism?

Understanding the determinants of and threats to professional skepticism at different structural levels will facilitate the formulation of solutions that can foster more consistently appropriate levels of professional skepticism.

External auditors clearly have the responsibility to apply appropriate professional skepticism throughout an audit. Understanding the determinants of and threats to professional skepticism at different structural levels will facilitate the formulation of solutions that can foster more consistently appropriate levels of professional skepticism. While auditors can and must do better in their central role, we believe that a complete solution to the problem of enhancing auditor professional skepticism requires an approach that addresses threats at all structural levels and that involves all of the key stakeholders that share responsibility in enhancing the reliability of the financial reporting process. In the context of this section, we focus on how other key stakeholders can contribute to the improved application of professional skepticism by auditors.

While audit committees, internal auditors, managements, analysts, trade exchanges, and regulators also have the responsibility to properly apply skepticism in their respective financial reporting roles, the purpose of this section is to offer a wide range of ideas on how these other key stakeholders might contribute to the enhanced application of appropriate professional skepticism by auditors.¹⁵ Our aim is to spark additional thought and dialogue and to encourage broader ownership of this issue across these key stakeholder groups. This is important because auditors' ability to exercise an appropriately high level of professional skepticism is enhanced when other key stakeholders' efforts are aligned with those of auditors. The overall goal

¹⁵ See Auditing Practices Board, 2012, "Professional Skepticism: Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality," www.frc.org.uk. Also see KPMG, Glover, and Prawitt, 2012, COSO Monograph: Enhancing Board Oversight: Avoiding Judgment Traps and Biases.

of enhancing skepticism to improve the fairness, reliability, and transparency of financial statements provided to the public can be aided by considering how other key stakeholders might contribute to, or detract from, the appropriate application of skepticism by auditors.

We provide suggestions for possible changes at the profession level that may further enhance auditor professional skepticism, including considerations for key stakeholders that we divide into three subgroups: boards of directors and audit committees, regulators and inspectors, and auditing standard setters. We do not intend to provide a complete roadmap of measures that could be considered for how other stakeholders may better align their efforts with auditors' efforts to enhance professional skepticism, and we do not suggest that adoption of every idea we present below is necessary to enhance auditor professional skepticism. We acknowledge that some of our suggestions are more practical to implement than others, at least in the short term, but we believe it is valuable to explore a broad range of ideas.

Strengthening the Role of the Board and Audit Committee

We believe boards and audit committees have opportunities to contribute to the skepticism exercised by external auditors.¹⁶ Recent standards enhance the auditor's communication of relevant financial and other information to the audit committee and will, hopefully, enhance two-way communication and facilitate understanding of roles and responsibilities.¹⁷ As the external audit firm interfaces with boards and committees that effectively represent the interests of investors and that understand, transparently communicate, and are accountable for their role in overseeing and fostering high-quality auditing, some fundamental threats to auditor professional



skepticism will be mitigated and other efforts to improve professional skepticism will be more effective. Our thoughts for areas where boards and audit committees can enhance auditor professional skepticism are categorized into three parts: clarified role and strengthened independence of the audit committee acting for the benefit of the investing public, audit committee financial reporting expertise, and more transparent audit committee communication.

Clarified Role and Strengthened Independence of the Audit Committee: Progress has been made in some jurisdictions to clearly establish the audit committee as the "audit client." These are important efforts in relation to auditor professional skepticism.¹⁸ The audit committee can influence auditors' skepticism through its own objective attitude and desire to support the auditor's role in gathering sufficient, appropriate evidence to support an opinion that the financial statements and related disclosures are fairly presented. Expression in writing in the charter and orally to the auditor and management that the auditor's client is the audit committee, not management, can enhance auditor professional skepticism. With respect to the payor/selector model, the party that bears the cost of the audit is likely not as important in relation to the appropriate exercise of skepticism as the party responsible to select and retain or replace the auditor. A process and a set of criteria could be established for evaluating external auditor performance as part of the audit committee's auditor selection/retention process. Those criteria could place

¹⁶ A recent paper by the U.S. National Association of Corporate Directors (NACD), dated January 2013, titled "Honing Skepticism," notes the importance of exercising skepticism by those in the corporate boardroom, both in itself and for its role in enhancing the professional skepticism of external auditors. Also see KPMG, Glover, and Prawitt, 2012, COSO Monograph: Enhancing Board Oversight: Avoiding Judgment Traps and Biases.

¹⁷ For example, PCAOB Auditing Standard No. 16, Communications with Audit Committees. 2012. www.pcaob.us.org.

¹⁸ See the FRC's Auditing Practices Board publication, Auditor Skepticism: Raising the Bar, March 2011. Clarified guidelines and requirements around achieving appropriate audit committee independence from management, in appearance and fact, may also be an area that could improve the ability of audit committees to enhance auditors' professional skepticism.

special emphasis on the ability of the auditor to identify, assess, and address significant audit risks in accordance with applicable auditing standards and on the auditor's consistent exercise of appropriate professional skepticism in conducting the audit.

Audit Committee Financial Reporting Expertise: Audit committees facilitate auditor professional skepticism by asking probing questions of management, internal auditors, and external auditors that help directors identify and understand issues and appropriately follow up on how those issues have been investigated, evaluated, and ultimately handled. Improved performance is likely to come from audit committees that have at least one member who qualifies as a "financial reporting expert," with sufficient background and expertise to understand complex financial accounting and auditing concepts in order to appropriately apply professional skepticism. For larger entities with larger boards, including more than one financial reporting expert on the audit committee can enhance the audit committee's ability to ask probing questions of the auditor. Further, audit committee members should have opportunities for education and training in the areas of accounting, auditing, professional judgment and skepticism, relevant technology, enterprise risk management, industry specialization, financial reporting best practices, and other relevant topics. These measures are more likely to be effective to the extent audit committees are independent of management and act in accordance with their role representing the interests of investors.

Guidance could be developed to help audit committees to make an independent consideration of industry, business, reporting, and fraud risks, as well as a high-level understanding of how to assess how well the audit plan addresses relevant risks. Audit committee professional associations could provide training in best practices and could produce guides to help measure audit committee performance.

Strengthened expertise will allow the audit committee to better evaluate whether auditors and management have a thorough understanding of the company, its accounting and reporting system and policies, and the industry to which the company belongs. In this role, the internal audit function can be a valuable resource to the audit committee, as it gathers and conveys relevant information to the audit committee about critical issues, including the tone at the top of the company,

the effectiveness of internal control, the competence of management and accounting professionals, the effectiveness of accounting and reporting systems, and any occurrences of management override.

More Transparent Audit Committee Communication and Accountability: Audit committees have considerable responsibility for overseeing, fostering, and encouraging the quality of auditing that takes place within the entity for which they have fiduciary obligations. However, audit committees currently have little responsibility for communicating their roles or responsibilities with other key stakeholders.¹⁹ Greater transparency and open communication by the audit committee could enhance the committee members' sense of accountability and responsibility for oversight and encouragement of high-quality auditing.

In their communications with other stakeholders, audit committees could communicate that they have performed their oversight duties and responsibilities, which could be briefly outlined, with an appropriate level of due diligence to adequately represent stakeholders' interests. The audit committee could assess and communicate whether the level and quality of internal and external audit effort employed by the entity represents both a responsible use of the entity's resources and is adequate to deliver high-quality auditing with sufficient professional skepticism to appropriately protect outside stakeholders. Such communication might help encourage audit committees to consistently seek to fulfill their central role representing investors and creditors as they oversee the efforts and professional skepticism of internal and external auditors.

¹⁹ In some jurisdictions, such as in the United States, the audit committee provides a report that is included in SEC registrants' proxy filings. However, little guidance is provided on what the audit committee should communicate in the report. Not surprisingly, the informativeness of such proxy reports varies widely. Along these lines, in a November 2012 "Point of View" document titled "Enhancing Transparency of the Audit Committee Auditor Oversight Process," Ernst & Young takes the position that audit committees should engage in a periodic "auditor independence and effectiveness assessment" and explicitly report to shareholders on the results of that assessment.

Regulators/Inspectors

Regulators and inspectors can also take steps to contribute to the consistent application of appropriate professional skepticism by auditors. We organize our ideas into four categories: Inclusion of a judgment framework and skepticism continuum into auditing standards and practices; oversight of auditors and audit committees; oversight, inspection and standard setting; and taking steps to avoid hindsight and confirmation bias in the inspection process.

Inclusion of Judgment Framework and Skepticism Continuum in Auditing Standards and Practices: One of the factors currently limiting the ability both to apply and evaluate the application of appropriate professional skepticism is the lack of a common definition and a shared understanding or framework for its appropriate application. Accordingly, regulators could collaboratively work with standard setters and practitioners to develop such a definition, framework, and practical guidance. Based on guidance in the standards, regulators could work to reach common ground with the profession as to the practical implementation of the standards, including the practical limitations of implementing the continuum and the parameters surrounding the link between risk of material misstatement and the appropriate application of professional skepticism as well as the link to the nature and extent of the auditor's procedures and documentation appropriate in the circumstances. Over time, the development of a common understanding in these areas will facilitate regulation, standard setting, and inspections that could significantly enhance the application and assessment of professional skepticism in practice. To make the best use of a common skepticism definition and framework, we suggest that regulators consider including and applying the auditor skepticism continuum in inspector training and protocols.

Oversight, Inspection, and Standard Setting: When the same body is given responsibility for inspection, enforcement and standard setting, care needs to be taken that standard setting does not become overly compliance focused, which could have unintended consequences on the appropriate application of professional skepticism.



Awareness of Common Biases in Inspection Process:

Research suggests that people, including accounting and other professionals, are subject to biases stemming from certain judgment tendencies (see Exhibit 3). One example is what researchers label the “hindsight” or “outcome” tendencies. This bias can lead observers of others’ judgments to conclude after the fact that judgments made before additional events occurred or additional information became available were incorrect or lacking. In an audit inspection setting, this means that inspectors could in some cases perceive that the auditor’s judgments, made before such external events or additional information came to light, reflect insufficient professional skepticism and audit evidence, even in cases where the level of evidence and skepticism was in fact appropriate given the facts and circumstances at the time of the audit. To the extent such common human biases can be accounted for and mitigated, inspection processes will be more likely to maximize their potential to enhance the appropriate application of professional skepticism by auditors. Agreement and practical guidance on shared evidence and documentation conventions that demonstrate the appropriate application of professional skepticism in different circumstances will help reviewers and inspectors evaluate the audit procedures and conclusions given the facts and circumstances available to the auditor at the time the evidence was collected and documented.

Auditing Standard Setters

Auditing standard setters can also take steps to contribute to the consistent application of appropriate professional skepticism by auditors. We organize our ideas for steps that auditing standard-setting bodies can take into three categories: infusion of a professional judgment framework and a skepticism continuum into auditing standards, revision of auditing standards and application guidance to encourage a skeptical mindset, and development of a framework for the documentation of professional skepticism.

Infusion of Professional Judgment Framework and Skepticism Continuum into Auditing Standards:

Auditing standards are currently drafted given an implicit assumption that auditors will exercise appropriate professional judgment and skepticism. However, as noted earlier, little practical guidance is currently available on what appropriate judgment and skepticism is or how it should be demonstrated and documented. We recommend that standard setters work in concert with the profession and with regulatory bodies to consider how best to integrate a professional judgment framework and skepticism continuum into the auditing standards, providing a coherent framework for the appropriate application of judgment and professional skepticism.²⁰ Auditing and quality control standards could also benefit from a consideration of threats to professional skepticism organized by structural level. We believe the ability of auditors to consistently execute audits with an appropriate level of professional skepticism would be enhanced by a shared definition of professional skepticism, together with practical implementation guidance, that are formulated in the context of a skepticism continuum.

Revision of Standards and Application Guidance to Encourage a Skeptical Mindset:

Current standards are largely written in a positive or confirmatory frame of reference to gather sufficient appropriate evidence to provide support for an assertion. Research in judgment and decision making over the last few decades has demonstrated the power of judgment frames. Standard setters should consider infusing standards with a skeptical frame to encourage an appropriately skeptical mindset on the part of auditors—for example, a standard could encourage auditors to consider “what could go wrong,” to make the “opposing case” to management’s view, or to seek potentially disconfirming evidence.²¹

Development of a Framework to Document Appropriate Application of Professional Skepticism:

Standard setters could work in concert with other key stakeholders to develop a globally recognized framework, together with practical implementation guidance, illustrations, and best practices for the appropriate application and documentation of professional judgment and skepticism across different risk settings. As discussed above, one fruitful area for practical implementation guidance is to link levels of the professional skepticism continuum to expectations around the proactive search for contrary or disconfirming evidence.

²⁰ An example of such a judgment framework can be found in Glover, S.M., D.F. Prawitt, and KPMG, 2011, Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework.

²¹ Maksymov, E., M. Nelson, and W. Kinney, 2012. Effects of Procedure Frame, Procedure Verifiability, and Audit Efficiency Pressure on Planning Audits of Fair Values. Working paper, Cornell University.

Conclusion

In light of the changing environment of financial reporting and demands for enhanced audit quality and relevance, an understanding of and an ability to exercise proper professional skepticism is increasingly important for all stakeholders who participate in the financial reporting process. Audit professionals must be able to identify and exercise a sufficient level of professional skepticism—one that is appropriate for the risks involved. There is currently a lack of practical guidance around the appropriate application and documentation of professional skepticism in auditing standards and in the professional literature. We believe this represents an important opportunity for the profession, academics, standard setters, and regulators. The skepticism continuum we provide represents a potential step forward in understanding the nature of professional skepticism and in applying, documenting, and evaluating an appropriate level of skepticism in varying circumstances. In order to make changes that have the potential to enhance professional skepticism in the financial reporting process, auditors and others involved must understand the nature of professional skepticism, including how skepticism is threatened and how it can be enhanced at the various structural levels (Individual Auditor, Engagement Team, Profession/Audit Firm). An increased capacity to understand and identify threats to professional skepticism at particular structural levels and in the context of measures already in place will assist the profession in taking appropriate steps to mitigate such threats and will assist others in evaluating relevant costs and trade-offs that are explicit or implicit in alternatives considered.

Through the exercise of an appropriate level of professional skepticism in thought and action and through proper documentation of the results of those actions, auditors can improve audits and better demonstrate how they exercised appropriate professional skepticism. Coordinated efforts by all of the key stakeholders will increase the likelihood that audit quality will be improved and the transparency and reliability of reported financial information enhanced. Our hope is that this paper will provide a conceptual foundation for a productive ongoing dialogue that will lead to specific actions to enhance auditor professional skepticism and, ultimately, audit quality.

Our hope is that this paper will provide a conceptual foundation for a productive ongoing dialogue that will lead to specific actions to enhance auditor professional skepticism and, ultimately, audit quality.
