Draft IAASB Staff Questions and Answers

Professional Skepticism in an Audit of Financial Statements

1. This Questions & Answers (Q&A) publication is issued by the staff of the International Auditing and Assurance Standards Board (IAASB) to highlight how fundamentally important and central professional skepticism is in an audit of financial statements performed in accordance with the International Standards on Auditing (ISAs).[1] Specifically, this Q&A focuses on considerations in the ISAs and ISQC 1[2] that are of particular relevance to the proper understanding and application of professional skepticism during the audit. Auditors of the financial statements of entities of all sizes may find this Q&A helpful in the conduct of their audits.

2. This publication has been developed in response to a renewed focus by stakeholders, particularly regulators, oversight bodies and policy makers, on auditors' application of professional skepticism when conducting audits of financial statements. The publication does not amend or override the ISAs and ISQC 1, the texts of which alone are authoritative. Reading this Q&A is not a substitute for reading the standards. The Q&A is not meant to be exhaustive and reference to the standards themselves should always be made. This publication does not constitute an authoritative or official pronouncement of the IAASB.

Background

3. The integrity and quality of financial information are supported and enhanced by a robust external independent audit, carried out objectively and with professional skepticism by the auditor. In the aftermath of the global financial crisis, as lessons are being drawn and policy debates are being held, public interest attention has turned to the important role of professional skepticism in an audit of financial statements and whether auditors have been applying it appropriately in their audits. In recent public statements, regulators, oversight bodies, policy makers, investors and others have, in particular, called for auditors to exercise increased levels of professional skepticism in performing audits, further challenge management assumptions and judgments in forming independent views rather than being satisfied with evidence that supports management's views, and take steps to further promote an audit firm culture and business environment that foster increased levels of professional skepticism.

4. Concerns raised over insufficient or inappropriate levels of auditor skepticism have also led to debates regarding the role of professional skepticism in an audit and how its application in practice could be improved. These concerns have in particular arisen in the context of the recent trend in financial reporting towards the provision of financial information that is more relevant and decision-useful for users but less readily verifiable, particularly fair value financial information. In addition, given more volatile economic conditions, many entities have been facing greater business challenges and uncertainties. In those

[1] All references to ISAs in this publication are to the clarified ISAs, which are in effect for audits of financial statements for periods beginning on or after December 15, 2009.

[2] ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance, and Related Services Engagements*

circumstances, professional skepticism takes heightened importance as the significant judgments made by management in preparing the financial statements are likely to become more difficult and subjective.

5. The following Q&As highlight requirements and application and other explanatory material in the ISAs that focus on specific considerations relating to the proper application of professional skepticism in an audit of financial statements. The Q&As also highlight requirements and application and other explanatory material in ISQC 1 that focus on specific considerations at the audit firm level that foster the development and application of appropriate professional skepticism by auditors on audit engagements.

6. While certain requirements and application and other explanatory material in particular are highlighted, this publication does not reproduce all of the ISA provisions that are relevant to the auditor's responsibility to plan and perform an audit with professional skepticism. The proper application of the entire suite of ISAs has bearing on the conclusions the auditor draws from the evidence obtained in forming an opinion on the financial statements. The fact that any particular ISA does not make specific reference to professional skepticism does not imply that the auditor need not apply appropriate professional skepticism in carrying out the requirements of the ISA.

QUESTIONS AND ANSWERS

Q1. *What is professional skepticism, and what role does it play in an audit of financial statements conducted in accordance with ISAs?*

7. 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.[3] There is no single way in which professional skepticism can be demonstrated – it is a mindset. It is an integral part of the auditor's skills set.[4] It also is inseparably linked to the fundamental ethical principle of auditor independence.[5] The ISAs in particular emphasize that the auditor's independence enhances

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

[4] The International Accounting Education Standards Board for Accountants' (IAESB) International Education Standard (IES 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.

[5] 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. Independence of mind 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. Independence in appearance is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's or a member of the audit team's, integrity, objectivity, or professional skepticism has been compromised.

the auditor's ability to act with integrity, be objective and maintain an attitude of professional skepticism.[6]

8. Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence, conditions that may indicate possible fraud, and circumstances that suggest the need for audit procedures in addition to those required by the ISAs.[7] 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 persuasive.[8]

9. Professional skepticism plays a fundamentally important role in the audit. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalizing when drawing conclusions from audit observations, or using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.[9]

10. Professional skepticism is also necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.[10]

11. The application of professional skepticism assists to enhance 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.[11]

12. Professional skepticism is closely interrelated with professional judgment. Both are essential to the proper conduct of the audit and are key inputs to audit quality. Maintaining a skeptical mindset facilitates the appropriate exercise of professional judgment by the auditor, particularly regarding decisions about the nature, timing and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence, evaluating whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the ISAs, and evaluating management's judgments in applying the entity's applicable financial reporting framework.[12]

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[6] ISA 200, paragraph A1

[7] ISA 200, paragraph A18

[8] ISA 200, paragraph A48

[9] ISA 200, paragraph A19

[10] ISA 200, paragraph A20

[11] ISA 200, paragraph A43

[12] ISA 200, paragraph A23

Q2. How do the ISAs help guide the auditor in applying professional skepticism during the audit?

13. Professional skepticism is so fundamental to the audit that it has been embedded throughout the ISAs. The ways in which the ISAs stimulate skeptical behavior are varied, ranging from a questioning but neutral mindset to a mindset of presumptive doubt.

14. In a questioning but neutral mindset, the auditor attempts to be unbiased in forming the auditor's beliefs and takes neither a positive (trusting) nor negative (suspicious) position. Those ISA requirements and guidance that stress the importance of the auditor being alert to factors or other matters that should raise caution and, as appropriate, cause the auditor to reassess whether the auditor's risk assessment and related responses remain appropriate are generally closer to the questioning-but-neutral-mindset end of the range. An example is the requirement for the auditor to remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.[13]

15. In a mindset of presumptive doubt, the auditor assumes some level of dishonesty by management until audit evidence indicates otherwise. Those ISA requirements and guidance that specifically direct the auditor to challenge the appropriateness of management's actions are generally closer to that end of the range. Examples are the requirement for the auditor to presume risks of fraud in revenue recognition[14] and the requirement for the auditor to review accounting estimates for management bias.[15]

16. The overarching requirement within the ISAs is for 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.[16] This requirement directs the auditor to adopt an attitude of professional skepticism in all aspects of planning and performing the engagement, but it is not repeated as a requirement within each ISA.[17] How the ISAs guide the auditor in adopting appropriate professional skepticism is illustrated below with reference to the various stages of the audit process, including engagement acceptance; general planning and quality control considerations; performing audit procedures, including identification and assessment of risks of material misstatement; evaluating misstatements and forming the audit opinion; and reporting.

17. As a preamble, however, it is important to note two matters. First, the auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of

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[13] ISA 550, *Related Parties*, paragraph 15

[14] ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 26

[15] ISA 240, paragraph 32(b)

[16] ISA 200, paragraph 15

[17] ISA 200, paragraph A69

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.[18]

18. Secondly, the auditor cannot be expected to disregard past experience of the honesty and integrity of management and those charged with governance. Nevertheless, a belief that they are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.[19] In this regard, the ISAs highlight the importance of professional skepticism when considering the risks of material misstatement due to fraud because there may have been changes in circumstances.[20]

Engagement Acceptance

19. At the outset, the engagement partner is required to be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and determine that conclusions reached in this regard are appropriate.[21] This includes critically considering such matters as the integrity of the principal owners, key management and those charged with governance of the entity, and whether the engagement team has the necessary capabilities and competence.[22] At the firm level, the firm is required to establish policies and procedures addressing the essential maintenance of independence by the firm and its personnel and others involved on audit engagement teams.[23]

General Planning and Quality Control Considerations

20. Creating the right conditions for the maintenance of professional skepticism is an important aspect of planning the audit and the auditor's specific responsibilities for quality control. In particular, the engagement partner and other key members of the engagement team are required to be involved in planning the audit to draw on their experience and insight.[24] The engagement partner is also required to direct and supervise the engagement team, and to be satisfied that sufficient appropriate audit evidence has been obtained.[25] Direction of the engagement team involves, in particular, informing team members of their responsibilities in maintaining professional skepticism throughout the audit.[26]

21. Additionally, the engagement partner is required to take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters, and for being satisfied that engagement team members have undertaken appropriate consultation during

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18 ISA 200, paragraph A21; ISAs 240, paragraph 13; ISA 500, paragraph 11; ISA 505; paragraphs 10-11, and 16

19 ISA 200, paragraph A22

20 ISA 240, paragraph A8

21 ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 12

22 ISA 220, paragraph A8

23 ISQC 1, paragraph 21

24 ISA 300, *Planning an Audit of Financial Statements*, paragraphs 5 and A4

25 ISA 220, paragraphs 15 and 17

26 ISA 220, paragraph A13

the audit.[27] By consulting with those who have appropriate knowledge, seniority and experience within or outside the firm, the engagement team is able to obtain independent perspectives on the application of professional skepticism regarding significant technical, ethical and other matters.

22. The various levels of ongoing review and supervision required by the ISAs throughout the audit also serve as a "check and balance" that appropriate professional skepticism has been applied. For example, where deemed necessary by the firm, an engagement quality control review provides for a "second set of eyes" on the audit work performed through an objective evaluation of the significant judgments made and the conclusions reached.[28]

23. As the audit progresses, the ISAs call on the auditor to be 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, that may require revisions to materiality level(s) established at the planning stage.[29]

Performing Audit Procedures, Including Identification and Assessment of Risks of Material Misstatement

24. Maintaining appropriate professional skepticism is a requirement that permeates the ISAs that guide the performance of audit procedures. This is illustrated by reference to various aspects of the audit.

Engagement Team Discussion

25. The engagement team is required to discuss the susceptibility of the entity's financial statements to material misstatements, including how and where they may be susceptible to material misstatement due to fraud.[30] The discussion creates a forum for engagement team members to "brainstorm" and share knowledge and insights about various matters where an increased level of professional skepticism may be warranted, for example, with respect to related party relationships and transactions.[31] It also provides, in the light of changes in engagement circumstances, an opportunity for team members to challenge preconceptions about the quality of the entity's accounting and financial reporting practices, and the integrity of management and those charged with governance relative to the financial reporting process.

Fraud

26. Given the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.[32] This calls for an ongoing questioning of whether the information and audit evidence obtained suggests

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27 ISA 220, paragraph 18(a)-(b)

28 ISA 220, paragraphs 7(b), 20(a) and 20(c)

29 ISA 320, *Materiality in Planning and Performing an Audit*, paragraphs 12 and A13

30 ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 10, and ISA 240, paragraph 15

31 ISA 550, paragraph A9

32 ISA 240, paragraph A7

that a material misstatement due to fraud may exist. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor is required to challenge prior conclusions by investigating the inconsistencies.[33]

27. As management is often in the best position to perpetrate fraud, the ISAs guide the auditor in judging whether it is necessary to corroborate management's responses to inquiries with other information.[34] The ISAs also guide the auditor in applying a critical mind when evaluating whether unusual or unexpected relationships identified in performing analytical procedures may indicate risks of material misstatement due to fraud.[35]

28. The ISAs make clear that a possible response to assessed risks of material misstatement at the overall financial statement level is to emphasize to the engagement team the need to maintain professional skepticism.[36] In the context of fraud, this includes adjustments to the overall conduct of the audit to reflect increased professional skepticism, for example, through increased sensitivity in the selection of the nature and extent of entity documentation to be examined, or increased recognition of the need to corroborate management explanations or representations concerning material matters.[37]

29. If a misstatement comes to light that it is or may be the result of fraud and that involves management (in particular, senior management), the ISAs challenge the auditor to reevaluate the prior assessment of the risks of material misstatement due to fraud and the consequential impact on the nature, timing and extent of audit procedures. The ISAs also challenge the auditor to consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.[38]

Related Party Transactions

30. Planning and performing the audit with professional skepticism also is particularly important in relation to related party relationships and transactions, given the potential for these to be undisclosed.[39] In addition to being required to remain alert during the audit for information that may indicate previously unidentified or undisclosed related party relationships or transactions,[40] the auditor is required to probe management regarding the nature of identified significant transactions outside the entity's normal course of business and whether these may involve related parties.[41]

31. If circumstances relating to a related party with dominant influence give rise to fraud risk factors, the ISAs direct the auditor to critically consider such information when identifying

[33] ISA 240, paragraph 14

[34] ISA 240, paragraph A17

[35] ISA 240, paragraph 22

[36] ISA 330, *The Auditor's Responses to Assessed Risks*, paragraph A1

[37] ISA 240, paragraph A33

[38] ISA 240, paragraph 36

[39] ISA 550, paragraph 7

[40] ISA 550, paragraph 15

[41] ISA 550, paragraph 16

and assessing risks of material misstatement due to fraud.[42] If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the ISAs challenge the auditor to determine whether the underlying circumstances confirm the existence of those relationships or transactions.[43] The identification of related parties or significant related party transactions that management has not previously identified or disclosed to the auditor also is a condition that prompts further skeptical actions under the ISAs, including challenging management to identify all transactions with the newly identified related parties for the auditor's further evaluation.[44]

32. The ISAs further require a questioning mindset when the auditor identifies significant related party transactions outside the entity's normal course of business. In particular, in those circumstances, the auditor is required to and evaluate 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.[45]

External Confirmations

33. The ISAs guide the auditor in adopting a questioning stance when carrying out external confirmation procedures. For example, if management refuses to allow the auditor to send a confirmation request, the auditor is required to challenge management as to the reasons for the refusal, and seek audit evidence regarding the validity and reasonableness of those explanations. The auditor is also required in those circumstances to critically evaluate the implications of such refusal on the auditor's prior risk assessment and responses.[46]

34. When doubts arise regarding the reliability of the response to a confirmation request, the ISAs challenge the auditor to obtain further audit evidence to resolve such doubts.[47] Also, if the response to a confirmation request is deemed not reliable, the ISAs challenge the auditor to evaluate the implications on the auditor's risk assessment and related responses.[48]

Accounting Estimates

35. Adopting a questioning and critical mindset plays a central role when auditing accounting estimates, including fair value accounting estimates, and related disclosures. For example, in understanding how management makes accounting estimates, the ISAs drive the auditor to probe whether there has been or should have been a change from the prior period in the methods for making the estimates, and if so why. In the event of a change in the method for making an accounting estimate, the ISAs drive the auditor to challenge management to

[42] ISA 550, paragraph 19

[43] ISA 550, paragraph 21

[44] ISA 550, paragraph 22

[45] ISA 550, paragraph 23

[46] ISA 505, *External Confirmations*, paragraph 8

[47] ISA 505, paragraph 10

[48] ISA 505, paragraph 11

demonstrate that the new method is more appropriate, or is itself a response to changes in the environment or circumstances affecting the entity..[49]

36. The ISAs note that the review of prior period accounting estimates may assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The ISAs make it clear that a skeptical mindset helps the auditor to identify such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.[50]

37. For accounting estimates that give rise to significant risks, the ISAs stimulate the auditor to question how management has considered alternative assumptions or outcomes, and why it has rejected them, and critically evaluate the reasonableness of the significant assumptions used by management, and, where relevant, management's intent to carry out specific courses of action and its ability to do so.[51]

38. The auditor is also required to critically review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. As such indicators may affect the auditor's prior risk assessment and related responses, the ISAs guide the auditor to critically think about the implications for the rest of the audit.[52]

Consideration of Laws and Regulations

39. The auditor is required to be alert that audit procedures performed during the audit may point to identified or suspected non-compliance with laws and regulations.[53] The ISAs highlight the importance of professional skepticism in this regard, given the extent of laws and regulations that affect the entity.[54]

40. When non-compliance is identified or suspected, the ISAs signal the need for heightened skepticism. For example, if non-compliance is suspected, the auditor is required to discuss the matter with management and, where appropriate, those charged with governance,[55] and critically evaluate the implications on other aspects of the audit. [56]

Analytical Procedures

41. The ISAs further require a questioning stance when performing analytical procedures. For example, if analytical procedures identify fluctuations or relationships inconsistent with other relevant information or that differ from expected values by a significant amount, the

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[49] ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraphs 8(c)(v), 12(b) and A37

[50] ISA 540, paragraph A40

[51] ISA 540, paragraph 15

[52] ISA 540, paragraphs 21

[53] ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 15

[54] ISA 250, paragraph 8

[55] ISA 250, paragraph 19

[56] ISA 250, paragraph 21

ISAs challenge the auditor to take appropriate steps to investigate the differences, including making appropriate inquiries of management.[57]

Going Concern

42. The application of a skeptical mindset is particularly important when considering the entity's ability to continue as a going concern. In particular, the ISAs direct the auditor to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In this regard, the ISAs stimulate a variety of skeptical behaviors on the part of the auditor. For example, the auditor is required to challenge management's assessment if one has been performed or, if not, to question management's intended use of the going concern assumption.[58] The auditor is also required to remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.[59]

43. If such events or conditions are identified, the auditor is required to determine whether or not a material uncertainty exists. To do so, the ISAs require the auditor to challenge management in a number of ways, such as 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.[60]

Written Representations

44. While written representations are necessary information that the auditor requires in connection with the audit and are audit evidence,[61] the ISAs stimulate heightened skepticism about them in certain circumstances. For example, if the auditor has concerns about the competence or integrity of management, the auditor is required to determine what effect this may have on the reliability of representations (oral or written) and other audit evidence.[62] Also, if management does not provide one or more requested written representations, the auditor is required to take specific actions such as reevaluating management's integrity, and questioning the implications for the reliability of representations and other audit evidence.[63]

45. The ISAs also guide the auditor in critically assessing written representations as audit evidence. Specifically, if written representations are inconsistent with other audit evidence, the auditor is required to perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor is required to take specific actions, including reconsidering the prior assessment of the management's competence and integrity.[64]

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57 ISA 520, *Analytical Procedures*, paragraph 7

58 ISA 570, *Going Concern*, paragraph 10

59 ISA 570, paragraph 11

60 ISA 570, paragraph 16(b)

61 ISA 580, *Written Representations*, paragraph 4

62 ISA 580, paragraph 16

63 ISA 580, *Written Representations*, paragraph 19(a)-(b)

64 ISA 580, paragraph 17

Significant Unusual or Highly Complex Transactions

46. More generally, there are matters that may cut across several aspects of an audit where skepticism is important. An example is auditing significant unusual and or highly complex transactions. The September 2010 IAASB Staff Q&A publication, *Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions*,[65] 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.

Evaluating Misstatements and Forming the Audit Opinion

47. The ISAs drive the auditor to maintain a questioning attitude when evaluating the effect of identified misstatements on the audit, and of any uncorrected misstatements on the financial statements. For example, if the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material, the auditor is required to determine whether the overall audit strategy and audit plan need to be revised.[66]

48. Should management refuse to correct some or all of the misstatements communicated by the auditor, the auditor is required to understand why and critically consider the reasons when evaluating whether the financial statements as a whole are free from material misstatement.[67] A questioning attitude is further called for by the ISAs prior to the auditor's evaluation of the effect of uncorrected misstatements, when the auditor is required to reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.[68]

49. A questioning mind and a critical assessment of the audit evidence gathered are especially important when forming the opinion on the financial statements. For example, the ISAs challenge the auditor to evaluate the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.[69] The ISAs stimulate the auditor to critically evaluate such matters as whether management's accounting estimates are reasonable; whether the information presented in the financial statements is relevant, reliable, comparable, and understandable; and whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.[70] Additionally, the ISAs drive the auditor to evaluate whether the effects of the related party

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

66 ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 6(a)

67 ISA 450, paragraph 9

68 ISA 450, paragraph 10

69 ISA 700, *Forming an Opinion and Reporting on Financial Statements*, paragraph 12

70 ISA 700, paragraph 13(c)-(e)

relationships and transactions prevent the financial statements from achieving fair presentation in the case of a fair presentation framework.[71]

50. Importantly, when the financial statements are prepared in accordance with a fair presentation framework, the ISAs call for the auditor to "stand back" and critically consider the overall presentation, structure and content of the financial statements, and whether they represent the underlying transactions and events in a manner that achieves fair presentation.[72]

Reporting

51. The ISAs' requirements for the auditor to modify the audit opinion in specific circumstances enable the auditor to demonstrate in a visible manner that appropriate skeptical behaviors have been adopted during the audit.[73] Specific ISAs also call on the auditor to determine the implications for the opinion of the auditor's findings in certain circumstances or when the auditor is unable to gather necessary audit evidence, for example, when the auditor concludes that written representations from management are not reliable,[74] or when the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable.[75]

Q3. *How do the ISAs and ISQC 1 help auditors cultivate appropriate professional skepticism?*

52. Professional skepticism is strongly 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. Those personal behavioral traits and competence levels are, in turn, influenced by the education, training and experience levels of the engagement partner and the rest of the engagement team. Professional skepticism is also strongly influenced by the culture and business environment of the firm. Both the ISAs and ISQC 1 focus on creating an environment in which the auditor can cultivate appropriate professional skepticism.

53. At the engagement level, the ISAs create appropriate conditions for engagement team members to develop and apply appropriate professional skepticism. In particular, through directing the engagement team, the engagement partner is able to impart knowledge and insight to less experienced team members about such matters the nature of the entity's business, risk-related issues, problems that may arise, and the detailed approach to the performance of the audit. Also, discussion within the engagement team allows less experienced team members to raise questions with more experienced team members, thereby enabling the former to learn from the latter.[76]

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[71] ISA 550, paragraph 25(b)

[72] ISA 700, paragraph 14

[73] ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 6 and A3

[74] ISA 580, paragraph 18

[75] ISA 505, paragraph 9

[76] ISA 220, paragraph A13

54. Appropriate teamwork and training provide a supportive environment that assists less experienced members of the engagement team to clearly understand the objectives of the assigned work,[77] thereby enabling them to develop their skills, including a skeptical mindset. Equally, the process of ongoing supervision and review during the audit provides a continuing learning opportunity for less experienced team members, enabling them to enhance their understanding of professional skepticism in a number of ways. These include reinforcement of the instructions given to them, guidance on whether their work is being carried out in accordance with the planned audit approach, observing how significant matters arising during the audit are being addressed, obtaining an appreciation of which matters are being or should be identified for consultation, and receiving feedback from review of their work by more experienced team members.[78] 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, amongst other matters, critical areas of judgment and significant risks.[79]

55. At the firm level, the firm is required to establish various policies and procedures aimed at creating a firm culture and business environment[80] that are supportive of nurturing the growth of appropriate professional skepticism by engagement team members. In particular, the promotion of a quality-oriented internal culture through clear, consistent and frequent actions and messages from all levels of the firm's management[81] helps contribute to continual reinforcement of the importance of professional skepticism on audit engagements. Equally important is recognition by the firm's leadership that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all its engagements.[82]

56. Further, the firm is required to establish policies and procedures that address the competence, capabilities, and commitment to ethical principles of its personnel. This includes establishing procedures for performance evaluation, compensation, and promotion that recognize and reward the development and maintenance of competence and commitment to ethical principles, including professional skepticism.[83]

Q4. How do the ISAs help guide the auditor in evidencing the proper application of professional skepticism in an audit of financial statements?

57. Given that professional skepticism is a state of mind, the means by which the auditor demonstrates it does not lend itself to being explicitly captured and referenced as part of the auditor's documentation. The ISAs therefore do not explicitly require the auditor to document that the auditor has demonstrated professional skepticism. They also make clear that there may be no single way in which the auditor's professional skepticism may be documented. However, they explain that the audit documentation may nevertheless provide

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77 ISA 200, paragraph A14

78 ISA 220, paragraph A15-A17

79 ISA 220, paragraph A18

80 ISQC 1, paragraph 18

81 ISQC 1, paragraph A4

82 ISQC 1, paragraph A5

83 ISQC 1, paragraphs 29 and A28

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.[84]

58. Through specific documentation requirements, individual ISAs also enable the auditor to demonstrate the application of appropriate professional skepticism during the audit. Examples include documenting:

- The 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, those charged with governance, regulators and others.[85]
- Identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.[86].
- Matters that should be communicated to those charged with governance, including the auditor's views about significant qualitative aspects of the entity's accounting practices, and significant matters discussed, or subject to correspondence, with management.[87].
- 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.[88]

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84 ISA 230, *Audit Documentation*, paragraph A7

85 ISA 240, paragraphs 44(a) and 46

86 ISA 250, paragraph 29

87 ISA 260, paragraphs 16 and 23

88 ISA 540, paragraph 23