

**Meeting:** IAASB Consultative Advisory Group (CAG)  
**Meeting Location:** New York, USA  
**Meeting Dates:** September 15–16, 2015

## Agenda Item B

### Professional Skepticism

#### Objectives of Agenda Item

1. To receive a presentation on the topic of professional skepticism by an academic and to obtain Representatives' and Observers' views on how to enhance the application of professional skepticism in audits of historical financial information.

#### Project Status and Timeline

2. The IAASB has been taking steps towards re-emphasizing the importance of professional skepticism in audits of financial statements in the International Standards on Auditing (ISAs) since its Clarity Project, which was completed in 2009. Since that time, the IAASB agreed that that professional skepticism would continue to be a focus within its future projects. For example, more explicit references have been made to professional skepticism<sup>1</sup> within the IAASB's recently completed standard-setting projects addressing auditor reporting, other information, and disclosures.
3. The IAASB's [Work Plan for 2015–2016](#) further committed to give priority to the topic of professional skepticism. A Professional Skepticism Working Group (PSWG) with representatives of the three independent standard-setting boards – the IAASB, the International Ethics Standards Board for Accountants (IESBA) and the International Accounting Education Standards Board (IAESB) – has been established to provide the necessary platform for collaboration among the independent standard-setting boards to determine next steps with respect to professional skepticism. The next teleconference of the PSWG will be held immediately prior to the CAG meeting.
4. In conjunction with its June 2015 meeting, the IAASB hosted a panel discussion on the topic of professional skepticism to provide the IAASB a further understanding of the issues related professional skepticism in the context of a financial statement audit from experts in this area. Further information about the June 2015 panel discussion, including an audio, is available on the [IAASB's website](#) and was distributed to the CAG via email on August 18.
5. At its September 2015 meeting, the IAASB will discuss further insights relevant to further explore how to effectively respond to issues related to professional skepticism.

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<sup>1</sup> For example, as part of the disclosures project, new application material emphasizes the concept of professional skepticism when evaluating the effect of misstatements in disclosures (see paragraph A17 of ISA 450, Evaluation of Misstatements Identified during the Audit). Also, ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, requires the inclusion of the statement, "As part of an audit in accordance with ISAs, we exercise professional judgment and professional skepticism throughout the audit" in the Auditor's Responsibilities for the Audit of the Financial Statement section of the auditor's report."

## Format of the Session

6. Prof. Annette Köhler, Chair of the PS Working Group, will introduce the topic and the issues included in the following section of this paper, and report back on the discussions of the PSWG. Prof. Doug Prawitt of Brigham Young University, who was a panelist at the June 2015 IAASB meeting, will give a presentation to the CAG at its September 2015 meeting in light of his research efforts on the topic (see paragraph 12 of this paper).
7. As the IAASB plans to undertake additional efforts towards enhancing professional skepticism exercised in audits in conjunction with its planned projects on quality control, group audits and financial institutions, a discussion of the topic of professional skepticism has also been included in paragraphs 51–59 of **Agenda Item F.2, Draft Invitation to Comment: Responding to Public Interest Calls to Enhance Audit Quality**. Representatives and Observers will also be asked to provide their views about how the IAASB’s preliminary thinking with respect to professional skepticism is described in the draft ITC.

## Matters for CAG Consideration

### Background and Introduction

8. The ISAs define professional skepticism as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.”<sup>2</sup> The ISAs explicitly require auditors to exercise appropriate professional skepticism throughout the audit – i.e., during engagement acceptance; as part of identifying and assessing risks of material misstatement; in designing the nature, timing and extent of audit procedures; and in forming an opinion on whether the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework.
9. Professional skepticism is necessary to the critical assessment of audit evidence. It is also closely interrelated to the fundamental concepts of auditor independence and professional judgment and contributes to audit quality. Though most prominently dealt with in the ISAs, professional skepticism is also addressed in the IESBA’s *Code of Ethics for Professional Accountants* (IESBA Code)<sup>3</sup> and the IAESB standards.<sup>4</sup> **Agenda Item B.1**, an IAASB Staff Publication that was issued in February 2012, further discusses considerations in the ISAs and ISQC <sup>5</sup> that are relevant to the proper

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<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(l)

<sup>3</sup> The IESBA Code explicitly mentions the term professional skepticism in a number of places including in the definition of “independence” – both independence of mind, and independence in appearance. There is also a perceived connection between professional skepticism and the fundamental principle of objectivity, though there is not an explicit reference.

<sup>4</sup> International Education Standards (IES) 4, *Initial Professional Development – Professional Values, Ethics, and Attitudes*, prescribes learning outcomes that aspiring professional accountants should achieve in developing professional skepticism and professional judgment. IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*, prescribes the learning outcomes for professional skepticism and professional judgment that engagement partners are expected to develop and maintain through continuing professional development. Both standards emphasize that effective development of professional skepticism needs to include learning methods such as mentoring, reflective activity, and practical experience within the context of a work environment.

<sup>5</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audit and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

understanding and application of professional skepticism during an audit of financial statements.

## Calls for Enhancing Professional Skepticism

### *Inspection Reports and Reviews*

10. Audit inspection reports of audit oversight authorities have identified issues about the appropriateness and consistency of professional skepticism being applied in audits, in particular in areas that require high levels of professional judgment.<sup>6</sup> These inspection findings appear to be consistent with the findings of the IAASB's own ISA Implementation Monitoring project.<sup>7</sup>

### *National Initiatives*

11. At the national level, there have been several initiatives aimed at enhancing auditors' application of professional skepticism. For example:
  - The U.K. Financial Reporting Council (FRC) issued in 2010 a Discussion Paper titled, [Auditor Skepticism: Raising the Bar](#) and subsequently released [Feedback Paper](#), and [Professional Skepticism, Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality](#) publications. Amongst other things, the FRC publications address the philosophical origins of skepticism and sets out views about the conditions that are necessary for auditors to demonstrate appropriate professional skepticism, highlighting expectations for the individual auditor, engagement teams, audit firms and the supporting role that can be played by others, including preparers and audit committees.
  - The US Public Company Accounting Oversight Board (PCAOB) issued [Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits](#) in December 2012. Also, in 2011, the PCAOB issued a [Concept Release](#) (CR) in August 2011 to solicit views about ways that auditor independence, objectivity and professional skepticism could be enhanced. In that CR, questions were raised about whether existing client service relationships, in particular long-term ones, affect auditors' application of professional skepticism in audits, and whether some auditors simply accept the fact that management is honest and prepare the financial statements accurately.
  - A June 2014 CPA Australia publication, [Professional Skepticism: Looking Both Ways on a One Way Street](#), notes that at the core of professional skepticism is "professional courage." The

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<sup>6</sup> [IFIAR Report on 2014 Survey of Inspection Findings](#), March 3, 2015. This issue is not new. In their 2012 Report, 17 of the 22 IFIAR members that provided information regarding their inspection of listed public interest entities audit engagements cited the auditor's lack of professional skepticism as a possible cause for audit deficiencies. Also in 2012, the most frequently cited significant challenge and audit quality issue among IFIAR members was a lack of professional skepticism by auditors.

Also, in its publication [Conclusions from the PIOB Public Interest Workshop](#), September 2014, the Public Interest Oversight Board (PIOB) noted that "professional skepticism, as a state of the mind and attitude, should govern the performance of auditors, and inspire the attitude of other accountants, e.g., accountants in business. When accountants (practitioners, non-practitioners, accountants in business) do not display proper professional skepticism it is recognized as a barrier to effective performance."

<sup>7</sup> In July 2013, the IAASB issued a report, [The Clarified ISAs—Findings from the Post-Implementation Review](#), highlighting the findings of its efforts to learn whether the clarified ISAs are being consistently understood and implemented in a way that achieves the IAASB's goals in clarifying and revising them. This report summarizes the feedback from those most directly involved in the audit process in jurisdictions that have implemented the clarified ISAs.

paper notes that "...adopting skepticism and helping teams of young professionals to apply a critical approach is about setting the right environment to foster 'professional courage'," and that "...you can't be sufficiently skeptical without sufficient competence in your abilities, competence and position."

#### Academic Research

12. A number of publications and academic research have also suggested the need for more initiatives aimed at enhancing professional skepticism. For example, **Agenda Item B.2** includes a 2013 released study by Profs. Prawitt and Glover commissioned by the Standards Working Group of the Global Public Policy Committee. This study acknowledges that, because various definitions of, and perspectives on professional skepticism exist, there is a lack of common understanding or practical guidance on what professional skepticism is, and how it can be demonstrated, and documented.<sup>8</sup>
13. The paper also notes that it is important for accounting firms and other stakeholders in the financial reporting process – preparers, those charged with governance (e.g., audit committees), regulators and audit oversight authorities and standard setters – to undertake cooperative efforts towards enhancing professional skepticism.
14. IAASB-commissioned research indicated that factors such as cost (e.g., budget overruns/conflicts with management), hindsight bias,<sup>9</sup> time constraints, and audit firm rewards influence auditor's exercise of professional skepticism.<sup>10</sup>

#### Further Research Activities

15. Two major syntheses of academic research papers related to professional skepticism were released in 2013<sup>11</sup> and 2009.<sup>12</sup> The 2013 academic synthesis was developed at the request of the PCAOB. To build on these syntheses of research, an academic has been commissioned to conduct a further compilation of relevant research since those addressed in the 2013 academic synthesis. The WG

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<sup>8</sup> The suggestion to amend the definition of professional skepticism in the auditing standards was also included in an article titled, [Auditors Still Challenged by Professional Skepticism: Recommendations for Firms, Standard Setters and Regulators](#) that was published in the January 2015 edition of The CPA Journal. The article also provides a historical overview of the concept of professional skepticism.

<sup>9</sup> "Hindsight bias prompts evaluators to penalize staff auditors for skeptical behavior when no misstatement is found and reward them when a misstatement is found. Interestingly, participants in all conditions indicated a strong belief that the inconsistency should have been investigated. This means that despite the fact that the participants all agreed that the matter under consideration warranted additional investigation, the staff auditors that found no misstatement still received significantly lower evaluations." See Brazel, Joseph F.; Jackson, Scott B.; Schaefer, Tammie J.; Stewart, Bryan W. *Hindsight Bias and Professional Skepticism: Does the End Justify the Means?* (November 2013).

<sup>10</sup> This research was included in **Agenda Item 10-A** of the March 2015 IAASB meeting materials that summarize the findings of the research on various topics, including professional skepticism, that was performed in round 2 of the *Informing the IAASB Standard Setting Process Research Program* organized by the International Association for Accounting Education and Research, KPMG International and the KPMG Foundation, and the IAASB. Agenda Item 10-A, as well as those research papers are included as CAG reference materials.

<sup>11</sup> Kathy Hurr, Helen Brown-Liburd, Christine E. Earley, and Ganesh Krishnamoorthy. *A Journal of Practice & Theory* Vol. 32, Supplement 1, [Research on Auditor Professional Skepticism: Literature Synthesis and Opportunities for Future Research](#). 2013.

<sup>12</sup> Mark W. Nelson. *A Journal of Practice & Theory* Vol. 28, No. 2, [A Model and Literature Review of Professional Skepticism in Auditing](#). 2009.

plans to discuss this research in detail with the IAASB at its December 2015 meeting.

16. At that meeting, the also intends to finalize its ITC for issuance. The release of the ITC, and related outreach, will provide the IAASB with the opportunity to set forth its initial views on the topic of professional skepticism, based on the June 2015 Panel Discussion and the synthesis of research, and obtain further feedback as to how best to progress its efforts on the topic in light of the issues set out below.

### **Possible Issues for Consideration**

17. The topic of professional skepticism has different dimensions, including behavioral, that makes the concept very complex, and addressing it very difficult. It is also acknowledged that the application of professional skepticism is influenced by personal traits (i.e., attitudes and ethical values); as well as state-specific aspects of audits (i.e., knowledge and experience of individual auditors, incentive systems, etc.).<sup>13</sup>
18. At previous meetings, the CAG has indicated that professional skepticism exercised by an auditor on an engagement team is influenced by education, training and experience of the individual; the actions of the firm's leadership; the actions of the engagement partner; as well as the culture and business environment of the firm.<sup>14</sup> Accordingly, international standard setting may contribute to enhance the application of professional skepticism, but other actions are needed to appropriately address the concerns that have been raised and to enhance auditors' exercise of professional skepticism.
19. Responses to the following questions will continue to inform the WG and the IAASB on possible next steps.
  - Should professional skepticism in the ISAs be further emphasized? For example, is more discussion about professional skepticism needed in the ISAs beyond what is in for example, ISA 200, ISA 240,<sup>15</sup> ISA 500,<sup>16</sup> ISA 540<sup>17</sup> and the newly revised ISAs, including ISA 700 (Revised), to explain how professional skepticism affects the auditor's risk assessment, identification of, response to, and evaluation of significant risks?
  - What is meant in inspection reports by, "an auditor lacks professional skepticism", and how do audit oversight authorities determine that an inspection finding is due to a lack of professional skepticism?
  - What does the term "professional courage" (or "professional fortitude") mean and to what extent is there is a linkage to professional skepticism in the context of an audit of financial statements? Should more be done to foster professional courage or fortitude among auditors, and, if so, by whom?
  - What role, if any, should other stakeholders in the financial reporting cycle (e.g., those charged with governance and audit oversight authorities) play in enhancing auditors' exercise of

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<sup>13</sup> Academic research indicate that "traits" are invariant and can only be addressed via awareness, reflection etc., while "state-specific aspects" can be influenced on the firm, engagement or individual level.

<sup>14</sup> See minutes of the [September 2011 IAASB CAG meeting](#).

<sup>15</sup> ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

<sup>16</sup> ISA 500, *Audit Evidence*

<sup>17</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

professional skepticism?

- The academic community has released a number of experiential studies and research that offer helpful perspectives at a conceptual level about professional skepticism. However, they often do not relate to, or align with how the term is used in the ISAs. Should these concepts be incorporated in determining a way forward, and what steps should be taken to make the relevant aspects of this information readily available and easily digestible among auditors and other stakeholders, including standard setters?

#### **Matters for CAG Consideration**

1. Representatives and Observers are asked to provide their views about the matters raised in this paper and the presentation by Prof. Prawitt.
2. Representatives are asked to provide their views about how the IAASB's preliminary thinking with respect to professional skepticism is described in the draft ITC (see paragraphs 51–59 of **Agenda Item F.2**).
3. Representatives and Observers are asked to share their perspectives about where the WG should prioritize its efforts, and what other specific actions should be taken to meaningfully progress initiatives related to professional skepticism.

#### **Material Presented – IAASB CAG Paper**

Agenda Item B.1	February 2012 <i>IAASB Staff Questions &amp; Answers—Professional Skepticism in an Audit of Financial Statements</i>
Agenda Item B.2	Glover and Prawitt, <i>Enhancing Auditor Professional Skepticism: A 2013 released study commissioned by the Standards Working Group of the Global Public Policy Committee</i>
Agenda Item B.3	Slide Presentation titled: <i>Systematic Traps and Biases in Professional Judgment: Insights from Research in Psychology</i>

#### **Material Presented – For Reference**

March 2015 IAASB Agenda Item 10-A, <i>Overview of IAAER – KMPG-IAASB Research Round 2 Summaries</i>	<a href="http://www.iaasb.org/system/files/meetings/files/2015_0316-IAASB-March_2015_Meeting-Agenda_Item_10-A-final.pdf">http://www.iaasb.org/system/files/meetings/files/2015_0316-IAASB-March_2015_Meeting-Agenda_Item_10-A-final.pdf</a>
Brazel, Joseph F.; Jackson, Scott B.; Schaefer, Tammie J.; Stewart, Bryan W. <i>Hindsight Bias and Professional Skepticism: Does the End Justify the Means?</i>	<a href="http://files.iaaer.org/research/IAASB_Executive_Summary_12-3-14_(1).pdf?1421423093">http://files.iaaer.org/research/IAASB_Executive_Summary_12-3-14_(1).pdf?1421423093</a>
Iskandar, Takiah M.; Saleh, Norman M.; Jaffar, R.; Mohamed, Zakiah M.; Hussin, Sayed A. H. S.; <i>Professional Skepticism—A Study of Skepticism Traits in Auditing Financial Statements</i>	<a href="http://files.iaaer.org/research/Executive_Summary_01_Dec_2014.pdf?1421423074">http://files.iaaer.org/research/Executive_Summary_01_Dec_2014.pdf?1421423074</a>