

**Professional Skepticism–Discussion****Minutes – IAASB December 2015 Meeting<sup>1</sup>**

As part of its information-gathering activities on the topic of professional skepticism, the IAASB received a presentation (see Agenda Items 7-A and 7-B) from Mr. Brazel and Ms. Schaefer on their summarization of academic research on professional skepticism for the period 2013–2015.

In light of this presentation, the Board was of the view that the PSWG had identified the right questions that needed to be addressed and areas to explore as part of the professional skepticism initiative and that the matters discussed in the ITC and Overview were appropriate. The Board also agreed to signal in the ITC and Overview its commitment, together with the PSWG, to continue to consider the impact of academic research on the topic as it progresses its work. In addition, the Board questioned whether there was academic research on:

- Whether the use of audit data analytics could positively influence the application of professional skepticism. Ms. Schaefer noted that the research she is performing on data analytics is at a very early stage. She added that, while there may be a link between the use of data analytics and the application of professional skepticism, she is cautious about drawing any conclusions.
- Whether there is a correlation between the auditor application of professional skepticism and auditor incentives, including the individual paying the auditor (i.e., the audited organization versus a third party). Mr. Brazel responded that he is not aware of such research, but noted that it would be a good research topic and could feasibly be dealt with in the short term.
- When and how the auditor should know that enough professional skepticism has been applied. Mr. Brazel noted that these were excellent research questions and suggested that exploration of those topics could usefully model existing academic research on fraud brainstorming.
- The change in the apprentice model as a means of on-the-job training and coaching to the application of professional skepticism. Ms. Schaefer responded that, while academic research on the apprentice model exist, it does not specifically address professional skepticism.

**Objectives of the Agenda Paper**

1. The objectives of this agenda paper are to discuss the:
  - Proposed deliverables for the short, medium and longer term; and
  - Proposed outreach activities.
2. To assist Board members in this discussion, an overview with the key messages from information gathering to date is included as Appendix A.

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<sup>1</sup> These draft minutes are still subject to IAASB review and may be subject to further change.

## Introduction

3. 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>2</sup> within the IAASB's recently completed standard-setting projects addressing auditor reporting, other information, and disclosures.
4. In June 2012, the IAASB published a Staff Questions and Answers (Staff Q&A), [Professional Skepticism in an Audit of Financial Statements](#), focusing on the requirements and application material in the ISAs and ISQC 1<sup>3</sup> that are of particular relevance to the understanding and application of professional skepticism.
5. The IAASB's [Work Plan for 2015–2016](#) further committed to the topic of professional skepticism as one of its priority projects. 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. The objectives are to provide the necessary platform for collaboration among the independent standard-setting boards to determine next steps with respect to professional skepticism, including determining whether future standard-setting work in this area would be appropriate, or whether the development of other materials may be more appropriate.
6. At its [June 2015 meeting](#), the IAASB hosted a panel discussion on the topic of professional skepticism to provide the IAASB with a further understanding of the issues related to 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](#).
7. At its [September 2015 meeting](#), the IAASB further explored how to effectively respond to issues related to professional skepticism. The IAASB Consultative Advisory Group (CAG) discussed professional skepticism at its September 2015 meeting after having received a presentation by an academic. At the IAASB-CAG March 2016 meeting a discussion will be held on the Invitation to Comment: *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (the ITC).

## Objectives and Activities of the PSWG

8. The PSWG is a collaboration between the standard-setting boards. PSWG members have agreed to function as ambassadors on behalf of their respective boards, with the Chair of the PSWG serving as a facilitator for the group to discuss and progress the topic of professional skepticism.
9. The objective of the PSWG is to identify the conceptual issues related to professional skepticism

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<sup>2</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.”

<sup>3</sup> International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

across the suite of international standards, including where further alignment may be needed or issues may exist, and make observations or recommendations for further action to be considered.

10. In the June 2015 IAASB Agenda paper, the proposed activities of the working group were described as follows:
  - (a) Engaging in dialogue with key stakeholders to further understand their views (e.g., June 2015 panel discussions).
  - (b) Reviewing relevant research, findings and recommendations from academics, regulators, and others.
  - (c) Soliciting public input on views received, including on the summary of the June 2015 Panel Discussion.
  - (d) Developing materials to better explain how the requirements in the ISAs relating to professional skepticism should be applied.
  - (e) Monitoring the activities of others with respect to professional skepticism, to determine the most appropriate actions for the IAASB, as well as the timing of those actions.
  - (f) Collaborating with others, when appropriate, to determine what could be done beyond standard-setting to better assist and encourage auditors to apply professional skepticism in conducting their audits.
11. Based on the proposed activities discussed in June 2015, the IAASB asked the PSWG to:
  - Consider how the behavioral aspects of the issues relating to professional skepticism could be best dealt with, recognizing that auditors are not trained in behavior analysis.
  - Focus on those actions that can have the greatest impact on improving professional skepticism.
  - Undertake a root cause analysis before determining a way forward.
  - Acknowledge that it may only be possible to address some issues at the firm level, rather than the engagement level, although it was noted that the ISAs could better emphasize aspects of professional skepticism including, for example, addressing unconscious biases.
12. In its information gathering activities, the PSWG has taken the broader view that standard-setting activities alone would not be sufficient to address issues relating to professional skepticism, and therefore has also focused on environmental factors and actions by others in the financial reporting supply chain too.

### **Proposed IAASB Deliverables**

13. Short term: Non-authoritative PSWG Note on top of Staff Q&A on Professional Skepticism (Paragraphs 16-19).
14. Contemplated Medium term deliverable (Paragraphs 20-26):
  - Document on preliminary insights resulting from the analysis and observations from ITC, outreach and CAG and Board deliberations;

- Input to IAASB standard setting projects currently underway, including revision of ISA 540,<sup>4</sup> and expected projects on quality control, group audits and revision of ISA 315 (Revised);<sup>5</sup>
  - Project proposal for developing selected amendments to ISAs, as appropriate;<sup>6</sup>
  - Input to IAESB and IESBA; and
  - At a later stage, issues paper on issues arising when seeking to take professional skepticism into account in auditing standard setting.
15. Potential longer term: Position Paper on Principles for consideration of professional skepticism in standard-setting and comprehensive standards setting project proposal (Paragraphs 27-30).
- Further detail on each of these deliverables is set out below.

### Short-Term Deliverables

16. The Staff Q&A on professional skepticism published in 2012 was well received. Given the focus on professional skepticism to date, the PSWG has the view that re-emphasizing the usefulness of this document would be beneficial. The PSWG does not believe the usefulness of the document is undermined by some of the limited changes that have been made to the ISAs since its issuance.<sup>7</sup> Therefore, a short, sharp PSWG Note, focusing on the Staff Q&A, could help inform stakeholders that the IAASB and the other standard-setting boards view professional skepticism as important, and the topic is at the forefront of the Standard Setting Board's (SSB's) priorities. It can also help explain the activities in this area since the publication of the Staff Q&A.
17. The purpose of the PSWG Note is therefore threefold:
- To inform stakeholders of the activities of the IAASB, the IESBA and IAESB in the light of current developments in auditing and assurance;
  - To further stimulate public debate on the topic; and
  - To draw attention to the Staff Q&A and the continuing importance of professional skepticism.
18. The document would likely be short (1 to 2 pages), and proposed content could include:
- Information on the PSWG (objectives, at information-gathering stage, collaboration with other standard-setting boards, that each board is addressing professional skepticism with a different focus and within different timelines);

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<sup>4</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>5</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. Amendments, if any, to ISA 315 (Revised) arising from this project may also result in the need for amendments to ISA 330 *The Auditor's Response to Assessed Risks*.

<sup>6</sup> For example, ISA 230, *Audit Documentation*

<sup>7</sup> It is considered to update the Foreword from the IAASB Chairman to reflect the current environment

- A brief reflection on the outcome of information-gathering activities to date, including consultation with the IAASB Consultative Advisory Group (CAG) and discussions at roundtables;<sup>8</sup>
  - A link to project page containing further useful resources, including Staff Q&A; and
  - Next steps, including that the intention is to publish a document on preliminary insights resulting from the analysis and observations from the ITC, outreach and CAG and Board deliberations.
19. It is intended that the PSWG Note will be published in April 2016.<sup>9</sup> This will ensure that the publication is available for future outreach.

## Medium-Term Deliverables

### *Preliminary Views on Contemplated Medium-Term Deliverables*

20. Once feedback has been received on the ITC through comment letters and other sources, such as outreach, and this feedback has been systematically analyzed, the Professional Skepticism Working Group (PSWG) will be in a position to draw some observations, including potential practical implications, about the significance of professional skepticism to IAASB projects currently underway. These other projects include the projects on the audit risk model (primarily ISAs 315 (Revised)<sup>10</sup>, financial institutions and estimates (primarily ISA 540), group audits (primarily ISA 600)<sup>11</sup>, and quality control (primarily ISQC 1 and ISA 220<sup>12</sup>). These observations may form the basis for an *IAASB document about the preliminary insights* gained on the application of professional skepticism from the feedback and the reactions of the Board to those observations.
21. These preliminary insights may be of value to the other projects noted above, when seeking to revise requirements and application material that influence auditor behavior for matters in which professional skepticism might be particularly important, for example when,
- Identifying and assessing risks;
  - Evaluating the sufficiency and appropriateness of audit evidence;
  - Performing audit procedures on estimates with high estimation uncertainty or subjectivity;
  - Evaluating whether the work of component auditors is adequate for group auditor purposes; or
  - When seeking to address professional skepticism in firm or engagement level quality control requirements and application material.
22. There is some overlap between board members and supporting technical advisors of the PSWG and those of other Working Groups or Task Forces of the IAASB, and consideration could be given to determining whether further overlap might be desirable. Such overlaps may form the basis for *PSWG input into the projects being undertaken* by the other working groups, which may help these working

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<sup>8</sup> As part of its outreach during the period that the ITC is out for consultation, roundtables in various jurisdictions (including Europe, Malaysia and the United States) are being arranged.

<sup>9</sup> A draft could be discussed at the April 2016 Board call.

<sup>10</sup> Amendments, if any, to ISA 315 (Revised) arising from this project may also result in the need for amendments to ISA 330.

<sup>11</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

<sup>12</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

groups consider how the standards may take the need to apply professional skepticism into account when drafting those standards.

23. Furthermore, the preliminary insights noted above may also provide indications that standards other than those currently being addressed in the projects noted above could be improved on a selective basis in relation to the application of professional skepticism, including how the requirements are written to encourage a more challenging mindset. This could lead to a project proposal for limited amendments to certain ISAs, if applicable, and would be presented for the Board's consideration for making these changes. However, care would need to be exercised that no fundamental changes to the concept of professional skepticism and its application are undertaken based only on preliminary insights.
24. The feedback received from the ITC is likely to be of value to the other standards setting boards' (IESBA and IAESB) potential consideration of professional skepticism for their standards setting purposes. The analysis of the feedback and resulting observations will be discussed in the PSWG, which includes members from the IESBA and the IAESB. These members can then convey to their respective boards the preliminary insights that the IAASB has obtained, which would provide a basis for these boards' considerations of how to deal with professional skepticism in line with their respective strategy and work plans.
25. The additional experience gained when revising these standards on how professional skepticism can be taken into account in a more systematic fashion can then be used as a basis for longer-term deliverables on professional skepticism. The preliminary insights noted in the previous paragraph together with some of the experience gained from providing input into these other projects could be structured and summarized into a set of issues that arise when considering professional skepticism in auditing standards setting. These issues could be described in an issues paper that the IAASB could make available for comments and further outreach. There may be other parties with particular responsibilities that may affect the application of professional skepticism. The issues paper may also address what these responsibilities of other parties might be. The feedback received from the issues paper could also be used to develop a longer-term deliverable, such as an IAASB Position Paper on principles for the consideration of professional skepticism in auditing standards (see next subsection below).
26. In summary the potential medium term deliverables may include:
  - A document describing the preliminary insights obtained from PSWG observations resulting from the analysis of the feedback from the ITC and obtained from the CAG and IAASB consideration of those observations
  - Input on professional skepticism by the PSWG to other IAASB projects underway
  - A project proposal for limited amendments to certain ISAs, if the preliminary insights provide indications that standards other than those currently being addressed in the projects currently underway could be improved on a selective basis in relation to the application of professional skepticism.
  - Input for the consideration of professional skepticism by the IESBA and the IAESB in line with their respective strategy and work plans.
  - At a later stage, the publication of an issues paper for comments that describes the issues that have arisen in seeking to take professional skepticism into account in those projects, and

perhaps outlines the responsibilities that other parties may have in relation to professional skepticism

## Longer Term Deliverables

### *Preliminary Views on Potential Project IAASB Position Paper on Principles for Considering Professional Skepticism in Auditing Standard-Setting*

27. The issues paper published for comments noted above, which describes the issues that have arisen when seeking to take professional skepticism into account in the IAASB projects currently underway, together with the preliminary insights from Board consideration of the feedback from the ITC, would provide a robust conceptual and empirical foundation to explore whether principles for the consideration of professional skepticism in auditing standards setting could be developed. Many of the questions addressed in such a paper on principles would have been subject to previous analysis in the issues paper. Since it is unclear what those preliminary insights and responses to the issues paper might be, it is not possible to provide an outline of those principles at this stage. In general, developing principles of this kind for auditing standards setting could cover questions such as:
- What is professional skepticism and how does it relate to other IAASB and IESBA concepts?
  - How can professional skepticism be translated into auditor action?
  - What are the barriers to the effective application of professional skepticism?
  - How can quality management at firm and engagement level mitigate those barriers?
  - How can IAASB standards setting projects take professional skepticism into account, in particular:
    - How can standards encourage a skeptical attitude?
    - How can standards improve professional judgments involving professional skepticism?
    - How can standards help auditors translate judgments made into appropriate action?
    - How can standards guide auditors to provide evidence of the proper application of professional skepticism in the context of specific engagement standards?
  - What issues in relation to professional skepticism are beyond the remit of auditing standards setting and where would the responsibility for those lie?
  - What issues require further research and consultation?
28. Such principles could provide a basis for quality control on whether the standards appropriately address professional skepticism and on how to sustain consistency in the approach to professional skepticism in the standards, for example:
- The nature of the requirements, for example their neutrality;
  - The clarity of the requirements;
  - When re-emphasis of the principles in ISA 200<sup>13</sup> is necessary or when the general principles in ISA 200 suffice;

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

- When to require the nature and extent of evidence to be gathered in relation to professional skepticism and when this should be more a matter of professional judgment; and
  - When a course of action requires a more detailed requirement and when a principles-based requirement suffices.
29. The output could be in the form of an IAASB Position Paper – not a standard, because a “standard” is directed at auditors or firms, whereas this position paper would be directed at future standard-setting at the IAASB, and other auditing standard-setters. The principles would form criteria that could be used to determine if current standards appropriately deal with professional skepticism. Such principles could then form the basis for a comprehensive project proposal to engage in fundamental revisions to the ISAs in relation to the application of professional skepticism.<sup>14</sup>
30. Although this position paper would be directed at auditing standard-setting, some of the conclusions reached in developing the paper may be of value to the other standard-setting boards. The IESBA and the IAESB would be able to draw on these when further addressing professional skepticism as part of any projects for which professional skepticism may be relevant. Consideration could also be given to whether a separate document outlining the principles applicable to all three standards setters would be of value.

### **ITC and Outreach Activities**

31. The following planned and past outreach sets out where the topic of professional skepticism will be (or was) specifically discussed:
- February 25: International Association of Insurance Supervisors Accounting and Auditing Working Group
  - March 7: Roundtable at Nederlandse Beroepsorganisatie van Accountants (with a wide range of stakeholders participating in the discussions).
  - March 8: Discussions on the content of the ITC related to professional skepticism in the ITC with the IAASB and IESBA CAG (joint session).
  - March 10: IAASB Roundtable at Organization for Economic Co-operation and Development (a forum for sharing views on matters set out in the ITC, with a wide range of stakeholders participating in the discussions).
  - April 14 - 15: IAASB Roundtable in Malaysia (in conjunction with ACCA and The Malaysian Institute of Accountants) (a forum for sharing views on matters set out in the ITC, with a wide range of stakeholders participating in the discussions).
  - June 27: Potential event: Center of Audit Quality Workshop with focus on professional skepticism.

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<sup>14</sup> This could include changes to ISA 200.

## Proposed Timeline

Date	Activity
March – May 2016	<ul style="list-style-type: none"> <li>• Outreach activities on the ITC Consultations</li> <li>• Interaction with TF/WGs on professional skepticism in other projects including the projects on the audit risk model (primarily ISAs 315 (Revised), financial institutions and estimates (primarily ISA 540), group audits (primarily ISA 600), and quality control (primarily ISQC 1 and ISA 220)</li> <li>• Development of rough overview of principles for professional skepticism</li> <li>• Information-gathering activities other SSBs, National Auditing Standard Setters (NSS), Forum of Firms (FoF), Global Public Policy Committee (GPPC)</li> </ul>
April 2016	<ul style="list-style-type: none"> <li>• Development and publication of brief PSWG Note to regain traction to 2012 IAASB Staff Q&amp;A</li> </ul>
June – September 2016	<ul style="list-style-type: none"> <li>• Outreach, information-gathering and compilation and analysis of responses to the ITC</li> </ul>
September 2016	<ul style="list-style-type: none"> <li>• Analysis and observations from ITC and outreach; CAG and Board deliberations</li> </ul>
September-December	<ul style="list-style-type: none"> <li>• Drafting document on preliminary insights resulting from analysis and observations from ITC, outreach and CAG and Board deliberations;</li> <li>• Drafting project proposal, if appropriate</li> </ul>
December 2016	<ul style="list-style-type: none"> <li>• Document on preliminary insights resulting from analysis and observations from ITC, outreach and CAG and Board deliberations</li> <li>• Input to other IAASB Projects</li> <li>• Project proposal and formation of a Task Force, if appropriate</li> <li>• Input to IAESB and IESBA</li> </ul>

## Matters for IAASB Consideration

32. Members of the Board are asked whether they are supportive of the PSWG's proposed way forward and to provide their feedback on these proposals:

(a) With regard to the proposed or contemplated deliverables:

- Short-term deliverables (Paragraph 16–19): Is the proposed content sufficient to demonstrate the SSB's ongoing efforts on enhancing professional skepticism and renew traction to the IAASB Staff Q & A issued in 2012?

*Professional Skepticism*  
Discussion

- Medium-term deliverables (Paragraph 20–26): Does the Board agree with the proposed deliverables?
  - Longer-term deliverable (Paragraph 27-30): Does the Board see the potential merit in developing an IAASB Position Paper setting forth the principles for the consideration of professional skepticism in auditing standards setting?
- (b) With regard to completeness: Are there any other matters that should be taken into account in the different deliverables?
- (c) With regard to the timeframe: Is the proposed timeline for the short-term deliverables appropriate?
33. Board members are asked to inform the PSWG about any potential opportunities to engage with stakeholders on issues relating to professional skepticism.

## Appendix A

### Key Messages from Information-Gathering and Discussions to Date

#### Academic Research

34. In September of 2015, the PSWG commissioned a project that involved summarizing international<sup>15</sup> academic research in the area of auditor professional skepticism from the 2013 to 2015 time period. The work was intended as an update of the auditor professional skepticism literature since the syntheses performed by Nelson (2009) and Hurtt et al. (2013). The summary included both published and unpublished papers (i.e., working papers).
35. In summary the research found the following:
- *Incentives*: The evaluation of professional skepticism may depend more on the outcome than the process. This insight into the evaluation of professional skepticism should inform inspections of firms' evaluation systems or quality controls. The accountability or pressures associated with a potential inspection can enhance auditor professional skepticism, unless excessive documentation to appease inspectors becomes the auditor's over-riding concern.
  - *Time*: Substantial time pressure, particularly at year-end, can impair professional skepticism. If a future acceleration of reporting or other regulation curtails year-end audit time, professional skepticism may become impaired and audit quality could suffer. Solutions to year-end time pressure appear to be moving testing at final to interim, rescheduling other work, and working more hours.
  - *Competence and fraud detection*: The focus of most competency-related studies is on the extent auditors can detect and respond to fraud red flags or risks. Auditors do not generally respond appropriately to personality-driven fraud tendencies in management.
  - *Tone at the top matters*: suggesting the importance of firm culture on professional skepticism.
  - *Traits*: Auditor characteristics (such as the auditor's tendency to have a questioning mind or have presumptive doubt) predict auditors' professional skepticism judgments. Auditors with greater integrity or fortitude stand more resolute when disagreeing with management. Experience generally leads to greater professional skepticism.
  - *Mindset*: Certain prompts may induce greater professional skepticism in auditors. The effectiveness of prompts could be further tested in audit training sessions with real client evidence and audit documentation. Effective prompts could be incorporated into audit software (or be an optional procedure considered during planning). Field experiments (with some audits using the prompts and others not) could be performed to further determine the effects of the prompts on auditor professional skepticism mindsets.
  - *Environmental and contextual factors*: The characteristics and actions of management may impact professional skepticism. Audit partners are concerned that the current environment may create some professional skepticism-related competency deficiencies in young staff. The

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<sup>15</sup> Despite the international focus of the research the vast majority of studies reviewed were performed via experiments and surveys of US auditors or examinations of US public company data.

framing or word choice of tasks alters the mindset or approach auditors take, leading to more or less professional skepticism.

36. In addition, Hurtt et al (2013) builds on a framework developed in Nelson (2009) that proposes that lack of skepticism can either be the result of a failure in problem recognition (lack of skeptical judgment) or a failure to act on a problem recognized (lack of skeptical action). They found that the majority of research efforts to date have focused on the antecedents to skeptical judgments and on auditor characteristics in particular. In order to understand how skeptical judgment translates into skeptical action, additional research on skeptical action will need to be conducted.
37. Overall, the review of the auditor professional skepticism literature from 2013 – 2015 yielded many current studies tackling this crucial issue. The professional skepticism literature has grown extensively since Nelson (2009) and will continue to grow as new researchers with recent practice experience enter academia. There were few studies considering the important role training can play in the development of professional skepticism. Given the wealth of literature, that identifies the impediments and potential solutions related to professional skepticism, the commissioned researchers identified that more research needs to be performed to determine how these findings can be put into action with respect to more effective training in the area of professional skepticism.
38. In addition to the PSWG research there is also other research such as the study commissioned by the Standards Working Group of the Global Public Policy Committee released in 2013. This study notes that various definitions of, and perspectives on professional skepticism exist and, as a result, there is a lack of common understanding or practical guidance on what professional skepticism is and how it can be demonstrated and documented. The paper also notes that it is important for audit firms and other stakeholders in the financial reporting process including preparers, those charged with governance (e.g., audit committees), regulators and audit oversight authorities as well as standard setters to undertake cooperative efforts towards enhancing professional skepticism.

#### *IAASB CAG Discussions*

39. At the September 2015 IAASB CAG meeting Representatives and Observers received a presentation on the topic from Prof. Doug Prawitt explaining academic research indicating that auditor biases and heuristics impact how auditors exercise professional skepticism.
40. In this discussion the IAASB CAG discussed that:
  - Auditor awareness of those biases and heuristics can assist auditors to better mitigate their effects.
  - An accounting firm's incentive systems and reward mechanisms influences skeptical behavior among auditors. Accordingly, accounting firms should create a culture that rewards auditors who exercise skeptical behavior, or follow up on matters, even those matters that do not eventually result in an audit issue or finding.
  - A change in the tone at the top, including among those charged with governance, towards serving investors and users of the entity's financial statements, rather than management and the entity's customers, is necessary.

- There is an increased role for others (e.g., GPPC, International Federation of Accountants (IFAC) member bodies, regulators, including prudential and securities regulators, and those charged with governance to do more to encourage auditors to apply professional skepticism.

*IAASB Board Discussions*

41. At the June 2015 meeting, the IAASB Board was informed via panel discussion. The panel focused on a number of areas, including: whether skepticism implies a neutral attitude regarding management's honesty; the factors that indicate that professional skepticism is high in a particular engagement; the impact of national culture on skepticism; incentives for skepticism; the involvement of others in the financial reporting supply chain; the implications of the payor model (i.e., the entity directly paying for the audit); and what is necessary to demonstrate that the auditor has been sufficiently skeptical.
42. Reflecting on the views expressed by the panelists, with respect to the IAASB's International Standards, the IAASB asked the PSWG to explore:
  - Whether more could be said in the ISAs or in another form of guidance about the factors that influence professional skepticism, including individual biases and the auditor/entity relationship.
  - How ISQC 1 could further emphasize the need for a strong "tone at the top" and an environment that promotes the application of professional skepticism.
  - Whether the construct of the requirements in the ISAs are written in a way that promotes a mentality of corroborating management's numbers, as opposed to a more neutral or challenging mindset.
  - Whether the requirements in the ISAs are sufficiently robust in terms of evidence gathering, in particular in areas of significant management judgment.
43. At the September 2015 Board meeting Board members variously suggested the PSWG to further consider the following:
  - Explore targeted outreach to obtain meaningful feedback that is relevant to the application of professional skepticism
  - Focus on driving change in auditor behavior (rather than the impact of heuristics and biases), keeping in mind the reason why auditors are required to exercise professional skepticism – i.e., to address the principal-agent relationship issues that exist in financial reporting; and to encourage auditors to appropriately challenge management.
  - The relationship between "presumptive doubt" and a neutral stance, and whether the ISAs could do more to encourage auditors to consider "contradictory audit evidence," as some view auditors as being biased towards obtaining "confirming" evidence.
  - Whether it is necessary to revisit the PSWG's preliminary views with respect to appropriateness of the ISA definition of professional skepticism, as the ISAs do not define professional skepticism, but rather describes matters that are relevant to the attitude needed to exercise professional skepticism.

- Whether a variant or invariant concept of professional skepticism is appropriate, noting the ISAs take an invariant approach to the concept, although a variant concept is prevalent in academic research. Of those Board members that addressed the issue at the meeting, most supported an invariant concept.
  - How familiarity threats, a concept that is addressed in the IESBA Code of Ethics for Professional Accountants, may impact the auditor's application of professional skepticism, as well as how those threats may be eliminated or reduced to an acceptable level (e.g., engagement team member rotation). It was also noted that the concept of a "reasonable and informed third party" test in the IESBA Code might be useful should the IAASB decide to establish a professional judgment framework (e.g., as criteria that could be used to determine the quality and effectiveness of the application of professional skepticism). Such an approach would require auditors to consider the perspective of users, including investors in deciding whether they have appropriately applied professional skepticism.
44. The input of the Board during the December 2015 meeting on the ITC is also of interest to the further work of the PSWG. The discussion noted the following:
- The impact of familiarity and advocacy threats (concepts that are described in the International Ethics Standards Board for Accountants (IESBA) Code (the Code) on the application of professional skepticism.
  - The relevance of the various factors that influence auditors' application of professional skepticism including:
    - An explanation of the link between professional skepticism, professional judgment and documentation as a means of evidencing the application of professional skepticism.
    - A description of how professional skepticism is impacted by individual auditor actions, the firm and others. This includes how individual personality traits, engagement-specific factors (e.g., staffing and time pressures), firm-specific factors (e.g., firm culture, rewards and incentives), and external environmental factors (e.g., local norms and culture) affect auditors' application of professional skepticism.
45. The presentation on academic research by Mr. Brazel and Ms. Schaefer at the December 2015 meeting (see the key conclusions in paragraph 35 above) also provided insight into the type of research the Board was interested in, since the Board raised questions on whether there is academic research, or academic research could be performed, in the following areas:
- To determine whether the use of data analytics could positively influence the application of professional skepticism. It was noted that research in this area is at a very early stage.
  - To investigate whether there is a correlation between the auditor application of professional skepticism and auditor incentives, including the individual paying the auditor (i.e., audited organization versus a third party). The presenters not aware of such research, but noted that it would be a good research topic and could feasibly be dealt with in the short term.
  - To indicate when and how the auditor should know that enough evidence has been obtained to satisfy that sufficient professional skepticism was applied, and whether professional skepticism should be treated as ethical value. The presenters suggested that exploration of those topics could usefully model existing academic research on fraud brainstorming.

- To consider whether changes in the apprentice model as a means of on-the-job training and coaching affects the application of professional skepticism. The presenters responded that while academic research on the apprentice model exists, it does not specifically address professional skepticism.

#### *PIOB– September 2015 IAASB Meeting*

46. At the September 2015 IAASB meeting the PIOB representative expressed support for the collaborative efforts of the IAASB, IESBA and IAESB in establishing the PSWG. He noted that the topic of professional skepticism is very important, in particular because auditors are often criticized for not being sufficiently skeptical. He complimented the progress made to date, but encouraged the PSWG to commence thinking about practical outcomes as soon as possible. He pointed out that there are similarities between the professional skepticism discussions and past discussions about independence. He agreed with the suggestions made to consider the impact of familiarity threats, and expressed support for the PSWG's planned outreach activities. With respect to outreach activities, he suggested that the PSWG seek to further understand investors' perspectives about auditors' application of professional skepticism.

#### *Inspection Findings*

47. Audit inspection reports of audit oversight authorities have identified issues about the level, and consistency, of professional skepticism being applied in audits, in particular in areas that require more professional judgment. Inspectors have observed that, in those areas, there is often insufficient documentation of the auditor's considerations (e.g., alternatives considered, robustly challenging management's assumptions, etc.) to evidence that professional skepticism was appropriately applied, or to support the auditor's opinion on the financial statements.<sup>16</sup> The [IFIAR 2014 inspection findings survey](#)<sup>17</sup> for example identifies insufficient exercise of professional skepticism as a factor underlying many audit deficiencies.

#### *Developments within the Firms*

48. So far, the PSWG has not obtained information from the firms. However, future information-gathering activities will include the activities that firms are undertaking to respond to the calls for enhancing audit quality, at the partner and staff member level, the engagement level and firm level. This will also include information-gathering with respect to training related to professional skepticism.

#### *National Auditing Standard Setters*

49. Feedback from the NSS meeting in May 2015 indicates support for the IAASB's further consideration of the topic of professional skepticism via the joint initiative of the PSWG. It was acknowledged that:
- Inspections findings often cite auditor's lack of professional skepticism when they identify an issue in an audit, but there is not necessarily an auditing standard or requirement that specifically addresses it. In other words, there was a view that professional skepticism was being used as a "catch all" term to describe other issues in an audit.

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<sup>16</sup> Source: June 2015 Board paper

<sup>17</sup> Source: 2014 Inspection Findings Survey

- The concept of professional skepticism is closely interrelated to the fundamental concepts of auditor independence and professional judgment, and contributes to audit quality.
- An auditor's education, training, and experience is critical and affects their application of professional skepticism in an audit.
- It would also be helpful to clarify the linkage between professional skepticism and objectivity.
- There is a psychological aspect to professional skepticism which makes it very complex. It is influenced by personal behavioral traits (i.e., attitudes and ethical values) as well as the competence level (i.e., knowledge) of the individuals undertaking the audit. The professional skepticism exercised by the auditors on an engagement team is influenced by education, training and experience of the individual auditor, the actions of the firm's leadership, the actions of the engagement partner, as well as the culture and business environment of the firm.

#### *National Initiatives*

50. At the national level, jurisdictions are also undertaking initiatives related to enhancing auditors' application of professional skepticism. For example:
  - UK: In a follow up to a 2010 Discussion Paper titled, [Auditor Skepticism: Raising the Bar](#) and the subsequently released [Feedback Paper](#), the U.K. Financial Reporting Council (FRC) set out its views on the on the topic in a publication titled, [Professional Skepticism, Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality](#). The FRC publication notes the importance of ensuring a consistent understanding of the nature of professional skepticism and its role in the conduct of the audit. Amongst other things, the FRC publication addresses the philosophical origins of skepticism and sets out views about the conditions that are necessary for auditors to demonstrate the appropriate degree of 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.
  - US: The US Public Company Accounting Oversight Board (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.
  - Australia: 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 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."

#### *PSWG Deliberations*

51. The PSWG held further deliberations on professional skepticism during the preparation of the ITC. This included how the concepts of professional skepticism and professional judgment interrelate and

how documentation serves to better evidence the application of professional skepticism. The figure below and the related text was one of the outcomes. This will serve as an important basis for the further work of the PSWG.



*Figure: How Professional Skepticism Drives Action*

While professional skepticism is an attitude, this attitude is applied in making professional judgments that provide the basis for auditors' actions. The documentation of professional judgments made, and actions taken, may provide evidence that professional skepticism was applied. The diagram is a simple illustration of how professional skepticism drives action. Other relevant concepts in accounting, auditing and ethical requirements, including independence of mind, objectivity, competence as well as firm-specific and environmental factors may impact the application of profession skepticism. Documentation of professional judgments and actions provide evidence that professional skepticism was applied. The ISAs require auditors to document discussions of significant matters with management, those charged with governance and others, including the nature of the significant matters discussed and when and with whom the discussions took place.<sup>18</sup>

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<sup>18</sup> See ISA 230, *Audit Documentation*, paragraph 10.