

## Professional Skepticism- Issues and Working Group Recommendations

### Minutes – IAASB March 2016 Meeting<sup>1</sup>

Prof. Köhler introduced the topic by sharing the key messages from the outreach held to date and describing the proposed way forward with respect to professional skepticism in the short, medium and longer term, drawing the IAASB's attention to the matters set out in **Agenda Item 2-A**. She reminded the Board that the Professional Skepticism Working Group (PSWG) comprises representatives from the IAASB, the International Ethics Standards Board for Accountants (IESBA), and the International Accounting Education Standards Board (IAESB).

Prof. Köhler noted that CAG Representatives and Observers, at the joint IAASB and IESBA CAG session, highlighted the need to consider:

- Input received on the drivers and impediments to professional skepticism at the individual, engagement team and firm levels, as well as the root cause analysis of inspection findings by firms.
- Whether a greater emphasis on recruitment, education and training is needed to better enable auditors to appropriately exercise professional skepticism, in particular to challenge management in relation to significant judgments.
- The relationship of professional skepticism to sufficient appropriate audit evidence.
- Incremental change within certain ISAs versus a more holistic change.
- Linkages to existing IAASB projects and the need for practical input to these projects to further embed the concept of professional skepticism in the standards.

She also noted that CAG Representatives and Observers supported the collaboration across standard-setting boards (SSBs) to enhance the application of professional skepticism.

Board members emphasized the importance of the concept of professional skepticism to the audit, and noted that aspects of the project will need to be advanced quickly to provide input to the projects that are currently underway, in particular ISA 540.<sup>2</sup> It was therefore agreed that, for the June 2016 Board meeting, the PSWG should seek to develop considerations about the application of professional skepticism in standards affected by current IAASB standard-setting projects, with a focus on audit evidence and documentation. The Board agreed that the diagram as presented in the Invitation to Comment, *Enhancing Audit Quality, A Focus on Professional Skepticism, Quality Control and Group Audits* (the ITC) will serve as an important basis for this paper.

Board members also provided specific comments and suggestions for further consideration by the PSWG, including:

- Exploring the linkage between professional skepticism and risk assessment, in particular the

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

<sup>2</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*  
Prepared by Nancy Kamp-Roelands and Schuyler Simms (May 2016)

relationship between identifying and assessing significant risks and developing an appropriate response, including what audit evidence is needed .

- Whether to give prominence to the skillset needed to transform the concept of professional skepticism as a questioning mind into action by the auditor. This includes, among other things, the need for the auditor to sufficiently understand the entity’s business model and the underlying accounting issues.
- Exploring how data analytics can support the auditor’s risk assessment and provide insight to enable the auditor to focus on particular areas and appropriately exercise professional skepticism in relation to them.
- Exploring what constitutes sufficient appropriate audit evidence, in particular the appropriateness aspect, including when there may be the need to consider contradictory evidence, what next steps are needed if contradictory evidence is found, and how evidence can be weighted. These considerations may also impact ISA 500.<sup>3</sup>
- Further exploring what is needed to demonstrate sufficient application of professional skepticism, in particular how the ISAs might better address documentation of significant auditor judgments.
- Exploring whether the concept of professional skepticism as a “neutral” mindset is still appropriate, or whether there is a need to shift the auditor’s approach to take a more “challenging” mindset, recognizing this would be a significant change from current practice.
- Exploring impediments to the application of professional skepticism, such as familiarity threats, as well as potential trade-offs made in determining whether to obtain more audit evidence, for example, due to time pressure and cost/benefits.
- Considering examples of how the concept of professional skepticism may be applied in particular circumstances, as a means of supplementing requirements within ISA 200<sup>4</sup> and other ISAs.
- Exploring the role that others can play, including those charged with governance and regulators, in strengthening the application of professional skepticism in audits.

The IAASB agreed that, rather than focusing on developing a brief PSWG awareness note informing stakeholders about the activities of the IAASB and the other standard-setting boards on professional skepticism since the publication of the Staff Q&A in 2012, in the short term, the PSWG should first explore actions that could be taken to influence the appropriate application of professional skepticism in the IAASB’s current projects, in particular the ISA 540 project.

The IAASB also acknowledged that feedback to the ITC and further discussion by and with the other SSBs would inform the potential longer-term actions, including whether a more holistic approach to professional skepticism (which might include changes to the current audit model) may be necessary.

In relation to the proposed medium-term deliverable of a paper summarizing the feedback relating to professional skepticism on the ITC, and other outreach, as well as input from existing working groups, the Board noted that a feedback statement would be beneficial, but only after a thorough analysis of all

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<sup>3</sup> ISA 500 *Audit Evidence*

<sup>4</sup> ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing*

the input.

Longer-term, the IAASB agreed that the PS Working Group should explore whether more fundamental changes may be needed in the ISAs to address the concept of professional skepticism more generally, and that this be done in collaboration with the IESBA and the IAESB. It was also noted that providing timely input to the ISA 540 project and at a later stage the ISA 315 (Revised)<sup>5</sup> project would help inform further consideration by the Board on the need for any longer-term deliverable.

#### IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron agreed with Prof. Köhler's summary of the joint IAASB and IESBA CAG meeting discussion, and added that he was pleased to have the joint session given the mutual interactions. He noted various views from CAG Representatives. For example, one noted that skepticism is used in other disciplines outside of auditing and suggested that this be further explored to understand how this influences public perception of professional skepticism as exercised in audits of financial statements. Others emphasized the relevance of education, and highlighted the suggestions made to not only for auditors to obtain corroborative evidence but to also for the IAASB to explore what should be done when contradictory evidence is obtained. The important role of the "tone at the middle" (manager level) was also supported at the CAG, as was the suggestion that professional skepticism in the context of the public sector should be further explored.

Mr. Waldron suggested that professional skepticism be considered more broadly to make it more tangible, noting that he agreed with the remarks on societal expectations made by Prof. Van Hulle, and highlighting relevant aspects of a presentation by the Institute of Chartered Accountants of Scotland on moral courage at the IESBA CAG meeting. He also suggested that the value of an audit from the perspective of investors should be considered when considering what can be done to address professional skepticism.

#### PIOB OBSERVER REMARKS

Prof. Van Hulle noted the relevance of linking professional skepticism to changing societal expectations, adding that expectations are changing over time and that society expects auditors to be more critical than before. He suggested that any change to the definition of professional skepticism or further work should have sufficient flexibility to meet the changing societal expectations.

#### WAY FORWARD

The PSWG will further explore considerations about the application of professional skepticism in standards affected by current IAASB standard-setting projects, with a focus on evidence and documentation, for the June 2016 Board meeting. The PSWG will also analyze the responses to the ITC relating to professional skepticism, and present on high-level themes at the June 2016 meeting. A more robust discussion on the feedback is planned for the IAASB and IAASB CAG September 2016 meetings.

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<sup>5</sup> ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

## Objectives of the Agenda Paper

To discuss suggestions on how to emphasize the application of professional skepticism in making professional judgments with respect to planning the audit and obtaining sufficient appropriate evidence and in sufficiently documenting the application of professional skepticism. The focus is on the IAASB International Standards, in particular in International Standard on Auditing 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures (ISA 540),

## Introduction

1. At the March 2016 Board meeting the Professional Skepticism Working Group (PSWG) presented its proposed deliverables for the short, medium and long-term. The Board agreed that, in the short term, the IAASB representatives in the PSWG should first explore actions in the IAASB's current projects that could be taken to influence the appropriate application of professional skepticism, in particular in the ISA 540 project.
2. During the March 2016 Board meeting, the Board acknowledged the commonality of issues across multiple projects. Therefore, a joint working session discussion was held that included the ISA 540 Accounting Estimates Task Force (ISA 540 TF) ISA 315 (Revised) Working Group (ISA 315 WG), the Data Analytics Working Group and the PSWG. The outcome of this joint session was discussed with the Board, and as a result the Board asked the PSWG to focus its short-term work on providing input on specific areas of consideration related to professional skepticism to the ISA 540 TF in the following ways:
  - How to improve the exercise of professional skepticism in risk assessment for accounting estimates, including fair value accounting estimates, in ISA 540 in addition to overall risk assessment considerations related to ISA 315 (Revised).
  - How knowledge of the entity's business model supports the appropriate exercise of professional skepticism.
  - The role of professional skepticism in considering contradictory evidence and in weighing evidence.
  - Whether a change towards a more challenging mindset would be needed in the International Standards.
  - Proposals for changes to existing language in ISA 540 that may encourage the appropriate exercise of professional skepticism.
3. To address the specific areas for consideration raised by the Board and the ISA 540 TF, a subgroup of the PSWG was formed (PSWG-IAASB Subgroup or Subgroup). The Subgroup consists of the IAASB-related members of the PSWG.
4. The PSWG-IAASB Subgroup chair held a joint teleconference call with the WG chairs of ISA 315 (Revised), ISA 540, and Staff. The ISA 540 TF highlighted additional areas where it would be helpful for the PSWG-IAASB Subgroup to provide input. Proposed additional areas to be addressed include the following:

- How indicators of possible management bias are addressed in the ISAs, both in terms of where management bias is first defined (it is briefly noted within the application material of ISA 315 (Revised), and defined in ISA 540) as well as how it is defined. For example, the definition refers to the lack of “neutrality” by management in the “preparation” of information by management, whereas ISA 540 only relates to estimates (measurement). Preparation, however, also includes recognition/derecognition, classification, presentation and disclosure.
  - In relation to contradictory evidence, as referenced in paragraph 2, how the auditor would address those instances where there may be inconsistent conclusions between two experts (i.e., two experts may not agree on a complex matter, but that does not necessarily mean that the evidence is contradictory).
  - How certain auditor biases, for example a familiarity threat, may undermine the appropriate exercise of professional skepticism, and as a result may lead to an insufficient response to the identification of contradictory evidence.<sup>6</sup>
  - To consider whether explicit reference to exercising professional skepticism might be considered for certain types of assertions at class of transaction, account balance or disclosure level, (e.g. assertions that are highly relevant to the decision-making of intended users or inherently more subjective in nature).<sup>7</sup>
5. The PSWG-IAASB Subgroup considered the relevant timing and priority of the areas listed above within paragraphs 2 and 3, and determined that all of the areas noted are important and that therefore the PSWG-IAASB Subgroup intends to address them in the long term. However, for the purpose of this Board meeting, we should focus our attention on addressing the following areas in the short term:
- The exercise of professional skepticism in the context of risk assessment for accounting estimates, including fair value accounting estimates, in addition to overall risk assessment considerations related to ISA 315 (Revised).
  - How an understanding of the entity's business model supports the appropriate exercise of professional skepticism.
  - The role of professional skepticism in considering contradictory evidence and in weighing evidence, including inconsistencies in information.
  - How indicators of possible management bias are addressed in the ISAs.
  - Where explicit references to professional skepticism in specific ISAs may be useful.
6. Since the responses to the Invitation to Comment *Enhancing Audit Quality in the Public Interest, a Focus on Professional Skepticism, Quality Control and Group Audits* (the ITC) were due on May 16, 2016, and the PSWG and the IAASB did not want to prejudge the responses from stakeholders, the

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<sup>6</sup> ISA 200 paragraph A 22: The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance 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.

<sup>7</sup> For example, article 21.2 of the European Auditing Directive encourages firms and auditors to focus professional skepticism on 'reviewing management estimates relating to fair values, the impairment of assets, provisions and future cash flow relevant to the entity's ability to continue as a going concern'.

Board asked the PSWG to develop an approach to enable the improved application of professional skepticism within the construct of the current definitions of professional skepticism, judgment, evidence and documentation, when providing input into the ISA 540 project in the short term.

7. Therefore, the considerations in paragraphs 2 and 4 on (a) whether a change towards a more challenging mindset would be needed in the International Standards, and (b) considerations on proposals for changes to existing language in ISA 540 that may encourage the appropriate exercise of professional skepticism, will be considered after the responses to the ITC have been analyzed. This analysis will also discuss in more detail any impediments to the application of professional skepticism such as familiarity threats, as well as how an environment can be created that stimulates professional skepticism, including references thereto in an audit methodology.
8. The analysis of the responses to the ITC will be discussed at the September 2016 Board meeting and this may result in suggestions and considerations to the ISA 540 TF in addition to those presented in this June 2016 board paper.

### Approach Taken by the PSWG

9. The Subgroup recognized that, as indicated in ISA 200 paragraph A53, the ISAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. While ISA 200 requires the auditor to adopt an attitude of professional skepticism in planning and performing an audit, it is not repeated as a requirement within each ISA. Therefore, the PSWG-IAASB Subgroup considered whether and how the more general descriptions of professional skepticism could be augmented throughout the ISAs to support the application of professional skepticism, with specific attention to auditing accounting estimates. In doing so a matrix was developed that enabled the PSWG-IAASB Subgroup to provide recommendations to the ISA 540 TF (the Matrix) (**Agenda Item 2-B**).
10. As a basis for the Matrix, the Subgroup used the figure from the ITC as a starting point (see figure below).

*ITC Figure: How Professional Skepticism Drives Action*



11. The ITC explains that while professional skepticism is an attitude, this attitude is applied in making professional judgments that provide the basis for auditors' actions. The auditor exercises professional judgment and maintains professional skepticism throughout the planning and performance of the audit and, among other things, to:
  - Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
  - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
  - Assess the sufficiency and appropriateness of audit evidence.
  - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.
12. Consistent with the above, the Matrix identifies the critical elements of professional skepticism within each phase of the audit: Risk Assessment, The Auditor's Response to Assessed Risks (Design of procedures), The Auditor's Response to Assessed Risks (Performance of procedures), Forming an Opinion and Drawing Audit Conclusions. For each of these phases in the audit process, we explain how professional skepticism is described currently in the international auditing standards with respect to 1) professional skepticism as an attitude, 2) its application in professional judgments made and the actions taken and 3) critically assessing audit evidence and documenting the auditor's professional judgments and related actions.
13. The recommendations in this paper are meant to provide the ISA 540 TF with considerations that they may take into account when seeking to improve the application of professional skepticism in ISA 540 for auditing accounting estimates. In addition, the basis for the recommendations to the ISA 540 TF (**Agenda Item 2-B**) may prove useful for other projects, including ISA 315 (Revised), Group Audits, Data Analytics and Quality Control, as they contemplate changes to their respective standards.

## General Conceptual and Language Issues

14. The ISA 540 Task Force indicated that it is considering the language used to help enhance the application of professional skepticism in ISA 540, including the term "contradictory" in relation to evidence and asked the PSWG-IAASB Subgroup to provide input. The PSWG-IAASB Subgroup agreed to consider whether it would take up this issue. In its deliberations, the PSWG-IAASB Subgroup concluded that it would be able to address those terms in the short run that are directly linked to the application of professional skepticism (e.g., "contradictory" or "challenge"), but would not seek to address terms with wider implications for the ISAs as a whole. In addition, the Subgroup concluded that it would consider the use of the terms "contradictory" or "challenge" because these may be unnecessarily restrictive.
15. The following treatment seeks to provide a basis for Board decisions on the use of certain terms in relation to the enhancement of professional skepticism in ISA 540.

### **Inconsistent versus Contradictory Evidence**

16. The current treatment of professional skepticism in ISA 200 (paragraph A18) and the treatment of evidence in ISA 330 (paragraph 26) and ISA 500 (paragraph A1), among other standards, address the issue of evidence that “contradicts” other evidence. However, the word “contradict” suggests that the evidence in question diametrically opposes other evidence. However, there are cases in which there are inconsistencies between evidence that are not diametrically opposed to one another, i.e. evidence which disagrees with other evidence may not actually be considered “contradictory” evidence. This implies that the use of the term “contradicts” appears to be unnecessarily narrow for the consideration of evidence by auditors and therefore appears to be unnecessarily narrow for the application of professional skepticism in this context. For example, in cases where there are differences of opinion (i.e., two experts may not agree on a complex matter), it does not necessarily indicate that the evidence is contradictory, but rather serves to demonstrate that the evidence may be inconsistent, in which case the auditor would apply the requirements in paragraph 11 of ISA 500.
17. For these reasons, the PSWG-IAASB Subgroup recommends that the IAASB consider whether the term “contradicts” in the cases mentioned above ought to be replaced in IAASB Engagement Standards with the term “inconsistent”. This would be a consideration for the long-term. However, the PSWG-IAASB Subgroup does recommend that the ISA 540 Task Force consider whether the change in terminology can be effected in the revision of ISA 540 in the short term.

### **Challenge versus Question**

18. The verb “challenge” in the context in which it could be used in the ISAs is commonly defined as “to demand defiantly” or to “call into question; dispute”, whereas the verb “question” in this context is commonly defined as “to put a question or questions to”, “to be uncertain of; doubt”, or “to make an objection to; challenge; or dispute.” There is considerable overlap between the meaning of the two verbs, but there are also important differences. The word “challenge” does connote greater defiance or disputation, whereas “question” connotes an open mindset or the suspension of judgment in this respect. Furthermore, the term “challenge” implies that there is a party representing a “challenge” – that is, there is a disputation between challenger and “challenge”.
19. However, there are many cases where auditors are able to question the persuasiveness or reliability of audit evidence provided by management without needing to “challenge management” – rather, the auditor obtains evidence from sources other than management to respond to the auditor’s questions, uncertainty or doubts. The definition of professional skepticism refers to “an attitude that includes a questioning mind” and is therefore not necessarily restricted to needing to challenge management assertions directly in all cases by obtaining evidence from management. In other words “you question evidence or management”, but “you can only challenge management” – not the evidence.
20. The PSWG-IAASB Subgroup therefore recommends that the IAASB consider whether the term “challenge” or “question” is more appropriate in future standards setting: for the reasons described above, the Subgroup prefers the term “question”. The Subgroup also recommends that the ISA 540 Task Force consider this issue for the revision of ISA 540.

Recommendations to the ISA 540 TF

1. The PSWG-IAASB Subgroup recommends that the ISA 540 TF consider whether the term “contradicts” ought to be replaced with “inconsistent” in the revision of ISA 540.
2. The PSWG-IAASB Subgroup therefore recommends that the ISA 540 Task Force consider whether the term “challenge” or “question” is more appropriate for the revision of ISA 540.

**Matters for IAASB Consideration**

1. Have we addressed the most relevant topics for enhancing professional skepticism with respect to concepts or language or do we need to address other topics?
2. Do you agree with the recommendations made to the ISA 540 TF?

**Professional Skepticism in the Audit**

**Risk Assessment**

*What is the issue?*

21. Auditors may fail to exercise appropriate professional skepticism when obtaining an understanding of the entity and its environment, including the entity’s internal control. This may result in an inadequate understanding that further inhibits the auditor’s ability to exercise professional skepticism in identifying potential risks of material misstatement.
22. In obtaining an understanding of the entity and its environment, auditors gather information about the entity, the industry, and the environment, but may include the information in the audit file without exercising sufficient professional skepticism in considering whether that information is consistent. Unresolved inconsistencies in information may indicate that the auditor has not obtained a sufficient understanding of the entity and its environment.
23. A lack of discussion among the engagement team members about, specifically, the importance of exercising professional skepticism in considering inconsistent evidence and being alert for indicators of possible management bias (both intentional and unintentional) when determining the susceptibility of the entity’s financial statements to material misstatements may lead to the incorrect assessment of risks of material misstatement.

*How is it currently addressed in the standards?*

24. The objective of the auditor in ISA 315 (Revised) is to identify and assess the risks of material misstatement, whether due to fraud or error, through understanding the entity and its environment, including the entity’s internal control. ISA 315 (Revised) provides a list of areas of which the auditor should obtain an understanding; however, the standard could provide more guidance on how the auditor applies professional skepticism in obtaining the understanding, nor on how applying professional skepticism can assist the auditor in determining the extent of understanding that the auditor should obtain. Additionally, the only reference in ISA 315 (Revised) to the exercise of

professional skepticism is in the context of the monitoring of controls when the entity has an internal audit function [paragraph A116].<sup>8</sup>

25. The Professional Skepticism Staff Q&A makes reference to professional skepticism in the following ways as it relates to risk assessment:
  - It would be an ideal opportunity to discuss professional skepticism during the discussion among the engagement team around the risks of material misstatements to the financial statements as a whole [ISA 315 (Revised) paragraph 10].
  - Professional skepticism is relevant and necessary throughout the audit, in particular in the revision of risk assessment required by paragraph 31 of ISA 315 (Revised).
26. ISA 540 makes reference to professional skepticism within paragraph A40 related to the review of prior period accounting estimates and emphasizes that the exercise of professional skepticism assists the auditor in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias and the nature, timing and extent of audit procedures. The review of prior period accounting estimates, however, may only be one indicator of management bias.
27. IAPN 1000 paragraph 71 includes the auditor's responsibility to exercise professional skepticism, which assists the auditor in remaining alert for possible indications of management bias. IAPN 1000 paragraph 113 also explicitly addresses intentional and unintentional management bias and provides examples what the auditor can look for to determine whether management may be biased.

*PSWG-IAASB Subgroup Considerations (See Matrix at **Agenda Item 2-B** for additional detail)*

28. At the March 2016 Board meeting, the ISA 540 TF confirmed that exercising professional skepticism as part of risk assessment is critical given the impact the risk assessment process has on the rest of the audit.
29. The engagement team discussions around the susceptibility of the entity's financial statements to material misstatement required by ISA 315 (Revised) paragraph 10 is arguably one of the most critical touch points between an engagement team and the engagement partner. The language within this requirement could be revised to give more prominence to the importance of exercising professional skepticism in the context of understanding the entity and its environment, the assessment of risks and the need to remain alert for indicators of possible management bias (both unintentional and intentional).
30. ISA 315 (Revised)<sup>9</sup> provides a list of areas of which the auditor should obtain an understanding; however, the standard does not provide guidance on exercising professional skepticism in obtaining the understanding. Therefore, the PSWG-IAASB Subgroup recommends restructuring paragraph 11 of ISA 315 (Revised) to require the auditor to first obtain an understanding of the entity's business

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<sup>8</sup> Effective December 15, 2016, confirming amendments related to the Disclosures project and the Auditor Reporting project will revise paragraph A127 of ISA 315 (Revised) to include the following language, reinforcing the importance of professional skepticism: "In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200."

<sup>9</sup> ISA 315 (Revised), paragraph 11

model, objectives, and strategies,<sup>10</sup> then consider whether that understanding is consistent with the understanding obtained in performing the remaining procedures within paragraph 11 of ISA 315 (Revised). The PSWG-IAASB Subgroup believes that, when the auditor considers and resolves inconsistencies in the information that supports the understanding of the entity and its environment, the auditor is more likely to have obtained a sufficient understanding that assists the auditor in identifying risks of material misstatement, including indicators of possible management bias.

#### Recommendations to the ISA 540 TF

3. Consider restructuring the requirements within paragraph 8 of ISA 540, Risk Assessment Procedures and Related Activities, to promote a greater understanding of the entity's process for developing the accounting estimate, including whether inconsistencies between information exists. The understanding should be evaluated against information obtained during the overall risk assessment process for the financial statements as a whole. For example, this approach would require the auditor to consider whether the investments that the entity holds are consistent with its business model, objectives and strategies. The auditor would also be in a position to question whether the assumptions used in developing estimates are consistent with the entity and its environment, including the industry in which the entity operates.
4. The degree of estimation uncertainty inherent in an accounting estimate affects the auditor's assessment of the risks of material misstatement, including its susceptibility to unintentional or intentional management bias. Consider whether to specifically require discussion among the engagement team of those accounting estimates that represent risks due to a high level of estimation uncertainty inherent to the estimate, the absence or insufficiency of internal controls around the estimate, or the existence of potential indicators of management bias surrounding the estimate.

#### **Matters for IAASB Consideration**

3. Have we addressed the most relevant topics for enhancing professional skepticism at the risk assessment stage or do we need to address other topics?
4. Do you agree with the recommendations made to the ISA 540 TF?

#### **Risk Response – Design**

*What is the issue?*

31. Auditors may fail to exercise of professional skepticism when audit procedures performed are not sufficiently responsive to the risks of material misstatement at the assertion level.
32. For example, in the context of ISA 540 the procedures that should have been designed to respond to indicators of possible management bias may not have been included in the audit plan.

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<sup>10</sup> See ISA 315 (Revised), paragraph 11(d).

*How is it currently addressed in the standards?*

33. ISA 330 paragraph A1 states that overall responses to address the assessed risks of material misstatement at the financial statement level may include: “Emphasizing to the engagement team the need to maintain professional skepticism.”
34. ISA 540 paragraph A40 refers to professional skepticism related to the review of prior period accounting estimates and emphasizes that the exercise of professional skepticism assists the auditor in identifying the nature, timing and extent of audit procedures.

*PSWG-IAASB Subgroup Considerations (See Matrix at **Agenda Item 2-B** for additional detail)*

35. The PSWG-IAASB Subgroup believes that, if auditors consider “what could go wrong” at the assertion level, it would drive the exercise of professional skepticism, and put auditors in a better position to design and perform audit procedures, whether they be tests of controls or substantive procedures, that are responsive to the assessed risks. The design can include a spectrum of responses tailored to the specific range of assessed risks. It may also include different types of sources of evidence that are needed to respond to those risks.
36. ISA 230 paragraph A9 includes application material with respect to the requirements for documenting significant judgments, but ISA 540 could be expanded with examples for what and how to document auditor actions on significant judgments related to accounting estimates. In this way, for example, the auditor can demonstrate the exercise of professional skepticism through documenting how indicators of possible management bias have been considered and addressed when designing test of controls and substantive procedures. The ISA 540 TF might consider how ISA 540 might draw a link between its application material and that in ISA 230, including how documentation may assist auditors in making judgments requiring professional skepticism, including whether responses appropriately addressed assessed risks.

Recommendations to the ISA 540 TF

5. In the context of ISA 540, the auditor could consider more explicitly what could go wrong, for example, in the valuation of an asset, by focusing on the assumptions made by management, and the possibility of management bias in developing the accounting estimate. Promoting an interlinked thought process will drive the auditor to exercise professional skepticism to address indicators of possible management bias.
6. The ISA 540 task force could enhance the application of professional skepticism in this phase of the audit by requiring that the discussion among the engagement team members in accordance with ISA 315 (Revised)<sup>11</sup> should also focus on identifying instances of possible management bias in accounting estimates, including how audit procedures have been designed to address such matters.
7. The ISA 540 TF might consider how ISA 540 could draw a link between its application material and that in ISA 230, including how documentation may assist auditors in making judgments requiring professional skepticism.

**Matters for IAASB Consideration**

5. Have we addressed the most relevant topics for enhancing professional skepticism at the risk response -design stage or do we need to address other topics?
6. Do you agree with the recommendations made to the ISA 540 TF?

**Risk Response – Performing Procedures**

*What is the issue?*

37. Auditors may fail to exercise appropriate professional skepticism when performing procedures. In the context of ISA 540, auditors may fail to:
  - revise the auditor's risk assessment when audit evidence is obtained that is inconsistent with the audit evidence on which the auditor originally based the assessment, for example when the results of control testing indicate that controls are not operating effectively (ISA 315 (Revised), paragraph 31);
  - consider inconsistent evidence;
  - question management's assumptions;
  - corroborate auditor inquiries of management;
  - evaluate audit evidence; or
  - appropriately assess the impact of indicators of possible management bias on the assessment of the risk of material misstatements.

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<sup>11</sup> See ISA 315 (Revised), paragraph 10.

*How is it currently addressed in the standards?*

38. See paragraphs 33 and 34 above.

*PSWG-IAASB Subgroup considerations (See Matrix at **Agenda Item 2-B** for additional detail)*

39. Applying professional skepticism in making judgments related to the sufficient mix of audit procedures requires that all engagement team members feel comfortable to bring potential deviations, misstatements, or instances of management bias to the attention of more senior engagement team members. In addition, it is imperative that the auditor possess the skills necessary to understand the objective(s) of the audit procedures that are performed.
40. ISA 540 paragraph 23 requires the auditor to document indicators of possible management bias, if any. The existence of indicators of possible management bias may require the auditor to obtain more persuasive audit evidence. The requirement in ISA 540 paragraph 23 could be expanded to require the auditor to consider whether the auditor has appropriately considered the effect of indicators of possible management bias in performing the auditor's procedures and whether the auditor has obtained sufficient appropriate audit evidence when reaching conclusions relating to the results of those procedures.
41. The examples included in the application material of ISA 230 (paragraph A10) to prepare audit documentation relating to the use of professional judgment may provide a basis for further guidance in ISA 540 on the application of professional skepticism when responding to risks of material misstatements in accounting estimates. These examples are:
- The rationale for the auditor's conclusion when a requirement provides that the auditor "shall consider" certain information or factors, and that consideration is significant in the context of the particular engagement.
  - The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
  - The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
42. Inconsistent Audit Evidence
- Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence. 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.<sup>12</sup>
  - Paragraph 11(a) of ISA 500 address instances where there may be inconsistencies in, or doubts over reliability of, audit evidence. Further ISA 230 paragraph 11 indicates that, for significant audit matters, when the auditor identifies information that is inconsistent with the

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<sup>12</sup> See ISA 200, paragraph A18 and A21

auditor's final conclusion, the auditor shall document how the inconsistency was addressed. ISA 540 could make the auditor specifically aware of the obligations when the reliability of audit evidence is in question or inconsistencies in audit evidence are identified. This would reinforce the importance of the auditor evaluating inconsistent evidence in the audit of accounting estimates. However, it could be helpful if the standards were more specific on how the auditor evaluates or "weighs" inconsistent evidence.

43. The PSWG-IAASB Subgroup contemplated recommending to the ISA 540 TF the importance of reminding the auditor of the need to determine what amendments or additions to audit procedures are necessary to resolve inconsistencies in audit evidence obtained<sup>13</sup> and to consider the effect of the matter on other aspects of the audit, including revising the risk assessment.<sup>14</sup> In discussing this potential recommendation with the ISA 540 TF it appears that ISA 500 does not sufficiently address how the auditor should address inconsistent information, for example, by considering the need to obtain evidence from multiple sources, including outside the business, to obtain a better understanding of the potential misstatement. Since this issue is not just specific to accounting estimates, and requires enhancements to other auditing standards, issue should be considered for a long-term project.

Recommendations to the ISA 540 TF

8. Specific suggestions where the ISA 540 task force could enhance the application of professional skepticism in this phase of the audit include matters such as:
- a. how to apply the guidance in ISA 200, paragraph A43, in the context of the audit of accounting estimates
  - b. documenting how inconsistencies in audit evidence were addressed as required by ISA 230, paragraph 11; further, reference could also be made to ISA 330, paragraph 17, when dealing with deviations from controls upon which the auditor intends to rely and the implications where such controls are designed to address indicators of possible management bias
  - c. extending the requirement in ISA 540, paragraph 23, to require the auditor to appropriately consider the effect of indicators of possible management bias in performing the auditor's procedures and whether the auditor has obtained sufficient appropriate audit evidence when reaching conclusions about the results of those procedures.

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<sup>13</sup> ISA 500, paragraph 11

<sup>14</sup> ISA 315 (Revised), paragraph 31

### Matters for IAASB Consideration

7. Have we addressed the most relevant topics for enhancing professional skepticism at the risk response-designing procedures stage or do we need to address other topics?
8. Do you agree with the recommendations made to the ISA 540 TF?

### Forming an Opinion – Audit Conclusions

*What is the issue?*

44. Because of a lack of professional skepticism, auditors may not sufficiently address
  - Misstatements, identified during the audit, with which management disagrees.
  - Concerns about whether sufficient appropriate audit evidence has been obtained.

*How is it currently addressed in the standards?*

45. There are currently no explicit references to professional skepticism within ISA 450<sup>15</sup> or ISA 700.<sup>16</sup>
46. Within the Professional Skepticism Staff Q&A, there are two references to ISA 700 when referring to the importance of exercising professional skepticism throughout the audit both in terms of whether the auditor has 1) obtained sufficient appropriate audit evidence in order to be able to conclude about whether reasonable assurance was obtained [ISA 700, paragraph 11] and 2) evaluated whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation [ISA 700, paragraph 14].
47. ISA 540 includes no reference to professional skepticism as it relates to forming audit conclusions.

*PSWG-IAASB Subgroup considerations (See Matrix at **Agenda Item 2-B** for additional detail)*

48. The engagement partner can support the exercise of professional skepticism by (a) emphasizing to the other members of the engagement team that quality is essential in performing audit engagements and (b) providing an environment where the engagement team can raise concerns about whether sufficient appropriate evidence has been obtained to support the audit conclusions without fear of reprisals. The ITC includes a proposal for a Quality Management Approach to further create an environment where team members can question whether sufficient appropriate evidence has been obtained.
49. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. ISA 200 contains discussion of such matters

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<sup>15</sup> Effective for audits of financial statements for periods ending on or after December 15, 2016 the following language is added to ISA 450 paragraph A17 (Evaluating the Effect of Uncorrected Misstatements) as a result of conforming amendments related to the Disclosures project and the Auditor Reporting project: When considering the implications of misstatements in classes of transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with ISA 200.

<sup>16</sup> For ISA 700 (Revised) effective for audits of financial statements for periods ending on or after December 15, 2016 paragraph 38 requires that the Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further state that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit

as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

50. With respect to whether risks of material misstatement resulting from management bias have been sufficiently addressed may be difficult to evaluate at an assertion level and be better identifiable when considered in the aggregate of groups of accounting estimates or all accounting estimates. Further, the auditor should relate the results of audit procedures on accounting estimates to the understanding of the entity and its environment to identify potential patterns in the way estimates have been made.

Recommendations to the ISA 540 TF

9. Specific suggestions where the ISA 540 task force could enhance the application of professional skepticism when management disagrees with misstatements identified by the auditor may include the following matters:
- a. drawing on the content in ISA 450, paragraphs 9 and A10, and the need for the auditor to perform audit procedures that corroborate or undermine management's reasons for not making corrections, with a focus on evaluating whether there are indicators of possible management bias
  - b. providing guidance on the application of professional skepticism in ISA 540, paragraphs A116-A118, for example dealing with whether, based on the audit evidence obtained, the auditor has considered evidence that corroborates or undermines management's responses.
10. Specific suggestions where the ISA 540 task force could enhance the application of professional skepticism with respect to concerns about whether the auditor has obtained sufficient appropriate audit evidence include matters such as:
- a. address the requirements in ISA 540, paragraphs 18-21 by emphasizing a "standback" about matters such as: audit evidence obtained, inconsistencies identified and how they have been resolved, indicators of possible management bias, etc.
  - b. reinforcing that evaluating the sufficiency of audit evidence for disclosures in financial statements involves essentially the application of the same types of considerations as when evaluating sufficiency of audit evidence for accounting estimates recognized in the financial statements

### Matters for IAASB Consideration

9. Have we addressed the most relevant topics for enhancing professional skepticism at the forming a conclusion stage or do we need to address other topics?
10. Do you agree with the recommendations made to the ISA 540 TF?

### Overall Consideration

51. The Matrix helped the PSWB-IAASB Subgroup to develop and structure its recommendations to the ISA 540 TF. In a similar way the Matrix could be of help in addressing professional skepticism in other IAASB projects (e.g., ISA 315 (Revised), Quality Control, Data Analytics).

### Matters for IAASB Consideration

11. Do you agree with the approach taken to develop a matrix that addresses professional skepticism at the different stages of the audit process?
12. Would the Matrix in **Agenda Item 2-B** be useful to other standard setting projects if it was tailored?

### Way Forward

52. The PSWG-IAASB contemplates that the following issues may need to be addressed as part of a long term process by taking into account the responses received on the questions on professional skepticism included in the ITC:
  - A consistent approach with respect to professional skepticism in standard setting – for example, to take the concepts in the Matrix and the 540 learnings to see how to apply professional skepticism more specifically in the IAASB’s standard-setting projects going forward.
  - Consideration whether further changes are needed to ISA 200 – for example to give further examples about the impediments to the appropriate application of professional skepticism.
  - How the concept of professional skepticism fits into the Board’s proposed quality management approach and changes to ISQC 1 and ISA 220.
  - The definition of management bias with a broader application with respect to complex accounting estimates and capturing recognition, measurement, classification and presentation. In addition, considering in which ISAs reference to management bias may be relevant.
  - The treatment of professional skepticism within the standards, i.e., whether requirements and guidance in relation to the application of professional skepticism ought to be addressed primarily in one place (e.g., ISA 200) or spread throughout the ISAs; if the decision is made to address requirements and guidance in relation to the application of professional skepticism throughout the ISAs, should reference be made to the term “professional skepticism” in these ISAs, or should the requirements and guidance be self-standing without such reference?

53. During the coming months the PSWG will analyze the responses to the ITC and report back to the Board at its September meeting. The considerations as addressed in paragraph 2 on whether a change towards a more questioning mindset would be needed in the International Standards will be informed by the outcome of this analysis.
54. Also how to create supportive environment necessary for the appropriate exercise of PS and to what extent this may require any changes to ISQC1 and ISA 220 will be considered based on the outcome of the analysis of the responses to the ITC.