

Agenda Item 5-4(J3-A)

Professional Skepticism—Issues (Including Feedback to the ITC) and Joint Working Group’s Preliminary Recommendations on the Proposed Way Forward

Objectives of the Agenda Item

1. The objectives of the agenda item are:
 - To summarize the responses to the IAASB’s Invitation to Comment (ITC), *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* in relation to professional skepticism.
 - To highlight discussions of the International Ethics Standards Board for Accountants (IESBA) and International Accounting Education Standards Board (IAESB) relevant to the work of the Professional Skepticism Working Group (PSWG).
 - To present the PSWG’s preliminary recommendations on the actions that could be taken by the three standard-setting boards (SSBs), individually and in coordination, to enhance the application of professional skepticism and solicit views on these actions from a public interest standpoint from the IAASB and IESBA, as well as the IAASB, IAESB and IESBA Consultative Advisory Groups’ (CAGs), at their respective September 2016 meetings.

2. Due to the nature and diversity of views both within the responses to the ITC and among PSWG members, the PSWG is continuing to deliberate a number of key issues where a consensus has not yet been reached. Particular areas of concern and differing viewpoints from individual PSWG members have been highlighted within this paper, including with respect to the preliminary recommendations. Notwithstanding a lack of consensus in some areas, the PSWG has agreed to table the issues addressed in this paper, as it believes that input from the SSBs and their CAGs on key issues at this early stage is essential and will serve to further inform the PSWG’s discussions. The PSWG recognizes the need to take into account other feedback received by the respective SSBs in light of each Board’s remit. This paper therefore represents the PSWG’s analysis of comments on the ITC and its preliminary recommendations based on its discussions to date. The PSWG anticipates that its role to coordinate efforts across SSBs—including the consideration of potential implications of their individual approaches—will increase in importance as individual Boards seek to move forward, and that the timing of various actions by those Boards should take into account the need for this coordination.

3. This paper is organized into the following sections to highlight the various matters under consideration by the PSWG, as well as a subgroup of IAASB representatives advising current IAASB projects.

Section A	Overview of Feedback to Date on the Topic of Professional Skepticism
Section B	Preliminary Recommendations of the PSWG to the SSBs
Section C	Basis for PSWG’s Preliminary Recommendations
Section D	Specific Matters that Could Be Addressed by the IAASB
Section E	Specific Matters that Could Be Addressed by the IESBA

Section F	The Definition of Professional Skepticism, Including Consideration of the Potential Need for Fundamental Changes to the Concept
Section G	Consideration of a Common Description of Professional Skepticism by the SSBs and the Possibility of Extending the Concept beyond Audit and Assurance Engagements
Section H	Actions that Could Be Taken by Other Stakeholders to Address Professional Skepticism
Section I	Suggested Way Forward for the SSBs and the PSWG

A. Overview of Feedback Received to Date on the Topic of Professional Skepticism

High-Level Feedback to the IAASB's Invitation to Comment

4. At its June 2016 meeting, the IAASB received a presentation as to the themes arising from the comment letter responses to the ITC, as well as through outreach activities, including dialogue with the IAASB and IESBA CAGs. These themes were as follows:
- Professional skepticism is about the appropriate mindset of the auditor; concerns over a lack of professional skepticism in audits cannot be fixed in isolation by changes to the definition or within the IAASB's International Standards.
 - A sufficient knowledge of the business enables the auditor to ask probing questions, more effectively challenge management, and identify when evidence is contradictory. In this regard, the linkage to the IAASB's ISA 315 (Revised)¹ project was highlighted. Notably, it was acknowledged that professional skepticism is relevant throughout the entire audit.
 - Professional skepticism is about *behavior*—how can auditors be encouraged to act as critical challengers? Can changes to certain auditing standards more effectively direct auditors to what is expected (e.g., the approach taken in ISA 240)?² How does the culture of the firm influence and encourage skeptical behavior?
 - Training and education is important to infuse a professional skeptical attitude into the “DNA” of auditors in part by raising awareness for auditors of their (and management's) potential biases.
 - There is a strong link between professional skepticism and the role of the “tone at the top” and the “tone at the middle,” with recognition of the roles of the audit firm, the engagement partner, senior staff, and the engagement quality control (EQC) reviewer (where applicable). Developing professional skills, communication skills, and an environment where mentoring takes place were viewed as particularly important.
 - Additional guidance on exercising professional skepticism in particular circumstances (e.g., when auditing highly judgmental areas) would be helpful to enhance practice.
 - A joint approach by the IAASB, IESBA, and IAESB was supported, noting the need for consistency between the SSBs on the concept/definition of professional skepticism as well as

¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

² ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

clarification as to how the concept of professional skepticism relates to the fundamental principles in the IESBA *Code of Ethics for Professional Accountants* (IESBA Code).³

Further details of those responses are included within this paper. A full list of respondents is included in Appendix 1 of Agenda Item G.1.

5. Monitoring Group (MG) members⁴ responding to the ITC noted that there should be a consistent approach between the different SSBs.⁵ One MG member noted that a lack of due care, objectivity, or professional competence may sometimes be mislabeled as a lack of professional skepticism,⁶ which supports the view of many respondents that a coordinated approach to the topic across the SSBs is necessary. MG members also specifically expressed the view that the IAASB should consider additional requirements and application material throughout the ISAs that promotes a mindset that actively questions or makes inquiry regarding management's assumptions or audit evidence obtained.⁷ This could be reflected in the ISAs (including potentially the definition) by introducing a concept of a questioning mind that would tend to exhibit a more doubting attitude.⁸ The words used in the ISAs could change what is seen as the current confirmatory framework (obtain evidence to support management's assertion) to a framework which leads more to auditors seeking evidence both supporting and disconfirming management's assertions.⁹

Feedback to IESBA through Current Projects on Its Agenda

6. The concerns about professional skepticism in the International Forum of Independent Audit Regulators (IFIAR)'s external inspection reports have been described in the context of audits of financial statements. The IAASB's focus to date has therefore been on the concept as applied to assurance engagements. The ITC did not explicitly seek feedback on whether the concept of professional skepticism should extend to the other engagements addressed by the IAASB's International Standards, and no feedback was received in this regard.
7. There have been calls from certain IESBA stakeholders (including a MG member) for enhancement to the application of professional skepticism among professional accountants more broadly. In particular, some regulators have questioned whether the relevant "information," or "evidence" underpinning ethical decisions (usually relating to relationships between individuals within a firm and

³ The IESBA Fundamental Principles are (i) Integrity – to be straightforward and honest in all professional and business relationships; (ii) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments; (iii) Professional Competence and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards; (iv) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties; and (v) Professional Behavior – to comply with relevant laws and regulations and avoid any action that discredits the profession.

⁴ The Monitoring Group comprises the Basel Committee on Banking Supervision (BCBS), the European Commission (EC), the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS), the International Forum of Independent Audit Regulators (IFIAR), the International Organization of Securities Commissions (IOSCO), and the World Bank. BCBS, IAIS, IFIAR, and IOSCO responded to the ITC.

⁵ Monitoring Group: BCBS, IAIS, IOSCO

⁶ Monitoring Group: IOSCO

⁷ Monitoring Group: BCBS, IAIS, IOSCO

⁸ Monitoring Group: IAIS, IFIAR

⁹ Monitoring Group: BCBS, IAIS

the entity being audited or other matters of compliance with the IESBA Code) was assessed with adequate professional skepticism.

8. In its publication [Conclusions from the PIOB Public Interest Workshop, September 2014](#), the PIOB noted that “professional skepticism as a state of the mind and attitude, should govern the performance of auditors, and inspire the attitude of other accountants, e.g., accountants in business.” The publication further notes that “When accountants (practitioners, non-practitioners, accountants in business) do not display proper professional skepticism it is recognized as a barrier to effective performance.”
9. At its June 2016 meeting, IESBA members exchanged preliminary views about the meaning and the applicability of, the concept of professional skepticism, including whether it should be applicable to all professional accountants. Leveraging the work of the PSWG, the IESBA plans to continue such discussions (including at its upcoming September 2016 meeting) and determine the need for further actions.

Long Association Exposure Draft – December 2014

10. In its December 2014 letter to IESBA in response to its Long Association ED, the International Organization of Securities Commissions (IOSCO) (a MG member) suggested that IESBA determine how the concept of professional skepticism can be emphasized in the IESBA Code. In IOSCO’s view, the IESBA Code should have a dedicated section addressing professional skepticism in much the same way as it includes a section that addresses matters relating to auditor independence.¹⁰ In this regard, IOSCO suggested that the IESBA should undertake a project to develop a section in the IESBA Code to address professional skepticism as part of the IESBA’s *Strategy and Work Plan for 2014–2018* in support of its initiatives to improve audit quality.

Feedback on Part C of the IESBA Code (Part C Phase 1 ED) – April 2015

11. Four respondents to the IESBA’s Part C Phase 1 ED (including a MG member) were of the view that the IESBA Code should address how professional skepticism applies to professional accountants in business (PAIBs), i.e., non-auditors or non-assurance practitioners.¹¹ Specifically, it was suggested that:
 - The IESBA Code should emphasize the need for PAIBs to exercise an adequate level of professional skepticism throughout the process of preparing, presenting or filing information, because PAIBs’ work typically involves accumulating, distilling, and interpreting information from others, namely colleagues who work at the source (e.g., in operating departments) of an entity’s transactions.¹²
 - PAIBs should always maintain professional skepticism,¹³ and that the concept of professional skepticism should not be limited to auditors.¹⁴

¹⁰ The term professional skepticism appears in four instances in the extant IESBA Code as part of the description of independence. See Part B, *Independence – Audit and Review Engagements* of the extant Code, Sections 290, *A Conceptual Framework Approach to Independence*, paragraph 290.6 and 291, *Independence – Other Assurance Engagements*, paragraph 291.5.

¹¹ Respondents to the IESBA Part C Phase 1 ED included: Monitoring Group: IOSCO; Preparers: PAIB; Member Bodies and Other Professional Organizations: CPA Canada, Pennsylvania Institute of Certified Public Accountants (PICPA)

¹² Monitoring Group: IOSCO

¹³ Preparers: PAIB; Member Bodies and Other Professional Organizations: CPA Canada, PICPA

¹⁴ Member Bodies and Other Professional Organizations: CPA Canada

IESBA and IAASB CAGs – March 2016

12. During the March 2016 joint session, the IESBA and IAASB CAGs suggested that the interaction between the concept of professional skepticism and the fundamental principles in the IESBA Code should be clarified. It was also suggested that the IESBA Code should indicate that professional skepticism is an important attribute, as is “moral courage,” that enables or drives professional accountants’ compliance with the fundamental principles.
13. Further, some CAG representatives suggested that it might also be useful for the IESBA to consider how to emphasize the concept of professional skepticism in the IESBA Code, as part of its proposals to clarify the linkage between independence and the fundamental principles (currently being explored as part of the Structure of the Code project). This message was also received from some respondents¹⁵ to the December 2015 Exposure Drafts, *Proposed Revisions Pertaining to Safeguards in the Code—Phase 1* and *Improving the Structure of the Code of Ethics for Professional Accountants—Phase 1*. There is a perceived linkage between the concept of professional skepticism and four of the five fundamental principles (i.e., objectivity, integrity, professional competence and due care, and professional behavior); however, the IESBA Code does not make an explicit reference to this linkage.
14. There was also a suggestion that IESBA should explore whether it might be useful to include a few paragraphs in the proposed restructured IESBA Code to further emphasize professional skepticism. Some have suggested that the Board’s ongoing work to clarify the relationship between “independence” and “the fundamental principles” provides a basis for this further emphasis.

The IAESB’s Consultation on Its Future Strategy

15. International Education Standards (IESs) 2,¹⁶ 3,¹⁷ 4,¹⁸ and 8¹⁹ prescribe learning outcomes that assist professional accountants and engagement partners to demonstrate effective “professional skepticism” and “professional judgment.”
 - IES 2 establishes the learning outcomes for technical competence that aspiring professional accountants are required to demonstrate by the end of Initial Professional Development (IPD). In paragraph A5 of this IES, reference is made to professional skepticism as a competence area within professional values, ethics, and attitudes (see IES 4 below).
 - IES 3 establishes the professional skills that aspiring professional accountants are required to demonstrate by the end of IPD in order to perform the role as a professional accountant. Paragraph 7(c)(ii) of IES 3 includes as a learning outcome for professional skills “apply professional skepticism through questioning and critically assessing all information.”
 - IES 4 establishes the professional values, ethics and attitudes that aspiring professional accountants need to develop and demonstrate by the end of IPD in order to perform the role of a professional accountant. Paragraph 11(a)(i) of IES 4 includes a competency area for

¹⁵ Monitoring Group: IOSCO; Regulators and Audit Oversight Authorities: IRBA; NSS: Accounting Professional Ethics Standards Board (APESB), IDW, NZAuASB; Accounting Firms: EYG; Member Bodies and Other Professional Organizations: Assirevi, CPAA, FEE, ICAEW, WPK

¹⁶ IES 2, *Initial Professional Development – Technical Competence*

¹⁷ IES 3, *Initial Professional Development – Professional Skills*

¹⁸ IES 4, *Initial Professional Development – Professional Values, Ethics and Attitudes*

¹⁹ IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*

professional values, ethics and attitudes “professional skepticism and professional judgment.” It also described the related learning outcome as:

- “Apply a questioning mindset critically to assess financial information and other relevant data; and
 - Identify and evaluate reasonable alternatives to reach well-reasoned conclusions based on all relevant facts and circumstances.”
- IES 8 refers to professional skepticism in the context of audit engagements.
16. IESs 2, 3 and 4 apply to all professional accountants, not just those performing audits or other assurance engagements. The IAASB’s definition of professional skepticism is acknowledged in paragraph A2 of IES 4, which also notes that the terms “professional skepticism” and “professional judgment” within IES 4 are to be interpreted as applying to the broader context of a role as a professional accountant (though how this would be applied is not explicitly explained). This approach is different from that of the IAASB and the IESBA—as the IAASB’s current standards only refers to the concept of professional skepticism in the context of audit and assurance engagements, and the IESBA Code currently only addresses professional skepticism in the context of independence rather than a concept that applies to all professional accountants.
17. In its December 2015 Consultation Paper, [Meeting Future Expectations of Professional Competence: A Consultation on the IAESB’s Future Strategy and Priorities](#), the IAESB noted that professional skepticism and professional judgment (as areas of professional competence) are growing in importance for all professional accountants; this is supported by relevant accounting literature, research studies, and findings from regulators’ reports. The IAESB also noted it is evaluating what actions it should take to support the development, maintenance, and demonstration of professional skepticism and professional judgment for professional accountants. Potential actions include reviewing existing references to these competences in the IESs or expanding references to these topics in existing or new IESs. A specific question in its 2015 consultation paper to respondents was included as follows: “What action, if any, should the IAESB take to improve professional competence related to the appropriate exercise of professional skepticism and professional judgment?”
18. The IAESB had an initial discussion on the feedback to that consultation in [April 2016](#) and is considering next steps. Those respondents to the consultation paper who supported the IAESB undertaking further work in this area provided a range of suggestions on what action might be taken, for example:
- Developing support materials to assist in the implementation in the form of an information paper, case studies, thought leadership papers, guidelines on competency requirements, toolkits, study guides or examples of practice;
 - A literature review;
 - Enhancing requirements and explanatory material of IES 7,²⁰ IES 2, IES 3, and IES 4;
 - More effort to define relevant roles;
 - Root cause analysis; and
 - Revision of International Education Practice Statement 1 on Ethics Education.

²⁰ IES 7, *Continuing Professional Development*

19. Several respondents to the IAESB's strategy consultation were of the view that any action by the IAESB would need to be coordinated through other SSBs. The IAESB has established a separate task force to further consider what actions may be necessary in relation to professional skepticism, noting the importance of continuing to engage in the debates at the PSWG. The IAESB Professional Skepticism Task Force is in the process of considering specific matters to be addressed by the IAESB, for example a potential separate behavioral competence category in the IESs aimed at addressing the risks of auditor bias (see paragraph 30). The IAESB will determine what actions are necessary at its November 2016 meeting, taking into account the recommendations from its Task Force as well as the PSWG. As such, this paper does not go into detail as to the "Specific Matters that Could Be Addressed by the IAESB," beyond what is described in the preliminary recommendations in paragraph 21.

B. Preliminary Recommendations of the PSWG to the SSBs

20. The PSWG has undertaken a detailed review of the feedback to the IAASB's ITC and has sought to consider the best way forward for each of the SSBs in the public interest, not only individually but in a coordinated joint approach. The PSWG has kept the following principles in mind when formulating these recommendations:

- Work on the topic of professional skepticism is needed both in the short term – to improve audit quality and meet expectations in relation to an appropriate IAASB response to the ITC feedback – as well as in the longer term to explore whether a more fundamental shift is needed in terms of what is expected of auditors (and potentially professional accountants more broadly).
- Stakeholders responding to the various consultations have highlighted their expectations regarding coordination among the three SSBs on key concepts. Each SSB has its own strategy and work plan, and must carefully consider the best use of its limited resources across all its priorities. Nonetheless, it is important for each Board to understand the potential direction it might take as well as the implications of its actions on the other SSBs.
- The need for coordination will increase as individual Boards move towards key milestones – for example, issuance of exposure drafts or finalization of standards and pronouncements. The PSWG has a central role to play in this regard.

21. The PSWG's preliminary recommendations are as follows, with the basis for these recommendations described further in Section C and further illustrated in **Agenda Item J3-B**.

Board	Relevant Action	Further Details
All 3 SSBs	<ol style="list-style-type: none"> 1. Using the PSWG as the mechanism to do so, jointly explore: <ol style="list-style-type: none"> (a) In the longer term, whether it may be appropriate to extend the concept of professional skepticism beyond audit and assurance engagements (e.g., beyond how it is currently defined in the ISAs). (b) In the longer term, whether a common description explaining the interrelationships among key concepts in the SSB's standards and the IESBA Code should be developed and, if so, how this description could be articulated. (c) The potential standard-setting implications of (a) and (b), including providing views about whether this might result in changes to the SSBs' standards and the IESBA Code or whether a common description of professional skepticism could be promulgated in another way. (d) In the longer term, whether a fundamental change to the concept of professional skepticism is needed. 2. Continue to engage the PSWG to act as a central point for discussion of these and other issues as and when needed in relation to the discussions of the individual SSBs on matters that require coordination. 	Sections E, F and G Note: The PSWG would like to hear feedback at the SSBs' September Board and CAG meetings, to inform its consideration and timing of these issues.
IAASB	<ol style="list-style-type: none"> 1. Strengthen requirements and guidance in key standards currently under revision to emphasize the importance of the application of professional skepticism and set forth expectations about how professional skepticism is expected to be applied (e.g., accounting estimates / ISA 540,²¹ risk assessment / ISA 315 (Revised), quality control (firm level) / ISQC 1,²² quality control (engagement level) / ISA 220,²³ group audits / ISA 600²⁴). 2. Explicitly address impediments to professional skepticism where possible in current projects (e.g., in relation to 	Section D

²¹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

²² ISQC 1, *Quality Control for Firms That Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

²³ ISA 220, *Quality Control for an Audit of Financial Statements*

²⁴ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

Board	Relevant Action	Further Details
	<p>quality control using the quality management approach (QMA)).</p> <ol style="list-style-type: none"> <li data-bbox="418 275 1159 600">3. Commence information gathering and initial IAASB discussions on the topics of evidence and documentation, focusing on elaborating what the phrase “a critical assessment of evidence” in the definition of professional skepticism entails (e.g., by seeking to enhance ISA 500²⁵ and other ISAs) and reconsidering requirements related to the auditor’s documentation in accordance with ISA 230,²⁶ particularly in relation to significant professional judgments made in planning and performing the audit. <li data-bbox="418 617 1159 827">4. Provide feedback on the potential implications of the IESBA’s efforts to articulate the relationship between professional skepticism and the fundamental principles in the IESBA Code (as well as independence), in particular how this might affect both assurance engagements and other services. <li data-bbox="418 844 1159 1054">5. Provide input to the PSWG’s consideration of the applicability of the concept of professional skepticism beyond audit and assurance engagements and the common description of professional skepticism, and consider whether further changes are needed to ISA 200²⁷ or other IAASB International Standards. 	
IESBA	<ol style="list-style-type: none"> <li data-bbox="418 1083 1159 1293">1. Continue discussions on the relationship between professional skepticism and the fundamental principles in the IESBA Code (as well as independence) and consider how this relationship should be addressed within the IESBA Code (e.g., in upcoming exposure drafts or with a longer-term view). <li data-bbox="418 1310 1159 1415">2. Explicitly address impediments to professional skepticism where possible in current and potential projects (e.g., safeguards, fees, etc.) <li data-bbox="418 1432 1159 1642">3. Provide input to the PSWG’s consideration of the applicability of the concept of professional skepticism beyond audit and assurance engagements and the common description of professional skepticism, and consider whether further changes are needed to the IESBA Code. 	Section E

²⁵ ISA 500, *Audit Evidence*

²⁶ ISA 230, *Audit Documentation*

²⁷ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

Board	Relevant Action	Further Details
IAESB	<ol style="list-style-type: none"> 1. In view of the analysis of the drivers and impediments to professional skepticism, determine what future actions might be most useful to further develop professional competence (e.g., an emphasis on training, education and mentoring). 2. Provide feedback on the potential implications of the IESBA's efforts to articulate the relationship between professional skepticism and the fundamental principles in the IESBA Code (as well as independence). 3. Provide input to the PSWG's consideration of the applicability of the concept of professional skepticism beyond audit and assurance engagements and the common description of professional skepticism, and consider whether further changes are needed to the IESs. 	To be further considered by the IAESB Professional Skepticism Task Force; Report back to IAASB and IESBA at their December meetings

22. Further details on the way forward for the SSBs and the PSWG, including timelines related to these efforts, are described in more detail in Section I of this paper.

C. Basis for the PSWG's Preliminary Recommendations

A Focus on Drivers and Impediments

23. The ITC explored the drivers for, and impediments to, the appropriate application of professional skepticism. Respondents believed that many different stakeholders have a role to play in mitigating the impediments and enhancing the drivers, and that action by the three SSBs, as well as accounting firms and professional bodies, was likely to be necessary to enhance the application of professional skepticism. It was mostly agreed that the impediments identified by the IAASB in the ITC were appropriate, and some additional impediments, for example fee pressures for accounting firms, performance metrics that do not appropriately encourage professional skepticism, resource constraints, and auditor competencies, were identified. In particular, many respondents acknowledge the significance of auditor biases (cognitive) as an important impediment to applying professional skepticism.
24. Respondents to the ITC noted that drivers and impediments to the application of professional skepticism were suggested at four levels: individual (as a staff and as a partner), engagement, firm and profession. Accordingly, suggested actions to address the application of professional skepticism must match the appropriate level of impact with the impediments they are designed to address in order to be effective. For example, proposed solutions targeted at the profession (such as mandatory firm rotation) may not effectively or completely address the impediments at the individual auditor level (such as personal traits or biases).
25. The PSWG also noted that the various impediments identified by respondents were closely linked to the fundamental principles in the IESBA Code, most notably objectivity, as well as to the concept of independence. The PSWG concurs with the view noted in paragraph 6 that inspection findings attributed to a lack of professional skepticism may actually be a result of inappropriate application of the IESBA Code, but noted the fundamental principles are not covered in significant detail in the IAASB's or IAESB's standards. In this regard, the PSWG questions whether enhancements to the IAASB's standards or accounting firms' methodologies to more specifically address compliance with

the IESBA Code (or applicable relevant ethical requirements more generally) could help to improve the application of professional skepticism by reinforcing the importance of those fundamental principles and independence.

26. For reference, **Agenda Item J3-B** provides greater analysis in support of the PSWG's analysis, highlighting actions respondents suggested that could potentially mitigate some of the impediments—actions not only for the SSBs but also actions by other stakeholders in the financial reporting supply chain. The PSWG's views on the most significant impediments, and who may be best placed to address them, are set out below.

Auditor Bias (Individual Level)

27. Auditor bias was explicitly referenced by various respondents as an important impediment to applying professional skepticism²⁸ – in line with views that suggest that the application of professional skepticism is a behavioral trait that needs to be nurtured and reinforced. Academic research has characterized four common judgment biases as affecting an auditor's ability to properly apply professional skepticism in an audit of financial statements. These judgment biases include:

- Confirmation bias: the tendency to put more weight on information that is consistent with one's initial beliefs or preferences. When collecting information (particularly once a preliminary view is developed), an auditor may unwittingly put more weight on information or evidence that supports an initial preference or expectation. As a result, the auditor may rely unconsciously on evidence that is biased toward his or her expected or preferred alternative, rather than objectively evaluating the facts as they exist. An auditor may not adequately consider potentially contradictory information that could result in a valid alternative to a preliminary conclusion;
- Availability bias: the tendency for an auditor to consider information that is easily retrievable (e.g., a vivid or recent memory) as being more likely, more relevant, and more important for a judgment. In other words, the information that is most available to an auditor's memory may unduly influence estimates, probability assessments, and other professional judgments. Like other mental shortcuts, the availability tendency can serve an auditor well, but it can also introduce bias;
- Anchoring bias: the tendency to make assessments by starting from an initial numerical value and then adjusting insufficiently away from that initial value in forming a final judgment. The potential tendency may be exhibited when an auditor places too much reliance on one piece of information or set of circumstances. For example, an auditor may be anchored to management's unaudited, current period amounts, or other initial estimates, and an auditor may not sufficiently adjust from them. In such case, anchoring may lead an auditor to biased expectations compared to what an auditor might develop in the absence of management's amounts;
- Overconfidence bias: the tendency to overestimate one's ability to perform tasks or to make accurate assessments of risks or other judgments and decisions. This may be a prevalent subconscious tendency that results from personal motivation or self-interest. The potential tendency to be more confident than is justified may affect an auditor even when he or she is

²⁸ Investors: CFA Institute; NSS: AUASB, CAASB, JICPA, NZuASB; Accounting Firms: EYG, GTI, PwC; Member Bodies and Other Professional Organizations: ACCA, AICPA, CAANZ, CAQ, CPAA, ICAP, MAASB, SAICA; Academics: AAA, AH, Glover-Prawitt; Individuals and Others: CBernard

doing his best to be objective. In some instances, overconfidence can lead to an inability to recognize alternative points of view or contradictory evidence. In addition, overconfidence can affect an auditor's willingness to involve others who could provide meaningful perspective to the analysis. Overconfidence can be caused by a number of factors, including when an auditor has a large amount of information at his or her disposal, even if it is of low quality or redundant. In some instances, when the process to reach a decision is difficult, confidence can give an auditor a false sense of security regarding the quality of his or her judgment.

28. The PSWG was urged to continue to try to obtain insight as to how these individual auditor behaviors, inherent conscious and unconscious biases, impact the application of professional skepticism to enable the SSBs to understand how to better promote consistent application of professional skepticism.
29. It was suggested by respondents that specific inclusion of the auditor biases in the definition of professional skepticism may be one way to make auditors more aware of this impediment. The PSWG was of the view that further emphasis within the IAASB's quality control standards about these impediments and ways to mitigate them (e.g., through strong tone at the top, training and mentoring, and root cause analysis to explore instances when professional skepticism was not appropriately applied) would be more beneficial than simply making a change to the definition. It was also suggested that explicitly alerting the auditor to instances where auditor biases may be greater (e.g., areas involving greater judgment) could help to remind the auditor of their responsibility to obtain sufficient appropriate audit evidence, with consideration given to enhancing ISA 500 to help auditors better evaluate the sufficiency and appropriateness of the evidence obtained. In addition, the relationship with objectivity and independence was highlighted – suggesting a role for the IESBA to play in its Long Association and Structures projects.
30. Linked to the concept of auditor bias was the view that personality traits become important. Some respondents highlighted the importance of auditors objectively considering issues from different perspectives (including that of the user). Core personality traits could also be explored by accounting firms in their screening and recruitment processes. Others were of a view that achieving better alertness by the auditor and reducing the risks of auditor bias cannot be solved by changes to the standards alone (in particular the ISAs and IESs) and therefore other actions would be essential—for example, universities, member bodies and accounting firms fostering “moral courage” through training, education and mentioning. To help address this matter, the IAESB Professional Skepticism Task Force is discussing the opportunity to create a separate behavioral competence category in the IESs and to explain how it interacts with other competence categories to enable a professional accountant's role. The discussion includes the possibility of providing a description as to how professional accountants can acquire and maintain relevant behavioral competence.

Creating a Culture of Quality, Including Rewards Emphasizing Professional Skepticism (Firm and Engagement Levels)

31. Various suggestions, including from MG members and accounting firms, were made about how accounting firms in particular could drive greater application of professional skepticism. For example:
- Setting performance and compensation metrics that reward auditors for high-quality work, with incentives that are focused on appropriate judgment and audit quality, could help in increasing the application of professional skepticism.²⁹
 - There was a focus on the firm's responsibility to create a firm culture³⁰ that encouraged professional skepticism, including appropriate "tone at the top."³¹
 - Accounting firms were encouraged to promote the status of the audit within the firm so that it is not seen as a commodity.³²

A number of these topics were highlighted in the ITC as possible areas for improvement to the IAASB's quality control standards.

Payor Model, Fees from Non-Audit Services and Fee Pressures (Profession, Firm and Engagement Level)

32. A number of respondents, including MG members and other regulators and audit oversight authorities, cited the payor model,³³ fees from non-audit services,³⁴ and fee pressures³⁵ as an impediment to the appropriate application of professional skepticism. Concerns related to fee pressures on continuing engagements or re-proposal situations. For example, the economic pressure to keep the cost of the audit low can discourage the application of professional skepticism that might lead to increased audit work, without certainty of identifying a misstatement.³⁶ Fear of audit tendering, in particular for large clients that represent significant revenue for the audit firm,³⁷ was also explicitly highlighted.
33. A few respondents,³⁸ including one from the a MG member, cited the view that assurance practices may be pressured to keep pace with growth of non-audit services and may accept riskier assurance engagements, and that accounting firms may not be sufficiently investing leadership resources in assurance practices to monitor quality. Further, the MG member expressed a view that accounting

²⁹ Monitoring Group: IAIS; Investors: IA; Accounting Firms: KPMG, Member Bodies and Other Professional Organizations: CAQ, AICPA, CAANZ, ICAP, SMPC

³⁰ Member Bodies and Other Professional Organizations: CAANZ, CAQ, ICAEW, ICAP, SAICA, SMPC; Accounting Firms: CIIPA, EYG, GTI, IBRACON, INCPC, KPMG

³¹ NSS: CAASB, MAASB, NZAuASB; Accounting Firms: DTT, EYG, PwC; Member Bodies and Other Professional Organizations: AIC, CIIPA, ICAP, ISCA, SMPC

³² Accounting Firms: CHI

³³ Investors: CalPERS; Member Bodies and Other Professional Organizations: CAANZ, JICPA, NZAuASB

³⁴ Monitoring Group: IAIS; Investors: IA; Academics: TRay

³⁵ Monitoring Group: IAIS; Investors: CalPERS; Regulators and Audit Oversight Authorities: H3C; NSS: CAASB, CNCC-CSOEC; Preparers: PAIB; Member Bodies and Other Professional Organizations: CPAA, EFAA, ICAEW, ICAS, SAICA; Public Sector: AIC, AGSA; Individuals: JGrant

³⁶ Monitoring Group: IAIS

³⁷ NSS: CAASB; Academics: Tray; Accounting Firms: GTI

³⁸ Monitoring Group: IAIS; Investors: IA; Academics: TRay

firm leaders and audit partners may focus greater attention and more experienced resources to the advisory line of business rather than the assurance practice, despite the possible need for greater involvement and supervision by experienced auditors in the assurance practice given the growing complexity of audits and the judgment areas involved.³⁹

34. The payor model was highlighted as being particularly relevant to the public sector, with both the potential benefits and drawbacks from a parliamentary (versus client) funded model.⁴⁰
35. It was noted that, in addition to fee pressures, accounting firms also experience pressures to provide unqualified audit opinions for fear of upsetting the client otherwise.⁴¹ This impediment can be linked to the fundamental principles of integrity and professional behavior, which require the auditor (i) not to knowingly be associated with reports where the accountant believes the information is materially false or misleading and (ii) to avoid any action that the professional accountant knows or should know may discredit the profession. It was noted that compliance with the IESBA Code is critical to the exercise of professional skepticism in this respect.
36. From an ethics perspective, a relationship exists between these impediments and more general concerns over familiarity threats, and long-standing relationships with clients, and other threats to objectivity and independence. In this regard, the PSWG notes the interactions with a number of current IESBA initiatives, in particular the Long Association project⁴² and IESBA's Fee Working Group (IESBA WG) information-gathering initiative.⁴³
37. Also highlighted was the potential to alleviate these impediments by having strong (and competent) audit committees who ask the appropriate questions of management and challenge the auditor to prove how they have exercised professional skepticism. In addition, there is also a role for accounting firms in terms of setting an appropriate culture with respect to non-audit services (including having appropriate policies and procedures that do not reward selling of non-audit services at the expense of audit quality.)

Environmental Factors (Firm, Engagement and Individual Levels)

38. In addition to auditor biases, respondents identified certain environmental factors that can impede the auditor's ability to exercise professional skepticism – negatively affecting the auditor's ability to make sound professional judgments, for example:

³⁹ Monitoring Group: IAIS

⁴⁰ Public Sector: AGC

⁴¹ Monitoring Group: IAIS; NSS: NZAuASB; Academics: TRay

⁴² The objective of the IESBA's Long Association project is to review the long association provisions in the extant IESBA Code to ensure that they continue to provide robust and appropriate safeguards against the familiarity and self-interest threats arising from long association with an audit client. At its June 2016 meeting, the IESBA considered significant comments received on its February 2016 Exposure Draft, *Limited Re-exposure of Proposed Changes to the Code Addressing the Long Association of Personnel with an Audit Client* and related Task Force proposals. At its September 2016 meeting, the IESBA plans to consider a revised draft of those proposals with a view to finalizing them under the extant structure and drafting conventions of the IESBA Code. At that meeting, the IESBA will also consider a draft of the restructured text of the revised proposals (i.e., prepared in accordance with the new structure and format for the IESBA Code).

⁴³ The objective of this IESBA WG is to undertake fact-finding about fees charged by firms in various jurisdictions to identify whether there are trends or other factors that indicate a relationship between fees and threats to auditor independence and compliance with the fundamental principles, including objectivity and professional competence and due care, or whether there are reasonable perceptions that such threats exist, and how they might be addressed. The IESBA is planning to consider a report of this fact-finding at its December 2016 meeting.

- Herding and “Groupthink”: the inclination for teams to conform to a consensus decision without critical evaluation, inhibiting audit team members from voicing skeptical opinions that may challenge a senior team member.
 - Tight reporting deadlines: there may be a limited amount of time in which to complete the audit procedures due to either tight deadlines and/or budgetary constraints.
 - Resource constraints and high staff turnover: leading to engagements that may not be properly resourced with the necessary experience and expertise (including the use of auditor’s experts in accordance with ISA 620)⁴⁴ to enable the auditor to appropriately understand the business and effectively challenge management.
 - Risk of priming: whereby environmental cues may influence certain types of behavior (for example if certain language used in standards “promotes” actions that do not support appropriate skepticism).
39. A number of these areas can be addressed in the IAASB’s quality control project, in particular by explicitly noting that a lack of appropriate application of professional skepticism is a “risk to quality” and setting out an approach whereby accounting firms are expected to adequately manage this risk. For example, accounting firms are in the best position to ensure effective resource planning and develop appropriate contingency plans for unexpected delays or changes in the engagement as part of a QMA. At the engagement level, the PSWG believes more can be done to promote team discussions in key areas to encourage a culture of awareness and challenge about significant management judgment and a “stand back” to consider those judgments (and the auditor’s response to them) as a whole.
40. Concerns were raised by some respondents on overreliance on IT processes and use of automated checklists by auditors, with a view that the use of these tools may actually inhibit the exercise of professional skepticism by stifling auditors’ critical thinking and the ability to “read people.”⁴⁵ It was suggested that the IAASB’s Data Analytics Working Group could consider the effect of these automated processes on the exercise of professional skepticism and ways that the use of technology may affect the application of professional skepticism.

D. Specific Matters that Could Be Addressed by the IAASB

41. As highlighted in the ITC, respondents agreed there is a role for the IAASB to play to enhance the application of professional skepticism within audits. Many respondents highlighted the ongoing work in relation to revisions to ISA 540 to encourage auditors dealing with complex accounting estimates to take a more proactive, challenging approach in relation to management’s judgments. For example, a MG member specifically urged the IAASB to consider whether changes in the standards could focus on “challenging management’s reasoning or sources” rather than “corroborating evidence,” in order to shift the auditor’s mindset from one of an accepting attitude to one that is more skeptical.⁴⁶
42. The extant definition of professional skepticism allows for guidance on the application of professional skepticism to be included within the individual standards and appropriately applied based on the associated risks being addressed. Respondents to the ITC therefore urged the IAASB to do more

⁴⁴ ISA 620, *Using the Work of an Auditor’s Expert*

⁴⁵ Monitoring Group: IAIS; NSS: NZAuASB; Accounting Firms: GTI

⁴⁶ Monitoring Group: IOSCO

within the ISAs to demonstrate how the existing concept of professional skepticism within the ISAs is intended to be applied, for example through:

- Clarification of what is meant by a “questioning mind,” including:
 - Setting out expectations as to when to seek evidence that does not support management’s assertions.⁴⁷
 - Describing the links between professional skepticism, audit risk, professional judgment, action, and audit evidence.⁴⁸
 - Providing practical application examples, scenarios, and case studies to bring the definition of professional skepticism to life,⁴⁹ and further highlighting what behaviors, actions, and documentation constitute exercising appropriate professional skepticism in executing an auditor’s responsibility to obtain sufficient appropriate audit evidence across a range of risk scenarios for different assertions and accounts.⁵⁰
 - Explaining how to appropriately document the judgments and actions.
- Clarification of the context-specificity of professional skepticism, that is, what the implications of the appropriate exercise of professional skepticism in different risk settings are, including that:
 - Professional skepticism applies throughout the audit process.⁵¹
 - The joint applications of professional skepticism, judgment, risk assessment, and evidence evaluation involve an ongoing and iterative process until sufficient appropriate audit evidence has been obtained and documented.⁵²

There was also support for clarifying the relationship between professional skepticism and professional judgment.⁵³

43. It was mentioned that auditors should apply a user perspective in exercising professional skepticism.⁵⁴ One regulator suggested a more fundamental change to embed a user perspective into the auditor’s decision making. This would include the IAASB giving consideration to how to require auditors to be able to demonstrate that they have adequately taken into account what users would expect them to ask, what matters users would expect them to challenge, how far users would expect them to go in challenging those matters, and ultimately what evidence users would expect them to obtain to satisfy those challenges.⁵⁵

⁴⁷ NSS: AUASB, BDO, CAANZ, CAQ, FEE

⁴⁸ Investors: IA, ICGN; Accounting Firms: BDO, DTT, EYG, PwC; Member Bodies and Other Professional Organizations: CAANZ, CAQ, ICAS, SAICA

⁴⁹ Preparers: PAIB

⁵⁰ Member Bodies and Other Professional Organizations: CAQ

⁵¹ Monitoring Group: IAIS, IFIAR, IOSCO; Investors: CFA; Regulators and Audit Oversight Authorities: EBA, UKFRC; NSS: CAASB

⁵² Member Bodies and Other Professional Organizations: AICPA; Academics: Glover-Prawitt

⁵³ Regulators and Audit Oversight Authorities: IRBA

⁵⁴ Investors: CalSTRS; Regulators and Audit Oversight Authorities: UKFRC; Member Bodies and Other Professional Organizations: AAT, JICPA

⁵⁵ Regulators and Audit Oversight Authorities: UKFRC

44. Respondents who called for clarification of the behaviors that are expected from auditors in exercising professional skepticism suggested that the standards could benefit from additional application guidance in the following areas of importance where auditor judgment is required to be applied, for example:
- Identifying bias;⁵⁶
 - What constitutes sufficient challenge;⁵⁷
 - How to make a judgment on sufficient appropriate evidence;⁵⁸ and
 - How to document in such a way that the application of professional skepticism can be evidenced.⁵⁹ For example, in areas of accounting estimates with high estimation uncertainty this may include considering a number of different scenarios and documenting why management's decision is appropriate.⁶⁰

Interaction with Current IAASB Projects

45. The PSWG is open to a longer-term discussion to consider whether a more fundamental change to the concept of professional skepticism is needed (see discussion in Section F below). However, from a public interest perspective, it is important that the IAASB be clear what is expected from auditors in light of the definition today, and that actions be taken in the shorter term to enhance the focus on professional skepticism as key IAASB International Standards are being revised. A number of respondents to the ITC specifically supported the IAASB doing so as a means of improving practice in relation to particularly subjective and highly judgmental audit areas.
46. Accordingly, the PSWG believes the topic of professional skepticism should be a specific focus in a number of current IAASB workstreams as they move forward, with a focus on strengthening requirements in relation to auditor judgment and providing additional guidance as to how professional skepticism could be demonstrated in particular circumstances throughout the audit, including:
- Quality control (at both the firm and engagement level), with a focus on risks to quality (including auditor bias); establishing an appropriate culture whereby professional skepticism is encouraged and rewarded; and appropriately staffing engagements with the requisite experience and expertise.
 - Risk assessment (ISA 315 (Revised)), with a focus on the need for sufficient understanding of the entity to be in a position to challenge management, and an awareness of management's incentives and biases that may affect the risks of material misstatement or the possibility of fraud. Within this project, the IAASB could also clarify the relationship between professional skepticism and professional judgment, including the relationship between the auditor's judgments about risks of material misstatements and consideration of appropriate responses to those risks (e.g., the importance of applying professional skepticism when dealing with higher risks of material misstatement) (see paragraphs 78–80 and 98–100 in Section F).

⁵⁶ Investors: IA; Accounting Firms: GTI, PwC; Member Bodies and Other Professional Organizations: ICAP, SMPC

⁵⁷ Investors: IA; Accounting Firms: PwC; Member Bodies and Other Professional Organizations: ACCA, AICPA, CAI, SMPC

⁵⁸ Investors: IA; Accounting Firms: KPMG, PwC; Member Bodies and Other Professional Organizations: ACCA, AICPA, CAANZ, CAI, CAQ, SAICA, SMPC

⁵⁹ Investors: IA; Accounting Firms: PwC; Member Bodies and Other Professional Organizations: ACCA, AICPA, CAANZ, CAI, ICAS, FSR, SAICA; Preparers: PAIB

⁶⁰ Member Bodies and Other Professional Organizations: SMPC

- Group audits, with a focus on impediments to professional skepticism that may arise when using others to support a group audit engagement (e.g., the effects of culture, dealing with accounting firms outside of the network).
 - ISA 540, with a focus on suggesting that auditors take a challenging mindset as it relates to accounting estimates that involve greater management judgment and where there is an increased risk of unintentional and intentional management bias. In addition, work in relation to ISA 540 could highlight the need to consider the effect of contradictory audit evidence that comes to the auditor's attention, rather than an approach overly focused on corroboration (see also paragraph 41).
47. As respondents cautioned against requirements resulting in a compliance ("tick box") mind-set (which will deflect from the focus on applying professional skepticism),⁶¹ the IAASB will need to carefully consider how best to explain its expectations in relation to professional skepticism within the standards – notably focusing on highlighting what the IAASB believes are likely to be the significant judgments in relation to key audit areas and what is expected in relation to them (e.g., factors that are required to be considered, and actions that may be appropriate in the circumstances). The matters highlighted by respondents (as described in Section F will be an important part of this consideration.

Matters Relevant to ISA 540

48. Respondents to the ITC highlighted the IAASB's ongoing work to enhance ISA 540 as an opportunity to "raise the bar" in relation to professional skepticism. For example, IFIAR noted the importance of professional skepticism when auditors are considering accounting estimates involving a high level of management judgment, as these estimates are at an increased risk of unintentional or intentional management bias. IFIAR supported the IAASB in investigating further how ISA 540 can be strengthened to improve the focus on auditors approaching accounting estimates with a questioning mindset and highlight the need to consider the effect of contradictory audit evidence that comes to the auditor's attention, rather than an approach overly focused on corroboration.
49. During the June 2016 IAASB Board Meeting, the PSWG IAASB Subgroup (Subgroup) met with the ISA 540 Task Force (ISA 540 TF) and the ISA 315 (Revised) Working Group to discuss issues related to ISA 540 that require additional analysis and consideration by the PSWG IAASB Subgroup. The following issues were noted during the meeting:
- The concept of management bias, including whether it is better located in ISA 540 or elsewhere and whether it is appropriately defined (see paragraph 7 of ISA 540).
 - The possibility of including the concept of "auditor bias" in the ISAs.
 - Whether the auditor should have a "neutral mindset" or a more skeptical mindset.
 - Whether there might be alternative approaches to the requirements relating to discussion among engagement team members, for example, in circumstances when there is a small engagement team or when dealing with entities with only simple accounting estimates.
 - Whether the use of the phrase "the auditor shall challenge..." versus "the auditor shall question..." in specific requirements would result in differences in what would be expected to be documented.

⁶¹ Member Bodies and Other Professional Organizations: CAANZ, SAICA, SMPC

50. On a preliminary basis, the Subgroup has considered matters raised in connection with the discussions on ISA 540 and offers the following views for the IAASB's further consideration:
- Management Bias – While noting the placement in ISA 540 due to its particular relevance, the Subgroup believes that the concept of management bias could also be addressed earlier within the ISAs as part of the project to revise ISA 315 (Revised). While ISA 315 (Revised) already addresses management's incentives, it might be helpful to explicitly require the auditor to be alert for management bias, by highlighting the risk indicators of possible management bias as identified in paragraph A128 of ISA 540. Doing so would highlight that the concept of management bias applies more generally throughout the entire audit.
 - Auditor Bias – As noted in paragraphs 27–30, auditor bias can be a significant impediment to the effective application of professional skepticism throughout the audit. The Subgroup recommends that the concept of auditor bias, due to its strong linkage to the fundamental principle of objectivity in the IESBA Code, should be included within the ISAs and ISQC 1, and specifically considered during the quality control project.
 - Change in Mindset – The potential shift from the current neutral mindset to one that is more challenging or skeptical when applying professional skepticism was a key theme mentioned by respondents to the ITC. The Subgroup notes that this shift in mindset requires a more robust consideration of the impact of such a shift (see paragraphs 76–81 and 91–94 Section F).
 - Engagement Team Discussions – The Subgroup is of the view that there is a need for discussion of the susceptibility of the entity's financial statements to material misstatements, regardless of the size of the engagement team, since objectivity could be impaired. In particular, the Subgroup believes that auditor bias due to previous years' experience or familiarity with the entity should be given more prominence in the required engagement team discussion within paragraph 10 of ISA 315 (Revised). Respondents to the ITC suggested that one way to improve the engagement team discussion required by ISA 315 (Revised) would be through requirements to evidence substantive discussions, for example, between the engagement partner and EQC reviewer.
 - Documentation – The Subgroup has not concluded on whether a change in terminology would necessarily lead to a change in what would be documented in the audit file. As there continue to be questions about whether the application of professional skepticism is appropriately documented, in particular when the auditor is dealing with inconsistent or contradictory evidence, further IAASB discussion on this matter will be necessary in due course (see paragraphs 51–54).

Enhanced Focus on Evidence and Documentation

51. Respondents, including IFIAR, also suggested the need for the IAASB to consider standards outside the current projects, since the exercise of professional skepticism needs also to be addressed more explicitly in relation to evidence, documentation and ISA 620.⁶² IFIAR also noted the need to consider enhancing professional skepticism in relation to ISA 520,⁶³ in particular substantive analytical procedures and analytical procedures near the end of the audit, and ISA 320⁶⁴ and ISA 450⁶⁵ – when

⁶² ISA 620, *Using the Work of An Auditor's Expert*

⁶³ ISA 520, *Analytical Procedures*

⁶⁴ ISA 320, *Materiality in Planning and Performing an Audit*

⁶⁵ ISA 450, *Evaluation of Misstatements Identified during the Audit*

applying the concept of materiality in both planning and performing the audit, and in evaluating the effect of identified misstatements (including any uncorrected misstatements).

52. The IAASB's work to date on ISA 540 and preliminary discussions in relation to data analytics supports the view that a more holistic focus on evidence and documentation is necessary at this time. Accordingly, the PSWG recommends that the IAASB commence with information gathering and initial discussions on the topics of evidence and documentation. This work should focus on elaborating what the phrase "a critical assessment of evidence" in the definition of professional skepticism entails (e.g., by seeking to enhance ISA 500 and other ISAs) and reconsidering requirements related to the auditor's documentation in accordance with ISA 230, in particular in relation to significant professional judgments made in planning and performing the audit.
53. The PSWG believes that undertaking this work is in the public interest as it provides an opportunity for the IAASB to more fully consider how auditors can demonstrate the appropriate application of professional skepticism – not only in their approach to obtaining evidence, but also how the significant auditor judgments are expected to be documented. In connection with this project, the IAASB can also consider whether amendments to ISA 200 (including the definition of professional skepticism) may be necessary to further highlight the IAASB's views on the relationships between professional skepticism, professional judgment and action (i.e., the graphic included in the ITC).
54. Within this new initiative, the IAASB can begin to explore in a longer-term project the more fundamental questions that have been raised about professional skepticism and audit evidence, including a potential shift from a "questioning mind" to a "challenging mind," and also explore the implications of such a shift. However, the varying views expressed in response to the ITC suggest the IAASB will need to undertake careful study of the public interest considerations underlying the calls to action. See further discussion in Section F of this paper.

Consideration of the Need for a Professional Judgment or Professional Skepticism Framework

55. One of the areas mentioned in the ITC of being explored by the PSWG was whether a professional skepticism framework or a professional judgment framework that focuses on professional skepticism (a topic already explored by some accounting firms) should be developed. There were mixed messages on developing a professional skepticism or professional judgment framework.
56. Those that supported such a professional skepticism framework⁶⁶ noted that this can help overcome unconscious and cultural biases or support the application of professional skepticism. Others supported a professional judgment framework that could provide scenarios to demonstrate how a conclusion was reached and provides auditors with a helpful framework, which includes discussion of judgment traps and biases.⁶⁷
57. Suggestions were made that this could be a framework similar to the IAASB's *Framework for Audit Quality*, showing interactions between drivers and impediments and allowing for the inclusion of

⁶⁶ NSS: AUASB; Accounting Firms: EYG; Public Sector: AGSA; Member Bodies and Other Professional Organizations: AICPA, ICPAU, IRE-IBR; Academics: AAA

⁶⁷ Investors: CFA; Accounting Firms: BDO, KPMG; Public Sector: AGSA; Member Bodies and Other Professional Organizations: AICPA, IRE-IBR

practical illustrations and examples of how to document professional skepticism.⁶⁸ Others referred to including the framework as an authoritative part of the IAASB's International Standards.⁶⁹

58. There were also respondents who cautioned against developing a framework:
- The priority should be to improve and clarify the ISAs, and not to develop a framework (with a suggestion that the *Framework for Audit Quality* could be updated to include parts relevant to professional skepticism if necessary).⁷⁰ In addition, the IAASB could consider promoting one of the existing professional judgment frameworks rather than developing additional material.⁷¹
 - A framework suggests a checklist approach, which runs contrary to encouraging a challenging mindset and the exercise of appropriate professional judgment. As an alternative, guidance on how to document professional skepticism can be considered, which may address the concerns of some regulators.⁷²
 - It is too soon to develop a framework, since first a degree of understanding needs to be developed about the issue and therefore at this stage it is better to develop principles on how to take professional skepticism into account.⁷³
59. Although a professional skepticism or professional judgment framework could support structuring judgments and make the auditor more alert of the auditor's biases, the PSWG considered the concerns raised and the public interest and agrees the IAASB's focus should be on enhancing the ISAs and ISQC 1 at this time as the most impactful way of influencing auditor behavior, along with other potential actions by the SSBs and others (as described in Sections E, H, and I).

Linkage with SSB Discussions on the Possibility of Extending the Concept of Professional Skepticism beyond Audit and Assurance Engagements and Exploring a Common Description of Professional Skepticism

60. The IAASB's work on the topics explained in this section will inform its input into the PSWG's broader longer-term consideration of whether there is need for a new concept of professional skepticism. It is envisaged that the IAASB will be able to "raise the bar" in relation to professional skepticism through its current standard-setting agenda, as this is an important area of public interest. At the same time, the planned discussions about the potential need for a change to the concept of professional skepticism, and the further actions that might be taken by the IESBA and IAESB, may result in a need for the IAASB to revisit the definition of professional skepticism in ISA 200 in the future or make further enhancements to its standards to set out expectations regarding the application of professional skepticism. For example, the IAASB will need to carefully consider the implications of the IESBA's initial efforts aimed at exploring how to describe the relationship between the concept of professional skepticism and the fundamental principles and the PSWG's consideration of whether the concept of professional skepticism should be extended beyond audit and assurance engagements (see Sections E and G).

⁶⁸ NSS: AUASB

⁶⁹ Accounting Firms: EYG; Member Bodies and Other Professional Organizations: AICPA

⁷⁰ Public Sector: INTOSAI

⁷¹ Member Bodies and Other Professional Organizations: CAAZ

⁷² Member Bodies and Other Professional Organizations: EFAA, SMPC

⁷³ NSS: IDW

Matter for CAG Consideration

1. Do Representatives support the preliminary recommendations of the PSWG with respect to the IAASB described in paragraph 21, in relation to:
 - (i) A focus on professional skepticism in the current projects (see paragraphs 46, 50 and 87);
 - (ii) A new project related to evidence and documentation (see paragraphs 51–54); and
 - (iii) The need for IAASB involvement in longer-term considerations of the PSWG (see paragraph 60)?

If not, why not or what other activities do you believe are necessary by the IAASB in response to the feedback received to date?

E. Specific Matters that Could Be Addressed by the IESBA*Clarifying the Relationship between the Concept of Professional Skepticism and the Fundamental Principles*

61. Feedback to the ITC echoed the suggestions from the IESBA and IAASB CAGs to clarify the linkage between professional skepticism and the fundamental principles, in particular, integrity, objectivity, professional competence and due care, and professional behavior; as well as the concept of independence.⁷⁴ Respondents expressed the following varied views:
 - The fundamental principles support the exercise of professional skepticism.⁷⁵ One respondent suggested that the IESBA incorporate the concept of professional skepticism into the fundamental principles of integrity and professional behavior in the IESBA Code.⁷⁶
 - Threats to independence might also be threats to auditors' ability to exercise professional skepticism and that a skeptical mindset might safeguard against familiarity and self-interest threats to the fundamental principles, as well as independence.⁷⁷
 - Others note that the drivers and impediments to the application of professional skepticism are the same as the drivers and impediments to compliance with the fundamental principles and independence.⁷⁸
 - Consistent use of terminology across the ISAs, IESs and the IESBA Code would facilitate consistent understanding and application of professional skepticism.⁷⁹
62. The IESBA has not yet approved a professional skepticism project, nor has it made any decision about what, if any, additional material about professional skepticism should be included in the forthcoming exposure draft of Phase 2 of the re-structured IESBA Code (ED-2). As part of its ongoing

⁷⁴ Monitoring Group: BCBS, IOSCO; Regulators and Audit Oversight Authorities: H3C, UKFRC; NSS: AUASB, IDW, NZAuASB; Accounting Firms: BDO, DTT, EYF, GTI, PwC; Public Sector: AGSA; Member Bodies and Other Professional Organizations: CAANZ, CAQ, CPAA, DnR, FEE, ICAS, IDW, SAICA, SMPC, WPK

⁷⁵ Investors: CalSTRS, IA; NSS: IDW; Public Sector Organizations: AGSA

⁷⁶ Accounting Firms: PwC

⁷⁷ Monitoring Group: IAIS; Regulators and Audit Oversight Authorities: EBA

⁷⁸ Member Bodies and Other Professional Organizations: KICPA

⁷⁹ Monitoring Group: IAIS; Regulators and Audit Oversight Authorities: EBA

Structure of the Code project, the IESBA is considering if and how a description of the linkage between the fundamental principles and the concept of professional skepticism can potentially be included in the restructured IESBA Code.

63. IESBA Representatives on the PSWG have developed preliminary wording (referred to as a “straw man”) in **Agenda Item J3-C**.⁸⁰ The purpose of this preliminary wording is to solicit input from the CAGs and the SSBs about how to describe:
- The linkage between professional skepticism and the fundamental principles set out in the IESBA Code, as well as the concept of independence.
 - How, *when considering compliance with the IESBA Code* (and evaluating specific circumstances under the IESBA Code), professional accountants might be expected to apply professional skepticism and how this may be documented. This is because the ability to demonstrate the exercise of professional skepticism in the context of compliance with a professional accountant’s ethical responsibilities has been highlighted by regulators and audit oversight authorities as an area of concern. However, this relates to documentation in the context of decisions made in relation to the IESBA Code, not audit documentation in accordance with the ISAs.

This preliminary wording incorporates views from some respondents to the ITC about how to describe particular “components” of professional skepticism.

64. Any such efforts to articulate the relationship between the concept of professional skepticism and the fundamental principles will have implications for both the IESBA in the context of potential revisions to the IESBA Code and the IAASB, as the fundamental principles of the IESBA Code are highlighted within the ISAs and ISQC 1.⁸¹ In addition, as the fundamental principles apply to all professional accountants, not just those performing audits or assurance engagements, a broader discussion is occurring about extending the concept of professional skepticism (see Section G), notwithstanding the IESs already taking this position (see paragraph 16).
65. The PSWG has not yet had the opportunity to fully consider the preliminary wording, and acknowledges that its deliberations will be further informed by the discussions of the CAGs, the IAASB and the IESBA about the “Professional Skepticism ‘Straw Man’.”
66. The PSWG has agreed it will need to further consider whether:
- By referencing professional skepticism as a concept to one that assists professional accountants in complying with the fundamental principles, the preliminary wording would be viewed as extending the concept of professional skepticism to all professional accountants (versus those undertaking audit or assurance engagements) and, if so, what the implications may be on the IAASB’s International Standards (including on the definition of professional skepticism in ISA 200 and on standards for related services engagements, as well as on their respective work efforts).
 - Whether efforts to describe the relationship between the concept of professional skepticism and the fundamental principles suggest the need for a common description of the concept of professional skepticism to be developed.

⁸⁰ The preliminary wording is not written in the style of the IESBA Code (or IAASB or IAESB standards), as the aim of the draft is to consider the concepts first.

⁸¹ See ISQC1, paragraphs A7–A14, and ISA 200, paragraphs A14–A16.

67. The IAASB Representatives on the PSWG have noted that certain paragraphs within **Agenda Item J3-C** go beyond the intended purpose of the document, and are of the view that inclusion of those paragraphs within the IESBA Code should either be (i) deferred and explored as part of a longer-term project so as to incorporate the input from the IAASB and the IAESB or (ii) omitted because the current reference to the concept of professional skepticism in the extant IESBA Code⁸² is sufficient, and should be unchanged. These members are specifically concerned that statements within **Agenda Item J3-C** pre-empt a broader discussion about the applicability of the concept of professional skepticism to all professional accountants. In their view, a shift beyond the definition currently included in ISA 200 (which is intentionally linked to risks of material misstatement and evidence) would have implications for the IAASB's International Standards that address non-assurance engagements, within which the concept of professional skepticism is not explicitly referenced. In particular, they are concerned about inadvertent changes to the nature and extent of the work effort required for non-assurance engagements. The IAASB Representatives are also concerned with the possibility of the IESBA incorporating this language through the Structure of the Code project (see paragraph 68), because the impact of such changes would take place immediately without the thorough analysis and dialogue these members believe is needed to consider the implications of this language on the IAASB's International Standards that address non-assurance engagements. They are of the view that such changes, once having been made, are unlikely to be reversed. These Representatives believe the three SSBs and their respective CAGs do not have enough information to make an informed decision about these matters at this time, and that a more fulsome consideration is needed before any wording describing the relationship between professional skepticism and the fundamental principles can be incorporated into the IESBA Code.
68. IESBA Representatives on the PSWG are of the view that, if IESBA does make a decision to include additional wording to describe the linkage between the concept of professional skepticism and the fundamental principles in its proposed restructured IESBA Code (ED-2 planned for approval in December 2016), it will be a temporary step pending the considered outputs of the PSWG (and further consideration by each of the SSBs). If and when the IESBA undertakes a dedicated project on professional skepticism, any wording that may be included in the re-structured IESBA Code will need to be reconsidered.
69. Subject to the feedback from the CAGs, and the SSBs' discussions, the PSWG plans to resume its deliberations at its meeting in October 2016 and will refine its recommendations to the SSBs, in particular to IESBA, about next steps.

Other Potential Actions for Consideration by the IESBA

70. Other actions by the IESBA have been suggested including:
- Consideration of the role of "professional fortitude"⁸³ or "moral courage"⁸⁴ in applying professional skepticism.
 - Using the IESBA's fact-finding initiative with respect to fee-related matters to provide insights about the relationship between fees and compliance with the fundamental principle of

⁸² Extant Part B, Professional Accountants in Public Practice, Section 290, *Independence – Audit and Review Engagements*, paragraph 290.6 and Section 291, *Independence – Other Assurance Engagements*, paragraph 291.5.

⁸³ NSS: IDW

⁸⁴ Member Bodies and Other Professional Organizations: ICAS

professional competence and due care, which could explain some of the environmental factors that inhibit the auditor's application of professional skepticism.⁸⁵

Matters for CAG Consideration

2. Representatives are asked:
 - (i) Whether you support the preliminary recommendation for the IESBA to discuss the relationship between the fundamental principles in the IESBA Code (as well as independence) and professional skepticism and consider how this relationship should be addressed within the IESBA Code; or
 - (ii) Do you believe that further analysis and dialogue is needed to be able to reach an informed decision?; and
 - (iii) What other activities do you believe are necessary by the IESBA in response to the feedback received to date?
3. Representatives are asked to share their views on the preliminary wording included in **Agenda Item J3-C**, in particular:
 - (i) Whether the draft appropriately describes the linkage between the concept of professional skepticism and the fundamental principles of ethics set out in the IESBA Code;
 - (ii) Whether the draft captures all of the components of professional skepticism and, if it does not, what should be excluded or included; and
 - (iii) Whether there are any potential implications of wording of this nature on the IAASB's standards.

F. The Definition of Professional Skepticism, Including Consideration of the Potential Need for Fundamental Changes to the Concept

71. An issue in relation to professional skepticism that was addressed in the ITC was whether the respondents' interpretation of the concept of professional skepticism is consistent with how it is defined and referred to in the ISAs and, if not, how the concept could be described better.
72. Respondents had mixed views on whether their interpretation of professional skepticism is consistent with the way it is articulated in the ISAs and whether there was a need for a change to the definition. Feedback in response to this question also indicated that there may be a need to more fundamentally revisit the concept of professional skepticism—and what is expected of auditors.

Opportunities to Clarify the Definition or Strengthen the Current Approach in the ISAs

73. Some respondents explicitly noted the view that their interpretation of professional skepticism is consistent with the way it is articulated in ISA 200⁸⁶ and that they agreed with the definition.⁸⁷ There

⁸⁵ NSS: JIPCA

⁸⁶ Investors: CalSTRS; Accounting Firms: BDO, CHI; Member Bodies and Other Professional Organizations: ACCA, AIC, CIIPA, FACPCE, IBRACON, ICAEW, ICAZ, ICPAK, ICPAU, INCPC, KICPA, SMPC

⁸⁷ Investors: CalSTRS; NSS: CAASB, JICPA, NZAuASB; Accounting Firms: CHI; Public Sector: AGC; Preparers: PAIB; Member Bodies and Other Professional Organizations: AIC, EFAA, IBRACON, ICAEW, ICAZ, ICPAK, ICPAU, INCPC, ISCA, KICPA, SAICA, SMPC, SRA; Academics: AAA, AH, TRay; Individuals: DAHughes, KKTuraga, SDeViney

were respondents who explicitly agreed with the current questioning mindset.⁸⁸ The reasons provided why in their view no change to the definition was needed included:

- The definition of professional skepticism is appropriate; it is the application, evidencing or documentation of professional skepticism that is the bigger issue.⁸⁹
- The ISAs already require the auditor to investigate further and determine what modifications or additions to audit procedures are necessary to resolve any doubt about reliability or possible fraud.⁹⁰
- It is questionable whether professional skepticism can be enhanced by more requirements. Professional skepticism is subject to behavioral factors and personal traits, so solutions should focus on other ways to enhance professional skepticism.⁹¹

74. There were also respondents that agreed with the current questioning mindset, but thought that further clarification would be helpful, for example through clarifying the definition,⁹² or providing further guidance in the ISAs about how the professional skepticism could be demonstrated in some circumstances.⁹³

75. As noted in paragraphs 41–43, other respondents, in particular investors and regulators and audit oversight authorities, noted that the concept of a “questioning mind” in the definition needed to be reframed as the auditor challenging management’s assertions. MG members suggested the IAASB could consider additional requirements and application material throughout the ISAs that promote a mindset that actively questions, or makes inquiries regarding, management’s assumptions or audit evidence obtained.⁹⁴

Exploring Whether There Should Be a More Fundamental Change to the Concept of Professional Skepticism

76. Respondents who supported changing the definition suggested introducing a concept of a questioning mind that would tend to exhibit a more doubting or assertive attitude.⁹⁵ The words used in the ISAs could change the current confirmatory framework (obtain evidence to support management’s assertions) to a framework which leads more to auditors seeking evidence both supporting and disconfirming management’s assertions.⁹⁶

77. One regulator also noted that the definition should be expanded to include:

- Not only a questioning mind but one that robustly evaluates management’s assertions;

⁸⁸ NSS: HKICPA, IDW, NBA; Member Bodies and Other Professional Organizations: DnR, EFAA

⁸⁹ NSS: NZAuASB

⁹⁰ Investors: CalSTRS

⁹¹ NSS: NBA

⁹² Investors: CalPERS, ICGN; NSS: CNCC-CSOEC, IDW, NBA; Accounting Firms: BDO, EYG, GTI, PwC, RSM; Public Sector: AGSA, GAO

⁹³ NSS: AUASB, NBA, Accounting Firms: BDO; Member Bodies and Other Professional Organizations: CAANZ, CAQ, FEE

⁹⁴ Monitoring Group: BCBS, IAIS, IOSCO

⁹⁵ Monitoring Group: IAIS, IOSCO; Member Bodies and Other Professional Organizations: AICPA, MAASB, FSR, ICAS

⁹⁶ Monitoring Group: BCBS, IAIS

- Not only being alert to the potential for misstatement but also remaining open minded, probing and proactive about the potential for misstatement, notwithstanding past experience and the absence of manifest indicators of that potential having been realized;
 - Not only a critical appraisal of the evidence that management presents but also subjecting it to robust challenge through comparison with other relevant available sources of evidence whether those contradict or corroborate management's position.
78. Many respondents noted some change could be enacted through modifications to current ISAs. However, other respondents called for a more fundamental change to the concept of professional skepticism,⁹⁷ which may change the current model of an audit. The three most prevalent calls for action related to:
- A change to a starting point to be a doubting mindset (sometimes referred to as “presumptive doubt”);
 - A requirement to actively seek out contradictory evidence; and
 - Applying a continuum of professional skepticism that increases commensurate with the assessed risks of material misstatement.
79. Respondents who believe the concept needs a more fundamental change suggested, among other ideas, the IAASB taking action to compel auditors to exhibit a more doubting attitude that robustly challenges management's assertions.⁹⁸ This doubting attitude, depending on the circumstances and the information available regarding an account or an assertion, would lead the auditor to undertake actions and make decisions so as to gather the evidence needed to be convinced that the risk of material misstatement is effectively low. There was caution that a too neutral vision of professional skepticism could lead to an approach where audits focus too much on corroborating management assertions and do not really exercise professional skepticism until some combination of facts and indicators suggest a clear problem with those assertions.⁹⁹
80. Such a doubting attitude would result in considering alternative sources of evidence,¹⁰⁰ including actively seeking out contradictory evidence¹⁰¹ and weighing evidence when both supportive and contradictory evidence is found. This was also confirmed by one member of the public sector who was of the view that the auditor should search for conflicting evidence in higher risk areas, such as significant judgments.¹⁰²
81. However, some respondents cautioned that a more doubting attitude should not lead to a mindset of “presumptive doubt.” In their view, professional skepticism does not mean the auditor should distrust all information and representations by management. Moving towards a more “presumptive doubt” approach would create a difficult working relationship, may increase public expectations on the work effort, and may result in costs that outweigh the benefits of obtaining further evidence.¹⁰³ Another

⁹⁷ Monitoring Group: BCBS, IAIS, IOSCO; Investors: IA; Regulators and Audit Oversight Authorities: ESMA, UKFRC; Member Bodies and Other Professional Organizations: AICPA; Academics: Glover-Prawitt

⁹⁸ Monitoring Group: BCBS, IAIS, IOSCO; Individuals: JGrant

⁹⁹ Monitoring Group: IAIS

¹⁰⁰ Regulators and Audit Oversight Authorities: EBA, UKFRC

¹⁰¹ Monitoring Group: BCBS, IAIS; Investors: IA; Public Sector: GAO

¹⁰² Public Sector: GAO

¹⁰³ NSS: NBA; Member Bodies and Other Professional Organizations: AICPA, IDW, DnR, EFAA

concern was that if the definition was modified towards an attitude of presumptive doubt, this may inappropriately raise the amount of evidence practitioners must obtain to constitute sufficient appropriate audit evidence for the entire audit.¹⁰⁴

82. Some respondents believed the IAASB should explore whether the ISAs should more explicitly set out the concept of professional skepticism as a continuum,¹⁰⁵ rather than as an invariant concept. These respondents noted that the degree of professional skepticism throughout the audit might vary with risk identified and the professional judgments that were likely to be required (e.g., when auditing complex financial instruments or accounting estimates or other areas typically assessed as higher risks of material misstatement) – with linkage to the evidence that was expected to be obtained.
83. For example, as the risk of, and opportunity for, management reporting bias increases, there should be heightened professional skepticism and heightened skeptical actions taken by the auditor. The standards should incorporate the logic of a skepticism continuum that links higher levels of risk of material misstatement to more skeptical mindset and skeptical actions. The continuum would recognize that it is always important to have a questioning mind, but would clarify when the auditor should apply more or less of a challenging mindset and skeptical action.¹⁰⁶
84. There were also respondents who noted the link between professional skepticism and risk assessment without explicitly referencing to a continuum.¹⁰⁷ A suggestion was made to link risk assessment and obtaining audit evidence more explicitly and in doing so give more prominence to paragraph A33 of ISA 240, which acknowledges ways in which increased professional skepticism can be exercised as part of the overall response to address the assessed risks of material misstatement due to fraud, as well as when more or less audit evidence may be obtained as a result of the auditor's assessment of risk. It was suggested to further clarify whether different "levels" of professional skepticism may be applied, and how this would relate to the current description of professional skepticism as an "attitude" or "mindset."¹⁰⁸

Preliminary Recommendations of the PSWG

85. Overall, respondents to the ITC had mixed views about whether their interpretation of the concept of professional skepticism is consistent with how it is defined and referred to in the ISAs, and whether the concept could be described better. Many respondents did not support changing the definition or concept, but many also supported clarifying or enhancing the concept in some way. However, among those that suggested clarifying or enhancing the concept, there were mixed views as to what ought to be clarified or enhanced and where (definition, requirements or application material). There were also many respondents that made suggestions involving fundamental changes to the concept of professional skepticism, but there were mixed views on what the fundamental changes ought to be. Finally, many respondents noted the behavioral aspects relevant to the appropriate application of professional skepticism—an area being further explored by an IAESB task force. Because of these views, the PSWG believes that exploring the question of the need for a more fundamental change to the concept of professional skepticism would be a longer-term activity of the PSWG, informed by the debates of the individual SSBs as they undertake the shorter-term recommendations.

¹⁰⁴ NSS: CAASB

¹⁰⁵ Regulators and Audit Oversight Authorities: ESMA; NSS: MAASB; Public Sector: GAO; Accounting Firms: PwC; Member Bodies and Other Professional Organizations: CAQ, FEE; Academics: AAA, Glover-Prawitt

¹⁰⁶ Member Bodies and Other Professional Organizations: AICPA, CAANZ, CAQ; Academics: Glover-Prawitt

¹⁰⁷ Member Bodies and Other Professional Organizations: ICAS

¹⁰⁸ Accounting Firms: KPMG

Responding through Current IAASB Standard-Setting Activities

86. The PSWG believes exploring how to clarify or enhance the concept of professional skepticism within the confines of the current definition would be responsive to the many respondents seeking such clarification or enhancement. As highlighted in paragraphs 42–47, the PSWG believes that the IAASB needs to consider these suggestions for clarification or enhancement in the interest of potentially improving the application of professional skepticism by taking actions in the projects currently on the IAASB's agenda to clarify what is expected of auditors.
87. To potentially clarify or enhance the concept of professional skepticism, the PSWG believes the IAASB should, in its near-term standard-setting activities, seek to clarify:
- The meaning of a questioning mind within the context of its current description in the ISAs;
 - How the fundamental principles of the IESBA Code and such issues as management bias, auditor bias and independence affect the application of professional skepticism;
 - The linkage between professional skepticism, professional judgment, and the auditor's risk assessment and response; and
 - The context-specificity of professional skepticism—that is, what the implications of the appropriate exercise of professional skepticism in different risk settings are.

Exploring Key Considerations Relating to Audit Evidence and Exploring Fundamental Change to the Concept of Professional Skepticism

88. As explained in paragraphs 51–54, the PSWG believes that it will be necessary for the IAASB to undertake a new project to explore the conceptual issues related to audit evidence and documentation that have been raised not only in the context of the IAASB's current projects, but also in response to the ITC. Discussions on what constitutes sufficient appropriate audit evidence, and whether auditors should be required to actively seek out contradictory evidence, in particular in relation to areas involving significant management judgment, are likely to engender debates about the underlying nature of an audit and the costs and benefits of changing the auditor's approach, including with respect to professional skepticism. Learnings from exploring how best to enhance the application of professional skepticism in the IAASB's current projects will also provide insight as to whether the concept of professional skepticism has in fact evolved in the ISAs.
89. While the majority of responses did not support fundamental change to the concept of professional skepticism, the number and nature of the respondents (including a few from MG members, other regulators and audit oversight authorities, member bodies, and academics) suggests that the IAASB needs to consider these responses carefully as part of its public interest mandate before determining how to respond. Fundamental changes to the concept of professional skepticism may have the potential to either prompt a paradigm shift for audits (or, in one case, for all activities of professional accountants) that may involve considerable increases in work effort (even by an order of magnitude or greater), or result in requirements that cannot be realistically implemented and thereby serve to exacerbate the reasonableness gap portion of the expectations gap. Due to the potential impact of such fundamental changes and therefore the need to consult widely and thoroughly with stakeholders, these issues would need to be dealt with within a longer term project.
90. The PSWG believes it is important that the IAASB and its stakeholders be aware of the potential implications of fundamental changes in these areas, and has begun to analyze these implications in detail (to be shared with the SSBs in due course). The discussion below seeks to address some of the potential implications that may arise through the suggested fundamental changes, but, as this

treatment is based on preliminary considerations, it is not necessarily complete and is not comprehensive. The PSWG would welcome views to inform its further consideration of these issues, so that the SSBs can more fully consider the potential for fundamental change to the concept of professional skepticism in due course or other actions by the SSBs, including the IAESB, which could reinforce the existing concept of professional skepticism.

Moving towards a More Doubting Attitude

91. Calls for the application of a “doubting attitude” or a “propensity to doubt” (at its extreme, “presumptive doubt”) when applying professional skepticism may be based on the view that currently the ISAs require a “neutral mindset” of the auditor.¹⁰⁹ The ISAs do not set out a particular mindset but rather require the auditor to exercise professional skepticism by acting as necessary in the circumstances – i.e., the actions required of the auditor depend upon the specific circumstances in the audit, with the following assertions:
- “... the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance.”¹¹⁰
 - “The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.”¹¹¹
 - “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.”¹¹²
 - “... If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that the terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further.”¹¹³
92. Some respondents have called on the auditor to have a more “doubting” attitude throughout the audit, in particular in relation to significant management judgments. It has also been suggested that there should be a shift from obtaining evidence to corroborate management’s assertions towards activity seeking out contradictory evidence (rather than simply addressing inconsistent or contradictory evidence if encountered). It is not clear, however, whether those respondents are suggesting the incorporation of “presumptive doubt” beyond the situational auditor responses contemplated in the current ISAs.
93. While an overarching attitude of “presumptive doubt” in relation to the whole audit (i.e., general presumptive doubt) would not be practicable (from a time or cost perspective), presumptive doubt could be applied to very specific matters, but doing so in standard setting would require considerable care to avoid unintended consequences. At a conceptual level, the ISAs already require presumptive doubt for the assertions in the financial statements because the ISAs require the auditor to obtain

¹⁰⁹ Accounting Firms: KPMG

¹¹⁰ ISA 240, paragraph 12

¹¹¹ ISA 540, paragraph 21

¹¹² Prior to being revised during the Clarity project, ISA 200 noted that “In planning and performing the audit, the auditor neither assumes that management is dishonest nor assumes unquestioned honesty.”

¹¹³ ISA 240, paragraph 13

sufficient appropriate audit evidence to form an opinion on those financial statements (i.e., the auditor cannot assume that the assertions in the financial statements are “true” without obtaining evidence to support them). The issue of presumptive doubt becomes more difficult when applied to the evidence that the auditor obtains because it does not answer the key question in relation to when audit evidence obtained is sufficient and appropriate (that is, when can the auditor cease doubting or suspending judgment).

94. It should be noted that the issue of presumptive doubt (whether general or in relation to specific matters) is closely linked to the theme “levels of skepticism”. The term “presumptive doubt” implies there is some kind of continuum with the neutral mindset somewhere in the middle with more or less doubt on the other ends). Consequently, any exploration of presumptive doubt needs to be performed in conjunction with any exploration of the “levels of skepticism” theme.

Actively Seeking Inconsistent or Contradictory Evidence

95. Some respondents suggested that auditors be required to actively seek evidence that may contradict the evidence provided by management.
96. Under the current ISAs, the performance of an audit is premised upon management being responsible for preparing the financial statements, and for being responsible for such internal control as management determines necessary to enable the preparation of financial statements that are free of material misstatement, whether due to fraud or error.¹¹⁴ The assertions in the financial statements are therefore the assertions of management based upon the information that management has used to prepare those financial statements.
97. An auditor is required by the ISAs to obtain sufficient appropriate evidence (and hence reasonable assurance) that the financial statements are free of material misstatement. To do so, auditors need to compare the assertions made by management in the financial statements with the evidence auditors obtain. Since management has prepared those financial statements primarily using information under its control, by design in most cases most of that evidence would be provided by management. However, there may be other sources from which auditors obtain evidence (e.g., confirmations from third parties, general economic information, etc.). While there are exceptions, it would be expected that management would generally apply some care to provide information to the auditor that is consistent.
98. Overall, the nature of an audit as currently conceived means that evidence is obtained primarily from management by the auditor to form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, even if the auditors make use of other sources of information too. In this sense, by design, an audit is currently primarily a “verification” rather than a “refutation” exercise, but one in which the auditor does make use of other sources of information and may conclude that the evidence obtained undermines one or more material management assertions in the financial statements. Auditors do assess and respond to the risks of material misstatement (that is, to the likelihood of occurrence of a material misstatement, or “what can go wrong”). Consequently, the focus of auditors is on detecting misstatements, which means that such a verification exercise should not be seen as being solely “corroborative”.

¹¹⁴ ISA 200, paragraph A2 (a)-(b)

99. With respect to contradictory evidence, the ISAs currently require the auditor to be alert for evidence that contradicts other evidence,¹¹⁵ but do not require the auditor to actively seek such evidence. A good number of other paragraphs in the ISAs clarify that inconsistent or contradictory evidence identified needs to be considered or that further procedures need to be performed. Ultimately, whether or not to seek contradictory evidence is an issue about seeking and using other sources of evidence.
100. The treatment of other sources of evidence can be portrayed along a chain of decisions. These decisions include:
- (i) When to seek other sources of evidence – which is in part dependent on the likelihood that other sources of evidence exist and can be obtained, the cost of doing so compared to the benefits, and perhaps most importantly, the assessed risk of material misstatement.
 - (ii) The work effort used to seek other sources of evidence – recognizing that moving towards an exhaustive search for all other sources of evidence would likely have a significant effect on the cost and time of an audit.
 - (iii) The work effort in relation to other sources of evidence once identified – including the factors that need to be taken into account when evaluating how to weigh inconsistent evidence from different sources.

The issue of whether auditors seek other sources of evidence and the work effort associated with such evidence is highly judgmental. Nevertheless, it may be worth exploring in the planned evidence project whether more guidance could be given for auditors addressing what to consider when deciding whether to seek other sources of evidence and when considering the work effort involved in dealing with any such information obtained (e.g., in relation to accounting estimates with higher risks of material misstatement).

Using Levels of Professional Skepticism, Rather than the Current Invariant Concept

101. Currently, the audit and assurance standards require the auditor to exercise professional skepticism without applying different “levels” of professional skepticism—that is, professional skepticism is an invariant concept. The IAASB has previously concluded that the application of professional skepticism does not vary by level of assurance being obtained (that is, the same level of professional skepticism is expected to be applied for both limited and reasonable assurance engagements).
102. Some respondents suggested that the ISAs apply a variable level of professional skepticism rather than the current invariant approach. In this respect, the main suggestion set forth by respondents (and is found in some academic literature) in relation to what professional skepticism varies with is the risk of material misstatement – in particular, that greater professional skepticism might be required for higher risks.
103. Some members of the PSWG believe that that the variable level of professional skepticism concept is not needed within the auditing standards, since the auditor’s response to risk is expected to vary depending on the assessed risks of material misstatement, so it is not clear how the concept of “levels” of professional skepticism would affect the auditor’s work effort, if at all. Furthermore, respondents who support this concept of variable professional skepticism refer to paragraph A33 of ISA 240 as an example of where the concept already exists. However, the PSWG is of the view that this paragraph relates specifically to the auditor’s response to fraud risks and does not justify such

¹¹⁵ ISA 200, paragraph A18

an approach in all phases of the audit given specific evidential issues (e.g., collusion and falsification of documents) related to responding to fraud risk. Some PSWG members were also concerned that by definition, using “levels” of professional skepticism might imply that in some cases the auditor need not exercise professional skepticism – which is counter to the current position in the ISAs.

Matter for CAG Consideration

4. Representatives are asked to share their initial views on the issues set out in this section, including whether they support the PSWG’s view that consideration of these issues will require a longer-term perspective informed by the other workstreams described in Sections D, E, and G.

G. Consideration of a Common Description of Professional Skepticism by the SSBs and the Possibility of Extending the Concept beyond Audit and Assurance Engagements

104. The ITC noted the need to further explore whether the concept of professional skepticism is consistently described across the ISAs, IES, and IESBA Code—for example, whether the links between the term professional skepticism and other concepts (such as professional judgment, integrity, independence of mind, objectivity, and sufficient appropriate audit evidence) are clear and well-understood. Many respondents agreed that the SSBs should move forward in a coordinated manner,¹¹⁶ and as noted in paragraphs 5 and 61, some respondents specifically requested clarification of the linkage between professional skepticism and the fundamental principles, noting the importance of independence. The IESBA is currently considering how this linkage could be articulated (see Section E).
105. Neither the ITC nor the respondents to the ITC addressed the issue of whether professional skepticism ought to be extended beyond assurance engagements, including potentially extending the concept to all professional accountants. Nonetheless, the IESBA has received limited feedback to this end from some within the PIOB and a few others (see paragraphs 6–11) in the context of its current projects. Those responses have prompted IESBA to also consider whether a new description of professional skepticism that extends the concept beyond assurance engagements to all professional accountants is necessary (see Section E). The IAESB’s education standards that are directed at IPD currently apply the definition used by the IAASB for assurance engagements to all activities of aspiring professional accountants (see paragraph 16). As decisions at the individual SSBs may have consequences for other SSBs, the PSWG believes it has a role to coordinate the views and facilitate a broader discussion about the possibility of extending the concept of professional skepticism.
106. The IAASB definition of professional skepticism is grounded in the concepts of risks of material misstatement and evidence, as set out in the IAASB’s International Standards (see further analysis in **Agenda Item J3-D**). Accordingly, the concept of professional skepticism is not specifically referenced in the IAASB’s standards related to agreed-upon procedures engagements or compilations engagements (a conscious decision by the IAASB when finalizing ISRS 4400¹¹⁷) as the IAASB believes that professional skepticism is an assurance concept and is therefore not relevant to non-assurance engagements.

¹¹⁶ Monitoring Group: BCBS, IAIS, IOSCO; Investors: CalPERS, IA, IGCN; Regulators and Audit Oversight Authorities: EAIG, EBA, ESMA, H3C, UKFRC; NSS: AUASB, CAASB, CNCC-CSOEC, HKICPA; Accounting Firms: CHI, DTT, EYG, GTI, PwC; Public Sector: AGSA, INTOSAI; Member Bodies and Other Professional Organizations: CAANZ, EFAA, FEE, ICAEW, ICPAU, IDW, INCPC, IRE-IBR, JICPA, KICPA, SAICA, SMPC, WPK

¹¹⁷ ISRS 4400, *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*
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107. An extension of the concept of professional skepticism to all professional accountants may have the unintended consequence of extending assurance-type work effort and related documentation requirements to other activities of professional accountants (like, for example, agreed-upon procedures engagements or compilation engagements or the preparation of tax returns by public practitioners, or management accounting or financial management activities by professional accountants in business). Accordingly, simply taking the IAASB definition as it stands or “tweaking it” may not be the best means of extending the concept beyond assurance engagements. The IESBA’s initial discussions have explored a more generic common description (rather than a definition), intended to demonstrate the attitude professional accountants are expected to have in evaluating their compliance with the IESBA Code (not in the context of particular types of engagements). However, since evaluation of compliance with the IESBA Code applies to all engagements and all fundamental principles (including due care), this may be viewed as extending the concept of professional skepticism to engagements other than assurance engagements (see paragraph 66 and **Agenda Item J3-C**).
108. Since the concept in the current definition is closely linked to the concept of the assessment of risks of material misstatement and to evidence, both of which are defined terms in the IAASB standards, extending the applicability of professional skepticism to other than assurance engagements may engender the need to consider establishing a clearer distinction between “information” and “evidence,” since the former is used in the compilation standard and evidence is a defined term in the assurance standards.
109. The PSWG is of the view that there may be a number of implications to the IAASB’s suite of standards if the concept of professional skepticism is extended beyond assurance engagements, and encourages the SSBs to jointly consider these implications further before deciding on a way forward. If a common description were deemed possible, key questions arise in relation to how such a description might fit in the respective SSBs’ standards and the IESBA Code and what due process would be needed to do so (as well as the implications on the definition in ISA 200 and the work effort set out in other standards).

Matter for CAG/IAASB Consideration

5. Representatives are invited to share their initial views on the issues set out in this section for further consideration by the PSWG.

H. Actions that Could Be Taken by Other Stakeholders to Address Professional Skepticism

110. Respondents acknowledged that professional skepticism is behavioral in nature and cannot be addressed by changes in standards or more guidance alone. Accordingly, there was also strong support for working with other organizations, in particular those in the financial reporting supply chain.¹¹⁸ For example:
- Respondents, including two from the MG, highlighted the relevance of greater transparency from regulators and audit oversight authorities about inspection findings, as well as audit firms,

¹¹⁸ Investors: IA; Accounting Firms: BDO, GTI, RSM; Preparers: PAIB; Member Bodies and Other Professional Organizations: AICPA, CAANZ, CAI, SAICA, SMPC, WPK

including their view on the “root causes” of these findings.¹¹⁹ Understanding the causal factors of these findings and how accounting firms may already be responding to these findings will help the SSBs identify if there are changes that need to be made to specific standards (e.g., to clarify the definition or address other issues such as a lack of sufficient appropriate evidence or inadequate documentation).

- Audit committees were called upon to take a more proactive role in challenging auditors on individual engagements (see also paragraph 37).¹²⁰ Suggestions for audit committees included: (i) intensifying the frequency of communication and being more open with auditors about their mutual areas of concern;¹²¹ (ii) being more assertive when recommending the (re)appointment of an auditor and questioning matters such as the firm’s commitment to quality and maintaining auditor independence, audit transparency measures, and the sufficiency of the audit fee; (iii) engaging with the auditors on the development of their audit plan and resourcing (including how the firm and engagement partner ensures competence, including the extent of reliance on external experts); (iv) facilitating the audit process and the engagement team’s access to relevant resources; and (v) being pro-active and challenging in assessing the quality of audits, including the use of professional skepticism.
- Companies, including internal audit functions, were called upon to support an environment in which auditors and others are encouraged to challenge management about whether their assertions are reasonable and to challenge themselves as to whether sufficient appropriate audit evidence was obtained. This would be supported by the tone at the top and culture of companies, along with whistle blower protections.¹²²
- Accounting firms were called upon to promote an environment that is supportive of auditors exercising professional skepticism. While there is a role for the IAASB to play in revising ISQC 1 and ISA 220, accounting firms were also encouraged to take specific action beyond compliance with those standards. Suggestions included: (i) obtaining a better understanding of the root causes of inadequate application of professional skepticism and remediating deficiencies as appropriate; (ii) recruitment, with a focus on ethics and competencies;¹²³ (iii) realistic resourcing and contingency planning;¹²⁴ (iv) training, including behavioral and “soft skills” development, and pooling and monitoring more junior employees via an apprentice model;¹²⁵ (v) fostering an independent and challenging skeptical mindset though firm culture and roles of the tone at the top, engagement partner, middle management, quality review partner, and those charged with governance within a firm, including embedding in performance

¹¹⁹ Monitoring Group: IAIS, IOSCO; Investors: ICGN; Regulators and Audit Oversight Authorities: UKFRC; NSS: AUASB, CNCC-CSOEC, IDW, JICPA, MAASB, NBA; Accounting Firms: GTI, PwC; Public Sector: AGSA; Member Bodies and Other Professional Organizations: AICPA, CAQ, IBRACON, ICAEW, SMPC; Individuals: JGrant

¹²⁰ Monitoring Group: IAIS; Those Charged with Governance: AICD; NSS: CNCC-CSOEC, MAASB, NZAuASB; Accounting firms: EYG, PwC; Member Bodies and Other Professional Organizations: CAQ, CPAA

¹²¹ Monitoring Group: IAIS

¹²² Investors: IGCN

¹²³ Monitoring Group: IAIS; Investors: ICGN; NSS: IDW

¹²⁴ Monitoring Group: IAIS, IOSCO; Regulators and Audit Oversight Authorities: H3C

metrics and challenging each other during team communications;¹²⁶ and (vi) enhanced communication with audit committees.¹²⁷

- Member bodies and professional organizations¹²⁸ and universities – instilling an attitude of professional skepticism in training for those entering the profession and providing better and more targeted coursework for auditors on key topics such as the appropriate application of professional skepticism, ethics training, and leadership.¹²⁹

Matter for CAG Consideration

6. Representatives are asked whether there are other parties in the financial reporting supply chain who have a role to play in enhancing the application of professional skepticism and, if so, what such parties would be expected to do.

I. Way Forward for the SSBs and the PSWG

111. This paper sets out preliminary recommendations for the SSBs and their CAGs to consider at their upcoming meetings (IAASB and IESBA and the IAASB, IAESB and IESBA CAGs – September; IAESB November). The PSWG will continue to engage as a central point for discussion of common issues as and when needed in relation to matters that require coordination, and will consider the feedback from the respective Board meetings at its October 2016 physical meeting. In this regard, the PSWG intends to take an active role, in particular in the short term, in light of the planned discussions at the individual SSBs.
112. Going forward, the PSWG will be responsible for considering whether a thought piece, feedback statement or other brief publication would be useful in the near term to give prominence to the work that the SSBs will be undertaking, individually and in coordination, and to also highlight the role of others (see Section H). This publication could provide insight as to how the three SSBs view the concept of professional skepticism, the planned actions each Board intends to take, and how these various actions are coordinated between the SSBs. It could also be an opportunity to highlight where others have a role to play (see Section H).
113. The outcome of the PSWG's deliberations will be discussed at the IAESB meeting in November and the IAASB and IESBA meetings in December, with updates to their respective CAGs as necessary. The PSWG will also continue to consider the implications of the timing of efforts of the individual Boards and will report back to the Board and their Steering / Planning Committees as necessary – for example, in relation to any wording that might be included in the proposed restructured IESBA Code (planned for approval in December 2016).
114. **Agenda Item J3-E** provides more details on the forward plans for the individual SSBs for reference.

¹²⁶ Monitoring Group: IAIS, IFIAR, IOSCO; Investors: CalSTRS; Regulators and Audit Oversight Authorities: ESMA, UKFRC; NSS: CPAB, MAASB; Accounting Firms: BDO, EYG, GTI, KPMG, PwC; Public Sector: AGSA, GAO; Member Bodies and Other Professional Organizations: CAANZ; Individuals: JGrant, TRay

¹²⁷ NSS: EBA

¹²⁸ Public Sector: AGSA

¹²⁹ Investor: IGCN; Public Sector: AGSA, INTOSAI