



May 16, 2016

Ms. Kathleen Healy
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
New York, NY 10017

Re: Invitation to Comment – Enhancing Audit Quality in the Public Interest—A Focus on Professional Skepticism, Quality Control and Group Audits

Dear Ms. Healy:

We are pleased to respond to the Professional Skepticism component of the Invitation to Comment (“ITC”).

We support the IAASB’s project to reconsider the concept, definition and application guidance around professional skepticism. While the concept of professional skepticism is not new, there is increasing evidence that there is not a common understanding of what professional skepticism is, what it entails, and how it is appropriately evidenced in the audit working papers. We have outlined most of our views on professional skepticism in the 2013 monograph, *Enhancing Auditor Professional Skepticism*, commissioned by the Global Public Policy Committee (hereafter the Enhancing Skepticism monograph). In this response we will reference the Enhancing Skepticism monograph and provide additional insights we have gained through subsequent consideration of this important topic.

We point out in the Enhancing Skepticism monograph that there is a lack of consensus in practice and in academia regarding just what professional skepticism is, what actions it includes, and how it should be evidenced in the work papers. We believe a fundamental cause of the lack of consensus is the current vague definition of professional skepticism in the standards along with limited references of the concept in the auditing standards (for example, there is only one reference to professional skepticism in ISA 330 and ISA 540 and it is not even mentioned in ISA 700).

We recognize that some leaders in the profession have a different perspective than we do around professional skepticism. For example, the traditional view is that professional skepticism is an attitude that includes a questioning mind, which the auditor should use throughout the audit but is not directly connected to risk of misstatement or evidence. In this view, professional skepticism is an omnipresent state of existence and if an auditor is deemed to lack skepticism it is because the auditor had inappropriately “turned off” their questioning mind. Those with this perspective are particularly critical of inspection findings indicating that auditors “lacked professional skepticism” because they see this label as an inappropriate application of the underlying concept, which is simply a mindset. From this perspective, it is difficult, if not impossible to determine *ex post* that an auditor did or did not have the appropriate mindset during the audit and as such the observed deficiencies should not be labeled a “lack of professional skepticism,” but rather a lack of compliance with auditing standards to gather sufficient, appropriate audit evidence. Professionals holding this view would advise the IAASB to turn back the hands of time, emphasize to the profession and regulators that the concept of professional skepticism is disconnected with auditor behavior, audit evidence and documentation, and preferably disallow regulators from evaluating the application of professional skepticism. Similarly, those holding the traditional view are concerned that the changes we propose in the

Enhancing Skepticism monograph may set unrealistic expectations and unintentionally raise the performance standard. Ironically, if we carefully analyze what has happened since the profession has faced increased regulatory inspection applying the current vague definition of professional skepticism, it appears that inspectors and regulators may have unrealistic expectations that may be raising performance standards, but perhaps in misdirected ways. In other words, it seems the profession may be currently experiencing the concerns used to argue against revision to the definition and application of professional skepticism in the auditing standards.

We believe it is time to move beyond the traditional view of professional skepticism for a few reasons: 1) we think it is unrealistic to reset world regulators' views about professional skepticism or insist that they stop evaluating the application of professional skepticism, 2) it seems the costs of continuing the current approach outweigh the benefits, and 3) we think a more practical and clear definition of professional skepticism combined with application guidance in auditing standards will improve audit quality through improvements in the consistent appropriate application of professional skepticism. We trust the IAASB can address potential concerns regarding expectations and performance standards in a revision and we think our recommendations have the potential to clarify expectations and performance standards for auditors and regulators.

In our opinion, the crux of the issue is whether professional skepticism in the standards should remain as simply an attitude or if the IAASB should develop a more useful and practical definition of professional skepticism that moves beyond attitude to recognize that the proper application professional skepticism, in combination with professional judgment, may lead to behavior such as a response, action, evidence collection and evaluation. Rather than try to disconnect professional skepticism from risk assessment, professional judgment and behavior, we believe the profession will be better served by acknowledging and describing how these concepts are connected. We also point out in the Enhancing Skepticism monograph, the connection between these concepts suggests there is a need to recognize that there is a continuum of professional skepticism (i.e., as the risk of material misstatement increases the auditor's skeptical mindset moves from a neutral to a more challenging mindset such as presumptive doubt). We believe that audit quality will be improved, and false-positive inspection findings reduced, if the auditing standards recognize that there are situations where the application of professional skepticism is particularly relevant and important and situations where it is less relevant and important (although always necessarily present to some degree). We believe application guidance illustrating when and how professional skepticism is applied and evidenced across the continuum will go a long way to help junior auditors properly understand and apply the concept. Similarly, we believe audit quality will benefit if the standards articulate that the appropriate application of professional skepticism may lead to action that is documented in the working papers.

We see that the IAASB and the task force are considering the interrelation between professional judgment and professional skepticism. In the ITC there is a figure (pg. 13) that illustrates a potential relationship between professional skepticism and professional judgment. We recognize the simple two-dimensional figure has limitations and was not likely intended to capture the full relationship. We point out that the application of professional skepticism and professional judgment are not linear and separate processes, but rather, along with risk assessment, represent a connected, continuous and iterative process. As we have considered the ITC and the concepts of professional skepticism and professional judgment, we are struck by just how connected these concepts are. While professional judgment and professional skepticism are not synonymous, there have similar and connected purposes in an audit setting.

The lack of parallelism in the concepts of professional skepticism and professional judgment is likely most apparent in situations where the auditors' initial risk assessment indicates that an area presents low risk of material misstatement. In these situations, the planned nature, timing and extent of evidence will reflect a low-risk setting. However, the proper application of professional skepticism in low-risk situations may identify potential red flags around the reliability or validity of evidence provided (e.g., falsified records, biased or incomplete information) and in such situations the auditor's application of professional skepticism will lead to actions such as a reevaluation of the initial risk assessment and likely a change in audit procedures to address the red flags identified.

As an illustration, consider a situation in the audit of a UK entity where the auditor deems an area low risk and the planned audit procedure is circularization or confirmation. If a confirmation is sent to a third-party entity with no operations or locations within the UK but the return response was post marked within the UK, the proper application of professional skepticism would recognize this finding as a potential red flag and the audit team would determine an appropriate response. Typically, as in this example, simply increasing the extent of testing (i.e., sending additional confirmations) would not likely be an effective skeptical response to the increase risked. Rather, professional skepticism along with professional judgment would lead the auditor to revise the nature of the audit evidence to specifically address risk posed by a potentially falsified confirmation response. If it is determined that the confirmation was intentionally falsified, the application of professional skepticism would result in an increased risk assessment and the auditor would apply skepticism and judgment to determine the appropriate response in that particular audit area as well as broader implications across the audit. In this example, if the auditor noticed what should have been a red flag but did not respond and the audit were subsequently inspected, the lack of response to the red flag likely would be considered an audit deficiency due to a lack of professional skepticism.

In the context of the continuum of risk of material misstatement, we believe that in higher risk situations there is a need for heightened professional skepticism that will work in tandem with professional judgment to adjust the nature, timing and extent of testing. As we indicate in the *Enhancing Skepticism* monograph, we believe it would be beneficial for the auditing standards to recognize the continuum and provide clarity that would assist auditors and regulators agree how to apply professional skepticism in low and high risk situations, how the auditor should respond, what actions could be taken, and how to tell the story of the proper application of both professional skepticism and professional judgment via audit documentation.

From our experience in teaching college students and training staff level auditors, simply telling these bright young professionals to use their professional judgment or to be professionally skeptical is not particularly satisfying because the concepts are too vague to be applicable. However, as we break down the concepts in to practical components and then provide tools, techniques and hands-on examples on how the application of professional judgment and skepticism can be improved (e.g., consider the opposing case, proactive fanning of issues, avoiding common biases) students and junior auditors are better able to understand and apply the concepts. For this reason, in the *Enhancing Skepticism* monograph we recommend that standard setters include frameworks for professional judgment and professional skepticism. Frameworks can provide professionals with common vocabulary, tools and techniques and will help to boost the ability of junior professionals in applying professional judgment and skepticism. Frameworks can help junior auditors to answers questions such as:

- If I wanted to apply more rigorous professional judgment/skepticism, what can I do?
- What actions demonstrate the proper application of professional judgment/skepticism and how do those action differ across the risk continuum?

- What are the common traps and impediments to the proper application of professional judgment/skepticism?
- How do I document the proper application of professional judgment/skepticism in the working papers?

In the monograph we also point out that it is important to recognize that both impediments and enhancements to professional skepticism occur at different structural levels (i.e., individual auditor, engagement team, audit firm, profession). This is important when designing potential enhancements to the standards and regulations so that potential enhancements are properly matched with the target structural level. Otherwise the enhancements may not improve the application of professional skepticism and instead just add unnecessary cost.

Adjustments to quality control policies and/or standards may be warranted to incent and recognize the appropriate application of professional skepticism. Academic literature in auditing and other areas of management suggest it is common for supervisors to overweight the impact of outcome and underweight the importance of good judgment processes. For example, a recent academic study finds that audit staff's skeptical behavior is evaluated based on whether the staff's investigation of an issue ultimately identifies a misstatement.¹ However, the proper application of professional skepticism will typically not result in the discovery of misstatements. Therefore, it is important to encourage and recognize the appropriate application of professional skepticism—including both in situations that do and do not result in the discovery of a misstatement.

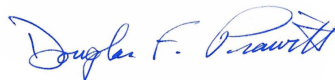
In summary, we believe the IAASB is facing an important opportunity to improve audit quality. We encourage the IAASB to carefully consider the opportunity and at least consider a different perspective where professional skepticism is defined as more than merely an attitude in the auditing standards. We believe that audit quality will improve if the IAASB is able to develop a more practical and useful definition of professional skepticism accompanied by application guidance that demonstrates the appropriate application of professional skepticism across the risk continuum and throughout the audit.

Thank you for the opportunity to respond to the ITC. Please feel free to contact us if you have questions regarding our comments or content in the Enhancing Skepticism monograph.

Sincerely,



Dr. Steven M. Glover
Associate Dean
K. Fred Skousen Professor



Dr. Douglas F. Prawitt
Glen Ardis Professor

¹ See Brazel, Jackson, Rech, Stewart, 2016, forthcoming in *The Accounting Review*, *The Outcome Effect and Professional Skepticism* (<http://ssrn.com/abstract=2349853>).