

## Professional Skepticism – Extract from IAASB's Invitation to Comment

Note: This document contains an extract from the International Auditing and Assurance Standards Board's (IAASB) Invitation To Comment: *Enhancing Audit Quality In The Public Interest: A Focus On Professional Skepticism, Quality Control And Group Audits* (the detailed ITC). It includes the text (i.e., paragraphs 15–44) and the questions included in the ITC related to professional skepticism.

IESBA members are asked to consider the extract below and provide their views on the matters for IESBA consideration in **Agenda Item 4-A**.

### EXTRACT FROM IAASB'S INVITATION TO COMMENT: ENHANCING AUDIT QUALITY IN THE PUBLIC INTEREST: A FOCUS ON PROFESSIONAL SKEPTICISM, QUALITY CONTROL AND GROUP AUDITS

#### How Can We Strengthen The Application Of Professional Skepticism In Audits?

15. How can we reinforce the fundamental concept that auditors need to apply appropriate professional skepticism throughout the audit? This question is at the core of the IAASB's efforts to improve audit quality.

#### *How Our Standards Address Professional Skepticism*

International Standards on Auditing (ISA) Definition: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.<sup>1</sup>

Our standards explicitly recognize the fundamental importance of professional skepticism. Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.<sup>2</sup>

The [February 2012 IAASB Staff Questions and Answers publication](#)<sup>3</sup> focuses on considerations in our standards that are of particular relevance to the proper understanding and application of professional skepticism. Amongst other matters, it discusses:

- What firms and auditors can do to raise awareness of the importance of professional skepticism;
- Aspects of an audit where professional skepticism may be particularly important; and
- How professional skepticism can be evidenced.

16. In conducting an audit in accordance with ISAs, the auditor is required to apply professional skepticism – recognizing that circumstances may exist that may cause the financial statements to be

<sup>1</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(l)

<sup>2</sup> See ISA 200, paragraphs A18 and A21.

<sup>3</sup> [www.iasb.org/publications-resources/staff-questions-answers-professional-skepticism-audit-financial-statements](http://www.iasb.org/publications-resources/staff-questions-answers-professional-skepticism-audit-financial-statements)

misstated. Professional skepticism is essential in all aspects of the audit – from planning and risk assessment through to the critical assessment of audit evidence in forming the auditor's conclusions. We believe it is in the public interest to explore what can be done to re-emphasize the important role of professional skepticism in audits of financial statements.

### **Calls for Action**

17. Investors, regulators and other stakeholders expect auditors to challenge management's assertions, including when management has used an expert to help prepare financial statements. Unless auditors do so, they cannot appropriately plan and perform an audit – nor can they conclude, with confidence, whether an entity's financial statements are fairly presented in accordance with the applicable financial reporting framework.
18. Concern about instances in which auditors did not appropriately apply professional skepticism in their audits is a globally recurring theme in audit inspection findings, and has been central to our discussions about audit quality. International Forum of Independent Audit Regulators has suggested that enhanced professional skepticism by auditors will contribute significantly to improving the quality of audits and that firms should prioritize efforts in this area.

The Public Interest Oversight Board (PIOB) noted that professional skepticism, as a state of the mind and attitude, should govern the performance of auditors, and inspire the attitude of other accountants, e.g., accountants in business. When accountants (practitioners, non-practitioners, accountants in business) do not display proper professional skepticism it is recognized as a barrier to effective performance.

- September 2014 [Conclusions from the PIOB Public Interest Workshop](#)<sup>4</sup>

19. We are seeking to understand what our stakeholders think about the “root causes” of these inspection findings, including their views about why auditors are not, or do not appear to be, appropriately applying professional skepticism. In particular, we want to know how auditors in practice are able to conclude that they have appropriately applied professional skepticism.
20. Questions have also been raised about how auditors can more clearly demonstrate the application of professional skepticism, in particular how to better describe the basis for the auditor's professional judgments and conclusions and how the auditor's mindset has affected the nature, timing and extent of audit procedures performed.
21. We have noticed that research studies sometimes describe the concept of professional skepticism in a manner that differs from how the concept is defined and addressed in the ISAs. For example, some studies describe the application of professional skepticism by referring to outcomes such as auditors assessing certain accounts as more susceptible to risk, obtaining more evidence or explicitly searching for inconsistent evidence, challenging management's judgments, or investigating differences between management's and the auditor's judgments.

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<sup>4</sup> [www.iaasb.org/system/files/meetings/files/Agenda%20Item%201-C%20-%20PIOB%20Sept%202014%20Public%20Interest%20Workshop%20Conclusions.pdf](http://www.iaasb.org/system/files/meetings/files/Agenda%20Item%201-C%20-%20PIOB%20Sept%202014%20Public%20Interest%20Workshop%20Conclusions.pdf)

22. The existence of various ways to describe the application of professional skepticism indicates that the concept of professional skepticism, and the expectations of how auditors should appropriately apply it, may need to be more clearly articulated in our standards.

### Factors Influencing Professional Skepticism

23. The topic of professional skepticism is addressed in the IAASB's standards and is also touched on in the International Accounting Education Standards Board's (IAESB) International Education Standards (IESs) and the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), referred to collectively in this consultation as the International Standards. The table below depicts the concepts in the IESs and the IESBA Code that are relevant to the application of professional skepticism in audits.

Relevant Concepts in the IESs	Relevant Concepts in the IESBA Code
<ul style="list-style-type: none"> <li>• Technical competence for professional accountants</li> <li>• Professional skills</li> <li>• Professional development, including with respect to values, ethics and attitudes</li> </ul>	<ul style="list-style-type: none"> <li>• Integrity</li> <li>• Objectivity</li> <li>• Independence of mind</li> <li>• Professional competence and due care</li> <li>• Professional behavior</li> </ul>

### Professional Skepticism, Professional Judgment and Documentation

24. The concepts of professional skepticism and professional judgment are closely related, and together are key inputs to audit quality. Professional skepticism often facilitates the appropriate exercise of professional judgment by an auditor. Similarly, the application of professional skepticism requires professional judgment. Both concepts are essential to the auditor's decision-making.
25. Professional judgment is defined in the ISAs as the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about appropriate actions in the audit engagement.<sup>5</sup> The application of professional skepticism is especially important in the context of audit work on those areas of the financial statements that are highly judgmental or subjective – areas that are influenced, for example, by recent developments in financial reporting standards.
26. While professional skepticism is an attitude, this attitude is applied in making professional judgments that provide the basis for auditors' actions. The documentation of professional judgments made, and actions taken, may provide evidence that professional skepticism

#### How Professional Skepticism Drives Action



<sup>5</sup> ISA 200, paragraph 13(k)

was applied. The diagram to the right is a simple illustration of how professional skepticism drives action. Other relevant concepts in accounting, auditing and ethical requirements, including independence of mind, objectivity, and competence, as well as firm-specific and environmental factors may impact the application of professional skepticism.

27. Documentation of professional judgments and actions provides evidence that professional skepticism was applied. The ISAs require auditors to document discussions of significant matters with management, those charged with governance and others, including the nature of the significant matters discussed and when and with whom the discussions took place.<sup>6</sup> We have heard that the additional reporting requirements in the new and revised Auditor Reporting standards, in particular, new ISA 701<sup>7</sup> may serve to improve documentation of professional judgments made during the audit, thereby better evidencing the application of professional skepticism.

*Enhancing Professional Skepticism – Role of Individual Auditors, Firms and Others*

28. Adopting and applying a skeptical mindset is a personal and professional responsibility for every auditor. The application of professional skepticism is influenced by personal traits, including fortitude (i.e., the strength of mind that enables the auditor to deal with matters arising during the course of the audit with courage), and the auditor's competence (e.g., knowledge, skills and experience).
29. Individual behavior, (including an auditor's), is also influenced by inherent cognitive biases as well as by external factors (such as familiarity threats). Questions have been raised about whether the existing client service relationships, in particular long-term ones, and the payor model affect auditors' ability to appropriately apply professional skepticism. Some stakeholders have asked whether situations arise where auditors unduly accept the fact that management is honest and prepares the financial statements accurately.
30. Firms also have an important role to play in cultivating a skeptical mindset in auditors. This includes designing and implementing policies, procedures and incentives that promote a culture that recognizes and reinforces professional skepticism as being essential – and therefore expected as audits are conducted. A firm's approach to training its auditors, including mentoring, reflective activity and practical on-the-job training, may also enhance the effective development of professional skepticism. Firms' policies and procedures may also focus on how to reward or incentivize auditors who demonstrate skeptical behavior. In addition, effective performance of Engagement Quality Control (EQC) reviews may contribute to the appropriate application of professional skepticism.
31. It is important to acknowledge, however, that other factors related to the audit can inhibit auditors' application of professional skepticism. Examples of such factors include tight financial reporting deadlines, and heavy staff workloads, as well as time and resource constraints more generally. Our stakeholders have suggested that auditors may approach an audit with a skeptical mindset at first, and appropriately identify issues that need attention, but may not always apply professional

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<sup>6</sup> See ISA 230, *Audit Documentation*, paragraph 10.

<sup>7</sup> New ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, will soon be effective, and will require auditors to communicate key audit matters in the auditor's report for audits of financial statements of listed entities. Key audit matters are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. See [www.iaasb.org/new-auditors-report](http://www.iaasb.org/new-auditors-report).

skepticism in following through with appropriate actions (i.e., revising risk assessment, designing and performing responsive audit procedures or properly documenting their findings and conclusions). This may ultimately call into question whether professional skepticism was appropriately applied in the audit.

32. Environmental and contextual factors can also affect the application of professional skepticism. These include the business environment, laws and regulations, as well as the local norms and culture in which an auditor operates. For example, we have learned from discussions with stakeholders that auditors in certain jurisdictions may be less comfortable challenging management when auditing areas in the financial statements that are highly judgmental or subjective.
33. Outreach and research suggests that firms, national auditing standard setters (NSS), and others are well-positioned to take on initiatives to assist in addressing the concerns that have been raised about professional skepticism. We have identified those parties as “direct influencers” (listed in the box to the right). We believe that the “direct influencers”, in particular audit committees, have a significant role to play in challenging and questioning the auditor’s application of professional skepticism.
34. NSS and professional accountancy organizations, educational institutions and others can positively influence the training and education of auditors, thereby developing and promoting the necessary competence to apply professional skepticism and raising awareness of the factors that may inhibit its appropriate application.

*Stakeholders who can directly influence professional skepticism*

- Firms/Networks of firms
- Standard setters, including NSS
- Professional accountancy organizations
- Educational institutions
- Those charged with governance, including audit committees
- Regulators and audit oversight bodies
- Management/those responsible for preparing the financial statements

**Our Preliminary Views on a Possible Way Forward**

35. We raised the possibility of undertaking work on professional skepticism in our consultation on our Strategy for 2015–2019 and current Work Plan. Stakeholders who responded to this consultation acknowledged the complexities and challenges we would face in addressing this topic. In general, respondents did not support a discrete standard-setting project leading to changes to ISAs as the primary or only response to the concerns and issues that have been identified. Rather, they suggested that it would first be necessary for us to further explore behavioral, training and other issues in order to have a better basis for understanding what more we and others could do in this area.
36. We are committed, in the public interest and with an open mind, to delving into this complex subject. We want to find meaningful actions that we and others could take to enhance the application of professional skepticism – in a way that takes into account personal traits and their influence on

auditor behavior and the importance of developing auditor competencies, recognizing that external factors or barriers will continue to exist.

#### **Our Activities to Date**

- [Feedback from the consultation](#)<sup>8</sup> on our *Strategy for 2015-2019* and *Work Plan for 2015-2016*
- Professional Skepticism [Panel Discussion](#)<sup>9</sup> hosted during our June 2015 meeting
- Feedback provided by the IAASB CAG at its [September 2015 meeting](#),<sup>10</sup> following a presentation from an academic specializing in professional skepticism
- Consideration of conceptual issues related to professional skepticism during our [September 2015](#)<sup>11</sup> meeting
- Summary of academic research on professional skepticism undertaken in 2013–2015 and related discussion at our [December 2015 meeting](#)<sup>12</sup>
- Incorporating discussion of professional skepticism into our outreach and liaison activities with a wide range of stakeholders

#### *Areas Being Explored*

37. We believe that responding to the concerns raised about professional skepticism will involve a coordinated approach by the IAASB, IAESB and IESBA. Accordingly, a [Joint Working Group](#) of representatives from these boards is exploring the following areas to inform our deliberations, including:
- Whether it is clear what is meant by “professional skepticism” and whether the concept is consistently described across the ISAs, IESs and IESBA Code – for example, whether the links between the term professional skepticism and other concepts (such as professional judgement, integrity, independence of mind, objectivity, and sufficient appropriate audit evidence) are clear and well-understood.
  - Whether the current requirements and guidance in the International Standards that refer to professional skepticism are clear as to what is expected from auditors, including:
    - Whether the manner in which requirements in the International Standards, in particular those that address the audit of highly judgmental or subjective areas, are designed effectively and use appropriate terminology and language to drive appropriate auditor behavior.
    - Whether guidance can be developed to support auditors in their consideration of whether they have appropriately applied professional skepticism in the context of an individual

<sup>8</sup> <http://www.iaasb.org/publications-resources/basis-conclusions-iaasb-work-plan-2015-2016>

<sup>9</sup> <http://www.iaasb.org/news-events/2015-06/professional-skepticism-panel-discussion>

<sup>10</sup> <http://www.iaasb.org/cag/meetings/new-york-usa-0>

<sup>11</sup> <http://www.iaasb.org/meetings/new-york-usa-10>

<sup>12</sup> <http://www.iaasb.org/meetings/new-york-usa-11>

engagement – for example, has enough of the right kind of work been done, and at the right time, as a basis for the auditor's conclusions?

- Whether there is a need for clarification in the ISAs about what constitutes evidence of the application of professional skepticism and how auditors should document the application of professional skepticism in their working papers.
- Whether there are specific actions that firms should take to address professional skepticism, including consideration of the effect of firm culture on the application of professional skepticism.
- How auditors can be effectively trained and how their competencies can be further developed to enhance the application of professional skepticism.
- How the International Standards should recognize and address the nature of auditors' personal traits and biases that may inhibit the appropriate application of professional skepticism.
- How the technical nature of these concepts can be better brought to life in the auditor's understanding of the purpose of an audit and with respect to stakeholders' expectations about how professional skepticism is to be applied.
- The potential effect of evolving use of technology in audits, together with increasing business complexity, for example, whether auditors use technology (such as audit software applications and checklists) appropriately to support the application of professional skepticism.
- The role of engagement partners, EQC reviewers, audit committees, audit oversight bodies and others in influencing the appropriate application of professional skepticism.
- How the local norms and culture impact the application of professional skepticism.
- Whether a professional skepticism framework or a professional judgment framework that focuses on professional skepticism (a topic already explored by some firms) should be developed.

We plan to emphasize the importance of professional skepticism in revising specific standards.

#### *Our Current Projects – A Step Forward*

38. We believe our current efforts on quality control and group audits, as well as our project on accounting estimates, provide opportunities to reinforce the concept of professional skepticism. Our efforts related to quality control and group audits are described in this consultation, for example:
- (a) How firm leadership responsibility and accountability (i.e., “tone at the top”), firm culture and strategy, as well as actions by the engagement partner, can better promote the application of professional skepticism in audits (see paragraphs 125–135). For example, we will explore:
    - (i) How to reinforce that quality is essential in performing audits and highlight the importance of an internal culture that sets expectations for the appropriate application of professional skepticism throughout the audit, and allows engagement team members to raise concerns without fear of negative consequences.
    - (ii) How a firm's policies and procedures reward and incentivize auditors who demonstrate skeptical behavior in performing audits.

- (b) Steps that could be taken to better encourage appropriate application of professional skepticism with respect to judgments made by the group engagement partner and group engagement team in a group audit, including more robust interactions and communications with component auditors (see paragraphs 198, 201, 242, 288 and 299).
39. As part of its work to revise ISA 540,<sup>13</sup> we will seek to stress the importance of professional skepticism and its role in making professional judgments in relation to the auditing of accounting estimates that are complex or have been identified as having high estimation uncertainty. These accounting estimates generally involve significant management judgment and therefore there is an increased risk of unintentional or intentional management bias. In this regard, consideration could be given as to how the requirements in ISA 540 are drafted, with a view to making amendments that improve the focus on auditors approaching accounting estimates with a more questioning mindset rather than one of corroboration. The revised standard could also highlight the need to consider the effect of contradictory audit evidence that comes to the auditor's attention.
40. Other areas that could benefit from more emphasis on professional skepticism may emerge from our:
- (a) Information-gathering about the use of audit data analytics.
  - (b) Future projects, such as the project to address issues with the auditor's identification and assessment of risks (ISA 315 (Revised)).<sup>14</sup>

#### **Relevant IAESB and IESBA Developments**

41. The IAESB's consultation on its future strategy acknowledges the relevance of the topic of professional skepticism and poses a question to stakeholders about what actions can be undertaken by the IAESB to improve auditors' professional competencies related to the application of professional skepticism.
42. The IESBA is actively contributing to the activities of the Joint Working Group, with a view to determining whether there are areas within the IESBA Code where there would be benefit in elaborating on, emphasizing or clarifying ethical considerations relating to professional skepticism in ways that would support and complement the discussion of professional skepticism in the ISAs and the IESs.

#### **How Your Feedback Will Be Used**

43. The Joint Working Group will consider various inputs, including the feedback to this consultation and the IAESB's next steps in developing its future strategy, as well as relevant national developments and the results of academic research. The group will make observations or recommendations for further actions for the standard-setting Boards to consider. These will include whether standard-setting activities may be appropriate and what other potential actions might be necessary in the public interest.
44. The Joint Working Group's work, feedback from this consultation, and our planned outreach in 2016 is intended to open the dialogue about these fundamental issues. This input will help us consider

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<sup>13</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>14</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*



whether changes to some of our standards could more directly encourage the application of professional skepticism. We will also consider other appropriate actions that we can take, either alone, or in coordination with others. By late 2016, we expect to be in a position to decide on our way forward.

The following questions were included in the detailed ITC.

1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?
2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?
3. Is the listing of areas being explored in paragraph 38–40 complete? If not, what other areas should we or the Joint Working Group consider and why? What do you think are the most important area to be considered?
4. Do you believe the possible actions we might take in the context of our current projects relating to quality control and group audits will be effective in promoting improved application of professional skepticism? If not, why?
5. What actions should others take to address the factors that inhibit the application of professional skepticism and the actions needed to mitigate them (e.g., the IAESB, the IESBA, other international standards setters or NSS, those charged with governance (including audit committee members), firms, or professional accountancy organizations)? Are there activities already completed or underway of which we and the Joint Working Group should be aware?