



Professional Scepticism in an Audit of a Financial Report

August 2012

Message from the AUASB Chairman

Australia continues to experience a prolonged period of economic uncertainty and with that comes associated challenges for firms and participants in capital markets. Against this backdrop, the value of an independent audit is heightened as it enhances the degree of user confidence in financial reports. Many entities today face difficult economic conditions that give rise to financial reporting challenges such as the assessment of going concern, the determination of fair values and the choice of approach to accounting estimates. Furthermore, today's financial reporting requirements seek to address information that is ever more relevant to users. As a result of this challenging environment, more judgement and increased subjectivity is involved in management's accounting and reporting decisions. These developments highlight the importance of auditors exhibiting a sceptical mindset, especially in areas of financial reporting that are complex or involve estimation.

The inspection programs of the Australian Securities and Investments Commission (ASIC) have raised concerns about whether professional scepticism is being applied properly in practice. ASIC's findings provoke questions about whether auditors: respond appropriately to unreliable audit evidence; seek to corroborate

evidence rather than challenge it; and adequately demonstrate in the audit working papers how professional scepticism has been applied. ASIC refers to key areas of audit judgement where the level of professional scepticism exercised or evidenced in the audit files needs to be improved, particularly: fair value measurement of assets; impairment calculations; and going concern assessments. Importantly, audit committees play a significant influencing role and commonly seek to foster appropriate professional scepticism in the external audit. Auditors, in turn, should demonstrate the value of their audit by seeking to convince audit committees that they have properly exercised professional scepticism in the conduct of the audit.

The need for professional scepticism in an audit cannot be overemphasised. Scepticism is an essential attitude that enhances the auditor's ability to exercise professional judgement in identifying and responding to conditions that may indicate possible misstatement. Professional scepticism includes a critical assessment of audit evidence. It also means remaining alert for evidence that contradicts other audit evidence or that brings into question the reliability of information obtained from management and those charged with governance. The consistent application of professional scepticism is imperative for auditors to draw appropriate conclusions in the conduct of their work.

The Auditing and Assurance Standards Board (AUASB) takes this opportunity to emphasise to both auditors and others, the important and fundamental role that professional scepticism has to play in the audits of financial reports. So too, it is opportune to remind audit firms of their role in education, mentoring and inspiring partners and staff to cultivate a sceptical mindset, recognising that it is a vital ingredient in performing high quality audit engagements. This AUASB Bulletin is presented in Question and Answer form and seeks to encourage auditors to bring "professional scepticism" to front-of-mind in the conduct of their audit engagements.

Merran Kelsall
AUASB Chairman

Questions & Answers

The following Questions and Answers are intended as a helpful reminder for auditors to enhance their use of professional scepticism, particularly in this uncertain economic environment.

The AUASB hopes this Bulletin will also provide a useful indicator for audit clients, board audit committees and regulators in their efforts to understand and question the application of professional scepticism by auditors.

Question 1

What is Professional Scepticism?

Professional scepticism is defined in the Auditing Standards as “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.”¹ The Auditing Standards explicitly require the auditor to plan and perform an audit with *professional scepticism* recognising that circumstances may exist that cause the financial report to be materially misstated.

Professional scepticism is fundamentally a mindset. A sceptical mindset drives auditor behaviour to adopt a questioning approach when considering information and in forming conclusions. In this regard, *professional scepticism* is inseparably linked to the fundamental ethical principles of objectivity and auditor independence. *Professional scepticism* is an inescapable element in the exercise of professional judgement.

Question 2

How is Professional Scepticism Applied?

Professional scepticism is applied largely by being alert. For example, being alert to audit evidence that contradicts other audit evidence obtained; or to information that brings into question the reliability of documents or responses to enquiries to be used as audit evidence. Further, it includes being alert to conditions that may indicate possible error or fraud, and to circumstances that suggest the need for audit procedures in addition to those required by the Auditing Standards.

Professional scepticism also includes a critical assessment of audit evidence, which comprises both information that supports and corroborates management’s assertions, and any information that contradicts such assertions. Applying professional scepticism in this regard means questioning and considering the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances.

In cases of doubt about the reliability of information or indications of possible error or fraud, the Auditing Standards require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter. The issue of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

While the auditor cannot be expected to disregard past experience with management and those charged with governance, a belief that they are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism or be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

Question 3

How does Professional Scepticism relate to the auditor’s responsibilities with respect to fraud?

The auditor’s professional scepticism throughout the audit is particularly important when considering the risks of material misstatement due to fraud.

ASA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of a Financial Report* places special emphasis on professional scepticism and requires the auditor to investigate further where conditions identified during the audit cause the auditor to believe that a document may not be authentic or may have been modified.

ASA 240 notes that maintaining professional scepticism in audits requires an ongoing questioning of whether the information and audit evidence obtained by the auditor suggests that a material misstatement due to fraud may exist. This includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. ASA 240 also recognises the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. Accordingly, the requirements of ASA 240 are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing further procedures.

In some cases, the Auditing Standards require the auditor to make presumptions about risks of fraud, the assessment of risks of material misstatement, or specify procedures that are required to be performed. Examples include the required presumption that there are risks of fraud in revenue recognition, the treatment of risks of management override and required procedures addressing the review of accounting estimates for biases.

¹ ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, paragraph 13(l).

The exercise of professional scepticism in addressing assessed risks of material misstatement due to fraud includes:

- Sensitivity in the selection of the nature and extent of entity documentation to be examined.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

Question 4

Why is Professional Scepticism Important?

Arguably the requirements in the Auditing Standards can be perceived as rules to be instinctively followed. However, that is neither the intention nor the auditor's obligation. Auditing, like other professions, requires the auditor to exercise professional judgement in dealing with an infinite number of circumstances. The Auditing Standards are "principles-based" and designed to be applied in practice through the exercise of professional judgement. The quality of that judgement, and consequently the quality of the audit, is dependent on many factors. They include: the auditor's education, training, experience, personality, and importantly, the ingredients of professional scepticism – an ever vigilant and enquiring mind.

Professional scepticism facilitates the proper exercise of professional judgement in audit decisions such as audit strategies and detailed plans, the assessment of evidence, the evaluation of management's judgements and forming conclusions. Without professional scepticism, the auditor does not challenge nor remain alert to inconsistencies and circumstances that indicate actual or potential misstatements or fraud.

In an audit engagement, auditors need to be alert to:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to enquiries.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the Auditing Standards.

Question 5

When is Professional Scepticism Necessary?

Under ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, auditors are required to plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial report to be materially misstated. This means an auditor must exercise professional scepticism *throughout* the audit even though the requirement is not repeated in each Auditing Standard.

Areas where professional scepticism needs to be exercised include, but are not limited to:

- Accepting the engagement—integrity of owners, management and directors;
- Identifying and assessing risks of misstatement—initial risk assessment procedures and revisions to initial assessments and planned audit procedures resulting from audit findings;
- Designing the nature, timing and extent of audit procedures, for example:
 - When considering areas of higher risk.
 - Planning and performing substantive analytical procedures—evaluating the reliability of data, investigating fluctuations or relationships that are inconsistent with expectations.
- Forming and expressing an opinion—concluding whether reasonable assurance has been obtained, deciding on the right form of opinion and evaluating whether fair presentation has been achieved.

An auditor's professional scepticism becomes particularly important when auditing areas that are complex, significant or highly judgemental, such as:

- **Accounting estimates**, including fair value accounting estimates, and related disclosures. For example, when:
 - Evaluating the reasonableness of significant assumptions used by management for accounting estimates that give rise to significant risks.
 - Determining whether changes in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.
 - Reviewing the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- **Going concern**. For example, when evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. It is important to stress that the proper exercise of professional scepticism is critical in evaluating financial

statement disclosures and the implications for the auditor's report when a material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

- **Related party relationships and transactions.** For example, when remaining alert during the audit for information that may indicate previously unidentified or undisclosed related party relationships or transactions; and in the context of identified significant transactions outside the entity's normal course of business, when evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting, to conceal misappropriation of assets or that calls into question the reliability of external confirmation requests.
- **Consideration of laws and regulations.** For example, when remaining alert for instances of non-compliance or suspected non-compliance with those laws or regulations that may have a material effect on the financial statements or that have a fundamental effect on the operations of the entity. This may also be relevant in the context of a group audit, for instance due to business practices and cultures in different jurisdictions.
- **Use of specialists.** Either management or the auditor may employ the services of a subject matter expert to assist with complex areas such as accounting for financial instruments. The auditor needs to exercise professional judgement in assessing the risks of using the work of an expert, in planning to use their work and in the assessment of the audit evidence obtained from the specialist. Particular attention should be paid to the risk of bias in the specialist's work.

Question 6

How is Professional Scepticism Evidenced?

Professional scepticism is often demonstrated in the various discussions held by the auditor during the course of an audit. Those discussions comprise both formal and informal discussions with those charged with governance, management, client staff and the audit team. Documenting the important points of those discussions is required by the Auditing Standards—see comments below.

Good quality evaluations of the auditor's engagement team provide a source of evidence about an auditor's ongoing display of professional scepticism. Specific observations about an auditor's demonstration of professional scepticism not only serve as documented evidence but will certainly assist in training and motivating less experienced auditors.

The Auditing Standards require auditors to document discussions of significant matters. Such documentation helps to demonstrate how significant judgements and key audit issues were addressed and how the auditor has evaluated whether sufficient appropriate audit evidence has been obtained.

The auditor is required to prepare sufficient and appropriate audit documentation to enable an experienced auditor, having no previous connection with the audit, to understand the significant decisions made, the conclusions reached, and the significant judgements made in reaching those conclusions. Although this is the primary audit documentation requirement, such documentation may also serve to demonstrate that professional scepticism has indeed been properly exercised – a brief notation of this fact may be overlooked and is all that is necessary.

An important feature of audit documentation that helps confirm the exercise of professional scepticism is

where the auditor not only documents the corroboration of audit-related matters but also documents *challenges* to the subject matter. All too often, the auditor's working papers provide supporting evidence but rarely include even the briefest notes on *alternatives* considered and the auditor's views on those alternatives.

Examples of circumstances where audit documentation should demonstrate clearly that professional scepticism has been properly applied:

- Discussions among the engagement team.
- Significant decisions regarding the susceptibility of the financial statements to material misstatement due to fraud, or error and communications about fraud or error made to the client and regulator(s).
- Identified or suspected non-compliance with laws and regulations and discussions with the client and regulator(s).
- The basis for the auditor's conclusions on accounting estimates, and any indicators of possible management bias.
- Identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, including how such inconsistency was addressed.
- The basis for the auditor's conclusions on the reasonableness of areas of subjective judgements.
- Use of experts. For example, to check the authenticity of documents and to opine on alternative accounting methods.
- Communications with client management and their staff.

Given that professional scepticism is a state of mind, it is difficult for the auditor's documentation to fully capture how the auditor applied professional scepticism throughout the audit. The Auditing Standards note that there may be no single way in which the auditor's

professional scepticism is documented. Nevertheless, partners, senior auditors and quality assurance reviewers should be alert to this issue and ensure that the entire body of audit documentation on an engagement presents an appropriate level of evidence that professional scepticism has been clearly exercised.

Auditors should carefully consider improving audit working papers to demonstrate the exercise of professional scepticism that is perhaps more clearly evidenced in working paper review notes.

Question 7

How can awareness of the importance of Professional Scepticism be maintained?

Professional scepticism is influenced by personal behavioural traits (i.e., attitudes and ethical values) as well as the competence level (i.e., knowledge) of the individuals undertaking the audit. These, in turn, are influenced by education, training and experience. Professional scepticism within the engagement team is also influenced both by the actions of the firm's leadership and the engagement partner, and by the culture and business environment of the firm. The Auditing Standards include requirements and guidance designed to help create an environment at both the firm and engagement levels in which the auditor can cultivate appropriate professional scepticism.

The key drivers are:

- Fostering conditions necessary for individual auditors, engagement teams and audit firms to demonstrate the appropriate degree of professional scepticism.
- Ensuring that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit.

Firm Level

The challenge for firms is to attract, develop and retain people with the appropriate skills and attitudes. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. Accordingly, the 'tone at the top' and continual reinforcement of the importance of professional scepticism on audit engagements are important influences on individuals' behaviour.

Continual reinforcement of the importance of professional scepticism is achieved through:

- a. The establishment of policies and procedures that address performance, evaluation, compensation, and promotion;
- b. Developing and implementing internal training and continuing education programs for all levels of the firm personnel; and
- c. Monitoring and assessing the effectiveness of a. and b. above.

The culture of the firm should emphasise the importance of:

- a. Understanding shareholders' perspectives when making audit judgement;
- b. Coaching less experienced staff; and
- c. Sharing experiences about difficult audit judgements.

Firm methodologies and review processes should provide practical support for auditors in:

- a. Understanding a business and assessing risk;
- b. Early identification of issues enabling time to resolve them;
- c. Identifying and assessing unusual transactions;
- d. Changing risk assessments, materiality and audit plans in response to audit findings;

- e. Documenting audit judgements demonstrating the rationale for conclusions, the relationship of the conclusions to the underlying circumstances and the strength of audit evidence obtained—thereby illustrating the appropriate use of professional judgement; and
- f. Raising matters with board audit committees/directors and offering alternatives that may reflect shareholder perspectives.

Engagement Level

The engagement partner takes responsibility for the overall quality of each audit engagement to which that partner is assigned. The engagement partner's actions and appropriate messages to the other members of the engagement team emphasise that:

- a. Quality is an essential focus in performing audit engagements; and
- b. The engagement team's ability to raise concerns and issue auditor's reports that are appropriate in the circumstances are fundamental to audit quality.

Ideal opportunities to address and emphasise the importance of maintaining professional scepticism throughout the audit is during audit team discussions on:

- a. The susceptibility of the entity's financial statements to material misstatement through error or fraud;
- b. The integrity and honesty of management and those charged with governance; and Communicating information affecting risk assessments and audit procedures.

The knowledgeable and experienced engagement partner, audit manager/supervisor and the engagement quality reviewer can all help others develop a questioning mind and can set expectations and emphasise the importance of professional scepticism when:

- a. Directing and supervising the audit engagement, especially in areas of judgement, significant risk and contentious matters;
- b. Demonstrating good business knowledge and experience—providing a basis for identifying unusual events or transactions;
- c. Being actively involved in leading and participating in team planning meetings, and assessing risk and planning audit strategies and procedures;
- d. Consulting specialists; and
- e. Reviewing audit documentation that requires improvement in demonstrating the exercise of professional scepticism.

It is the responsibility of each individual auditor to maintain an attitude of professional scepticism throughout the audit. Continual self-assessment enables the auditor to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations, or using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

Individual auditors should:

- a. Obtain a good understanding of the business;
- b. Develop a questioning mind and be willing to challenge management's assertions;
- c. Critically assess information and explanations;
- d. Challenge audit evidence as well as corroborate it;
- e. Develop a sense of management's motivations for possible misstatements;
- f. Investigate the nature and cause of deviations or misstatements without jumping to conclusions;
- g. Be constantly alert for evidence that is inconsistent with, or calls into question the reliability of, other audit evidence;
- h. Consider alternatives where appropriate; and

- i. Develop confidence and persistence as essential personal traits in the conduct of a quality audit.

Board Audit Committees

Board audit committees can have a significant influencing role in their relationship with the external auditor. A board audit committee can seek to foster appropriate professional scepticism in the external audit through, for example:

- a. Challenging the auditor's understanding of the business, its environment and risks;
- b. Questioning whether the auditor has obtained an adequate understanding of relevant laws and regulations;
- c. Ensuring contentious issues and issues requiring significant judgement that management and the auditor have resolved are brought to the attention of the board audit committee;
- d. Understanding whether an appropriate degree of challenge was exercised by the auditor in resolving such issues—by requesting an explanation of the auditor's rationale, alternatives considered and why a particular alternative was considered most appropriate; and
- e. Promoting a culture within the entity that elicits a constructive response from management and staff to auditor challenges.

It is important for auditors to remain vigilant to the risk of considering the views of the board audit committee as replacement for the views of shareholders. The auditor's approach should be responsive to the expectations and perspectives of shareholders and other stakeholders. The degree to which professional scepticism is exercised on audit judgements will depend on the circumstances present on each engagement that the auditor is required to address.

Conclusion

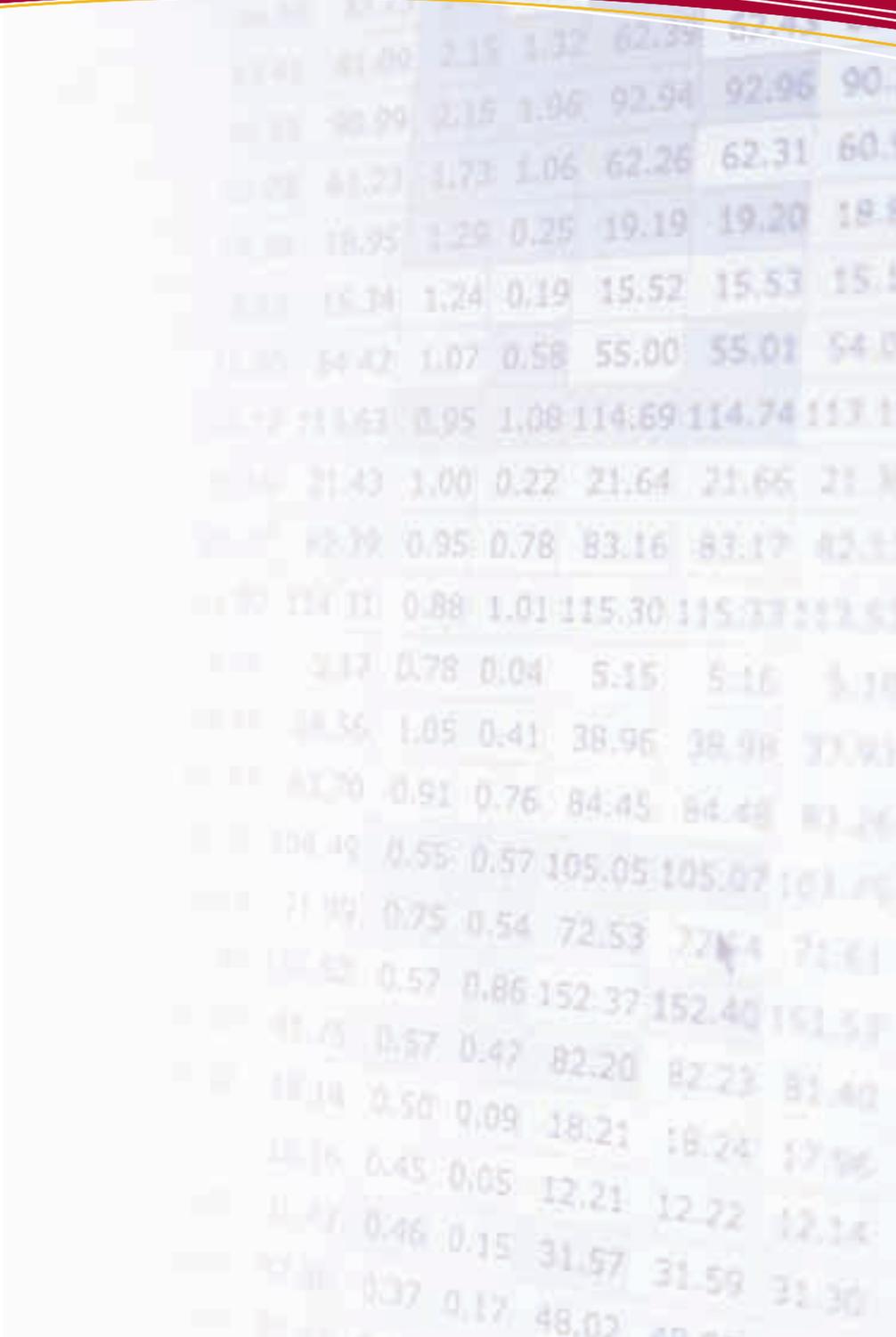
Although the nature of professional scepticism poses a number of challenges to auditors, as outlined above, it can be argued that professional scepticism is inherent in all audit activities. The characteristics of audit team supervision, communications, compliance with standards and file reviews alone demonstrate that professional scepticism is employed in conducting an audit.

The real questions on the exercise of professional scepticism are about how it is evidenced; how its sufficiency and appropriateness are assessed; and how it is perceived by others?

The test for auditors, especially in an uncertain economic environment, is to remain alert, to improve audit documentation and to continually and critically re-assess the application of professional scepticism. The engagement partner and engagement quality reviewer are in prime positions to significantly influence improvements in the application and documentation of the use of professional scepticism.

Further References

- The IAASB Staff Questions and Answers paper: *Professional Skepticism in an Audit of Financial Statements*; and
- The UK Auditing Practices Board's paper: *Professional Scepticism Establishing a Common Understanding and Reaffirming its Central Role in Delivering Audit Quality*.



1141	41.00	2.15	1.32	62.39	62.39	62.39
1142	38.99	2.15	1.96	92.94	92.96	90.1
1143	41.23	1.73	1.06	62.26	62.31	60.0
1144	18.95	1.29	0.25	19.19	19.20	18.5
1145	15.34	1.24	0.19	15.52	15.53	15.1
1146	14.42	1.07	0.58	55.00	55.01	54.0
1147	11.63	0.95	1.08	114.69	114.74	113.1
1148	21.43	1.00	0.22	21.64	21.65	21.3
1149	42.39	0.95	0.78	83.16	83.17	82.3
1150	114.11	0.88	1.01	115.30	115.33	112.5
1151	5.17	0.78	0.04	5.15	5.16	5.14
1152	38.35	1.05	0.41	38.95	38.98	37.93
1153	81.70	0.91	0.76	84.45	84.48	83.26
1154	104.49	0.55	0.57	105.05	105.07	103.49
1155	71.99	0.75	0.54	72.53	72.54	71.61
1156	152.52	0.57	0.86	152.37	152.40	151.58
1157	41.25	0.57	0.47	82.20	82.23	81.40
1158	18.14	0.50	0.09	18.21	18.24	17.96
1159	12.16	0.45	0.05	12.21	12.22	12.14
1160	31.47	0.46	0.15	31.57	31.59	31.30
1161	48.02	0.37	0.17	48.02	48.02	47.65

Copyright

© 2012 Auditing and Assurance Standards Board. The text, graphics and layout of this AUASB Bulletin are protected by Australian copyright law and the comparable law of other countries. Reproduction within Australia in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgment of the source. Requests and enquiries concerning reproduction and rights for commercial purposes within Australia should be addressed to the Executive Director, Auditing and Assurance Standards Board, PO Box 204, Collins Street West, Melbourne Victoria 8007. Otherwise, no part of this AUASB Bulletin may be reproduced, stored or transmitted in any form or by any means without the prior written permission of the AUASB except as permitted by law.

Disclaimer

AUASB Bulletins are issued to raise a general awareness of matters that are of interest to auditors and assurance practitioners. They do not provide authoritative guidance and do not amend existing Auditing Standards and Guidance Statements. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this AUASB Bulletin, or for any errors or omissions in the document.



Australian Government

**Auditing and Assurance
Standards Board**

Auditing and Assurance Standards Board

PO Box 204
Collins Street West
Melbourne 8007
Australia

Phone: +61 3 8080 7400

Fax: +61 3 8080 7450

Email: enquiries@auasb.gov.au