

AUASB Bulletin

Professional Scepticism in an Audit of a Financial Report

Australia, along with the rest of the world, continues to experience a prolonged period of financial uncertainty and with that comes the associated difficulties for all involved in financial markets. Against this backdrop of economic insecurity, the value of an independent audit is amplified because 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 and the determination of fair values. Furthermore, today's financial reporting seeks to address information that is ever more relevant to users. As a result of these imposing circumstances, more judgement and increased subjectivity is involved in management's accounting and reporting decisions. These developments heighten the importance of professional scepticism by auditors, especially in areas of financial reporting that are complex or highly judgmental.

Globally, audit inspections have raised concerns about whether professional scepticism is being applied properly in practice. Comments raised have included questions about auditors not responding appropriately to unreliable audit evidence, having sought to corroborate evidence rather than challenge it and not adequately demonstrating in the audit working papers how professional scepticism has been applied.

The need for professional scepticism in an audit cannot be overemphasised. Professional 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 vigilant 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 up-coming year-end audit engagements.

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Questions and Answers

The following Questions and Answers are intended as a helpful reminder for auditors to enhance their use of professional scepticism, especially 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.

Q1. 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.

Q2. 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. For example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

In cases of doubt about the reliability of information or indications of possible error or fraud, the Auditing Standards require that the auditor to investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter. The matter 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.

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

Q3. 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 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.

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

- Increased sensitivity in the selection of the nature and extent of entity documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters - management is often in the best position to perpetrate fraud.

Q4. 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 judgements 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.

Q5. How is Professional Scepticism Evidenced?

Professional scepticism is demonstrated in basically 2 ways – the spoken word and the written word.

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 and client staff and also with the audit team. Documenting the important points of those discussions is required by the Auditing Standards (see comments below) however, good quality staff assessments 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 judgments and key audit issues were addressed and how the auditor has evaluated whether sufficient and appropriateness of audit evidence has been obtained.

Under the Auditing Standards, 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 among other things, the significant decisions made regarding significant matters arising during the audit, the conclusions reached thereon, and significant judgments 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 – brief notation of this fact may be overlooked and all that is necessary.

An important feature of audit documentation that helps confirm the exercise of professional scepticism is where the auditor does not only document corroboration of audit-related matters but 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* 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 material misstatement due to fraud, and communications about fraud made to the client and regulators.
- Identified or suspected non-compliance with laws and regulations and discussions with the client and regulators
- 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 judgments.

- Use of experts – for example, to check the authenticity of documents and to opine on alternative accounting methods

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.

Q6. 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 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.
- c. Monitoring and assessing the effectiveness of a. and b. above.

Engagement Level

The engagement partner takes responsibility for the overall quality on each audit engagement to which that partner is assigned. The actions of the engagement partner and appropriate messages to the other members of the engagement team emphasize that quality is essential in performing audit engagements and the importance to audit quality of, for example, the engagement team's ability to raise concerns without fear of reprisals and in issuing auditor's reports that are appropriate in the circumstances.

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;

- b. How and where fraud might occur;
- c. The integrity and honesty of management and those charged with governance; and
- d. 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. Consulting specialists;
- c. 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.

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 is assessed; and how it is perceived by others?

The test for auditors, especially in this current economic environment, is to remain alert, to improve audit documentation and to continually and critically re-assess the application of professional scepticism.

This Bulletin, comprising Questions & Answers (Q&A), does not amend or override the Australian Auditing Standards, the texts of which alone are authoritative. Reading this Q&A publication is not a substitute for reading the standards. This Q&A Bulletin is not meant to be exhaustive and reference to the standards themselves should always be made. This publication does not constitute an official pronouncement of the AUASB.