



**AUDITING PRACTICES BOARD**

**AUDITOR SCEPTICISM: RAISING THE BAR  
FEEDBACK PAPER**

**MARCH 2011**

# Auditor scepticism: Raising the Bar – Feedback Paper

10 March 2011

## *Introduction*

1. The application of an appropriate degree of professional scepticism is a crucial skill for auditors. It is clear that auditors must be prepared to challenge management's assertions in order both to act as a deterrent to fraud and to be able to confirm, with confidence, that a company's financial statements give a true and fair view. However, balance is required – challenging everything in a well run company may slow down the publication of its financial statements and risk unnecessary costs.
2. In August 2010 the Auditing Practices Board (APB) issued a Discussion Paper 'Auditor Scepticism: Raising the Bar' with the objective of exploring:
  - The nature of auditor scepticism and how it is developed and promoted within audit firms, and
  - Whether more needs to be done to ensure that an appropriate degree of scepticism is applied in practice.
3. The purpose of this Feedback Paper is to summarise the comments received in response to 'Auditor Scepticism: Raising the Bar' and to outline the proposed actions that the APB, and other parts of the Financial Reporting Council (FRC), intend to take.
4. In June 2010, the FSA and the FRC jointly issued Discussion Paper 10/3 entitled 'Enhancing the Auditor's Contribution to Prudential Regulation'. One of the issues explored in that Discussion Paper was how the application of professional scepticism could be enhanced in the audits of financial institutions in the key areas of judgement concerning accounting estimates and related disclosures. There is therefore some overlap between these two consultations and the responses received in relation to DP 10/3 relating to auditor scepticism have been taken into account in developing this Feedback Paper. The Feedback Statement on DP 10/3 can be found at [www.frc.org.uk/publications/pub2302.html](http://www.frc.org.uk/publications/pub2302.html).
5. However, the issues discussed in 'Auditor Scepticism: Raising the Bar' were raised in the wider general context of auditor scepticism in audits in all market sectors and this Feedback Paper, including our proposed actions, is framed in that wider general context too.

6. 27 responses to 'Auditor Scepticism: Raising the Bar' have been received from:

Accounting firms	11
Accountancy bodies	6
Other stakeholders	10

7. A list of individual respondents is included as Appendix 1 and their responses have been posted to the APB's website<sup>1</sup>. While there was a high degree of consistency in the responses from the accountancy firms and their professional bodies, the responses from other stakeholders varied on whether adequate scepticism was consistently applied and, if not, what action should be taken.

---

<sup>1</sup> [www.frc.org.uk/apb/publications/response\\_scepticism.cfm](http://www.frc.org.uk/apb/publications/response_scepticism.cfm).

## *Summary of responses received*

### **Responses from the accountancy profession**

#### *Scepticism in practice*

8. Responses from accountancy firms and accountancy bodies recognised that scepticism is a vital ingredient for audit quality and that it is primarily developed and maintained through cultural, human resource and training arrangements within the firms. Many of these responses asserted that auditors are sufficiently sceptical in practice and challenged the basis on which regulators question whether sufficient scepticism had in fact been demonstrated in recent audits.
9. Several of the responses from the profession noted that there was a possibility that regulators could confuse the proper application of IFRS, which contemplates a range of potential outcomes, with a lack of scepticism on the part of the auditor. In particular some drew attention to the requirement that impairment losses for financial assets need a neutral assessment of loss events incurred at the balance sheet date and not losses that are expected to occur in the future. Other responses observed that it was not unusual for auditors and management to have different views on estimates but suggested that, where both fell within a reasonable range, it was inappropriate for the auditor to try to replace management's view of what a reasonable estimate was with their own.
10. Many of the responses from the profession noted that new Auditing Standards (especially the Standard that relates to the audit of accounting estimates<sup>2</sup>) are more rigorous and encouraged regulators to monitor the effectiveness of these new standards before taking further action.

#### *Transparency*

11. Some of the responses from the accountancy profession acknowledge that it is difficult for regulators, when performing inspections based on 'cold reviews' of working papers, to determine whether sufficient scepticism had been exercised in practice. They noted that working papers are designed to document the audit evidence that has been obtained to support the auditor's opinion on the financial statements and that this does not always involve documenting all aspects of the audit teams' thought process during the course of the audit. Some respondents thought that it was worth exploring whether working papers should record more of the audit team's thought process, but few considered that the retention of review notes would achieve this objective. Some thought that the

---

<sup>2</sup> ISA (UK & I) 540 'Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures' applies to audits of accounting periods ending on or after 15 December 2010

auditor's communications with audit committees could be used to demonstrate the scepticism that was applied during the audit.

### *Role of audit committees*

12. Many of the responses from the accountancy profession recognised that audit committees can enhance auditor scepticism and saw benefit in the FRC developing further guidance for audit committees in this area. Some also observed that audit committees indirectly influence audit quality by having a beneficial effect on the culture and processes of the audited entity and a few respondents thought that there would be benefit in the FRC developing guidance for directors on the quality, sufficiency and integrity of the evidence they should be producing to support key financial statement judgements. The FRC paper on Going Concern<sup>3</sup> was seen as having had a beneficial impact on practice and was seen as a good precedent for integrated guidance on accounting, auditing and corporate governance.

### *The nature of scepticism*

13. Several responses commented on the APB's description of the nature of scepticism. While there appears to be a reasonable degree of support for the analysis in the Discussion Paper that described a 'sliding scale' that distinguished the initial mindset from the reaction to audit findings, there was strong disagreement that the initial mindset should be characterised as one of 'presumptive doubt'.

### *Research*

14. The Discussion Paper contained an appendix that described academic research in the area of auditor scepticism. Because little research work has been undertaken in the UK, this described work that had been undertaken in the United States and some of it dated back to the 1990's. Many of the respondents questioned the relevance of the research on the basis of the age and origin of the work performed and disagreed with many of the research findings. However, there was little encouragement for relevant research to be undertaken in the UK.

### *Continual improvement*

15. A number of responses from audit firms stated that they are not complacent about the level of scepticism currently demonstrated and are committed to continuous improvement in audit quality including the ongoing training of auditors in the skills required for them to have the appropriate questioning mindset.

---

<sup>3</sup> 'Going concern and financial reporting' issued in November 2008

## Responses from other stakeholders

16. The evidence from investors and the corporate sector was more questioning of the extent to which scepticism was in fact being applied by auditors. Those investor groups who responded generally welcomed the Discussion Paper, confirmed the importance of auditor scepticism and, while recognising the changes that have taken place in the accounting framework, thought that auditors needed to do more to challenge management. There was also support for instilling a greater awareness of the importance of scepticism through increased training and changes in the culture within audit firms.
17. Responses from the corporate sector generally suggest that sufficient scepticism is currently being applied and warned about the impact of raising the level of scepticism required on the cost of audits.
18. Other responses included:
  - a summary of responses to a questionnaire addressed to internal auditors,
  - a view from an academic that the concept of 'critical thinking', combined with more emphasis on understanding management motivation, would help set the appropriate mindset,
  - a view that more emphasis should have been given to compliance with legal requirements relating to adequate accounting records and capital maintenance, and
  - a view, from a retired audit practitioner, that significant changes were needed to the process for auditor appointment and to the liability environment if scepticism was to be achieved in practice.
19. Access was also provided to a website that described one person's experience in dealing with an audit firm, and a forensic accountant, in the context of whistle blowing.
20. Because of the variety of views expressed by other stakeholders it is difficult to prepare a succinct summary of their responses; readers are encouraged to read the full responses on the APB website.

## *Proposed actions*

### **Auditing Practices Board**

21. The majority of the responses received, especially from the accountancy profession, observed that many of the new requirements in the recent Clarity ISAs (UK & Ireland) have the effect of better embedding scepticism into audit processes and warned against further prescription within the Standards until the effectiveness of the Clarity ISAs has been evaluated. Whilst recognising the importance of this point, the APB has decided to undertake work in the following areas:
- Ensuring that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit,
  - Reviewing ISAs (UK & I) for possible ambiguities in relation to the nature and importance of professional scepticism, and proposing such changes as may be needed to make sure the position is clear,
  - Reviewing ISQC (UK & I) 1 to ensure that it has sufficient requirements and guidance relating to the need for firms to have appropriate policies and procedures for promoting the competencies that underlie professional scepticism,
  - Considering how the application of scepticism can be made more transparent, and
  - Considering, with other parts of the FRC, whether there is a need for guidance on the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been the subject of significant challenge by auditors.

#### *Ensuring that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit*

22. The Discussion Paper noted that the degree of scepticism to be applied is important because it influences both the effectiveness and the efficiency of an audit. Too little scepticism undermines audit effectiveness; too much risks unnecessary cost. The Discussion Paper observed that current auditing literature was not very forthcoming about the degree of scepticism to be applied in practice.
23. In order to advance debate about the degree of scepticism to be applied in practice, the Discussion Paper suggested that there was a sliding scale involving (1) an initial mindset and (2) reaction to findings. In relation to the initial mindset it was suggested that a distinction could be made between a neutral position (where the auditor does not assume either that the financial statements are misstated or that management is dishonest) and a more questioning approach that is sometimes referred to as

'presumptive doubt'. It suggested that the recently updated ISAs (UK&I) could be characterised as reflecting a 'presumptive doubt' approach.

24. There was considerable adverse reaction from the accountancy profession to the suggestion that the ISAs (UK &I) reflected a 'presumptive doubt' approach. Many respondents thought that use of this term meant that the auditor had to assume that there was a misstatement both when planning the audit and when evaluating audit evidence. They thought that this was inappropriate and that requiring this to be the initial mindset would significantly add to audit costs. This reaction to what was meant by 'presumptive doubt' was a misunderstanding, the Discussion Paper had used the term as it had been used in academic research<sup>4</sup>, as meaning 'the auditor exhibiting a heightened awareness of the risk that the figures could be affected by error or dishonesty' rather than making the assumption that there was a misstatement.
25. Putting to one side what the initial mindset is called, responses from the accountancy profession demonstrated a wide range of views about what the initial mindset should be, from one of presumptive doubt through to one of having 'a neutral mindset'. Taken together with the FSA's concerns expressed in DP 10/3 that in some cases the auditor's approach seems to focus too much on gathering and accepting evidence to support management's assertions, we are concerned that there is a lack of consensus about the nature of professional scepticism and its role in the conduct of an audit.
26. The APB does not accept that the auditor's role is limited to ensuring that management have appropriate evidence to support its assertions if this means accepting the evidence management present without subjecting it to robust challenge and comparison to alternative sources of evidence. The APB also questions whether even a 'neutral mindset', or indeed just an 'inquiring mind', is the appropriate mindset for an auditor especially when :
- this mindset is applied during the planning process to assess the risk of misstatement in the different elements of the financial statements and these risk assessments are fundamental in determining the nature and extent of evidence to be obtained in the rest of the audit, and
  - many of the numbers in financial statements are accounting estimates.
27. The APB also notes that an element of 'doubt' underlies a number of the requirements in Auditing Standards<sup>5</sup>.

---

<sup>4</sup>Bell,T.B, M.E. Peecher, and I. Solomon. 2005 'The 21<sup>st</sup> century public company audit'.

<sup>5</sup> ISA (UK & I) 200 states 'The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated and ISA (UK & I) 240 states 'the auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the

28. Accordingly, the APB intends to give further thought to how best to achieve a more consistent understanding, both for auditors and audit committees, of the nature of professional scepticism and its role in the conduct of an audit.

*Reviewing ISAs (UK & I) for possible ambiguities in relation to the nature and importance of professional scepticism and proposing such changes as may be needed to make sure the position is clear*

29. Once a consistent understanding as to the nature of professional scepticism and its role in the conduct of an audit has been developed, the APB will determine whether changes, including additional guidance, need to be made to ISAs (UK & I) or whether communicating a consistent understanding can be accomplished by other means.

*Reviewing ISQC (UK & I) 1 to ensure that it has sufficient requirements and guidance relating to the need for firms to have appropriate policies and procedures promoting the competencies that underlie professional scepticism*

30. ISQC (UK and I) 1<sup>6</sup>, the standard relating to audit firms' quality control systems, requires audit firms to establish policies to:

- Provide them with assurance that they will have sufficient personnel with the competence and capabilities to perform audits (paragraph 29), and
- Assign personnel to audit engagements with appropriate competence and capabilities (paragraph 31).

31. There is little in ISQC (UK & I) 1, or indeed ISAs (UK & I), that establishes requirements relating to the ways in which competence and capabilities are obtained through recruitment, formal training, on the job training and appraisal processes. The APB intends to explore whether there would be benefit in expanding ISQC (UK & I) 1 to require audit firms to have policies and procedures that effectively promote, develop and nurture in their personnel the competencies that support and underlie the application of professional scepticism.

32. In this context, the APB will also consider whether to develop a framework of the appropriate competencies that support and underlie professional scepticism, including the ability to assimilate a sufficient understanding of the audited entity's business to enable effective challenge, critical analysis of the evidence and properly based audit judgements. This may involve revisiting The Auditors Code in the context

---

auditor's past experience of the honesty and integrity of the entity's management and those charged with governance'.

<sup>6</sup> International Standard on Quality Control

of current standards and guidance including ISA (UK&I) 200 which refers to the need for judgement and scepticism and the APB's Ethical Standards for Auditors which establish the importance of objectivity and integrity.

*Considering how the application of scepticism can be made more transparent*

33. A number of respondents observed that there is little transparency as to the extent of scepticism demonstrated by the auditors and thought that audit committees could usefully explore this in the context of their review of audit effectiveness. The APB believes that audit committees have an important role to play in assessing whether auditors have been sufficiently sceptical in practice and whether the right environment has been established by them and by management to facilitate appropriate auditor scepticism. One way of facilitating this assessment could be by expanding the reports that auditors currently prepare for audit committees to highlight the key areas where auditors have challenged management's views and whether and how those challenges were resolved to their satisfaction. This idea resonates closely with some of the thoughts in the FRC's Discussion Paper 'Effective Company Stewardship' issued in January 2011<sup>7</sup>. The APB plans to explore this idea in conjunction with considering responses to 'Effective Company Stewardship'.
34. 'Auditor Scepticism: Raising the Bar' noted that academic research suggested that audit firms' electronic documentation systems limit the retention of detailed comments that show how thinking on a particular topic evolved and how final conclusions were reached. It noted that, in the past, some of the 'thought trail' might have been provided through partner and manager review notes but observed that review notes are not now commonly retained. The Discussion Paper questioned whether the retention of review notes would help describe the 'thought trail' as well as provide evidence of the effectiveness of the review process.
35. A number of audit firms acknowledged that there may be potential for considering how working papers might be enhanced to better demonstrate that scepticism had been applied but the majority opposed the retention of review notes on the basis that:
- Most review notes were of the nature of 'housekeeping' and did not document the auditor's thought process,
  - Retaining review notes would increase the audit firms' litigation risk, and
  - ISAs (UK & I) were correct in focussing on the documentation on the nature and extent of the evidence obtained to support the auditor's opinion on the financial statements.

---

<sup>7</sup> [www.frc.org.uk/publications/pub2486.html](http://www.frc.org.uk/publications/pub2486.html)

36. While there may be some merit in firms retaining review notes initially the APB intends to explore whether the preparation of summary memoranda that set out the rationale for the most important audit judgements should be mandated, at least for the audit of listed companies. Requiring a summary of the thought process on important issues is likely to:

- Improve the quality of the thought process,
- Encourage the application of scepticism, and
- Provide transparency to the rationale for the most important audit judgements to assist Engagement Quality Control and other reviews.

The APB hopes that a thorough understanding of the issues should enable crisp, concise documentation, focused on the important issues, to be prepared, which should not be overly time consuming.

37. The APB will also explore whether engagement team reviews of audit work and documentation and related audit firm policies and procedures<sup>8</sup> could be more effective in recording the most important audit judgments and promoting the application of appropriate auditor scepticism, and if so how.

*Considering, with other parts of the FRC, whether there is a need for guidance on the approach to be taken by auditors when considering the presentation in the financial statements of matters that have been the subject of significant challenge by auditors.*

38. In conjunction with other parts of the FRC, the APB will explore the need for guidance on the approach to be taken by auditors when considering the true and fair presentation of financial information (especially in relation to the adequacy of disclosures) about matters (such as key judgments and assumptions underlying critical accounting estimates) that have been subject to significant challenge by them as a result of the proper adoption of a sceptical mindset.

### **Professional Oversight Board (POB)**

39. Many of the responses from the profession asserted that auditors are sufficiently sceptical in practice and challenged the basis on which regulators question whether sufficient scepticism was in fact demonstrated in recent audits. The Audit Inspection Unit (AIU) has met or will meet with each of the major firms to provide specific examples to support the concerns set out in their 2010 report.

40. Taking account of the responses received, POB has decided to undertake work in the following areas:

---

<sup>8</sup> Such reviews are required to be performed in accordance with ISA(UK&I) 220 and policies and procedures for such reviews are required to be established by the audit firm in accordance with ISQC (UK&I) 1.

- The AIU will continue to focus on the extent to which scepticism has been applied in practice in the course of those audits subject to future inspection,
- The AIU will review the application of the new requirements of ISA (UK&I) 540 on the audit of accounting estimates, and
- The POB will explore how scepticism is recognised within the audit firms' competency frameworks.

## **Financial Reporting Council**

41. A number of the responses to the Discussion Paper recognised that audit committees can enhance auditor scepticism and indirectly enhance audit quality through encouraging an appropriately supportive culture and processes in the audited entity. Some saw benefit in the FRC developing further guidance for audit committees.
42. Harnessing the powers of audit committees to improve both audit quality and the quality of the judgements made in financial reporting underlies a number of the provisions in the UK Corporate Governance Code for listed companies and supporting guidance. This theme also arises in some of the proposals in the FRC Discussion Paper 'Effective Company Stewardship' on which comments have been invited by 31 March 2011. The FRC will consider responses to 'Effective Company Stewardship' before deciding whether to take further action in this area.

## Appendix 1

### Respondents to 'Auditor Scepticism: Raising the Bar'

	<b>Accounting Firms</b>
1	Baker Tilly
2	BDO
3	Deloitte
4	Ernst & Young
5	Grant Thornton
6	KPMG
7	Kingston Smith
8	Mazars
9	PricewaterhouseCoopers
10	Wales Audit Office
11	National Audit Office
	<b>Accountancy Bodies</b>
1	ACCA
2	CIPFA
3	ICAI
4	ICPAI
5	ICAEW
6	ICAS
	<b>Other stakeholders</b>
1	British Telecommunication plc
2	The Confederation of British Industry (CBI)
3	Dr Andrew Higson
4	Chartered Institute of Internal Auditors (CIIA)
5	Investment Management Association (IMA)
6	Leeds Building Society
7	Mr C Yaxley
8	International Corporate Governance Network (ICGN)
9	Local Authority Pension Fund Forum (LAPFF)
10	Association of British Insurers (ABI)



**FINANCIAL REPORTING COUNCIL**

**5TH FLOOR**

**ALDWYCH HOUSE**

**71-91 ALDWYCH**

**LONDON WC2B 4HN**

**TEL: +44 (0)20 7492 2300**

**FAX: +44 (0)20 7492 2301**

**WEBSITE: [www.frc.org.uk](http://www.frc.org.uk)**

© The Financial Reporting Council Limited 2011

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368.  
Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.