



AUDITING PRACTICES BOARD

PROFESSIONAL SCEPTICISM

**ESTABLISHING A COMMON UNDERSTANDING AND REAFFIRMING
ITS CENTRAL ROLE IN DELIVERING AUDIT QUALITY**

MARCH 2012

Professional scepticism

Establishing a common understanding and reaffirming its central role in delivering audit quality

Contents

	Page
Section 1 Introduction	1
Section 2 Exploring the roots of scepticism and identifying lessons for its role in the conduct of an audit	3
Section 3 Scientific scepticism and the scientific method	6
Section 4 The origins of the modern audit	9
Section 5 Conclusions about professional scepticism in the audit	12
Section 6 Fostering conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism	14
Section 7 Taking these matters forward	18

Professional Scepticism

Section 1 - Introduction

This paper sets out the APB's considered views on the nature of auditor scepticism and its role in the audit. Given the significance of scepticism to the quality of individual audits, and to the value of audit more generally, we believe that this document is an important point of reference on this topic and one which we hope all auditors will consider with great care.

It is written in an unusual format for an APB document, being much more discursive than is customary and drawing analogies from a diverse group of areas. This is because we believe that what is meant by scepticism needs to be more broadly understood and that drawing these analogies will assist in broadening that understanding. We are also keen to stimulate and provide input to an international debate on the issue of scepticism and believe that this broader and more discursive approach will provide a valuable input to that debate.

This document builds on the APB Discussion Paper published in August 2010 'Auditor Scepticism: Raising the Bar' and the subsequent Feedback Paper published in March 2011, which summarised the comments received and outlined the actions that the APB, and other parts of the FRC, intended to take in light of the responses received.

The Feedback Paper noted the following¹:

- Responses suggested a wide range of views about what the initial mindset should be and raised concerns for the APB that there is a lack of consensus about the nature of professional scepticism and its role in the conduct of an audit.
- The APB did 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 questioned whether a 'neutral mindset', or indeed just an 'inquiring mind', is appropriate for an auditor. The auditor's mindset is applied during audit planning to assess the risk of misstatement of the financial statements and such risk assessments determine the nature and extent of audit evidence to be obtained. It is also applied in assessing the validity of accounting estimates that are subject both to significant uncertainties and to considerable management judgment.

The first of the areas in which the APB proposed to undertake further work was ensuring that there is a consistent understanding of the nature of professional scepticism and its role in the conduct of an audit.

Section 2 considers the philosophical origins of scepticism in ancient Greece and how it later influenced scepticism in the scientific method that began to flourish in the 17th Century. The relationship between scepticism and the disposition to believe or disbelieve is explored as well as the influences of evidence and behaviours on that disposition.

¹See 'Auditor scepticism: Raising the bar: Feedback Statement' – March 2011
<http://www.frc.org.uk/apb/publications/pub2343.html>

Professional Scepticism

Section 3 seeks to provide insight into the mind-set required to develop the audit strategy and plan and to evaluate the audit evidence obtained, by demonstrating how another learning – science – has developed a sceptical approach that now commands respect.

Section 4 seeks to provide further insight into the mindset of the auditor by considering the nature of the agency relationships, and the resultant need for assurance, that gave rise to early auditing traditions in manorial households from the 14th Century.

Section 5 sets out the APB's conclusions from the foregoing analysis as to what a sceptical audit looks like. It suggests that professional scepticism is the cornerstone of audit quality – it defines the quality of each audit judgment and through these the overall effectiveness of the audit in meeting the needs of shareholders and other stakeholders.

Section 6 sets out the APB's views about the conditions that are necessary for auditors to demonstrate the appropriate degree of professional scepticism. It highlights the APB's expectations of individual auditors, engagement teams, audit firms and of the supporting role that can be played by audit committees, management and others.

Finally, Section 7 sets out how the APB proposes to take these matters forward.

Professional Scepticism

Section 2 – Exploring the roots of scepticism and identifying lessons for its role in the conduct of an audit

Scepticism is derived from the Greek word “σκέψις” (skepsis), meaning²: *examination, inquiry into, hesitation or doubt, especially of the Sceptics or Pyrrhone philosophers*. Greek philosophical Scepticism was a school of thought from the 5th Century BC that doubted the certainty of knowledge. From this developed the philosophical viewpoint that it is not possible to gain certain knowledge (truth) about the natural world.

Scepticism in Greek philosophy

Beyond understanding the etymological basis for the modern term “scepticism”, what more can we learn from early Greek philosophical scepticism?

- First, the essence of scepticism is doubt and that doubt stimulates informed challenge and inquiry. The sceptics’ doubts arose from the many conflicting views that persisted about fundamental issues. Their doubt stimulated them to challenge conventional wisdom and to inquire after a better understanding of the nature of knowledge.
- Second, in the face of doubt they would suspend their judgment about the truth.
- Third, in its extreme forms scepticism is not pragmatic as it may lead to the conclusion that no judgments about the truth can be made³.

The disposition to believe or disbelieve and its conditioning influences

Today, scepticism commonly means ‘doubt as to the truth of some assertion or supposed fact’⁴. Doubt is unbelief, whose antonyms include belief and trust⁵. Neither doubt nor trust need be absolute. Each has expression in different degrees. Uncertainty lies between them and absolute trust (belief) and absolute distrust (disbelief) are at their extremes. Doubt, trust and uncertainty are passive concepts – states of mind. They describe an individual’s disposition to believe or disbelieve an assertion.

The actual level of doubt or trust in the state of mind conditions the individual’s response. When the levels of both trust and doubt are low, there is uncertainty which either may result in a passive response – the indefinite suspension of judgment – or may stimulate an active inquiry to pursue the truth or falseness of the assertion. The results of that inquiry will further condition the state of mind and the process may be repeated. Only if and when a state of mind of trust or doubt is sufficiently high will the active response – acceptance or rejection of belief in the assertion – ensue.

² Liddell & Scott Greek-English Lexicon

³ Bertrand Russell, in his 1958 book: “The Will to Doubt” illustrates such “heroic” scepticism by retelling the following: *“A story is told of Pyrrho, the founder of Pyrrhonism (which was the old name for scepticism). He maintained that we never know enough to be sure that one course of action is wiser than another. In his youth, when he was taking his constitutional one afternoon, he saw his teacher in philosophy (from whom he had imbibed his principles) with his head stuck in a ditch, unable to get out. After contemplating him for some time, he walked on, maintaining that there was no sufficient ground for thinking he would do any good by pulling the man out. Others, less sceptical, effected a rescue, and blamed Pyrrho for his heartlessness. But his teacher, true to his principles, praised him for his consistency.”*

⁴ The Shorter Oxford English Dictionary.

⁵ See Roget’s Thesaurus of synonyms and antonyms: categories 484 (Belief) and 485 (Unbelief; Doubt)

Professional Scepticism

The disposition to believe or disbelieve an assertion may be conditioned by many influences. These include not only the results of inquiry but also potentially the biases of the individual (whether conscious or sub-conscious) and the individual's perceptions and assessments of their self-interest. These other conditioning influences must be filtered out if objective truth is to be attained.

In the context of audit judgments, it may be helpful to understand the implications of the behavioural rules ('heuristics') underlying human decision-making and judgment processes. A number of heuristics have been proposed to help explain these processes, especially in the face of complex problems or incomplete information. It is also thought that they may, in some circumstances, introduce systematic errors or biases into these processes.

One illustration of these ideas may be found in a recent academic paper⁶, which shows that people are less likely to adjust their beliefs in response to evidence that contradicts their optimistic beliefs than to evidence that contradicts their pessimistic beliefs.

What is needed to counteract this is a mechanism to encourage a structured consideration of the alternative point of view. One example of such a mechanism being applied in a financial services context is 'reverse stress testing'. In this form of stress testing, the directors consider what it would take to make the entity fail and then assess the evidence as to the likelihood of those circumstances arising.

Evidence based theories of knowledge and scientific scepticism

Later Sceptics were more pragmatic, arguing that there were ways of approaching (even if not quite attaining) the absolute truth. The Empirical school of thought proposed that the only or primary source of knowledge is experience gained through the senses. It therefore emphasised the role of empirical (observed) evidence in inducing knowledge rather than deducing knowledge from innate ideas and traditions.

Empiricism was highly influential in the development of science and the scientific method in the 17th Century. Scientific scepticism doubts the veracity of assertions that are not supported by empirical evidence that is reproducible and therefore seeks to exclude other influences from the scientific search for truth.

Evidence, trust and agency in the audit process

An audit is an evidence-based process to assess and report on the truth and fairness of the financial statements prepared by the directors to whom capital resources are entrusted by the shareholders. The audit is entrusted to another agent of the shareholders – the auditor.

⁶ See: *How unrealistic optimism is maintained in the face of reality*, by Sharot, Korn and Dolan, in *Nature Neuroscience*, Nov 2011. This and earlier research considering the impact of new evidence on existing beliefs is discussed in a recent Research Paper from Societe Generale: *In defence of the doom merchants: when hearing isn't listening*, Jan 2012 at: <http://www.frc.org.uk/images/uploaded/documents/Societe%20Generale%20Research%20Paper%20January%202012.pdf>. The Paper suggests that people have a natural tendency to take note of the evidence which backs their own theories and to ignore evidence which contradicts them. If anything, this tendency is exacerbated when they are exhorted to try harder.

Professional Scepticism

This description refers to two features of an audit which are relevant to scepticism – the evidence-based nature of the audit and the entrustment and agency relationships inherent in the audit. The role of scepticism in relation to each of these is explored further below. The evidence-based nature of the process suggests some parallels with, and is explored in the context of, the scientific method and scientific scepticism in Section 3. In Section 4, lessons about the expression of professional scepticism are also identified by considering the nature of the entrustment and agency relationships and the need for assurance that gave rise to the tradition of auditing servants in the manorial estates of the fourteenth century in the origins of the modern audit in the UK.

Professional Scepticism

Section 3 – Scientific scepticism and the scientific method

The scientific method seeks to understand the causes and effects of natural processes by:

- **Empirical observation** of their behaviours in different conditions;
- Postulating how they work (**constructing theories** of cause and effect that are consistent with the observations) – an approach that relies on inductive logic.
- Predicting effects that would necessarily follow from the truth of a theory in specific conditions (**constructing hypotheses**) – an approach that relies on deductive logic.
- **Testing** those hypotheses by considering not only what evidence would support them but also what evidence would falsify them – accordingly, experiments are designed and performed to find such evidence.
- Each step of the process is **transparent and repeatable**, subject to the critical review of other scientists and capable of being challenged and retested by them.
- In the development of scientific knowledge in a new area, there may be several competing theories, each of which has survived hypothesis testing. The advancement of a theory to the status of accepted scientific knowledge requires a '**critical experiment**', one capable of providing evidence that will prove the superiority of one theory over all the other competing theories.

This process can disprove a postulated theory but cannot absolutely prove it. If testing falsifies a hypothesis, then theories are reassessed in light of the new observations and if necessary new ones are postulated. A theory that survives rigorous testing remains plausible, for the time being. Scientific knowledge is therefore dynamic and constantly subject to challenge.

Prior to the development of the scientific method, knowledge of the natural world was largely based on accepted ancient wisdom (axiomatic truths) and advanced by developing consequential "knowledge" by logical deduction (the deductive method). A critical development in the evolution of the scientific method was the acceptance that there are no axiomatic truths that can be observed and that there is a continuing need to question and challenge all matters that may appear to be so.

Robert Boyle is widely recognised as the father of modern chemistry and an early proponent of the scientific method. His treatise on the new approach is aptly called 'The Sceptical Chymist'⁷.

Scepticism in the scientific method can be described as a systematic form of continual informed questioning that requires the scientist:

- To critically appraise existing theories, actively looking for alternative plausible mechanisms of cause and effect that are consistent with their rigorous assessment of the empirical (observed) evidence;

⁷ Robert Boyle, 1661: The Sceptical Chymist: or Chymico-Physical Doubts & Paradoxes Touching the Spagyrist's Principles Commonly call'd Hypostatical As they are wont to be Propos'd and Defended by the Generality of Alchemists

Professional Scepticism

- To undertake experiments that are repeatable and transparent, to look for evidence that contradicts rather than supports the validity of any given theory; and
- To suspend judgment about the validity of any given theory (ie to defer making an active decision to believe or disbelieve it) until it has both survived destructive testing and has been subjected to critical experiments the evidence from which makes it possible to conclude that one theory is superior to all other current plausible theories.

There are many parallels between the scientific method and the audit and, whilst this analogy should, of course, not be taken too far, at a certain level there is much to learn from a consideration of the nature of scientific scepticism and the role it plays in the conduct of the scientific method. Scientific scepticism is the backbone of the scientific method, influencing every judgment in the process of learning and ultimately supporting the whole body of scientific knowledge.

However, the subject matters of scientific and audit inquiry are different in nature. The subject matter of Science is knowledge of the natural world, which experience shows to ordinarily behave in a systematic way. The subject matter of auditing is the outputs from the business performance and reporting systems of the entity, which though usually intended to operate systematically often do not as they are subject to the vagaries of external influences, as well as human error and fraud.

In science, the potential variables are identified and can be controlled and varied individually under laboratory conditions. In the audit, they cannot and the outputs of the business performance and reporting systems of the entity must be observed in real world (multivariate) conditions.

Notwithstanding these limitations to the analogy between the audit and the scientific method, elements of the scientific method suggest critical audit activities which will underpin appropriate scepticism in the audit:

- Empirical observation *suggests* developing a good understanding of the business of the audited entity and of the environment;
- Constructing falsifiable hypotheses *suggests* actively considering that material misstatements may exist and designing audit tests to identify them, rather than only considering how well the evidence obtained by management supports their conclusion that there are none; and
- Transparency and repeatability *suggest* the importance of documentation in underpinning transparency and repeatability of the audit work to internal reviewers and to external inspectors.

The comparison says less about how far the auditor should go in pursuing these activities:

- When should the active search for risks of material misstatement stop?
- How far should the auditor's understanding be pursued?
- How much testing and stress testing should the auditor undertake?
- When is the evidence sufficient?

The scientific analogy suggests there is no absolute level to which such matters should be pursued. Scientific scepticism is pursued up to the point where other similarly objective scientists would want to go before they accept or reject a hypothesis. In the scientific field, acceptance of a hypothesis only occurs when the

Professional Scepticism

level of trust in that hypothesis is approaching virtual certainty. This may not be the most appropriate point to which professional scepticism should be pursued in the audit. This is considered further in the next section in the context of the historical origins of the modern audit in the UK.

Professional Scepticism

Section 4 – The origins of the modern audit

The origins of the modern audit can be seen in the tradition of auditing household servants in manorial estates that developed from the fourteenth century⁸. The auditor was the most trusted servant in the household and all other servants were required to account to the auditor for the resources entrusted to them.

In its simplest form, an account was required from each household servant of all money and other assets entrusted to them – they were “charged” with the assets when placed in their care and “discharged” when the auditor had heard and accepted their account.

When free incorporation joint stock companies were established in the Joint Stock Companies Act of 1844, there were default provisions for auditors to be appointed, that built on these traditions. Under the default provisions, at least one of the auditors should be appointed by the shareholders, their fees should be paid by the company but set by a government agency (the Commissioners of the Treasury) as they saw fit, and their report should be made publicly available. The auditor was neither required to be a shareholder nor a professional accountant but often was a shareholder and frequently employed professional accountants to assist them.

The Joint Stock Companies Act of 1856 enhanced the earlier default provisions to specifically allow the auditor to employ accountants to assist them at the company’s expense and to prohibit the auditor from being a director or an officer of the company and from having any interest in any transaction of the company other than as a shareholder. The absolute requirement that companies should have an audit (initially just for joint stock banks but later extended to all companies) as opposed to optional default provisions, originated in the 1879 Companies Act following the collapse of the City Bank of Glasgow. In time, the practice of appointing shareholders as auditors fell away and public accountants were employed to undertake the role directly.

Looking back, it would seem that, in its origin, the audit was essentially a check, carried out on behalf of a principal by their trusted associate or agent, on the fidelity of other agents to whom the principal’s resources were entrusted. The trust that existed between principal and auditor was a critical ingredient, if not the critical ingredient of the audit. The importance of professional skills only came later. The whole rationale for the audit was that the principal could not assume, and therefore sought assurance about, the fidelity of those to whom their assets were entrusted.

This may suggest how far the auditor should pursue professional scepticism in the audit. The strong bond of trust between the principal and the auditor and the principal’s need for assurance about the fidelity of those to whom they had entrusted their assets would have determined the mindset of the auditor. That would have guided the appropriate degree of scepticism in the auditor when holding a hearing to question those entrusted with the principal’s assets and to assess whether they had given a proper account of their handling of those assets. They would have asked the questions they would expect their principal to ask, they would have challenged where they would expect their principal to challenge and they would have pursued matters until they were satisfied that the evidence would satisfy their principal.

⁸ See *Be careful what you wish for: How accountants and Congress created the problem of auditor independence*, 2004, Sean M. O’Connor at: http://www.bc.edu/dam/files/schools/law/lawreviews/journals/bclawr/45_4/01_FMS.htm

Professional Scepticism

This is perhaps a fair lens through which to understand the necessary degree of scepticism in the modern audit. What would the shareholders (and other stakeholders) expect the auditor to ask, what matters would they expect them to challenge and what evidence would they need to satisfy those challenges?

Whilst fidelity may have been the issue in the 19th Century and much of the 20th Century (and remains an issue in the 21st Century), the development and increased complexity of business activity, and the increased size and reach of such businesses, combined with the arrival of the technological age mean that there are many other areas in relation to which shareholders (and other users) seek information and reassurance. For example, misalignment of their personal interests may simply lead to misalignment of risk taking appetite between the directors and shareholders.

This suggests that whilst the sceptical mindset is a constant, the degree of action taken by a sceptical auditor (by way of inquiry, challenge and testing) is responsive both to the expectations of shareholders (and other stakeholders) and to what emerges as the audit proceeds. This is the 'sliding scale' that was referred to in *Auditor Scepticism: Raising the Bar*.

Because of the need to consider their expectations, the perspective of shareholders and other stakeholders (as users) is embedded in the auditing standards in relation to materiality, and scepticism should embed that perspective in the making of all audit judgments. Against this background, the APB believes that when undertaking a modern audit the following factors accentuate the need for the auditor to be especially vigilant and aware of his or her responsibilities for the exercise of professional scepticism:

- There is potential for auditors not to be sceptical or thought not to be sceptical because they are engaged and paid by the company in a way that is relatively detached from shareholders. In addition, they have little, if any, direct contact with shareholders throughout the audit process; as a result, shareholders have no way of observing, and thereby gaining trust in, the audit process. This emphasises the need for strong governance generally and, in particular, the importance of the responsibility that audit committees have in both assessing and communicating to investors whether the auditors have executed a high quality, sceptical audit;
- Auditors necessarily have strong working relationships with management and audit committees, which may lead them to develop trust that may lead to either a lack of, or reduced, scepticism; and
- The audit firms' business models encourage a culture of building strong relationships with audited entities. This introduces the risk of the auditor putting his or her interests ahead of those of shareholders and could lead the audit firm and the auditor to develop trust or self-interest motivations that may compromise either their objectivity or willingness to challenge management to the extent required.

It is perhaps not surprising that auditors often refer to the audited entity as the 'client', given the strength of these relationships and the all but formal appointment of the auditor by the directors and not by the shareholders. However, trust in management may compromise the auditor's exercise of scepticism because that trust may colour his/her judgement as to when and where a sceptical approach is required. It is important to lean against unjustified trust developing, just as it is important to address threats to the auditor's objectivity that may arise from the provision of non-audit

Professional Scepticism

services – it is interesting to note in this context that the auditor originally was not permitted to have any interest in any transaction with the company.

The factors described above are widely recognised to pose challenges to the reality and perception of auditors' professional integrity (including their objectivity and independence). The need to address these challenges gives rise to a variety of responses that seek to lean against them, including the responsibilities, liabilities and disclosures relating to the audit and the auditor established in the law and professional standards, including the Ethical Standards. This is also one of the principal reasons for the need for the application and demonstration of appropriate professional scepticism in the audit.

Despite the increasing role of audit committees as independent non-executive directors in monitoring and challenging the entity's financial information and controls (in effect as the representatives of the shareholders), there is also a risk that audit committees' views may be seen too readily by the auditor as a surrogate for those of the shareholders. Just addressing the concerns of the audit committee does not necessarily amount to meeting the expectations of shareholders (and other stakeholders).

For all of these reasons, the rigorous assessment of when, and the degree to which, professional scepticism is required is fundamental to an effective audit.

Professional Scepticism

Section 5 – Conclusions about professional scepticism in the audit

In the growth and development of a living thing, the expression of its DNA in the formation of its cells defines its essence and its effectiveness in meeting the challenges of its environment. In the words of Richard Dawkins⁹:

DNA neither cares nor knows. DNA just is. And we dance to its music.

In the same way, the expression of professional scepticism by the audit team defines the essence of the particular audit. It defines the quality of each audit judgment and, through these, the overall effectiveness of the audit in addressing the challenges it faces in meeting the needs of shareholders (and other stakeholders) who rely on it. The reality and perception of the expression of professional scepticism define and underpin the confidence that others place in the audit and in turn the confidence they place in the audited financial statements.

The preceding analysis suggests that the appropriate application of professional scepticism in the audit requires a mindset which rigorously questions and challenges management's assertions with a degree of doubt that reflects the expectations of shareholders (and other stakeholders) for whose benefit it is performed. All judgments made in the course of the audit should be founded on the perspective of the shareholders (and other stakeholders). That mindset demands the sort of hard evidence – to back each audit judgment and, ultimately, the board's assertion that the financial statements give a true and fair view - that would be convincing and persuasive to shareholders (and other stakeholders), given the auditor's risk assessment.

The analysis suggests that in an appropriately sceptical audit:

- The auditor's risk assessment process should involve a critical appraisal of management's assertions, actively looking for risks of material misstatement.

These may arise due to fraud or error and may reflect weaknesses in the design or the operation of management's system for controlling and reporting the entity's financial position and performance (such that relevant matters are not identified, or are not adequately controlled or reported, or that the design has not been implemented and operated effectively¹⁰).

- The auditor develops a high degree of knowledge of the audited entity's business and the environment in which it operates, sufficient to enable it to make its risk assessment through its own fresh and independent eyes rather than through the eyes of management.
- This enables the auditor to make informed challenge of consensus views and to consider the possible incidence of low probability high impact events. The alternative would give rise to the risk of what is known in science as "hypothesis bias" which is an example of "group-think". The challenges in acquiring sufficient knowledge and experience should not be underestimated, especially in relation to complex business models. The traditional pyramid structure of the audit team may not always be appropriate and different

⁹ Richard Dawkins: River Out of Eden: A Darwinian View of Life (1995), 133.

¹⁰ This is not to suggest that the auditor must always test the operating effectiveness of the financial reporting system, rather than taking a substantive approach and testing the outputs from that system.

Professional Scepticism

models may need to be explored, such as including experienced business people on the team.

- The auditor designs audit procedures to consider actively if there is any evidence that would contradict management assertions not only to consider the extent to which management has identified evidence that is consistent with them. The opposite of a sceptical audit might be one in which the auditor merely rationalises and documents management's assertions.
- The auditor has strong skills in making evidence-based judgments and suspends judgment about whether the financial statements do or do not give a true and fair view until satisfied that:
 - There has been sufficient inquiry and challenge;
 - Sufficient testing of management's assertions has been undertaken;
 - The quality of the resulting evidence obtained has been critically appraised and judged by the auditor to be sufficiently persuasive; and
 - Where there are plausible alternative treatments of an item in the financial statements (such as different valuation bases), an assessment has been made as to whether one is superior and whether sufficient disclosure of the alternatives has been given, in order to give a true and fair view.
- The auditor approaches and documents audit judgments and audit review processes in a manner that facilitates challenge and demonstrates the rigour of that challenge.
- The auditor's documentation of audit judgments is conclusive rather than conclusionary and therefore always sets out not only the auditor's conclusion but also their rationale for the conclusion, relating it to the nature of the challenges raised in the underlying work and reviews, the strength of the evidence obtained and the perspective of shareholders (and other stakeholders). The auditor needs strong skills in logical argument to do this effectively.

Professional Scepticism

Section 6 – Fostering conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism

The application of an appropriate degree of professional scepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management's assertions they will not be able to confirm with confidence that a company's financial statements present a true and fair view.

The APB believes that in order to demonstrate the value of the audit, the auditor should perform a sceptical audit, evidence the exercise of appropriate scepticism in the audit documentation and convince audit committees and ultimately the shareholders (and other stakeholders) that it has done so.

The challenge for firms is to identify, develop and retain people with the necessary skills and to deploy them appropriately. It also involves nurturing the conditions that allow professional scepticism to flourish.

The prospects for a sceptical audit are likely to be enhanced if the environment in which the auditor operates also recognises and supports the important role that scepticism plays in the audit.

The APB considers that the conditions necessary for auditors to demonstrate the appropriate degree of professional scepticism are likely to include the following.

Individual auditors

- Develop a good understanding of the entity and its business.
- Have a questioning mind and are willing to challenge management assertions.
- Assess critically the information and explanations obtained in the course of their work and corroborate them.
- Seek to understand management motivations for possible misstatement of the financial statements.
- Investigate the nature and cause of deviations or misstatements identified and avoid jumping to conclusions without appropriate audit evidence.
- Are alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.
- Have the confidence to challenge management and the persistence to follow things through to a conclusion – even if predisposed to agree with management's assertion, the auditor should actively consider the alternative views and challenge management to demonstrate that they are not more appropriate.

Engagement teams

- Have good business knowledge and experience.
- Actively consider in what circumstances management numbers may be misstated, whether due to fraud or error, and the possible sources of misstatement, notwithstanding existing knowledge and relationships.
- Develop a good understanding of the entity and its business in order to provide a basis for identifying unusual events or transactions and share information on a regular basis.

Professional Scepticism

- Partners and managers are actively involved in assessing risk and planning the audit procedures to be performed - they think about the changes that are taking place in the entity and its environment and plan audit tests that are responsive to them.
- Partners and managers actively lead and participate in audit team planning meetings to discuss the susceptibility of the entity's financial statements to material misstatement including through fraud and the misuse of related parties.
- Partners and managers are accessible to other staff during the audit and encourage them to consult with them on a timely basis.
- Engagement teams document their key audit judgments and conclusions, especially those reported to the audit committee, in a way that clearly demonstrates that they have exercised an appropriate degree of challenge to management and professional scepticism. In particular, the reasons why the audit team concurs with management's assertions are clearly articulated in a way that, where appropriate, discusses the appropriateness of reasonably credible alternative views and the reasons why they have not been adopted.
- Partners and managers bring additional scepticism to the audit through taking the steps necessary to carry out, face to face where appropriate, a diligent challenge and review of the audit work performed, and the adequacy of the documentation prepared, by other members of the engagement team.

Audit firms

- The culture within the firm emphasises the importance of:
 - understanding and pursuing the perspective of the shareholders (and other stakeholders) of the audited entity in making audit judgments;
 - coaching less experienced staff to foster appropriate scepticism;
 - sharing experiences about difficult audit judgments within the firm;
 - consultation with others about difficult audit judgments; and
 - supporting audit partners when they need to take and communicate difficult audit judgements.
- Scepticism is embedded in the firm's training and competency frameworks used for evaluating and rewarding partner and staff performance.
- The firm requires rigorous engagement quality control reviews that challenge engagement teams' judgments and conclusions.
- Firm methodologies and review processes emphasise the importance of, and provide practical support for auditors in:
 - developing a thorough understanding of the entity's business and its environment, sufficient to enable the auditor to carry out a robust risk assessment through their own fresh eyes;
 - identifying issues early in the planning cycle to allow adequate time for them to be investigated and resolved;
 - rigorously taking such steps as are appropriate to the scale and complexity of the financial reporting systems, to identify unusual transactions;
 - changing risk assessments, materiality and the audit plan in response to audit findings;
 - documenting audit judgments in a conclusive rather than a conclusionary manner and therefore setting out not only the conclusion but also the rationale for the conclusion, relating it to the nature of the challenges

Professional Scepticism

- raised in the underlying work and reviews, the strength of the evidence obtained and the perspective of shareholders (and other stakeholders);
- raising matters with the Audit Committee (or those charged with governance) in relation to which the auditor believes the perspective of shareholders (and other stakeholders) about the treatment or disclosure of the matter in the financial statements or related narrative reports could well be different from that adopted by the entity; and
 - ensuring that the disclosures relating to such matters are carefully assessed to ensure that those of relevance to shareholders (and other stakeholders) are sufficient and appropriate in the circumstances, having regard to the auditor's consideration of the true and fair view¹¹.

The role of Audit Committees and management

Whilst it is the responsibility of the auditor to ensure that an appropriate degree of professional scepticism is applied in an audit, the Audit Committee and management can have a significant influencing role.

The Audit Committee's role includes overseeing the integrity of financial reporting and the related processes (including internal financial controls, the independence and objectivity of the external auditor and the effectiveness of the audit process). In this role, the APB believes that Audit Committees should seek to foster appropriate professional scepticism in the external audit, for example, through:

- Promoting the development of a culture within the entity which elicits a constructive response from management and staff to auditor challenge;
- Challenging whether the auditor has developed an adequate understanding of the business and its environment and provided an appropriately informed fresh perspective in making its risk assessment;
- Ensuring that, where management and auditor have resolved either contentious issues or issues that involve significant judgment, these are brought to the audit committee's attention; and
- Seeking to understand in relation to issues brought to their attention (including issues where management and auditor agree the position) whether or not an appropriate degree of challenge was exercised by the auditor – for example, by demanding an explanation of the auditor's rationale for particular conclusions, what alternatives were considered and why the specific judgment was considered to be the most appropriate of the alternatives.

The APB believes that this is consistent with the FRC's *Effective Company Stewardship* proposals¹², under which it is proposed that Audit Committees should produce fuller reports for the Board, in particular setting out their advice on the integrity of the Annual Report and explaining how they discharged their responsibilities for this and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors). Taken together with the proposal for Boards to discuss these matters in the Annual Report, the effect should be to ensure that the Annual Report demonstrates that the audit addressed those matters of most interest to shareholders and other stakeholders with appropriate challenge and scepticism.

¹¹ See the FRC document: *True and Fair – July 2011* at: <http://www.frc.org.uk/images/uploaded/documents/Paper%20True%20and%20Fair1.pdf>

¹² See <http://www.frc.org.uk/about/effcompsteward.cfm>

Professional Scepticism

Section 7 – Taking these matters forward

The main purpose of this document is to explain the APB's views on professional scepticism and to encourage auditors to apply its principles in executing high quality sceptical audits and in documenting and demonstrating that they have done so. The APB has also considered the definition of professional scepticism and the extent and manner in which it has been dealt with in the ISAs (UK & I) and in ISQC 1 (UK & I), in light of the conclusions drawn in this Paper.

Although these standards contain many elements¹³ that support the understanding of professional scepticism developed in this Paper, it is also possible for an auditor to follow the 'letter' of the standards without conducting a truly sceptical audit. The APB acknowledges that these standards may well need to be improved further to reflect better some of the conclusions reflected in this Paper and to be clearer about the performance, documentation and communication of professional scepticism.

Accordingly, whilst it has concluded that in taking these matters forward, the immediate emphasis should be on encouraging auditors and others to deliver a step change in behaviours that will achieve consistency in the manner in which professional scepticism is exercised in the conduct of their audits, it also intends to seek to influence the IAASB to enhance the auditing standards in due course.

The APB therefore proposes to:

- Stimulate debate and acceptance by stakeholders of the conclusions set out in this Paper about the nature and role of professional scepticism in the audit;
- Encourage the auditing profession and the audit firms to consider the implications of these conclusions for their business models and culture and for their approach to audits and to implement such changes as are necessary to respond to the challenges they identify – including the need to reflect the perspective of shareholders (and other stakeholders) in exercising their professional judgment;
- Promote these conclusions with Audit Committee members and management to encourage them to recognise and act on the important contribution that they can make to support the appropriate exercise of professional scepticism;
- Promote with those preparing the financial statements and Annual Report the benefits of open communication and consideration of the key judgments involved in doing so and in responding to the challenges raised in the audit; and
- Promote the conclusions set out in this Paper internationally, with a view to identifying ways in which the International Standards on Auditing might be developed to better reflect these conclusions, as part of the post Clarity ISA implementation review.

¹³ See IAASB Staff Questions and Answers on "Professional Skepticism in an audit of Financial Statements" at: <http://www.ifac.org/sites/default/files/publications/files/IAASB%20Professional%20Skepticism%20QandA-final.pdf>



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

© The Financial Reporting Council Limited 2012

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.