

# THE ROLE OF PROFESSIONAL SKEPTICISM IN FINANCIAL STATEMENT AUDIT AND ITS APPROPRIATE APPLICATION

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## Abstract

The contemporary financial crisis along with global and complex business environment emphasizes the critical importance of high quality and with credibility financial reporting. The contemporary environment imposes the need for additional and more relevant information related to the entities and processes that support the quality of financial reporting. Independent, external auditors play an important role in supporting the quality of financial reporting process by providing an independent opinion that financial statements present fairly in all material respects, or give a true and fair view of, the reporting entities' financial position, results of operations, and cash flows, in accordance with an applicable reporting framework.

Auditors adhere to professional standards and legal and regulatory requirements while performing financial statement audits. Those standards require that appropriate professional skepticism be applied in the exercise of professional judgment. The widespread and diversification of business in this modern day, has continued to increase the complexity of business transactions and of accounting standards. Given increased complexity and subjectivity together with a continued emphasis on reliable financial reporting, has elevated the interest in the application of high degree of professional skepticism by the auditors. While a responsibility for appropriate professional skepticism is not the sole domain of financial statement auditors, this paper focuses on professional skepticism applied by auditors in the conduct of a financial statement audit.

**Key words:** financial reporting, professional judgment, questioning mind, risk assessment, material misstatement, fraud

## 1. Introduction

In the auditing literature there are various definitions and perspectives in terms of professional skepticism. Although the concept of professional skepticism is relatively straightforward, there is a lack of consensus and practical guidance on what professional skepticism is, how it can be demonstrated and documented in response to different circumstances and how threats and potential opportunities for enhancing the application of professional skepticism manifest themselves at different structural levels.

In order to move the dialogue on improving the consistent appropriate application of professional skepticism, initially will be reviewed definitions and meanings of professional skepticism. A review of the professional and academic literature suggests that the concept of professional skepticism may have more characteristics. In this paper will be presented six characteristics that constitute basic attributes of the auditor's professional skepticism and provide a solid foundation for determining what means to be a skeptic.

The auditing literature has described differing perspectives of professional skepticism. Early auditing standards suggest a neutral approach to skepticism, while more recent standards seem to promote one of presumptive doubt. The absence of clear direction and practical application guidance on what behaviors and actions constitute appropriate professional skepticism in different circumstances, represents an important opportunity for the audit profession, academics, standard setters, and regulators, to develop more comprehensive and practical view of professional skepticism. One of the perspectives is introduction of **"professional skepticism continuum"** that acknowledges that the appropriate application of professional skepticism will depend on the risk characteristics of the classes of transaction, account balances, or disclosures and related assertions.

In addition, we will identify threats and potential opportunities to professional skepticism, and specific actions to enhance auditor professional skepticism and, ultimately, audit quality. In the final section, we will present some recommendations and ideas on how the application of professional skepticism might be enhanced through the cooperative efforts of other stakeholders in the financial reporting process, including boards and audit committees, regulators and inspectors, and standard setters.

## **2. The concept of professional skepticism**

Like other concepts fundamental to auditing, it is difficult for a single definition to capture fully the meaning of professional skepticism. When we examine the definition of professional skepticism in auditing standards and the academic literature, we find related, but different definitions.

The Center for Audit Quality (CAQ), in its 2010 report on fraud, describes professional skepticism as follows: "Skepticism involves the validation of information through probing questions, the critical assessment of evidence, and attention to inconsistencies. Skepticism is not an end in itself and is not meant to encourage a hostile micromanagement; it is an essential element of professional objectivity required of all participants in the financial reporting supply chain. Skepticism throughout the supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted".

Similar to the CAQ report, International Standards on Auditing define professional skepticism as "an attitude that includes a questioning mind and critical assessment of audit evidence". They explicitly require the auditor to plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated[1].

Auditing standards emphasize a questioning mind and a critical assessment of audit evidence. However, terms such as "a questioning mind" and "a critical assessment of audit evidence" are somewhat ambiguous and leave open to interpretation what constitutes appropriate levels of questioning or critical assessment, and how such behavior is demonstrated and documented in settings that present different risks at the classes of transaction, account balances, or disclosures and related assertions.

As an attitude, professional skepticism is fundamentally a mindset. Along with an auditor's mindset, other elements of professional skepticism include an auditor's attributes and actions.

The three elements of professional skepticism (1. attributes, 2. actions and 3. mindset) permeate the entire audit process and are integral to audit quality. These elements of

professional skepticism interact dynamically as auditors respond to conditions and pressures that change or arise during the audit [2].

**1. Attributes (knowledge, skills and abilities)** – the audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. Auditors should be assigned to tasks and supervised commensurate with their level of knowledge, skills, and abilities so that they can evaluate the audit evidence they are examining.

**2. Mindset (an attitude)** – the auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity.

**3. Actions (a critical assessment)** – gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process.

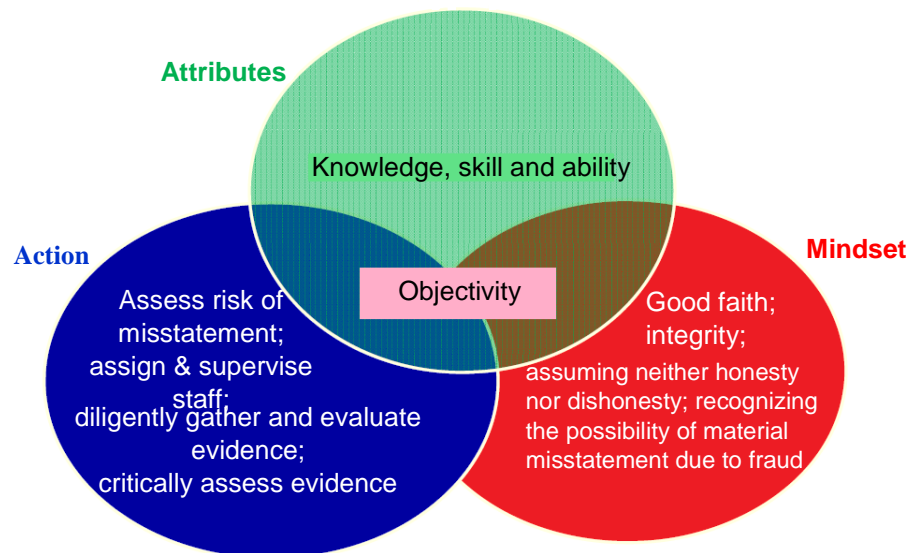


Figure 1. Three elements of professional skepticism

Source: Center for Audit Quality (2013), *Auditor Objectivity and Skepticism – What’s Next*, American Accounting Association Annual Meeting, slide 5

The word skepticism is derived from a Greek verb that means to inquire. Additionally, the word skeptic is derived from **scepsis**, a Greek noun that relates to “examination, inquiry, and consideration”. Today, skepticism commonly means “doubt as to the truth of some assertion or supposed fact”. Doubt is unbelief, whose antonyms include belief and trust. Neither doubt nor trust need be absolute. Each has expression in different degrees. Uncertainty lies between them and complete trust and complete doubt are their extremes. Doubt, trust and uncertainty are passive concepts – states of mind. They describe an individual’s disposition to believe or disbelieve an assertion [3].

Professional skepticism incorporates the attributes (1.knowledge, 2.skills and 3.abilities) commonly associated with being a skeptic in a professional setting. Hurtt, Eining and Plumlee (2003), present a theoretical model of professional skepticism that is grounded in

psychological literature and philosophical literature on methodological skepticism. This model suggests professional skepticism is a multi – dimensional construct comprised of six personal characteristics that constitute the essential attributes of an auditor who is professionally skeptical [4]:

**1. Questioning mind** – refers to the attitude of an individual relating to curiosity and interest. Auditors that have a questioning mind attitude will continually ask questions for the purpose of further clarification and definition; and demand reasons, justification or proof. An auditor will adopt the questioning mind attitude in order to obtain sufficient evidence before making audit judgments or forming conclusions. Auditors may also question the accuracy of their own judgments. Studies on skepticism attitudes align the nature of the mind with the question of doubt and distrust among auditors [4]. ISA 200 specifies that auditor must make critical assessment of audit evidence with questioning mind regarding the validity of the evidence. The paragraph explains that in order to maintain a questioning mind, auditor must be alert to contradicting or questionable audit evidence with regard to the reliability of documents or management representations.

With regard to the risks of material misstatement due to fraud, ISA 240 requires auditor to maintain a questioning mind and critical assessment of audit evidence. Due to the nature of fraud, auditors must have a skeptical attitude that results in the continual questioning of whether the information and audit evidence obtained suggests the existence of material misstatement due to fraud. Accordingly, the questioning mind attitude is an aspect of skepticism that is explicitly required by auditing standards and widely supported by research in the auditing area, which, in turn, is expected to contribute to enhancing auditor performance.

**2. Suspension of judgment** – is a dimension of professional skepticism that refers to an attitude of auditors to postpone making audit judgments until sufficient evidence has been gathered. Auditors who possess these characteristic will not accept any statement or explanation without critically evaluating the audit evidence. Although the importance of the suspension of judgment attitude is highlighted in extant studies, generally auditing standards do not include specific discussion regarding the suspension of judgment.

**3. Searching for knowledge** – refers to the auditor's curiosity or desire to investigate. The aim of the investigation is to obtain additional information in order to reduce task uncertainties. The knowledge gained by auditors is useful in the application of various audit procedures and techniques. ISAs underline the importance of having relevant knowledge, especially when a risk of material misstatements due to fraud exists. In the event of high fraud risks, audit procedures must be enhanced and diversified to obtain more authentic information.

**4. Interpersonal understanding** – refers to the understanding of reasons or motivations of an individual that drive the person's behavior. Regarding the audit, interpersonal understanding is an indicator of how auditors appreciate the motivation and integrity of individuals who present the audit evidence. Interpersonal understanding is characteristic that also requires auditors to be suspicious of the actions and behavior of the client. Auditors must comprehend the motives and incentives which may drive the client's behavior. Currently, auditing standards in general have not made any explicit reference on the dimension of interpersonal understanding as a skepticism component.

**5. Self – confidence** – refers to feelings of self – worth and belief in one's own abilities. Auditors who possess this attribute are more confident to perform audit tasks effectively and make their own audit judgments and conclusions. Auditors that possess the self – confidence attribute are capable of challenging client's assumptions and decisions; and are suspicious of evidence presented to them. Self- confident auditors are certain of their work and able to defend themselves against pressure from others. Self – confidence can subsequently reduce the risk of material misstatements in financial statements due to fraud.

Although self – confidence is recognized as an important dimension of professional skepticism that must be maintained by auditors during the conduct of audit work, it is not currently under consideration by the auditing standards.

**6. Self – determining** – refers to the ability of an auditor to decide on the adequacy of the information presented as evidence before he makes audit judgments. Auditors that possess this characteristic rely less on client’s suggestions and will not be easily influenced by the belief or opinion of others. Regarding the audit, self- determining dimension of professional skepticism also involves undertaking additional investigations and evidence until auditors are personally satisfied and confident to form their own decisions. Self – determining nature of auditor is often related with the attitude of professional courage, stating that “auditor must have the professional courage not only to critically examine and perhaps discard the proposals of others, but to submit his own inventions to the same kind of detached and searching evaluations.” There is no doubt that self – determining is necessary criterion for professional skepticism. Although the importance of this characteristic in audit work is highlighted in scholarly discussions, this aspect of professional skepticism has not received any general discussion in auditing standards.

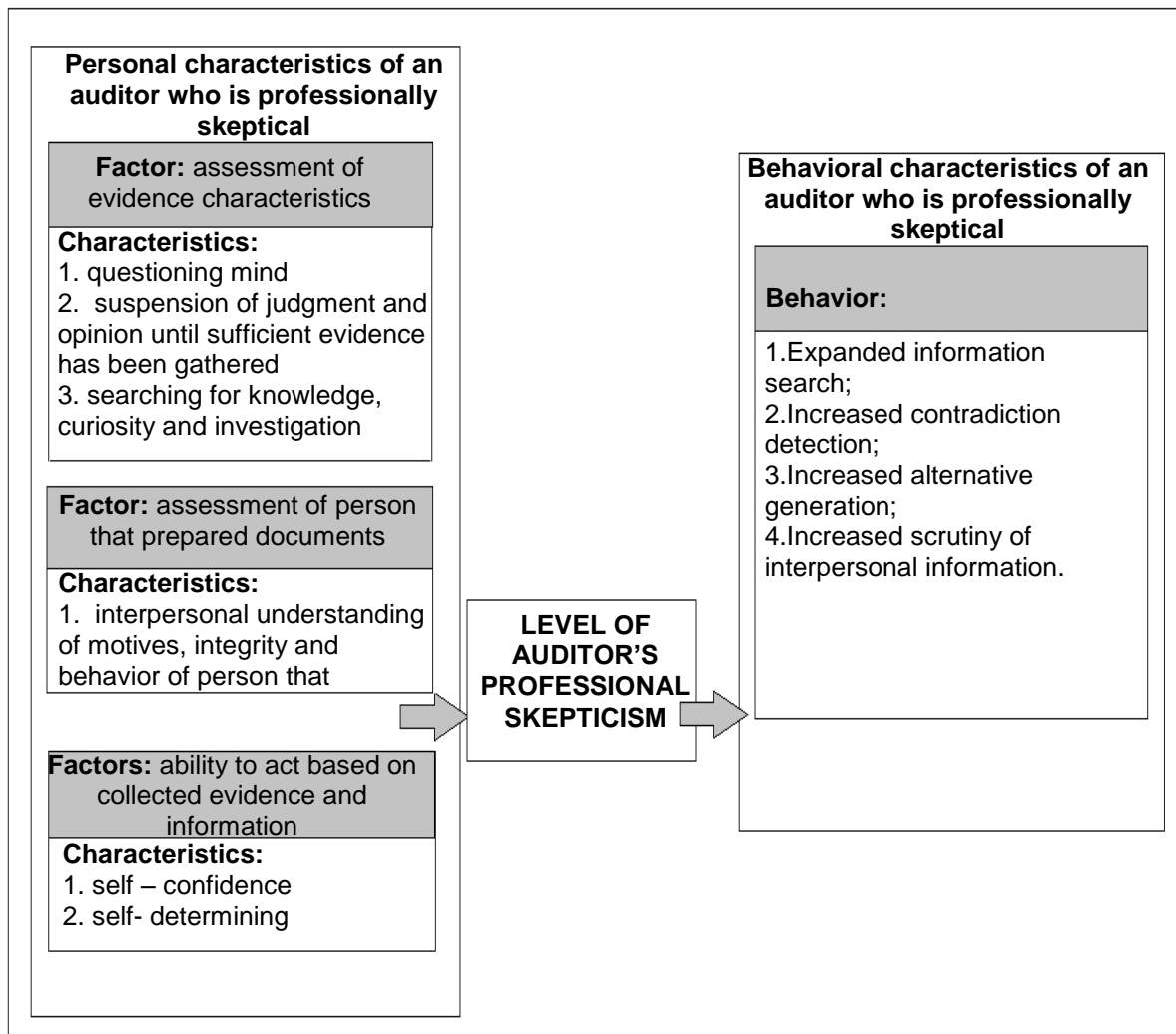


Figure 1. Model of professional skepticism

Source: Albičić, P.S., (2014), *Professional Skepticism of Auditors and Risk of Fraudulent Financial Reporting*, Journal of Accounting and Management, page 5

These six personal characteristics of an auditor who is professionally skeptical lead to four behaviors [4] that are clearly present in the auditing standards:

**1.Expanded information search** – considering the professional audit literature, we find the expanded information search behavior is consistent with the ISA 200 requirement that auditor obtain a sufficient level of evidence prior to forming an audit opinion. Similarly, ISA 240 recognized the relationship between risk and the expanded need for audit evidence and discusses some of the methods that the auditor can employ in the search for additional evidence.

**2.Increased contradiction detection** – during the conduct an audit, an auditor is expected to develop specific expectations and to compare these expectations to actual audit findings to identify any differences. Identification of these differences or contradictions is necessary for an effective audit. In addition, contradiction detection may motivate the expanded information search discussed above.

**3.Increased alternative generation** - in addition to the development of specific expectations discussed above, auditors are also required to understand and explain any differences. The ability to generate potential alternatives is a crucial step in understanding differences encountered during the audit. For example, when an auditor is given evidence such as a client representation, the auditor exercising professional skepticism will identify and consider other plausible explanations.

**4.Increased scrutiny of interpersonal information** – the tendency to self – determination resulting in taking additional research and gather evidence as long as the auditors are not personally satisfied and confident to make their decisions.

Although the academic auditing literature has dedicated substantial effort and attention to exploring and specifying professional skepticism, a succinct and generally accepted definition and view of skepticism are still lacking. Indeed, different nuances and emphases have been attached to the term “professional skepticism” in the auditing literature, resulting in a heterogeneous use and understanding of what professional skepticism essentially means. At the one end of the spectrum are definitions and descriptions that view professional skepticism as a *neutral construct*; at the other end of the spectrum, skepticism is conceptualized in terms of *presumptive doubt* [5].

The *presumptive doubt* seems consistent with the specific requirement in auditing standards to presume that there are significant risks of fraud in revenue recognition regardless of past experience in auditing revenue at an entity and regardless of the assessed competence and integrity of management [6]. Presumptive doubt assumes some level of carelessness, incompetence, or dishonesty on the part of financial statement preparers.

Many areas in the auditing standards appear to take a *neutral perspective*. In essence, this perspective implies that the auditor neither blindly trust nor distrust the entity’s management. With such an approach, the auditor evaluates evidence carefully and objectively but without necessarily presuming a high likelihood of management carelessness, incompetence, or fraud. Finally, though not in the professional literature, others have asserted that in some circumstances skepticism can involve a level of trust, accompanied by appropriate verification.

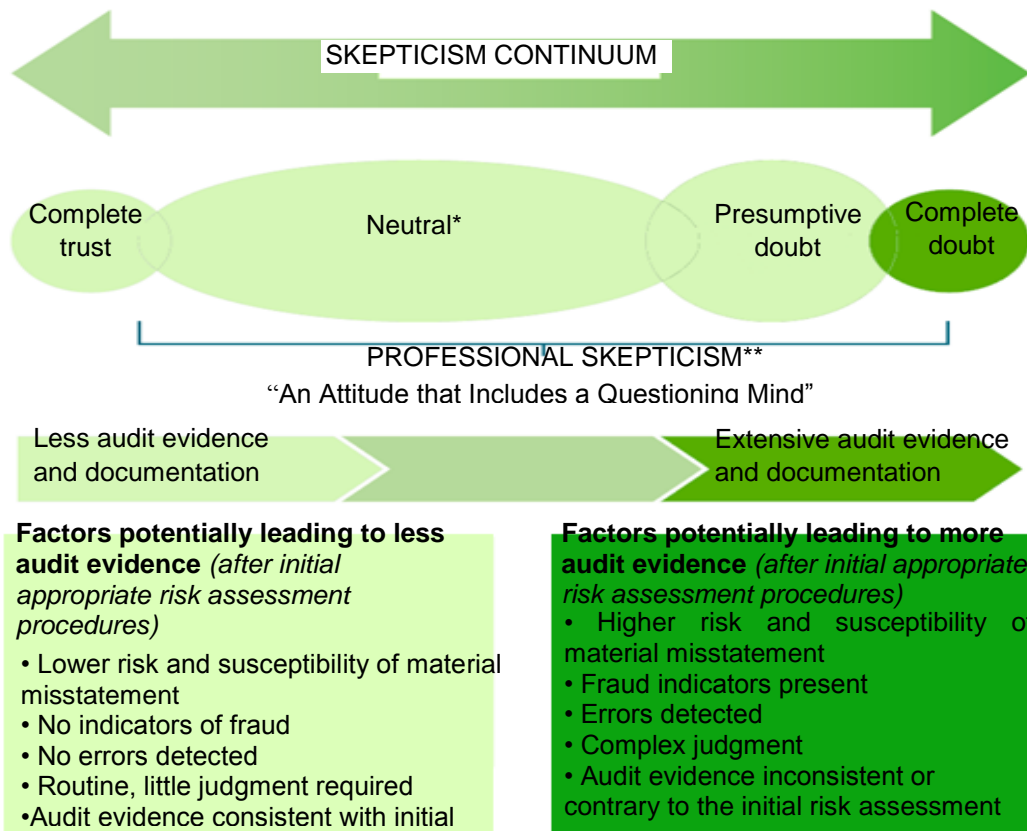
The existence of a range of different perspectives results in varied practices. The absence of clear direction and practical application guidance on what behaviors and actions constitute appropriate professional skepticism across a range of risk scenarios for different assertions and accounts has led to different views, applications, and opinions. In such an environment, reasonable observers, professionals, and regulators might understandably disagree. Each of the different perspectives on the mindset underlying professional skepticism has implications for audit effectiveness and potentially for efficiency. However, as argued by Glover and Prawitt (2013), none of them is necessarily optimal in all audit situations, and thus none can be viewed as superior to the other.

### 3. Appropriate application of professional skepticism

Different perspectives and the lack of clear guidance concerning the application of professional skepticism represent an important opportunity for the audit profession, academics, standard setters, and regulators, to develop more comprehensive and practical approach to professional skepticism.

Professors Stephen Glover and Douglas Prawitt of Brigham Young University propose a different view on the exercise of professional skepticism in a 2013 publication from the Center for Audit Quality’s Global Public Policy Committee. The report by the Global Public Policy Committee, “Enhancing Auditor Professional Skepticism” (2013), articulates a variety of definitions of professional skepticism and introduces a **professional skepticism continuum** where the appropriate level of skepticism depends on the risk characteristics of the area under audit. The appropriate level of skepticism to apply is initially determined only after a careful and rigorous risk assessment. However, Glover and Prawitt (2013) stress that to ensure an appropriate level of professional skepticism is consistently applied to collecting and evaluating all audit evidence, the auditor should continue to reevaluate the initial determination throughout the engagement. Professors Glover and Prawitt (2013) suggest that viewing professional skepticism as a continuum which ranges from neutrality over presumptive doubt to complete doubt in dependence of the particular audit situation and risk environment might be more beneficial than strictly focusing on any one of the individual skepticism perspectives.

Figure 2 illustrates that the professional skepticism continuum is founded on the belief that professional skepticism is related to a questioning mind, and that an individual may range from a neutral mind – set, to a presumptive doubt mind – set, to complete doubt. Complete trust would be outside the range on the continuum of professional skepticism.



\* Neutral – neither assuming management dishonesty nor unquestioned honesty.

\*\* Professional skepticism does not include the area of the continuum depicted by complete trust; in the area depicted as complete doubt the auditor will move to a forensic mindset.

Figure 2. The Application of Professional Skepticism

Source: Glover, S.M., D.F. Prawitt (2013), *Enhancing Auditor Professional Skepticism*, Brigham Young University, page 4

The continuum then relates to evidence collection, whereby lower skepticism is associated with less audit evidence and documentation and higher skepticism is associated with more audit evidence and documentation.

In using the continuum approach, less persuasive evidence is required for those instances where no fraud indicators exist, no errors are detected, routine processes requiring little judgment are examined, and the audit evidence is consistent with the initial risk assessment, regardless of the area of risk being audited. Likewise, less persuasive evidence would be required for those assertions of lower risk. For example, an asset account balance that is clearly immaterial and presents no risk of material misstatement would not require additional audit work beyond the initial risk assessment. This frees auditors to focus the bulk of their efforts on high – risk areas where there logically should be greater doubt.

The factors leading to the need for additional audit evidence recognize that the complexity of business transactions, expanded use of fair values and subjective estimates, and the move to more principles – based accounting standards all tend to heighten the degree of professional judgment and skepticism auditors need to apply. Some of the areas of the audit where the use of professional skepticism may be important are outlined below and largely relate to areas of the audit that are complex, subjective or highly judgmental [7].

- *Accounting estimates* – this can include fair value accounting estimates, the use of significant assumptions by management in developing accounting estimates, and reviewing the judgments and decisions used by management for management bias in developing accounting estimates.

- *Going concern* – the auditor should review management’s assessment of going concern and whether management’s plans are feasible, this being particularly important where there is a significant doubt over the entity’s ability to continue as a going concern.

- *Related party relationships and disclosures* – it can be difficult to obtain information on related parties, as knowledge may be confined to management meaning that the auditor may have to rely on management to identify all related parties. The auditor should also be skeptical when assessing the business rationale behind related party transactions.

- *Consideration of laws and regulations* – the auditor should be alert throughout the audit for indications that there may have been a suspected non – compliance with laws and regulations.

Professional skepticism is also important as it relates to the auditor’s consideration of fraud in the audit. Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this incentive, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.

Examples of the application of professional skepticism in response to the assessed fraud risks are:

- (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and

- (b) obtaining sufficient appropriate evidence to corroborate management’s explanations or representations concerning important matters, such as through third – party confirmation,



use of a specialist engaged or employed by the auditor, or examination of documentation from independent sources [8].

Professors Glover and Prawitt (2013) suggest that the consistent application of appropriate professional skepticism would be enhanced if audit firms, standard setters, regulators, and inspectors were to integrate a skepticism continuum conceptually similar to the one illustrated in Figure 3, and then work to provide relevant practical implementation guidance.

## **4. Identifying threats and potential opportunities to enhance the application of professional skepticism**

Although PCAOB standards require auditors to appropriately apply professional skepticism throughout the audit, observations from the PCAOB's oversight activities indicate that, as a practical matter, auditors are often challenged in meeting this fundamental audit requirement. In maintaining an attitude that includes a questioning mind and critical assessment of audit evidence, it is important for auditors to be alert to unconscious human biases and other circumstances that cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.

Certain conditions inherent in the audit environment can create incentives and pressures that can pose a threat to the appropriate application of professional skepticism and allow unconscious bias to prevail. Professors Glover and Prawitt (2013) suggest that a key to understanding, evaluating, and appropriately addressing factors that may either threaten or enhance professional skepticism is to recognize that different factors come into play at different structural levels of the professional setting.

### **4.1. Individual Auditor Level**

It is the responsibility of each individual auditor to maintain an attitude of professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This, involves, among other things, considering what can go wrong with financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence regardless of whether it corroborates or contradicts management's assertions.

#### **Threats**

Research has found that auditors' judgments can be flawed when individual do not consistently follow a sound judgment process and when they fall prey to *systematic, predictable trap and biases* that can lower the quality of judgments. Bias – inducting tendencies that can predictably lead even the brightest, most experienced professionals, including auditors, to make suboptimal judgments are [9]:

- *Overconfidence* is the tendency of individuals to overestimate their own abilities to perform tasks or to make accurate assessments of risks or other judgments and decisions. Overconfidence can lead the auditor to not spend enough time critically thinking about client – related facts that would otherwise raise red flags.

- *Confirmation* is the tendency of individuals to seek information that supports their initial beliefs or preferences. If individual auditor does not seek contradictory evidence, their professional skepticism is not heightened because the auditor does not detect discrepancies.

- *Anchoring* is the tendency of individuals to evaluate information from a starting point and then not adjusting sufficiently away from that starting point despite evidence to the contrary. For example, the individual auditor may anchor on last year's account balance or procedures used last year and insufficiently adjust for new information.

- *Availability* is the tendency for decision makers to consider information that is easily retrievable from memory as being more likely, more relevant, and more important for a judgment. By focusing on more readily available information, the individual auditor may not make the effort to engage in critical thinking about patterns available in audit evidence.

One of the most prevalent factors faced by auditors is *time pressure*. Time pressure requires individual auditors to complete very complicated tasks quickly [10]. This pressure may cause the auditors not to apply the appropriate level of professional skepticism, which may result in the collection of insufficient evidence or evidence that can be easily collected, but on the other hand may be less relevant. Recognizing that auditors work under significant time pressure is an important factor in applying professional skepticism. With hindsight and time removed as a critical factor, judgments made under such time pressure are easy to criticize but to genuinely gain insight and improve capability; we have to distinguish time as a key factor.

Individual auditors' judgment and level of skepticism can be affected by their *supervisor's preferences*. Auditor cannot ignore the preferences of the supervisor who will make him select evidence that is likely to be related to supervisor's preferences and limit auditor from obtaining evidence that supports more correct judgments [11].

*A lack of knowledge and experience* can also affect the appropriate level of professional skepticism. The lack of relevant knowledge and experience among the junior auditors can limit their ability to effectively apply professional skepticism. Junior auditors usually in the most complex audit areas have difficulty in understanding the accounting and auditing standards, policies and procedures of the audit firm. This threat suggests the importance of mentoring junior auditors and maintaining rigorous levels of supervision by more experienced auditors.

## **Potential opportunities**

In order to exercise sound judgment, it is helpful to *consistently follow a good judgment process*. When an understanding of components of a good judgment process, as well as the common threats to good judgment, the quality, justifiability, and defensibility of judgments can be improved [12]. Such a process provides a consistent, logical approach to ensuring judgment are well considered, and provides a common conceptual framework and shared vocabulary to train and mentor auditors. If auditors understand and follow a good judgment process, many judgment traps and biases can be avoided or mitigated [13].

Frames are mental structures or perspectives that we use to determine the relevance or importance of information. The underlying analogy behind framing is that different perspectives are visible through different window frames. Different frames can lead to significantly different understandings and interpretations will affect behavior and decisions [12]. By *proactively identifying and understanding the frames* that they and others are using, and making an effort to understand what issues look like from different frames or perspectives, auditors can improve in their ability to appropriately and effectively question their own or other's initial conclusions and more effectively challenge client explanations. For example, in considering an entity's accounting or disclosure choices, it is often helpful to consider the situation from the perspectives of management, regulators, investors, and how the choice might look if reported in the business press in the future in light of different eventualities.

A maxim of human behavior is that people respond to how they are evaluated and rewarded. Therefore, auditors must be placed in an *environment that evaluates positively and rewards appropriate application of professional skepticism* [13].

## **4.2. Engagement Team Level**

At the engagement level, the engagement partner is required to take 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 the 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.

### **Threats**

*Pressure to maintain and cultivate client relationships* can influence individual's and team's ability to exercise sufficient professional skepticism. The latest PCAOB and IAASB standards are designed to ensure that auditors will maintain professional skepticism and not develop relationship with management that is too close. At the same time, the standards mandate that the auditor develop a close but professional relationship with management to promote transparency and communication.

One of the most prominent factors documented by prior research that affects the ability of engagement teams to exercise an appropriate level of professional skepticism is *budget and time pressures*. Our data suggests that the more experienced the auditor, the less time pressure is perceived to negatively affect auditor skepticism. Additionally, engagement management issues can discourage the use of fraud experts or other specialists during an audit.

*The members of the engagement team are influenced by the attitudes and preferences of their supervisors*, and engagement teams and their members often reflect the level of professional skepticism that is applied by their supervisors. Therefore, a threat to professional skepticism can occur if the supervisor does not apply an appropriate level of professional skepticism. Also, a threat to professional skepticism arises if *inexperienced auditors are not properly assigned to tasks or properly mentored*. More experienced auditors need to recognize the limitations in knowledge and experience to junior auditors and identify when team members needs help in order to effectively apply professional skepticism.

Some seriously flawed judgments with calamitous outcomes have been attributed to the set of group decision behaviors known as "*groupthink*". Members of a group who are subject to groupthink behaviors tend to suppress their own views for various reasons [13]. For example, in some cases groupthink tendencies can result in group judgments that are more aggressive in terms of risk tolerance than would have been acceptable to any individual member of the group [13]. Thus, groupthink tendencies can pose a threat to the appropriate exercise of professional skepticism, and should be considered in efforts to enhance skepticism in professional practice.

### **Potential opportunities**

*The tone or direction set by engagement team leadership* can be a major factor in the level of professional skepticism exhibited by the engagement team and individual team members. From the auditor's perspective engagement partners and managers should take the initiative to ensure the audit team understands the importance, value, and expectations of professional skepticism. By directly communicating this expectation to the staff early and often, the engagement partner can establish this understanding during the planning phase of each audit and reinforce it throughout the engagement [12].

To perform the audit with professional skepticism, it is important that personnel assigned to engagement teams have the necessary knowledge, skill, and ability required in the circumstances, which includes appropriate technical training and experience. As we have previously discussed, the lack of relevant knowledge and experience among the junior

auditors suggests the importance of *mentoring junior auditors and maintaining rigorous levels of supervision by more experienced auditors*. In directing the work of others, senior engagement team members, including the engagement partner, may have knowledge and experience that may assist less experienced engagement team members in applying professional skepticism. 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 emphasize the importance of professional skepticism when [14]:

- Directing and supervising the audit engagement, especially in areas of judgment, significant risk and contentious matters;
- Demonstrating good business knowledge and experience – providing a basis for identifying unusual events or transactions;
- Being actively involved in leading and participating in team planning meeting, and assessing risk and planning audit strategies and procedures;
- Consulting specialist; and
- Reviewing audit documentation that requires improvement in demonstrating the exercise of professional skepticism.

Professional skepticism can be enhanced through *proper high – level internal review and oversight* focused specifically on application of skepticism. It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention are identified and addressed appropriately [8]. Audit firms might also further develop policies around circumstances requiring *consultation outside the engagement team*. Such consultations might focus not only on technical considerations, but also on whether an appropriate level of professional skepticism is applied by the team's response to particular circumstances. Professional skepticism is interrelated with an auditor's training and experience as auditors need an appropriate level of competence in order to appropriately apply professional skepticism throughout the audit. In addition, it is important for the firm's culture to continually reinforce the appropriate application of professional skepticism throughout the audit.

#### **4.3. Profession/ Audit Firm Level**

The challenge for audit 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 skepticism on audit engagements are important influences on individual's behavior.

#### **Threats**

If professional associations or audit firm leadership *do not adequately emphasize, incentivize, and support* audit quality; the maintenance of a questioning, objective, probing mindset; and the auditor's role in the context of the broader capital markets, then engagement teams may fail to exercise sufficient professional skepticism. Also, messages from firm leadership that are excessively focused on revenue or profit growth over achieving audit quality, can undermine the application of professional skepticism.

Also, *regulation can be a potential threat to professional skepticism*, if regulation and / or inspection focus is not in accordance with the relevant audit risks. In other words, auditors focus their effort in areas that are not sufficiently correlated with risk of material misstatement for a specific engagement; the influence of previous inspections can result in misplaced focus and effort, and potentially less attention to areas that present greater audit risk [9].

## Potential opportunities

As we mentioned in discussing threats to professional skepticism at the engagement team level, one major take away from the existing research is that it is important to *set a proper tone at the top*. The PCAOB's inspection findings have identified instances in which the firm's culture allows or tolerates audit approaches that do not consistently emphasize the need for professional skepticism. Consistent communication from engagement team leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed by audit partners and staff [8]. Further, audit firms should work to *establish a culture of consultation*. The firm's culture should support auditors in obtaining the expertise necessary to exercise adequate professional skepticism.

As indicated previously, one of the most important ways of enhancing the ability of auditors to apply appropriate professional skepticism is to develop their ability to follow a good judgment process in order to avoid judgment trap and biases that can undermine effective application of professional skepticism. Therefore, *audit firms should develop and implement a sound audit judgment process* and help ensure that auditors understand and implement that process so that it becomes deeply engrained in ongoing firm training and audits [14].

Five basic actions can help auditors arrive at sound professional judgments, according to the CAQ resource. These are [15]:

- *Identify and define the issue* – this is not always as easy as it sounds, and it depends on the auditor's ability to consider multiple perspectives, including information that contradicts management's assertions.

- *Gather the facts and information, and identify the relevant literature* – this is not limited to learning the company's version of events through discussion. Critical assessment of evidence such as contracts, memoranda, calculations, meeting minutes, and external information is also part of the process.

- *Perform the analysis and identify alternatives* – auditors need to be thorough while examining potential alternatives and they should be vigilant in identifying information that could disconfirm expectations of management's position.

- *Make the decision* – if a supportable judgment process has not been followed, the auditor might need to reconsider the process and the evidence obtained.

- *Review and complete the documentation and rationale for the conclusion* – documentation should be performed throughout the judgment process, as it can enable a more objective and complete assessment.

Personality traits likely influence an individual's ability to appropriately apply professional skepticism, but experience as well as a number of recent research studies indicate that knowledge and skills that can enhance auditors' ability to apply professional skepticism can be developed through training [13]. Audit firm should *develop or expand training for auditors* at all levels oriented toward responsibilities and procedures for fraud detection. These programs should emphasize interviewing skills and the exercise of professional skepticism, as well as testing techniques [16].

## 5. The role of other stakeholders in enhancing auditor professional skepticism

While skepticism is a concept that is primarily used in the context of the professional skepticism of an external auditor, audit committees, internal auditors, managements, analysts, and regulators also have the responsibility to properly apply skepticism in their respective financial reporting roles. These other key stakeholders might contribute to the enhanced application of appropriate professional skepticism by auditors.

## **5.1. Board and audit committees**

Whilst it is the responsibility of the auditor to ensure that an appropriate degree of professional skepticism is applied in an audit, the board and audit committees can have a significant influencing role in their relationship with the external auditor.

The audit committee can influence auditor's skepticism through its own objective attitude and desire to support the auditor's role in gathering sufficient, appropriate evidence to support an opinion that the financial statements and related disclosures are fairly presented [16]. Also, audit committees facilitate auditor professional skepticism by asking probing questions of management, internal auditors, and external auditors to find sources of bias. To do so, the audit committee first needs to acknowledge the possibility that bias may exist and that something may go awry, potentially resulting in fraud. Probing questions are essential both to test the integrity of management and to communicate a clear expectation of ethical behavior [17]. Audit committee members should be comfortable in asking probing questions and should use internal auditors, external auditors, ethics and compliance personnel, or others as sources of information to supplement what they learn directly.

Further, audit committee member should have opportunities for education and training in areas of accounting, auditing, professional judgment and skepticism, relevant technology, enterprise risk management, industry specialization, financial reporting best practices, and other relevant topics. These measures are more likely to be effective to the extent audit committees are independent of management and act in accordance with their role representing the interests of investors [13].

Researches suggest that audit committees currently have little responsibility for communicating their roles or responsibilities with other key stakeholders. Greater transparency and open communication might help encourage audit committees to consistently seek to fulfill their central role representing investors and creditors as they oversee the efforts and professional skepticism of internal and external auditors. The audit committee must clearly state its expectation that the auditors conduct their audit with an appropriate degree of professional skepticism, recognizing that it is a key contributor to audit quality. The audit committee should monitor the tone of communication and intervene appropriately if the auditors do not appear to be exercising such skepticism or if management is reacting inappropriately in response [18].

## **5.2. Regulators and inspectors**

Regulators and inspectors can also take steps to contribute to the consistent application of appropriate professional skepticism by auditors. In recent years regulatory bodies have issued documents highlighting the importance of professional skepticism in an audit of financial statements. PCAOB and other regulators around the world have expressed concern about the continued high rate of audit deficiencies identified in their inspections and other oversight activities. And many of these deficiencies appear to be associated with the insufficient exercise of professional skepticism. On December 4, 2012, PCAOB issued *Staff Audit Practice Alert No.10: Maintaining and Applying Professional Skepticism in Audits* to emphasize and remind auditors of the requirement to appropriately apply professional skepticism throughout audits. It provides specific examples of audit deficiencies in which a lack of professional skepticism was at least a contributing factor. The practice Alert includes examples that raise concerns about a lack of professional skepticism, such as instances in which engagement teams did not:

- obtain an understanding of the specific methods or assumptions underlying estimates;
- evaluate the significance of evidence that supported values other than those closest to the issuer's recorded prices;
- test beyond inquiring of management the significant assumptions underlying valuations;

- question whether certain assets were potentially impaired, despite evidence that the carrying amount may not be recoverable; and
- question an issuer's use of a GAAP exception even though doing so conflicted with the plain language of the exception and with the firm's internal accounting literature.

A number of audit firms are currently undertaking significant initiatives in response to PCAOB inspection findings to better understand the factors that influence the application of professional skepticism on their auditors. In addition to that, they need to evaluate the specific factors that led to any lack of, or impairments to, the application of professional skepticism. This is a difficult but crucial area to get right in auditing.

As described in a recent literature synthesis on this topic, professional skepticism is a multi – dimensional concept that remains difficult. One of the challenges faced by audit inspectors is that there are two aspects to skepticism – skeptical thinking and skeptical actions. Skeptical thinking operates, or does not operate, within an individual auditor's mind. While it can probably be witnessed on a real time basis, the transparency to others of skeptical thought rapidly reduces over time. Audit inspectors, who review audit documentation some time after it is performed and do that not see original client records, may see evidence of skeptical actions but, without knowing what was in the auditor's mind at the time, it is difficult to evaluate the adequacy of these. The problem of evaluating the degree of skeptical thinking within an audit team is exacerbated by the removal from the audit documentation of review notes on completion of the audit.

Regulators could collaboratively work with standard setters and practitioners to develop such a definition, framework, and practical guidance. Agreement and practical guidance on shared evidence and documentation conventions that demonstrate the appropriate application of professional skepticism in different circumstances will help reviewers and inspectors evaluate the audit procedures and conclusions given the facts and circumstances available to the auditor at the time the evidence was collected and documented.

### **5.3. Standard – setters**

The desire to provide reliable financial statements motivates standard – setters to discover the bases behind a high – quality audit. The PCAOB has provided standards emphasizing their interpretation of qualities necessary in an effective audit. Auditor's skepticism is usually perceived to be a positive factor that is related to better quality audits. ISAs and PCAOB standards explain that professional skepticism is critical to audit performance and helps determine whether financial statements are free of material misstatement. The standards currently refer to "an appropriate level of professional skepticism". At this time, we have no way of measuring or training for such "an appropriate level". We might find that professional skepticism occurs along continuum and that an auditor can be either too high or too low.

Standard setters could work in concert with other key stakeholders to develop a globally recognized framework, together with practical implementation guidance, illustrations, and best practices for the appropriate application and documentation of professional judgment and skepticism across different risk settings.

A better understanding of professional skepticism will also be useful in evaluating training and experiential mechanisms. Training audit staff to be professionally skeptical is an important issue. Audit work needs to be undertaken to satisfy the relevant audit assertions and therefore creating an internal culture that recognizes the importance of professional skepticism on all audits, regardless of past experience with the audit client, is pivotal activity that needs to be promoted within all firms so that it can be demonstrated that professional skepticism has been applied. Standard setters can positively influence the training and education of auditors, thereby developing and promoting the necessary competence to apply professional skepticism and raising awareness of the factors that may inhibit its appropriate application.

## Conclusion

Academic research and PCAOB standards and oversight emphasize that professional skepticism is fundamental to the role and performance of auditors. The application of professional skepticism throughout the audit is a foundational aspect of audit quality and the integrity of the audit process. High quality auditing by independent and objective auditors is key to the effective functioning of capital markets and the protection of investors and the public interest.

Audit inspectors throughout world have expressed concern about whether professional skepticism is being applied properly in practice. There is currently a lack of practical guidance around the appropriate application of professional skepticism in audit standards and in the professional literature. This represents an important opportunity for the profession, academics, standard setters and regulators, to develop more comprehensive and practical approach to professional skepticism. Professors Glover and Prawitt propose a different view on the exercise of professional skepticism and they advise auditors to approach each engagement using a “*professional skepticism continuum*” where the appropriate level of skepticism depends on the risk characteristics of the area under audit.

Research also shows the need to study and better understand the influence of threats to auditor attributes, mindset and actions that are involved in appropriately application of professional skepticism throughout the audit process. A key to understanding, evaluating, and appropriately addressing factors that may either threaten or enhance professional skepticism is to recognize that different factors come into play at different structural levels of the professional setting. Understanding the determinants of and threats to professional skepticism at different structural levels will facilitate the formulation of solutions that can foster more consistently appropriate levels of professional skepticism.

The good news is that regulators, standard - setters, and board and audit committees are increasingly focusing their attention on advancing the understanding and application of professional skepticism. Coordinated efforts by all of the key stakeholders will increase the likelihood that audit quality will be improved and the transparency and reliability of reported financial information enhanced.

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