

## Professional Scepticism of Auditors



The public places high trust on the audited financial statements because it enhances the degree of confidence of intended users. A high-quality audit features the exercise of professional judgement by the auditor and more importantly, a mindset that includes professional scepticism throughout the planning and performance of the audit. The auditor's professional scepticism becomes particularly important when addressing areas of audit that are more complex, significant or highly judgemental. It helps in determining whether changes in accounting estimates from the prior period are appropriate in the given circumstances. Professional scepticism is also crucial in reviewing the judgements and decisions made by management in making accounting estimates to identify whether there are indicators of possible management bias. As an attitude, professional scepticism is fundamentally a mindset which drives the auditor behaviour to adopt a questioning approach when considering information and arriving at conclusions. This article analyses auditors' professional scepticism as a very important aspect of auditing. Read on...

### Professional Scepticism

Professional scepticism is an important attribute that enhances the auditor's ability to identify and respond to conditions that may indicate possible misstatement in the financial statements. It includes a critical assessment of audit evidence and being alert for audit evidence that contradicts other audit evidence or that brings into question the reliability of information obtained from management. This critical assessment is necessary for the auditor in order to draw appropriate conclusions. Adopting

and applying a skeptical mindset is ultimately a personal and professional responsibility to be embraced by every auditor. It is an integral part of the auditor's skill set and is closely interrelated to the fundamental concepts of auditor independence and professional judgement, and contributes to audit quality.

It is also influenced by personal behavioural traits, which include motivation and competence. Audit firms have an important role to play in cultivating a skeptical mindset in auditors by providing the



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necessary education and training to them. This includes designing and implementing policies and procedures that promote an internal culture which recognises that scepticism is essential in performing audit engagements.

According to Standard on Auditing (SA) 200 Revised, "*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*," issued by the Institute of Chartered Accountants of India, professional scepticism is defined as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The IAASB's International Standards on Auditing define professional scepticism as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence." It requires the auditor to plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. The definition describes the following important elements that help in understanding as to what professional scepticism means.

- As **an attitude**, professional scepticism is fundamentally a mindset which drives the auditor behaviour to adopt a questioning approach when considering information and arriving at conclusions. In this regard, it is inseparably linked to the fundamental principles of auditor's objectivity and independence.
- It also includes **being alert to conditions that may indicate possible fraud**, for example, audit evidence that contradicts

other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence.

- Lastly, it is **a critical assessment of audit evidence**, which comprises both information that support and contradict management's assertions. It means questioning and considering the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

#### Importance of Professional Scepticism in Audit of Financial Statements

It plays a fundamentally important role in the audit and is an integral part of the auditor's skill set and is closely interrelated with professional judgement. It facilitates the appropriate exercise of professional judgement by the auditor, in cases like:

- The nature, timing and extent of audit procedures to be performed.
- Whether sufficient audit evidence has been obtained and whether more needs to be obtained.
- Drawing of conclusions based on the audit evidence obtained.

The application of professional scepticism enhances the effectiveness of an audit procedure and reduces the possibility that the auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

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discussions held by the auditor during the course of an audit. For example, the auditors communicating with the management about an accounting practice which may not be the most appropriate practice considering the particular circumstances of the entity. ”

#### Application of Professional Scepticism in Audit

The application of professional scepticism is relevant and necessary throughout the audit process. The stages where it can be applied are:

- While accepting the engagement, considering matters such as the integrity of principal owners and management.
- Identifying and assessing risks of material misstatement, e.g. performing risk assessment procedures.
- Designing the nature, timing and extent of further audit procedures that are responsive to assessed risks of material misstatement, and evaluating audit evidence.
- Designing and performing substantive analytical procedures since the auditor's expectations play an important role when evaluating the results of analytical procedures and challenging management's explanations for deviations from expected results.
- Forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applied financial reporting standards.

### Demonstration of Professional Scepticism

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Audit documentation is one of the most critical evidences of professional scepticism because it provides evidence that the audit was planned and performed in accordance with the applicable legal and regulatory requirements. *Standards on Auditing – 220 (SA-220)* states that - "The auditor shall document:

- (a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
- (b) Conclusions on compliance with independence requirements that apply to the audit

**F**raud is very difficult to detect since it includes sophisticated and carefully

organised schemes designed to conceal. The auditor's professional scepticism is particularly important when considering the risks of material misstatement due to fraud. It includes requirements specifically addressing the need to maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management. ☺

engagement, and any relevant discussions with the firm that support these conclusions.

- (c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
- (d) The nature and scope of, and conclusions resulting from, consultations done during the course of the audit engagement.

Since professional scepticism is a state of mind, it is sometimes difficult to capture through documentation as to how the auditor applied professional scepticism throughout the audit. There may be no single way in which the auditor's professional scepticism is documented or demonstrated.

### Steps for Enhancing Awareness About Professional Scepticism

Professional scepticism is influenced by personal behavioural traits and competence level of the individuals undertaking the audit. Within the engagement team it is influenced both by the actions of the firm's leadership and the engagement partner, and by the culture and business environment of the firm.

#### Firm Level

The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The continuous reinforcement of the importance of professional scepticism on audit engagements influences an individuals' behaviour.

Opportunities for the firm to create expectations and insist on importance of professional scepticism are:

- Establishing policies and procedures to promote an internal culture recognising that quality is essential in performing engagements.

- Promoting a quality-oriented practice through clear, consistent and frequent actions and messages from all levels of the firm's management. This may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda.

#### Engagement Level

At this level, the engagement partner is required to take responsibility for the overall quality of each audit engagement assigned to him. An ideal opportunity to address and emphasise on the engagement team about the importance of professional scepticism throughout the audit is during the discussion by the engagement partner and other key engagement team members about the susceptibility of the entity's financial statements to material misstatement. This discussion also provides a basis upon which engagement team members communicate and share new information that may affect risk assessments or the audit procedures performed.

While activities at the firm level and engagement level contribute to the mindset of professional scepticism, it is the responsibility of each individual auditor to maintain an attitude of professional scepticism.

### Professional Scepticism with Respect to Fraud - Auditor's Responsibilities

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professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management. It also requires the auditor to investigate further where conditions identified during the audit caused the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor.

Audit procedures that are effective for detecting error may not be effective in detecting fraud. The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

#### Aspects Where Professional Scepticism May be Important

- The auditor's professional scepticism becomes particularly important when addressing areas of audit that are more complex, significant or highly judgemental.
- Determining whether changes in accounting estimates from the prior period are appropriate in the given circumstances.
- Reviewing the judgements and decisions made by management in making accounting estimates to identify whether there are indicators of possible management bias.
- When evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's

**T**oday's financial reporting seeks to address information that is more relevant to users. As a result, more judgement and increased subjectivity is involved in management's accounting and reporting decisions. Also, many entities today face difficult economic conditions that give rise to unique financial reporting and auditing challenges. These developments heighten the importance of professional scepticism by auditors, especially in areas of financial reporting that are complex or highly judgemental. It is, therefore, in the public interest to re-emphasise upon both auditors and others the important role that professional scepticism has to play in audit. ☞



plans are feasible in the circumstances.

- Any information during the course of audit that may indicate previously unidentified or undisclosed related party relationships or transactions; and in the context of identified significant transactions outside the entity's normal course of business, when evaluating whether the business rationale (or lack thereof) of the transactions suggests that

these may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests.

- Remaining alert while performing other audit procedures for instances of non-compliance or suspected non-compliance with those laws or regulations that may have a material effect on the financial statements or that have a fundamental effect on the operations of the entity causing it to cease operations, or call into question its continuance as a going concern.

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#### References:

1. [www.iaasb.org](http://www.iaasb.org)
2. *Standard on Review Engagements (SRE) 2400 (Revised), "Engagements to Review Financial Statements"*
3. *Standard on Auditing (SA) 200 Revised, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing."*
4. *Standard on Auditing (SA) 220 (Revised), "Quality Control for an Audit of Financial Statements"* ■