

Professional Scepticism



The significance of professional scepticism to the quality of audits cannot be overemphasised. The article explores the barriers to professional scepticism and how they can be mitigated. Scepticism is a learnt art and has to be applied throughout the audit process. One of the key areas regulators focus on is whether professional scepticism has been exercised during the course of the audit. Read on...



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An audit professional needs to possess certain essential knowledge, skills and attitudes such as analytical ability, technical knowledge, listening and communication skills, integrity, independence and professional scepticism. Of all these qualities professional scepticism is the cornerstone of audit quality. Without this trait, technical knowledge and communication skills will be of little avail. It is said that most frauds and misstatements are not discovered due to lack of professional scepticism. Professional scepticism is defined as an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The definition talks of scepticism being an attitude, a mindset. So how do we cultivate such an attitude, maintain and strengthen it?

Need for scepticism

In our day-to-day life we take spot decisions, make quick value judgements and jump to conclusions. The first evidence that catches our eye influences us greatly and colours subsequent judgements. We also unconsciously discount evidence that contradicts our pet theories and beliefs. We are also easily

suggestible, believe rumours and whatever is said in the media. All this is fine when not much is at stake. But in the profession we are in, much is at stake. We are responsible to a large section of society which relies solely on us regarding the integrity of the numbers in the financial statements. Huge amounts of money are at stake. We cannot afford not to take time to deliberate and gather sufficient evidence before coming to a conclusion. Scepticism helps us overcome suggestibility and the tendency to arrive at speedy decisions. Through scepticism you step back and wait before judging and deciding. You cannot be a hurried sceptic.

Traits of a sceptic

What are the character traits of a professional sceptic? How can we spot one? Scepticism is a context one comes from. It is a way of being. It is not in the nature of intellectual knowledge that can be acquired through studying or listening to a lecture or by reading a book or attending a seminar. It does not require high IQ or brainpower. It is a way of perceiving and orientation. You have to be a sceptic. You *come from* a state of scepticism. You have to be a certain kind of person to be a sceptic. The mindset of scepticism reveals what is normally hidden from view. You will then see things that you did not see before. It opens doors that were otherwise shut to the non-sceptical. Within the context of scepticism questions arise that are of a different kind. A sceptic does not take things for granted. For a sceptic the first answer is not the best answer. He also looks at the same issue afresh every time. A person who is sufficiently sceptical intuitively knows that there is something wrong with a document or an assumption or an estimate. The sceptic is not a fault finder or error seeker. He is looking for truth, not victims. He is not suspicious but cautious. Caution keeps his mind alert to danger signals. When we believe that nothing will go wrong we become complacent and lose our alertness. We will not notice when something goes wrong. A sceptic is more of a creative thinker. Scepticism can help produce innovative, out-of-the-box ideas. The sceptic keeps his mind open by looking out for alternate possibilities and points of view. He is not content with merely the known evidence but looks for the yet to be known. Scepticism creates an alert and inquiring mind that is open to the not yet known. We, as auditors, are looking for persuasive evidence but the sceptic does not get persuaded immediately. If bank balances are very high he is just not persuaded merely by a bank confirmation. He enquires into the cause of

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the huge balances and seeks evidence for the cause. We need to be a professional sceptic, not an amateur sceptic. That means it has to be a measured and mature scepticism.

Barriers to scepticism

So what does it take to develop professional scepticism? Firstly we must remove the barriers standing in the way of our becoming a professional sceptic. If we do not remove these obstacles they will be interfering in our thought processes and preventing us from asking the right questions and demanding the right explanations. Some of them are inbuilt human biases and need much awareness before we can overcome them. We need to create defence mechanisms to thwart them. Secondly, to develop the sceptical mindset, we need to ask the right questions. Questions are the domain in which scepticism shows up and is nourished. A sceptical mind is a questioning mind.

Scepticism and trust

We are not programmed by evolution for scepticism. Life is based on trust when we live in social groups. If we had to verify every statement everyone made before we acted, life will come to a standstill. Scepticism is an acquired trait. It has to be cultivated. The first and foremost dilemma to resolve on our journey to becoming a professional sceptic is the trust versus doubt issue. If we do not resolve this issue we will be torn between trusting and doubting. It is not that managements are interested in committing fraud or misstating their financials. Managements are human too and can make errors of judgement and inadvertent mistakes.

The greatest barrier to professional scepticism is total and unflinching trust. The more you trust the less you will doubt. Does this mean we trust nobody? It is not a question of going the opposite way and becoming suspicious of everything and everybody. Then the audit will never get over. We have to trust and doubt at the same time. That is the paradox. Both the levels of trust and scepticism have to be sufficiently high. Only trust or only doubt will be detrimental. No trust

and no doubt also will not work. To inquire into the truth of an assertion requires us to tell the client that we have no reasons to disbelieve him but would also like to verify the merits of the assertion independently. We are not questioning their competence or integrity. Scepticism is about the estimate or assumption, not the person. There is nothing personal about it. As auditors, no matter who says what, we take a stand that we question, challenge and verify. We need not come from a place of distrust. We come in good faith. But this does not preclude us from having an open mind, of verifying the validity of a statement, of examining it from all sides to ensure that nothing has been missed out. Our aim, as auditors, is to be thorough in our job. Being thorough does not mean to distrust. Part of being thorough requires a sceptical mindset. Scepticism aids in thoroughness. Just as an analytical bent of mind or attention to detail does. That is the role of an auditor. Not to distrust, but to verify and reinforce the trust. Every time our scepticism is assuaged, trust increases. One must not be intimidated by statements such as 'don't you believe me?' Of course we do, but we are documenting that belief based on our understanding, after backing ourselves with the necessary evidence that can stand the test of a hard-nosed reviewer. Ultimately we must remember we are responsible to the stakeholders and, if a problem arises, to the regulators and courts of law. The judge is going to look for hard evidence and whether due professional care was exercised and documented with well-reasoned arguments. He is not interested in trust or distrust.

Displaying lack of trust is bad for relationships as relationships are based on trust. The auditor will have to walk on the razor's edge balancing trust expected by his client and scepticism demanded by his profession. He has to err on the side of scepticism which is also the expectation of the many regulators and reviewers breathing down his neck to ensure that he is doing a professional job. Trust is emotional and subjective while scepticism is objective. To give an opinion of true and fair view requires an objective and impartial view. Trust requires no further validation as it is already validated by the client. Scepticism demands validation, irrespective of the source. We are paid to validate what we get from a trustworthy source. By

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validating the evidence we validate our trust. Trust grows in this manner and does not weaken scepticism. Scepticism then becomes an aid in enhancing trust, not diminishing it.

Independence

Another important barrier to professional scepticism is lack of independence. If we are dependent on the high fees paid by the client or if it is a prestigious client, our professional scepticism will become weak. The more dependent we are on the fees, lower will become our scepticism. We will not even ask the questions we are supposed to ask. Such questions will not even arise in us as it is devoid of context. It will be prevented from arising by the thoughts of dependency. If this is not bad enough, we will actively go about finding evidence to support the clients' viewpoint and justify his explanations. It is easy to rationalise any assertion in whichever manner we want. Once we give in to this pattern, it will become a habit. We will become better and better at creative justifications. Lack of independence will weaken our integrity. Without a foundation of integrity, there can be no independence and without independence there can be no professional scepticism and without professional scepticism we cannot deliver a high-quality audit. The resolution of this issue depends on how much the value of integrity means to us.

Emotional bias

Emotional bias can also influence our judgements and impair scepticism. When we like someone we will tend to assume he can do no wrong. If he is a well-known public figure our bias increases. We may assume that he will be upright to protect his public image. Experience has shown that this is not always the case. If there have been no problems or issues with the client for many years, we will tend to relax our defences. The international brand of the company may also unconsciously influence and intimidate us. Even if we develop a soft corner for one person at the top of the organisation, it will influence the way we perceive the organisation as a whole. We cannot prevent such biases since they happen to us automatically. But we can create defences so that it does not weaken our scepticism. One line of defence to reduce the impact of emotional bias on our scepticism is to place high value on professionalism at work. When we call ourselves professional and members of a highly-valued profession, it means we have to live up to the value of professionalism. So when it comes to discussing audit

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issues we remember to bring in the professionalism that we value and behave like a professional. When we meet the CFO during lunch we are our social self. When we meet him at the discussion table we are our professional self. Professionalism will always be respected in the long run. Emotional bias can be kept at bay by embracing a higher value such as professionalism.

We must also restrain ourselves from displaying our skill in rationalising and justifying on behalf of the client as though we were his consultant. If we keep doing this, and we may find it quite satisfying, we will start behaving as though we are part of his organisation. To be objective we will have to develop a mindset which sees the issue as though it belongs to nobody. It is examined for what it is, for its own sake, without reference to a person or an organisation. Otherwise, we will lose our perspective and be less sceptical. We may see it from the client's point of view and build arguments to support it.

Acceptance of Authority

Another common bias is the unconditional acceptance of authority. Being intimidated by authority is a cultural conditioning for most people but not a useful quality for auditors. The greater the acceptance of higher authority the lower will be our scepticism. It is common to get opinions from senior professionals with good public standing. To accept it blindly would be unprofessional on our part. Even though such opinions are well thought out, we must examine them independently with special focus on whether some aspect has not been considered. Opinions generally give good reasons for their conclusions. They normally do not give reasons why a contrary conclusion is untenable. We need to play the devil's advocate and examine it from both ends. Scepticism is also required in determining whether the evidence is persuasive. Some opinions may look persuasive but on closer look may not be so. A sceptic needs to distinguish between persuasive and non-persuasive evidence that comes camouflaged as persuasive. A case in point is a bad opinion that passes off as a good opinion if it is not

subjected to scepticism. The same is the case when we refer to a book or a professional magazine or the financial statement of another organisation. We have a huge inbuilt bias to the written word. Anything written is generally given greater weightage and acceptability and so tends to lower our scepticism.

Second partner review

One way in which we can overcome emotional bias is through a second partner review who has no emotional connect with the client. Since we must not only be objective but be seen to be objective, we must consult and discuss critical issues with other competent professionals within our own organisation. Having a hierarchy where a junior auditor's judgments regarding audit evidence is questioned by the audit senior, whose judgments in turn are questioned by the audit manager, who in turn is questioned by the audit partner, who is finally questioned by the quality and peer reviewer will go a long way in reducing bias.

Areas for scepticism

So what do we need to be sceptical about? Abnormal variations, estimates, fair values, related party transactions, opinions, interpretations, judgements, forecasts and projections, provisions, impairments, materiality, risks, and the quality and nature of evidence are some examples. For instance, we need to be sceptical about explanations for variations while performing variance analysis and resist accepting obvious and generalised explanations. However, it is not wise to be sceptical about each and every thing. We have to be sceptical selectively so that we are focused. It should matter either from a governance perspective, or impact the financial statements or it could be a compliance issue or affect stakeholders' interests. We need to be sceptical when the explanation seems too simplistic or too complex to our common sense. Much of auditing is common sense and we must not disregard the wisdom of common sense. We also need to be sceptical if there is more than one point of view possible or if we see conflicting and contradictory evidence. The absence of hard evidence and unconvincing explanations should arouse scepticism.

How scepticism works

How does scepticism work? It works by looking for evidence to the contrary. It tries to disprove the evidence, and by failing to disprove, it proves. When you go about to prove an assertion you will invariably find reasons to prove it. You will look for evidence

in the direction of proof. But that is not sufficient to make the assertion infallible. It has to stand another test. That of not being disproved. For example, you may find a hundred reasons why no provision needs to be made for a debt or investment. If you stop there you will miss the one reason which will tell you why a provision is necessary. When you focus only on one aspect you will miss its opposite. We therefore need to be sceptical about one-sided evidence. We need to document both reasons for and reasons against and weigh the evidence. Since evidence is normally persuasive, we can easily fall into the error of cherry picking reasons which persuades us to arrive at a conclusion we have predetermined. This is called confirmation bias, which means that we will go about proving the conclusions we have already decided upon. To overcome confirmation bias, we should focus more on negative and error-related disconfirming evidence rather than positive confirming evidence. Confirmation bias can also be reduced by documenting not only why our conclusion is true, but also why we disagree with the contrary conclusion. Another useful tool to aid us in our scepticism is to compare our evidence with expectations. It is essential to know about the client's business benchmarked to industry standards to develop meaningful expectations, such as ratio of the cost-of-sales to sales or salaries to turnover. It is critical to establish an acceptable range of expectations outside of which we become cautious and sceptical.

Questions

The attitude of scepticism is cultivated through asking the right questions during the course of audit. The kind of questions a professional sceptic would ask himself has to begin with the broad picture and then drill down to the account balance level. He has to think like the CEO and CFO of his client. How do they perceive the industry and their company? How short or long are they in delivering their promises? What pressures are they under? What are the market expectations? How did they weather the storm in the past or how did they celebrate their golden years? With this at the back of our mind, we pick up the risk-prone account balances one by one and ask what could go wrong in this balance; is an alternate view possible in this estimate; could there be a different way of looking at this issue; in what way

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could this balance be understated or overstated; could this contingent liability turn out to be a real liability; how much reliance should I place on this projection; is there even a shred of paper to say that this balance is recoverable, and so on.

The quality of the audit is determined by the quality of our questions. The quality of our questions is in turn determined by our attitude of scepticism. The sceptic in you frames the question and the question reinforces your scepticism. Scepticism is a context where questions that challenge assumptions show up. When you wear the hat of scepticism the thought process shifts to an objective inquiry. It challenges conventional wisdom and accepted practices. We often believe that when a certain practice was followed last year or is being followed in another company it should be right, whereas the sceptical attitude is to challenge assumptions in the same audit every year. Challenging and questioning will open up new ways of thinking as there is always scope for improvement and refinement in every area. The auditor's skill comes to the fore when he has to make a judgement whether there is any data that has not been included in the estimate, any parameter left out in a projection, or the implications a policy has on various stakeholders, or evidence that refutes management's assertions. He has to think of what is missing, not just what is presented to him.

While we need to keep improving our skills in becoming a professional sceptic, we must also become aware of how we frame our sceptical questions. Scepticism must not be displayed blatantly so that the client feels he is being mistrusted. We have to go by the dictum that no one is guilty unless proved otherwise. We cannot start with the presumption of guilt and frame our questions from there. Since trust is a sensitive issue we have to be careful while questioning. For instance we cannot say this entry has been passed to increase profits or this policy has been framed to improve the topline. Even if you think this is the case, the language has to be more sophisticated. It should not be perceived as an accusation. We have to argue on merits of the entry or the policy and not on a preconceived notion that all companies pursue only one goal, which is to increase profits. The way questions are framed and the way answers are interpreted is important for the auditor-auditee relationship. ■