

Professional Skepticism

Due to recent events involving sudden collapse of large corporates, the debate whether their auditors were sufficiently skeptical in performing their attestation function has captured headlines in business news. Concerns expressed by certain regulators and industry leaders have been highlighted and will continue to be part of the future of audit debate. When we, as professionals think of future of audit, we think of audit in artificial intelligence and in blockchain environment, audit of big data that inundates businesses on a day-to-day basis and professional skepticism that we need to maintain as a pivot of auditing profession to meet the needs of audit in the future. Accounting and auditing knowledge will continue to be base line but professional skepticism will lie at the heart of a quality audit. We will continue to carry out attest function in future also as the risk of misstatement due to frauds and errors will not get eliminated, rather it may get enhanced as highly tech savvy minds would be involved in committing frauds and technology based tools might have missed or be the cause behind generation of new types of errors. In such scenario, it is important to recapture the importance of professional skepticism as an essential part of the auditor's mindset so as to understand the reasons why approaching an audit with an attitude of professional skepticism is becoming increasingly important. Read on...



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Concept of Professional Skepticism

The concept of Professional Skepticism has been dealt with in Standards on Auditing adopted by the Institute of Chartered Accountants of India. Standard on Auditing (SA) 200 on *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing* attributes following inclusive meaning to the term Professional Skepticism - *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.* SAs are designed to support the auditor in obtaining reasonable assurance while performing attestation function and the Standards on Review Engagements (SREs) are designed to support auditors

in obtaining limited assurance. Both SAs and SREs require that the auditors need to exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit or review, as the case may be. SA 700 (Revised) on *Forming an Opinion and Reporting on Financial Statements* specifically requires that, while communicating his responsibilities to the users of the Auditor's Report, the auditor should *inter alia* assert that "as part of an audit in accordance with SAs, he exercises professional judgment and maintains professional skepticism throughout the audit." The SAs contain objectives, requirements and application, and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. Para 7 of SA 200 also require the auditors to, *inter alia*:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal controls;
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks;
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

As per para 15 of SA 200, the auditor needs to plan and perform an audit with professional skepticism, recognising that circumstances may exist which cause the financial statements to be materially misstated. Professional skepticism includes being alert to the critical assessment of audit evidence and includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Thus, among other things, exercising professional skepticism helps the auditor to reduce the risks of matters critical to an effective audit. The application of professional skepticism enhances the effectiveness of an audit procedure and of its application and reduces the possibility, such as:

- Overlooking unusual circumstances;
- Over generalising when drawing conclusions from audit observations;
- Misinterpret the audit results;
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof;
- Misapply an appropriate audit procedure.

Exercise of both professional skepticism and professional judgment are indispensable elements of ensuring audit quality.

The concept of professional skepticism is also closely integrated with exercise of professional judgment by the auditor. Professional judgment refers to application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement. Exercise of both professional skepticism and professional judgment are indispensable elements of ensuring audit quality. It is a multi-faceted concept that is affected by traits, training and culture.

Professional skepticism is relevant and necessary throughout all assurance engagements, starting from client acceptance to forming an opinion, covering all stages of audit processes. The above requirements of SA 200 is summarised hereunder:

While performing risk assessment procedures :

Auditor should be skeptical when performing risk assessment procedures at the planning stage of the engagement. For example, while discussing the findings of analytical procedures with the management, in addition to explanations offered, based on his professional skepticism, he may insist on additional corroboratory evidences to support explanations offered.

While obtaining audit evidence :

The reliability as well as sufficiency of audit evidence need to be considered, especially when there is a risk of material misstatement. Whenever the auditor is skeptical about the responses/evidence provided, he may have to decide whether the same are reliable and sufficient for his objectives or would require additional evidence in the form of direct third party confirmations, physical verifications of assets / inventories, explanations from legal counsel of auditee, consultation with an expert and so on.

While evaluating audit evidence:

The auditor should critically assess audit evidence and be alert for contradictory evidences that may undermine its reliability, sufficiency or appropriateness. Professional skepticism is an attitude of the questioning mind. In the course of evaluating audit evidence, this attitude of the auditor raises the questions which helps in critical assessment of the audit evidence. For example, an auditor may complete verification of material receivables by calling for external confirmations, however, his skeptical attitude will help him in framing a view whether classification of such receivables as current or non-current is appropriate or not.

The application of professional skepticism should reduce detection risk because it enhances the effectiveness of applied audit procedures and reduces the possibility that the auditor will reach an inappropriate conclusion when evaluating the results of audit procedures.

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Importance of Professional Skepticism in current times

The challenges before the audit profession is accentuated by the increasing complexity of business and financial reporting, including greater use of estimates and management judgments, changes in business models brought about by technological developments and disruptive innovations; and the fundamental reliance the user places on reliable financial reporting. In addition, given the increasingly complex and subjective nature of Indian Accounting Standards (Ind AS) requirements, greater reliance by the financial statements preparator on substance of a transaction over its legal form increase the challenges before the auditors. At present, the auditors find themselves in a fast-moving business environment in which they need to understand the impact of all rapid changes happening in businesses, technology, regulations within a limited period of time with limited resources and under the pressures of deadlines.

Auditors perceived lack of professional skepticism is looked upon by the regulators and the public as being at the root of issues with audit quality. This criticism has risen in importance pursuant to the global financial crisis as well as due to increase in number of proceedings under the Insolvency and Bankruptcy code before the National Company Law Tribunal. Presently, in India, bankers, investors and large creditors are very critical about the financial health of entities from whom they have receivables. This increases the need of critical assessment of Going Concern assumption. The auditor's professional skepticism is the single most important tool in such assessment as well as other assessment like mismatch in assets and liability pattern of a financial institution which has significant relevance in present times.

Professional skepticism will continue to be on the agenda of all stakeholders for a long time to come as it is so intrinsically linked to other key audit issues such as audit quality.

In such circumstances, importance of professional skepticism in current times cannot be undermined. The basics, sufficient knowledge of the client's business model and strong professional competencies, in addition to a sound understanding of relevant standards, laws, and regulations, enable robust professional skepticism. Auditors need to be confident to challenge management on range of subjective matters which are heavily based on management's judgement or estimates. Personal traits such as confidence; an inquisitive nature; practical experience; cultural background; and an individual's ability to

deal with stressful situations play a key role in the exercise of professional skepticism. Equally, personal bias can act as impediments to the proper exercise of professional skepticism. Awareness of shortcomings coupled with continuing education, effective training of the audit team members remains vital. Application of data analytical tools and artificial intelligence in audit help the auditor in identifying inconsistencies in the audit evidences gathered including responses from management and as a result help in raising probing questions to management.

Other auditing aspect where professional skepticism may be relevant

The SAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. SA 200 requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each SA. Thus, in achieving the overall objectives, the auditor considers the objectives and requirements of other relevant SAs.

In addition to areas such as risk assessment by questioning responses received to inquiries and other information from management, review of significant and unusual transactions and so on, as discussed above, one will find application of professional skepticism while dealing with other aspects of assurance engagements.

Some of the references found in other SAs are tabulated as follows:

Independence	Importance of independent auditor: Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.
Agreeing the terms of Audit Engagements (SA 210)	The auditor is expected to apply professional skepticism in considering integrity of management while accepting an audit engagement. He also needs to specifically communicate that he will exercise professional judgement and maintain professional skepticism.
Planning an Audit (SA 300) / Quality Control for an Audit of Financial Statements (SA 220)	The base for proper planning and quality control in an attestation function is direction to, supervision over and performance of members of the engagement team. This in turn <i>inter alia</i> depends on the manner in which the auditor emphasises the engagement team members about the need to maintain a questioning mind and to exercise professional skepticism as required by SA 200 in gathering and evaluating audit evidence.
The Auditor's Responsibilities relating to fraud in an audit of Financial Statements (SA 240)	When management provides the auditor with audit evidence in the form of answers to enquiries, management representations or documentary evidences, the auditor carefully considers the integrity of such evidences and whether additional corroboratory evidences should be obtained from the management or from other reliable sources. Application of professional skepticism takes paramount importance in such area considering the fact that management is often in the best position to perpetrate fraud through management override of controls and recognizing the fact that audit procedures that are effective for detecting errors may not be effective in detecting fraud.
Consideration of Laws and Regulations in an Audit of Financial Statements (SA 250)	Auditor remains alert for instances of identified or suspected non-compliances with respect to applicable laws and regulations while performing audit procedures for forming an opinion on financial statements.
Auditing Accounting Estimates, including Fair Value Accounting estimates and related disclosures (SA 540)	Auditor uses professional skepticism while evaluating reasonableness of management assumptions; review of prior period accounting estimates to assist, in current period, in identifying circumstances or conditions that increases the susceptibility of accounting estimates to, or indicate the presence of, possible management bias.
Related Parties (SA 550)	Planning with professional skepticism is particularly important in reviewing related parties disclosures, given the potential for unidentified or undisclosed related party relationships and transactions. In recent times, on account of various regulatory restrictions related to transactions with related parties, this area relating to disclosures in financial statements etc. is prone to material misstatement.
Going Concern (SA 570)	To achieve the objectives laid down by this SA, the auditor needs to use his professional skepticism while evaluating events or conditions that indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and also while evaluating management plans for future actions so as to continue as a going concern
Auditor's responsibility relating to Other Information (SA 720)	As the auditor is not required to carry out verification of Other Information so as to ascertain inconsistency between the Other Information and the financial statements and / or his knowledge obtained during the course of audit, maintaining professional skepticism while reading the Other Information would be the single most important factor while discharging responsibilities under this SA.
Audit conclusion and reporting (SA 700 / 701 / 705 / 706)	Finally, the auditor should also apply professional skepticism while forming an opinion, by considering the overall sufficiency of audits evidence to support the audit opinion and by evaluating whether the financial statements overall are a fair presentation of underlying transactions and events.

Auditing

Documentation

SA 230 on Audit Documentation deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements and it *inter alia* requires the auditor to document audit procedures performed in support of his basis for a conclusion about the achievement of the overall objectives. There is no specific way in which the auditor's application of professional skepticism may be documented as it is a state of mind. Nevertheless, audit documentation remains critical in evidencing application of professional skepticism because it provides evidence that the attest function was planned, performed and concluded in accordance with relevant SAs. The general audit documentation may provide evidence of the auditor's exercise of professional skepticism. Some of the examples of demonstrating that professional skepticism was applied while performing the attest function are as under:

There is no specific way in which the auditor's application of professional skepticism may be documented as it is a state of mind.

- Documentation covering the manner in which contradictory or conflicting evidences or inconsistencies between the responses / information received and audit evidences obtained were resolved.
- Documentation relating to briefing in audit team meetings.
- Documentation relating to discussion with management, such discussion may cover:
 - ◆ Probing questions and management responses

relating to controls etc.

- ◆ Discussions relating to identified or suspected non-compliances with laws and regulations;
- ◆ Basis for arriving at accounting estimates, its reasonableness and relevant factors;
- ◆ Specific information called for to resolve inconsistencies; observed in the course of performance of audit procedures;
- ◆ Procedures adopted to identify the Related Parties;
- ◆ Basis on which it was concluded that disclosures made meets the requirements of relevant standards as well as statutory requirements;
- ◆ Discussion relating to expected future profits and underlying assumptions in support of recognition of deferred tax assets;
- Documentation relating to use of experts.
- Documentation by Quality Review partner or other senior member of audit team dealing with audit conclusions.

Training and monitoring

Standard on Quality Control (SQC) 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements* reinforce the importance of training of team members. It is critical to imbibe the application of professional skepticism at the firm's level as well as the engagement level, including through setting the right tone at

the top. The manner in which audit partner communicates about professional skepticism sets the benchmark for the team members who perform better if the partner is supportive of them being professional sceptic. Clarity over audit aim behind conducting a procedure and also over ultimate audit objectives among all the team members, during the entire duration of engagement, would assist in enhancing professional skepticism.

Conclusion

Considering the challenges and progression happening in auditing environment, it has never been more critical for the audit firm to invest in people and develop the appropriate processes to drive audit quality through appropriate skeptical behavior.

Professional skepticism is the state of mind which is ready for the situation that grabs the errors or questions the evidence produced in support of financial events and other events while conducting an assurance engagement. Instilling professional skepticism starts at the beginning of one's career and a good and successful auditor is one who has professional skepticism imbibed in his DNA. Professional skepticism is at the core of the audit profession and will continue to be so in future. With changes happening in business environment and manner of its records keeping, the auditor also needs to use artificial intelligence and technology-based tools so as to improvise his ability to ask right questions. Based on this attitude, the Auditors can continue to be relevant and play pivotal role in nation building by establishing unquestionable credibility over reports signed, sealed and delivered by him. ■