Professional skepticism in an audit of financial statements
(Staff questions and answers)
Introduction

Questions and answers

1. What is professional skepticism?
2. Why is professional skepticism important in audits of financial statements?
3. What can be done by audit firms and auditors to enhance the awareness of the importance of professional skepticism and its application?
4. At what stage in the audit process is professional skepticism necessary?
5. How does professional skepticism relate to the auditor’s responsibilities with respect to fraud?
6. In addition to fraud, are there other aspects of an audit where professional skepticism may be particularly important?
7. How can the application of professional skepticism be evidenced?
8. Do regulators and oversight bodies of audit firms and those charged with governance have a role to play in supporting skeptical behavior among auditors?
INTRODUCTION

• Audited financial statements → enhances degree of confidence for users

• Essential attitude: professional skepticism = critical assessment of audit evidence / contradictions
  o Ability to identify / respond to indications of possible misstatement
  o Appropriate conclusions
  o Personal and professional responsibility

• Today’s financial reporting
  o More judgment
  o Increased subjectivity
  o Difficult economic conditions
  o Topics: fair values / related party transactions / going concern assessment ...
QUESTIONS

1. What is professional skepticism?

- An attitude
  - A questioning mind (mindset)
  - Being alert to conditions which may indicate possible misstatement (error / fraud) – contradictions in audit evidence
  - Critical assessment of audit evidence / management assertions / supporting evidence
  - Adopt a questioning approach
  - Auditor’s independence

- Recognizing that circumstances may exist → materially misstatements of financial statement
  - Planning / performing audit
  - Doubt: modifications audit procedures
QUESTIONS

2. Why is professional skepticism important in audits of financial statements?

• Auditor’s skill set → facilitating the exercise of professional judgment → audit quality
• Enhancing effectiveness of audit procedure
• Reducing the possibility of:
  o Selecting inappropriate audit procedures
  o Misapplying inappropriate audit procedures
  o Misinterpret audit results
  o Overlooking unusual circumstances
• Decisions on:
  o Nature / timing / extent audit procedures
  o Sufficient audit evidence
  o Evaluation of management’s judgment
  o Drawing conclusions bases on the audit evidence obtained
QUESTIONS

3. What can be done by audit firms and auditors to enhance the awareness of the importance of professional skepticism and its application?

FIRM LEVEL
• Tone at the top
• Establish policies and procedures to
  o Promote internal culture based on quality/competence at all levels
    - performance - compensation
    - evaluation - promotion
  o Develop and implement internal training and education (professional development)
    - work experience - coaching
    - on the job training - independence education
QUESTIONS

3. What can be done by audit firms and auditors to enhance the awareness of the importance of professional skepticism and its application? (Continuation)

ENGAGEMENT LEVEL (engagement partner)
• Engagement partner emphasizes quality
• Discussion with engagement team on the susceptibility of the financial statements to material misstatements = share information
  o Applicable financial reporting framework?
  o Fraud might occur how → where material misstatements
• Supervision audit engagement
• Review work performed
• Appropriate consultation on matters
4. At what stage in the audit process is professional skepticism necessary?

- Engagement acceptance: integrity of owners / management
- Identifying and assessing risk of material misstatement
  - Performing risk assessment procedures
  - Revising assessment of risk → modify audit procedures
- Designing the nature, timing and extent of (responsive) audit procedures + evaluation evidence
  - Increase quantity of evidence in higher risk areas
  - Substantive analytical procedures
  - Particular circumstances (eg. Confirmation request denied)
- Forming an opinion on accordance with applicable financial reporting framework
  - Reasonable assurance / appropriate audit evidence
  - Able/unable to gather evidence
  - Achievement of: fair presentation
QUESTIONS

5. How does professional skepticism relate to the auditor’s responsibilities with respect to fraud?

- Considering the risk of material misstatement due to fraud
- ISA 240:
  - Keep professional skepticism even when good past experiences with management
  - Further investigation of doubt about authenticity of audit evidence
  - Ongoing questioning of audit evidence if material misstatement due to fraud is possible
  - Increased sensitivity in selection of nature/extent documentation to be examined
  - Increased recognition of the need to corroborate management info
  - Investigate inconsistencies
  - Reevaluate prior assessment to risk of material misstatement due to fraud when it occurs
QUESTIONS

6. In addition to fraud, are there other aspects of an audit where professional skepticism may be particularly important?

- Areas more complex, significant or highly judgmental
  - Accounting estimates (fair value, related disclosures)
    - Evaluating reasonableness
    - Changes in methods appropriate
    - Reviewing judgments and decisions by management (biased?)
  - Going concern
    - Future actions/plans: feasible, outcome
  - Related party transactions/relations
    - Disclosed?
    - Fraudulent?
  - Considerations of laws and regulations
  - Unusual/highly complex transactions
QUESTIONS

7. **How can the application of professional skepticism be evidenced?**

- Auditor’s exercise of professional skepticism → document
- ISA requirements: audit evidence on planning / performing / matters arising / judgments
  - significant decisions reached during discussion audit team
  - Identified or suspected non-compliance with laws and regulations as result of discussions with management
  - Basis of auditors conclusions
  - Inconsistent information – significant matter – how addressed?
  - Basis for conclusion on reasonableness subjective judgment
  - Authenticity or not after further investigation
8. Do regulators and oversight bodies of audit firms and those charged with governance have a role to play in supporting skeptical behavior among auditors?

• No requirements in ISA’s
• Adequate two-way communication
  o Auditors: planning scope / timing / significant findings / quality aspects / higher assessed risks
  o TCWG: - Discuss issues of risks / materiality
    - Identify risk areas for additional procedures
    - Assist in understanding entity / environment
• Oversight and inspection on audits
THE END