



Demonstrating Professional Skepticism

Insights from Recent Research for Auditors of Financial Statements

By Douglas M. Boyle and Brian W. Carpenter

In Brief

Demonstrating professional skepticism while conducting an audit is an important, well-documented expectation of the profession. A skeptical mindset ensures that auditors approach audits recognizing that it is always possible that fraud is present. Unfortunately, recent audit deficiencies and failures have raised questions as to whether auditors exhibit an appropriate degree of skepticism. This article reviews the profession's guidance regarding professional skepticism, summarizes the results of studies examining audit deficiencies and failures attributed to a lack of sufficient professional skepticism, and offers suggestions to aid auditors in exhibiting appropriate levels of professional skepticism in audit engagements.

Professional skepticism is a concept of critical importance to the audit profession. Statements on Auditing Standards (SAS) 1, *Responsibilities and Functions of the Independent Auditor*, clearly states that “Due care requires [emphasis added] the auditor to exercise professional skepticism” (AU 230.07). SAS 99, *Consideration of Fraud in a Financial Statement Audit*, further clarifies the essential role of professional skepticism by discussing and restating its elements and necessity in conducting an audit:

Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. 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. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest. (p. 1724; AU 316.13)

In Staff Audit Practice Alert 10, “Maintaining and Applying Professional Skepticism in Audits” (Dec. 4, 2012), the PCAOB underscores this emphasis by stating the following:

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board standards. Those standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team. (p. 1)

In addition to the above sources, throughout the professional literature, there are similar calls for auditors to exhibit appropriate levels of professional skepticism through a questioning mindset, as a fundamental requirement in conducting an audit.

Audit Failures Associated with a Lack of Professional Skepticism

Despite the well-documented expectation and requirement for auditors to exhibit

professional skepticism, research indicates that it is often not implemented in a manner satisfactory to the SEC’s, enforcement division and the PCAOB’s review process.

In a 2013 Center for Audit Quality study (Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, “An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998-2010,” 2013; http://www.theqaq.org/docs/press-release-attachments/caq_deficienciesmay2013.pdf?sfvrsn=2), the authors examined SEC sanctions of auditors involved in 87 cases of alleged fraudulent financial reporting by public companies (including national and non-national firms). In those 87 audit reports, 58% received an unqualified opinion with no modification and 42% received an unqualified opinion with only some type of explanatory paragraph. Importantly, an insufficient level of professional skepticism was the third-most cited contributory cause of fraudulent reporting in SEC sanctions, being noted in 60% of these cases. Moreover, Staff Audit Practice Alert 10 noted, “Observations from the PCAOB’s oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism” (p. 1).

These concerns expressed by the PCAOB, the SEC, and others will likely lead to increased scrutiny of professional skepticism in future audits. Evidence of increasing levels of scrutiny is discussed in “Public Company Accounting Oversight Board Strategic Plan: Improving the Quality of the Audit for the Protection and Benefit of Investors 2013–2017” (November 2013; <http://pcaobus.org/About/Ops/Documents/Strategic%20Plans/2013-2017.pdf>), which highlights the concern about the quality of audits and the key role that professional skepticism plays in the focus of future oversight. Emphasizing the need for vigilance, the plan notes the following:

PCAOB inspections continue to find high rates of audit deficiencies at global network firms, underscoring the need for the continued vigilance of our inspection teams, a continued focus by auditors on identifying and remediating root causes of deficiencies, monitoring supervision within the firms, and the importance of our standard-setting and

enforcement programs. To be effective in advancing audit quality, we must pay attention to how firm practice, culture and remediation can affect the core values of independence, objectivity, and professional skepticism. (p. 3)

The report’s strategic plan presented three overarching goals to help achieve the PCAOB’s mission. One key element is strengthening professional skepticism, with an implementation strategy that promises to “monitor and hold auditors accountable to high standards of professional skepticism, independence and objectivity through inspections and, where necessary, disciplinary proceedings” (p. 19). In addition, the report identifies professional skepticism as one of the potentially “serious violations of PCAOB standards or securities laws by auditors” (p. 42) that would result in “high-priority” investigations.

Although it is clear that professional skepticism should play a central role in audits, the SEC and the PCAOB have raised important concerns regarding the frequency of audit sanctions and deficiencies associated with the implementation of this requirement. Fortunately, recent research provides practical and important insights into the concept of professional skepticism and how it can be more effectively implemented within the culture of audit firms. The next section summarizes these findings as well as their implications for auditors.

Key Research Findings

In a 2013 article discussing skepticism [R. Kathy Hurr, Helen L. Brown-Libur, Christine E. Earley, and Ganesh Krishnamoorthy, “Research on Auditor Professional Skepticism: Literature Synthesis and Opportunities for Future Research,” *Auditing: A Journal of Practice & Theory*, vol. 32 (Supp. 1), pp. 45–97, 2013], the authors discuss a practical model, known as the Nelson Model, that identifies two components of professional skepticism: skeptical judgment and skeptical actions. In order to make an informed skeptical judgment, an auditor must possess the experience and knowledge to recognize a potential issue and to formulate an appropriate response. Thus, an auditor who lacks these desired traits will be less likely to make an informed skeptical judgment. Conversely, an auditor with these traits is more likely

EXHIBIT

Promoting Professional Skepticism: Elements of “Tone-at-the-Top” Messaging

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 firm 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. On the other hand, messages from firm leadership that are excessively focused on revenue or profit growth over achieving audit quality can undermine the application of professional skepticism. (p. 8)

Performance Appraisal, Promotion, and Compensation Processes

An audit firm’s performance appraisal, promotion, and compensation processes can enhance or detract from the application of professional skepticism in its audit practice, depending on how they are designed and executed. For example, if a firm’s promotion process emphasizes selling nonaudit services or places an undue focus on reducing audit costs, or retaining and acquiring audit clients over achieving high audit quality, the firm’s personnel may perceive those goals as being more important to their own compensation, job security, and advancement within the firm than the appropriate application of professional skepticism. (p. 9)

Professional Competence and Assigning Personnel to Engagement Teams

A firm’s quality control system depends heavily on the proficiency of its personnel, which includes their ability to exercise professional skepticism. 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. 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. (p. 9)

Documentation

It is important for a firm’s quality control system to establish policies and procedures that cover documenting the results of each engagement. Although documentation should support the basis for the auditor’s conclusions concerning every relevant financial statement assertion, areas that require greater judgment generally need more extensive documentation of the procedures performed, evidence obtained, and rationale for the conclusions reached. In addition to the documentation necessary to support the auditor’s final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor’s final conclusions. (pp. 9–10)

Monitoring

Under PCAOB standards, a firm’s quality control policies and procedures should include an element of monitoring to ensure that quality control policies and procedures are suitably designed and being effectively applied. If the firm identifies deficiencies, it should evaluate the reasons for the deficiencies and determine the necessary corrective actions or improvements to the quality control system. Accordingly, if a firm identifies deficiencies that include failures to appropriately apply professional skepticism as a contributing factor, the firm should take appropriate corrective actions. (p. 10)

Source: Selected quotes taken from PCAOB Staff Practice Alert 10, *Maintaining and Applying Professional Skepticism in Audits*, 2012.

to ask questions and identify potential issues in an audit involving complex accounting areas often predicated on estimates and professional judgment.

On this point [Richard Coppage and Trimbak Shastri, “Effectively Applying Professional Skepticism to Improve Audit Quality,” *The CPA Journal*, August 2014, p. 24], the authors discuss examples of specific areas identified by the PCAOB in which auditors have failed to demonstrate appropriate levels of skepticism. These examples include numerous areas of failure in the audit process, ranging from those caused by faulty planning and supervision to those attributable to not appropriately questioning specific measurements, disclosures, and management representations. The vast array of examples underscores the need for skeptical judgment throughout the audit process. To meet this requirement, it is important that audit partners and managers assign to the audit team individuals possessing the traits and level of experience and knowledge commensurate with the level of audit risk associated with a particular area. An auditor assigned to a high-risk area should possess the traits and experience necessary to identify an anomaly in a trend or ratio, perform complex analytical and substantive procedures, and apply professional judgment to key estimates and assumptions. This selection process should be performed and documented during the planning phase of the audit.

The second component identified in the Nelson Model, referred to as “skeptical actions,” addresses the concern that an auditor possessing the proper degree of experience and knowledge to make skeptical judgments might choose not to do so based on environment factors and potential pressures. Common pressures that may result in an auditor failing to take skeptical action include: engagement budget pressure, tight deadlines to complete the audit, firm promotion and reward systems that undervalue audit quality, firm culture that overemphasizes the client service aspect of the engagement to the detriment of skeptical behavior, and a tone at the top that does not continuously reinforce the critical need for skepticism at all levels of the audit. To ensure skeptical actions, audit partners and managers should budget a proper amount of time for each audit area to allow the staff the requisite amount of

time to make inquiries and engage in professional skepticism. Audit deadlines should be reasonable and include time for such skepticism. The firm criteria for promotion and recognition should properly balance engagement productivity and quality. In addition, the audit partner and manager should stress the importance of being professionally skeptical during the planning stage to help counter pressures associated with conflicting priorities.

When an auditor exercises skeptical judgment and takes appropriate skeptical actions, the likelihood of professional skepticism increases, resulting in a more effective audit. On this point, Hurtt, Brown-Liburd, Earley, and Krishnamoorthy advocate other characteristics applicable in both skeptical judgment and skeptical actions. The characteristics associated with skeptical judgment include: auditor (traits, experience and expertise, training, motivation, moral reasoning); evidential (confirming versus disconfirming, subjective versus objective sources); client (management integrity, complexity, riskiness); and external environmental (accountability to reviewers and regulators). The characteristics associated with skeptical action include: auditor (moral courage, independence); evidential (auditing standards); client (corporate governance); and external environmental (tenure with client, legal liability, incentive to demonstrate skeptical action). In expanding the Nelson model to include the above stated characteristics, an auditor would operate in a culture more conducive and supportive of professional skepticism.

In a recent study (Tina D. Carpenter and Jane L. Reimers, "Professional Skepticism: The Effects of a Partner's Influence and the Level of Fraud Indicators on Auditors' Fraud Judgments and Actions," *Behavioral Research in Accounting*, 2013), the authors asked 89 audit managers from Big Four firms to participate in an experiment to investigate how a partner's degree of emphasis on professional skepticism affects the assessment of the risk of fraud by the audit team. The study found that:

The partner's degree of emphasis on professional skepticism directly influences auditors' fraud risk assessments. Specifically, we find that auditors in the high partner emphasis condition provide higher fraud risk assessments than

do auditors in the low partner emphasis condition, both when fraud indicators are strong and when they are weak. However, those auditors in the high partner emphasis and strong level of fraud indicators conditions provide the highest fraud risk assessments relative to the other conditions. Further, these higher risk assessments did not translate into inefficiencies. Rather than identifying more total risk factors or selecting more total audit procedures, these auditors simply select more relevant fraud risk factors and more relevant fraud audit procedures—risk factors and procedures that directly relate to the fraud indicators present in the SEC case—than auditors in the three other conditions. Additionally, this group of auditors also identifies significantly fewer irrelevant fraud risk factors and selects significantly fewer irrelevant fraud audit procedures than auditors in the other three conditions. Thus, their effectiveness improves without sacrificing efficiency. (p. 47)

These findings further confirm the importance that audit partner emphasis on professional skepticism with the audit team during the planning stage plays in the performance of an audit. Partners faced with time demands and constraints are often limited in their ability to spend an adequate amount of time in the field with the audit staff. Thus, it is critically important for partners to focus their time spent in the field on areas with the most impact on the quality of the audit. Ensuring that the staff is clearly aware of the expectations of professional skepticism will improve the quality of all areas of the audit and is, accordingly, time well spent.

In another survey (Helen L. Brown-Liburd and Jeffrey R. Cohen, "Effects of Earnings Forecasts and Heightened Professional Skepticism on the Outcomes of Client-Auditor Negotiation," *Journal of Business Ethics*, vol. 116, no. 2, pp. 311–325, 2013), the authors asked 38 audit managers and partners from two Big Four firms to participate in an experiment to gain insight into the effect management incentives and auditors degree of professional skepticism have on an auditor's willingness to negotiate proposed journal entry adjustments with their client. One key finding was—

When auditors exhibit less professional skepticism, they are significantly less conservative and are more willing to make concessions to management in their final negotiating positions, especially in situations where management has an incentive to manage earnings to meet EPS targets. (p. 322)

This finding demonstrates the importance of professional skepticism during all phases of an audit and shows that the lack of it may enable earnings management. Thus, from the earliest interaction with the client, an auditor must set an appropriate "tone" of professional skepticism and consistently maintain a questioning mindset to forestall potential future pressure to "negotiate away" real future issues.

PCAOB Staff Practice Alert 10 provides an audit firm with practical insights to implement a comprehensive system of quality control to enhance the application of professional skepticism. As shown in the *Exhibit*, this system consists of five elements to assist audit teams in implementing professional skepticism.

This system should be incorporated into a firm's culture through ongoing training, communication, and feedback at all staff levels. Once this system has been integrated into the firm culture, the risk of an audit deficiency or failure will be greatly reduced. In addition, because the PCAOB and the SEC look for such a culture to be demonstrated in the course of an audit as well as throughout the firm, the documentation associated with the formal implementation of this system will establish professional skepticism as an important component of the firm's practices.

Implications for CPAs

The auditing profession has long recognized and emphasized the importance of professional skepticism in conducting an audit. However, recent audit deficiencies and failures have resulted in increased attention to the concept of professional skepticism. Furthermore, the response of the SEC and the PCAOB to these failures suggests that the concept of professional skepticism will receive increased scrutiny. Accordingly, it is beneficial and timely to examine the factors that increase the likelihood of exhibiting appropriate levels of professional skepticism. An awareness of

the findings highlighted above and consideration of the resulting suggestions should help ensure that all participants in the audit process exhibit appropriate levels of professional skepticism.

One major takeaway from the existing research is that it is important to set a proper tone at the top. From the auditors' 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.

In addition, it is important for audit firms to assess the personal attributes of the personnel assigned to the engagement team so it has individuals with the necessary traits and experience to make skeptical judgments. Audit firms should also

implement policies that provide the appropriate time and reward structures for skeptical action to take place. There should be a particular focus on assigning the proper audit personnel to complex, high-risk areas. Consistently demonstrating appropriate levels of professional skepticism throughout the audit sets an appropriate "tone" with the client which will serve to lessen potential pressure on the auditor to "negotiate away" significant future issues.

All decisions relating to professional skepticism should be fully documented. As the PCAOB has noted, "Areas that require greater judgment generally need more extensive documentation." Given the subjectivity of professional skepticism, it is inherently judgment-based. Accordingly, appropriate documentation is needed for any procedures performed, evidence obtained, decisions made, or conclusions reached whenever professional skepticism is involved. Similarly, it is important for the firm to specifically include mechanisms

for monitoring the exhibition and documentation of professional skepticism. If team members are aware that the documentation is monitored, they will understand that professional skepticism is being appropriately considered.

Finally, as emphasized by the PCAOB in Staff Practice Alert 10, four additional elements of tone at the top should be considered and incorporated within the firm's quality control system: 1) messaging; 2) performance appraisal, promotion, and compensation processes; 3) professional competence and assigning personnel to engagement teams; and 4) monitoring. Included in the Exhibit is an effective tool to understand and communicate these elements. □

Douglas M. Boyle, DBA, CPA, CMA, is an assistant professor and director of the accounting, and Brian W. Carpenter, PhD, is a professor of accounting, both at the University of Scranton, Scranton, Pa.



Oxford Executive MBA

Go from a game player to a successful game changer. This modular programme offers you the chance to join one of the world's most powerful networks and create a new future for your organization and for yourself as a leader.

Oxford Diplomas in Strategic Management

- Financial Strategy
- Strategy and Innovation
- Global Business
- Organisational Leadership

For more information and to download our brochure visit: www.sbs.oxford.edu/emba



Copyright of CPA Journal is the property of New York State Society of CPAs and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.