

Professional Scepticism in Audits

by Jonathan McGee

The Irish Auditing and Accounting Supervisory Authority, in a statement relating to Covid-19 challenges for auditors, underlined the critical importance of the exercise of professional scepticism in forming a view on an entity's financial statements. Professional scepticism, having a questioning mind and being alert to indications of misstatement, is critical to the delivery of high-quality audits. Indeed, the necessity to exercise professional scepticism by the auditor, is enshrined in company law and also permeates the auditing standards. In this article Jonathan McGee, explores the concept of professional scepticism and highlights its importance given the current economic times we are experiencing.

What is professional scepticism?

Although there are numerous references to the need for professional scepticism in the International Standards on Auditing (Ireland) (ISAs), a number of the professional bodies have referred in their findings, following monitoring visit cycles, to an apparent lack of evidence of professional scepticism by audit teams. In addition, regulatory bodies, both at home and abroad, have issued documents highlighting the importance of professional scepticism in audits.

Paragraph 13(l) ISA (Ireland) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, includes the following definition for professional scepticism:

'...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.'

ISA (Ireland) 200, includes further guidance as to why and how an auditor should approach the audit of financial statements using professional scepticism.

'The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. The auditor shall maintain professional scepticism throughout the audit, recognising the possibility of a material misstatement

due to facts or behaviour indicating irregularities, including fraud, or error, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance.' (ISA (Ireland) 200 para. 15)

Further guidance still is included within the application and other explanatory material section of the ISA. For example, paragraph A18 states that professional scepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the ISAs (Ireland).

Paragraph A19 of the ISA states that maintaining professional scepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

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

The auditor cannot critically assess audit evidence without employing professional scepticism. The ISA refers to this involving questioning contradictory audit evidence and the reliability of documents and management's responses to inquiries and the consideration of the sufficiency and appropriateness of audit evidence obtained. As mentioned previously above, concerning the auditor's past experience of the honesty and integrity of the entity's management and of those charged with governance, paragraph A22 of ISA (Ireland) 200 also reminds the auditor that *'... a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less-than-persuasive audit evidence when obtaining reasonable assurance.'*

Professional scepticism is also closely linked to the ethical considerations of independence and objectivity and to the use of professional judgement.

Demonstrating professional scepticism in the audit

Professional scepticism is demonstrated by:

1. Designing audit procedures to consider actively if there is any evidence that would contradict management assertions not only to the extent to which management has identified evidence that is consistent with them.

2. Making evidence-based judgments, by demonstrating:
 - there has been sufficient inquiry and challenge;
 - sufficient testing of management's assertions has been undertaken;
 - the quality of the resulting evidence obtained has been critically appraised and judged by the auditor to be sufficiently persuasive; and
 - where there are plausible alternative treatments of an item in the financial statements (such as different valuation bases), an assessment has been made as to whether one is superior and whether sufficient disclosure of the alternatives has been given, in order to give a true and fair view.
3. Documenting judgments and the review processes in a manner that facilitates challenge and demonstrates the rigour of that challenge.

The auditor's documentation of audit judgments sets out not only the auditor's conclusion but also their rationale for the conclusion.

The conditions for **individual auditors** are listed below:

- Develop a good understanding of the entity and its business.
- Have a questioning mind and be willing to challenge management assertions.
- Assess critically the information and explanations obtained in the course of their work and corroborate them.
- Seek to understand management motivations for possible misstatement of the financial statements.
- Investigate the nature and cause of deviations or misstatements identified and avoid jumping to conclusions without appropriate audit evidence.
- Be alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.

What are the implications in practice?

Firms need to be careful to demonstrate

scepticism in their audit files. Regulators have criticised audit files for lack of evidence to support the exercise of professional judgment and in turn lack of professional scepticism. The following are often cited by Regulators as areas in which professional scepticism is particularly relevant:

- assessment of fraud risk - danger of over-familiarity;
- substantive analytical review - investigating variances;
- provisions - insufficient challenge; and
- going concern - documentation of considerations.

Matters of professional judgment should be documented, and where that documentation is made by a more junior member of the audit team (up to and including the manager) who may not have the training, knowledge and experience of the partner, the partner should confirm their agreement with the judgment made or replace it with their own.

ISA (Ireland) 230, Audit Documentation, states that documentation should be "sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit" (ISA (Ireland) 230 para.8).

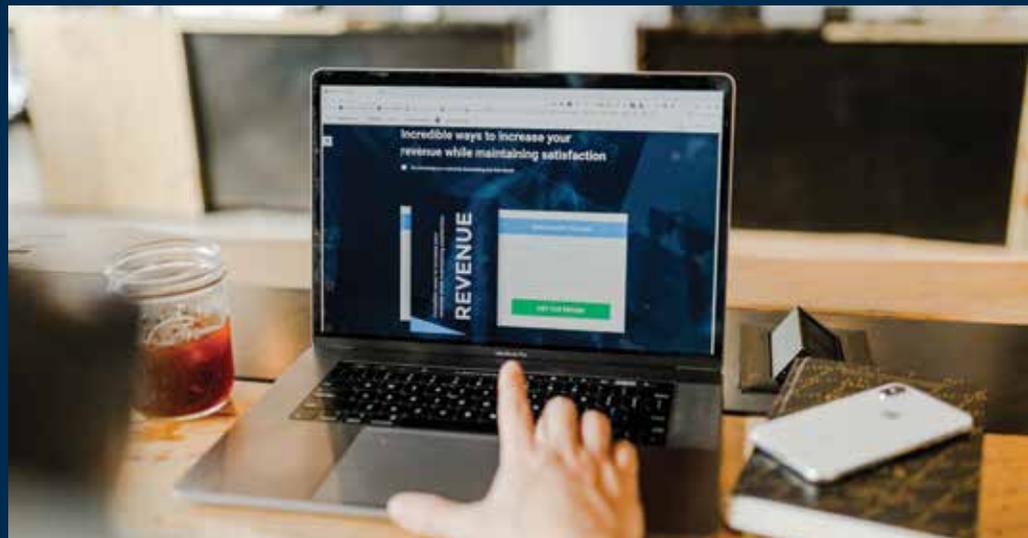
Within the application material of ISA (Ireland) 230, paragraph A7 refers to professional scepticism as an example of a requirement that applies generally

throughout the audit, and that there may be a number of ways in which compliance with the requirement to apply professional scepticism may be demonstrated within the audit file. It refers to the fact that there may be no single way in which the auditor's professional scepticism is documented on a file, but that the audit documentation may nevertheless provide evidence of the auditor's exercise of professional scepticism in accordance with the ISAs (Ireland). It cites the example of accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, documenting how the auditor evaluated that evidence, including the professional judgements made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained.

Not surprisingly, ISA (Ireland) 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, refers on numerous occasions to the auditor's responsibility for maintaining professional scepticism throughout the audit.

For example, with respect to the auditor's consideration of the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

The application material within ISA (Ireland) 240 includes further guidance concerning professional scepticism,



including that maintaining such scepticism "... requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist" and that "Due to the characteristics of fraud, the auditor's professional scepticism is particularly important when considering the risks of material misstatement due to fraud" (ISA 240, A7).

The standard states that management of an entity are often in the best position to perpetrate fraud, and that when evaluating management's responses to our enquiries with an attitude of professional scepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information. (ISA 240, A17).

Paragraph A31 of ISA 240 states that "Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional scepticism." It gives examples including the auditor applying "increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions" and through "increased recognition of the need to corroborate management explanations or representations concerning material matters."

Within the explanatory material of ISA (Ireland) 315, Identifying and Assessing the Risks of Material Misstatement, it is indicated that professional scepticism "is necessary for the critical assessment of audit evidence gathered when performing the risk assessment procedures, and assists the auditor in remaining alert to audit evidence that is not biased towards corroborating the existence of risks or that may be contradictory to the existence of risks", and, also that professional scepticism "is an attitude that is applied by the auditor when making professional judgments that then provides the basis for the auditor's actions." (ISA (Ireland) 315, A12).

We are also advised within ISA (Ireland) 315 that professional scepticism "is necessary for the critical assessment of audit evidence, and a robust and open engagement team discussion, including

for recurring audits, may lead to improved identification and assessment of the risks of material misstatement."

As part of evaluating the audit evidence the auditor obtains from their risk assessment procedures, the auditor needs to consider whether they have obtained a sufficient understanding of the entity and its environment, the entity's applicable financial reporting framework and the entity's system of internal control to be able to identify the risks of material misstatement, as well as whether there is any evidence that is contradictory that may indicate a risk of material misstatement.

ISA (Ireland) 540, which covers auditing accounting estimates, requires greater rigour and scepticism in the audit of accounting estimates including the auditor's consideration of indicators of possible management bias. Paragraph 8 of the standard tells us that the exercise of professional scepticism in relation to accounting estimates "is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional scepticism is important when there is greater susceptibility to misstatement due to management bias or fraud." ISA (Ireland) 540 includes reference to ISA 200 concerning the requirement for the auditor to maintain professional scepticism throughout the audit, and in particular, when reviewing management estimates relating to fair values, the impairment of assets and provisions.

The application notes to ISA (Ireland) 540 include some further examples, linking back to ISA (Ireland) 230, of other requirements within ISA (Ireland) 230 for which documentation may provide evidence of the exercise of professional scepticism by the auditor. Examples include, how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial statements, and how that expectation compares with the entity's financial statements prepared

by management; indicators of possible management bias and consideration of all audit evidence whether corroborative or contradictory etc.

It would always, but even more so perhaps given the current economic times we are experiencing, be important to consider ISA (Ireland) 570, Going Concern, when considering the need for the application of professional scepticism by the auditor.

A key part of the auditor's work related to assessing the appropriateness of the going concern basis, for example, typically includes reviewing financial projections. There is an obvious need for the auditor to maintain professional scepticism when reviewing any such projections as part of the auditors work to evaluate management's assessment of an entity's ability to continue as a going concern. The need for professional scepticism is also to the forefront, when assessing management's plans to deal with events or circumstances where a material uncertainty exists related to going concern.

In summary, the degree of professional scepticism to be applied is key, because it influences both the effectiveness and the efficiency of an audit. Too little scepticism endangers audit effectiveness, too much risks unnecessary cost. Achieving the right balance is vital!



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He trained in Gilroy Gannon in Sligo and spent a further three and half years working in the audit department of OSK in Dublin, following which he worked as a financial accountant with Bank of Ireland.

Jonathan's role in Mercia primarily involves conducting compliance reviews and presenting training courses.