

Scepticism: The Practitioners' Take



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Executive summary

Professional scepticism is at the heart of what auditors do. Without it, the audit has no value. The current debate about the need for auditors to exercise more scepticism is important. But to date the quality of the debate on scepticism has been somewhat superficial. Simply calling for more scepticism, or for more documentation of it, is neither practical nor desirable. Scepticism is a means to an end, not an end in itself. Auditors cannot carry on asking questions ad infinitum, nor should they. Reporting deadlines mean that there comes a point at which it not only seems pointless to ask any more questions (either 'just in case' or 'because we can'), it also becomes impractical. The problem of scepticism is one of human behaviour when working to deadlines and budgets.

The analysis of where things went wrong often sheds light on what might have been done differently, the questions that might have been asked and the judgements that might have been probed more thoroughly. But the idea that there is a pervasive lack of scepticism among auditors does not stand up to scrutiny. The Financial Reporting Council (FRC) that regulates auditors in the UK makes frequent references in its annual reports to areas in which it believes auditors could exercise more scepticism, but it has never made reference to any systemic lack of scepticism. Quite the contrary, there are references in several recent reports to improvements in audit quality and to the exercise of scepticism in particular.

The idea of scepticism is not easy to pin down and the urge to use it, or rather the lack of it, as a catch-all classification for anything that is wrong in auditing or financial reporting, should be resisted. Not everything is the result of a lack of scepticism. A better quality conversation needs to go beyond superficial analyses. Of course auditors can do better, as can management and audit committees. The important question is, 'how'?

ICAEW acknowledges the importance of scepticism in audit performance. What has not been heard, to date, is the auditors' take.

WHAT ICAEW HAS DONE, AND WHY

This publication is a response to calls for enhanced auditor scepticism. It attempts to move the debate forward by capturing and offering insight into what real auditors and the people who work with them know about scepticism, and what they think the issues are. It reveals how auditors currently try to exercise scepticism to the best of their ability within a limited timeframe. It also sets out what they are trying to do to make better use of that time, and the staff and other resources they have available.

We conducted interviews with 15 practising auditors, training providers who also perform file reviews, and audit regulators. We asked them about the nature of scepticism, who is responsible for it, and what needs to be addressed to improve it. The thoughts expressed in this publication are those of insiders, people with practical experience of real-world auditing who have up-to-date, first-hand experience of the pressures of working to deadlines and budgets.

Enhancing scepticism requires action on the part of auditors, audit committees, management, standard-setters and others. At the end of each section, we set out issues that we believe those groups might consider in reflecting on their respective roles and responsibilities regarding scepticism.

WHAT WE HAVE LEARNED SO FAR

There was a good level of consensus among those we interviewed on what needs to be done to enhance scepticism. Our key takeaways from the interviews we conducted are as follows:

- 1. Structural changes are needed within the firms.** Firms increasingly acknowledge that if their plans to exercise scepticism in higher risk areas are to survive contact with the first deadline, structural changes are needed to methodologies, working practices, training, recruitment and retention, to support and encourage scepticism in the field.
- 2. Auditors are not the only people who can or should exercise scepticism.** Auditors and audit regulators are challenging other stakeholders in the wider financial reporting supply chain, particularly preparers, to practice what they preach by exercising scepticism themselves. Auditors are also challenging regulators to be more open about 'what good looks like'.
- 3. Scepticism is about quality, not quantity.** Scepticism is about asking the right questions, not simply a lot of them, and about not accepting the first answer. It is also clearly about having the experience to recognise what can go wrong, and the structures in place to ensure that those without that experience - junior audit staff - learn to apply it from those who do.
- 4. Firms should not send out mixed messages.** They should not encourage scepticism in the classroom but then discourage it in the field. Everyone involved, particularly junior staff, needs time to develop, exercise and enhance their sense of what might be wrong. For junior staff to learn from their own mistakes, budgets may need to accommodate the pursuit of 'unprofitable' lines of enquiry.
- 5. A requirement to seek out contrary evidence will not enhance the exercise of scepticism.** Auditing standards and professional ethics require auditors to exercise professional scepticism throughout the audit and in specific areas. The international auditing standard-setter (the IAASB) will consider in more detail whether auditors should be required to seek out contrary or conflicting audit evidence as well as corroborative evidence in the near future. Its preliminary deliberations are aligned with the views of those we interviewed: requiring auditors to seek out such evidence does not seem feasible, desirable or necessary within the current framework.
- 6. To be sceptical, auditors need to manage the tension between the demands of independence and the need to understand the business in detail.** Specialist knowledge and an intimate knowledge of a business may lead to groupthink, but without them auditors cannot mount an effective challenge to management. Asking 'stupid' questions in the absence of such knowledge has value, but it is limited. Auditors need a bank of experience to enable them to react quickly in a changing environment. They also need to be able to step back and consider the bigger picture.

ICAEW will continue to explore this issue by, among other things, seeking further examples of 'what good looks like', in terms of how preparers and auditors identify areas in which more scepticism needs to be applied, and what they do in such cases that they would not do otherwise.

We would like to thank the people listed on page 16 who generously gave their time to be interviewed for this publication.

Other ICAEW resources on professional scepticism can be found at [icaew.com/scepticism](https://www.icaew.com/scepticism).

1. *Where are we now?*

While there is a discussion to be had about whether auditors should 'be' sceptical, or whether scepticism is something they 'do' or 'exercise', ICAEW believes that no one, least of all auditors, disagrees with the idea that scepticism can and should be enhanced. But simply telling auditors to be more sceptical, by mentioning the word more often in auditing standards, for example, and ignoring the practical limitations of an audit will not, in itself, change behaviour. Other naïve assumptions also need to be avoided. Scepticism is not a binary concept and auditors are not trying to avoid being sceptical. 'Being sceptical' is not something auditors either 'do' or 'don't do'; rather, a spectrum of scepticism is applied depending on the risk assessed.

In a speech entitled, 'Developments in Audit', on 25 October 2017, Melanie McLaren, Executive Director for Audit and Actuarial Regulation at the FRC said that:

...whilst there is evidence of greater professional scepticism, this is also the area where the FRC finds the greatest number of issues. Investor and public confidence in audit quality though remains vulnerable where circumstances indicate a failure by auditors to be sufficiently independent to provide robust challenge. Not enough auditors seek contrary as well as corroborative evidence, with groupthink being the danger.

She also said that, moving forward, the FRC will focus on promoting scepticism through standards and practice.

We asked interviewees what they thought of the current state of play, whether there was a genuine problem to be addressed, and whether auditors are getting any better, or worse, at exercising and documenting scepticism.

Interviewees believed that the most significant changes in recent years impacting the exercise and demonstration of scepticism are a general erosion of trust in business, increasing penalties for getting things wrong, increasing subjectivity in accounting requirements and rising expectations among regulators. Regulator expectations about the linkage of audit quality to reward have coincided with unrelenting pressure on fees for over a decade. When taken together, with increasingly demanding requirements in auditing standards more generally, firms have inevitably sought efficiencies, and they have not always got it right. A number of those we interviewed admitted, for example, that supervision and review could, and probably should, be stronger. But many believed that these pressures have also led to auditors being necessarily more sceptical than they were a decade ago.

There are differing takes on the nature and extent of the 'problem' with scepticism. All of those interviewed thought the issue important and, while there was no sense that it was considered a critical issue, they all acknowledged the need for vigilance and constant reinforcement. There should be a 'drip-feed of communications' or a 'regular shot in the arm of training', together with cautionary tales and war stories, to counter the effect of commercial pressure and to prevent backsliding.

Scepticism, and in particular the need to document it, is important simply because of the extent of regulatory comment. Reports of investigations into corporate collapses often refer to a lack of scepticism. Invariably, some relevant questions were in fact asked. But because auditors did not fully understand the issue, or the business context, or did not make the right linkages, they failed to appreciate the significance of the answer and moved on.

Regardless of where on the scale the problem is, or appears to be, interviewees acknowledged the need for a response. All interviewees accepted that there are areas in which auditors can do better and we were provided with numerous examples of areas in which evidence of a more sceptical approach is often needed.

'I think people are a bit more sceptical than they were 15 years ago. There is less trust around generally and people are more prepared to push the client a bit because they're more worried. If I have to put my name to this, I need to cover myself.' AG

'The mindset has changed because of regulatory pressure and thankfully we no longer get comments to the effect that, '...the FD promised me the debt is recoverable'. Well, he would say that, wouldn't he! But people are getting the message that they need to do more to verify what they've been told and then write down what they did.' ER

'We still spend too much time in the audit room and not enough kicking tyres. If you don't actually get out there, how are you going to find out that the accountant in the American subsidiary has been signing cheques on her own for the last 25 years? A systems review isn't going to pick this up and you know that things never operate quite the way they are supposed to. Being sceptical is about admitting that and making an effort. It always has been.' PH

'I'm not convinced we're any more or less sceptical than we used to be. What is different is what gets documented, which is actually better these days because of regulatory pressure. It still needs to be improved. We do now look harder for the sort of curiosity you need to do an effective review when we recruit people.' GS

'It's far easier to question someone if you remember that the client isn't the person in the suit standing in front of you; it's whoever served you your latte before you came in to work, because it's their pension fund that has shares in the company you're auditing.' JK

On the whole, interviewees were positive about the contribution of technology to the exercise of scepticism.

'Data analytics techniques can provide more opportunity to apply scepticism. The volume of data and the range of information we have now means that we can expose ourselves much more easily to contrary evidence if it's out there.' DI

'Technology is an enabler. The core skills are still analysis and interpretation, being able to make links isn't just about data, it's about conversations. Data can get a conversation started and improve its quality, but it doesn't do it for you. Finding a clever way to present data back to the client is not an audit.' SA

'Data analytics helps us focus on genuine anomalies rather than randomly selected samples of transactions.' JB

Advances in analytics and other emerging technologies have heightened expectations about the extent to which all auditors, preparers and regulators should use these resources. A failure to use the new technologies to find patterns that were not previously apparent represents a threat to the exercise of scepticism among preparers and auditors. It is also a potential threat to the relevance of auditing standards and to the effectiveness of audit regulation.

Expectations of preparers have changed markedly in recent years. Stephen Haddrill, FRC CEO, speaking at the 25 October 2017 event referred to above, also referred to scepticism. In the context of the banking crisis of 2008, he said:

...With hindsight, neither the banks, their internal risk managers, directors, financial regulators nor the audit profession exercised the level of scepticism needed...

This is an important acknowledgement of the obligation of preparers to exercise scepticism in their approach to reported information. It is a given that better quality information provided to auditors results in a better quality audit and, ultimately, investor confidence. This view was reflected by many of those we interviewed who believe strongly that scepticism is not just for auditors. It is for audit committees, management and internal auditors to demonstrate how they too have challenged, probed and tested systems, controls and the financial information they produce, before they hand it over to auditors. Some of those we interviewed pointedly noted outdated management attitudes that persist in a minority of preparers. These include treating requests for corroborative evidence to support a plausible answer

as an impertinence, and asserting that it is for auditors to prove management wrong, rather than for management to support their assertions.

TALKING POINTS FOR AUDITORS, AUDIT COMMITTEES, MANAGEMENT AND INVESTORS

Auditors

- How do we make sure that our people remember who the real client is?
- What more can we do to reinforce the need for scepticism on a day-to-day basis?

Audit committees, management and investors

- What have we done to make sure we've picked up the right issues? What have we done to make sure our processes for this are right?
- Have we challenged our own assumptions? What would we ask if we were the auditors?
- How hard do our auditors get pushed on fees, and what effect does that have on the quality of the audit?

2. Understanding people and firms

COGNITIVE BIAS, GROUPTHINK, AND FAST AND SLOW THINKING

Evidence suggests that some people may be more predisposed to be sceptical than others. Scepticism is exercised in different ways by different staff and there is no one-size-fits-most solution to measuring it, encouraging it, or even training. Understanding the rudiments of behavioural psychology and applying techniques developed in that field are increasingly important aspects of management within audit firms. Dealing with the differing aptitudes, receptiveness and preferred learning styles means that in developing effective questioning skills, for example, firms need to accommodate staff in different ways. Some respond well to written material and classroom training, others to videos and game playing, others again to being 'thrown in at the deep end' with a client. In most cases, they respond to a combination of all three.

Firms are increasingly aware of the need to manage the different types of cognitive bias. Many of those we interviewed are raising levels of awareness of this through training and several noted the marked impact of this on staff. Some have engaged psychologists to observe the performance of audit teams to better understand the key characteristics of a successful audit. Such techniques are potentially relevant to financial statement preparers, audit committees and others, as well as auditors.

'We do a lot of training around bias and applying scepticism - how to deal with contrary evidence and how to manage a domineering management team. We're also looking at how best to avoid groupthink: experimenting with separate discussions and having more junior staff speak first. We've also reworded our audit programmes: 'confirm that' something is right has been replaced with 'evaluate whether or not' something is right. It's a small distinction but it can have a big effect, sometimes more than you might think.' DI

'We weave scepticism and an understanding of fraud and error into every corner of our junior training portfolio. We put them through exercises and scenarios that often look straightforward but aren't when you scratch the surface. The most important point is always that enquiry alone is never enough.' KW

Many interviewees commented on the widespread use and value of ICAEW's *False Assurance* and *Without Question* films in this context. Some firms simply show the films or make them available to staff, but most interviewees said that the firm had incorporated them into their training programmes and used them as a basis for detailed discussions.

Several interviewees referred to the benefits arising from increased diversity in the firm's intake. All of those who had sought to remove academic filters or recruit more school leavers spoke with some enthusiasm about the benefits of bringing more varied life experience to the firm and thereby eliminating groupthink. Firms are increasingly looking for people with good social skills and the type of emotional intelligence that enables them to ask difficult questions effectively without creating resistance from the client.

'We look for general communication and empathy skills now more than we used to, as well as analytical skills. Without those soft skills you can't get the information you want out of the client in the first place.' ER

ICAEW's Audit Quality Forum paper, *Reliability Matters: Reliability and the Central Role of the Auditor*, refers to Daniel Kahneman's *Thinking, Fast and Slow* (2011), which explains his idea of two systems of thinking. System 1, fast thinking, is intuitive, relying on heuristics (hunches), perception, memory, expertise and experience. When this fails to provide a solution, people switch to the slower System 2 thinking, involving conscious reasoning that requires attention and concentration. The ICAEW paper notes that audit firms need to apply both systems. Auditors need to be sceptical in two ways. They use experience and intuition to know what to look for and when. These skills are developed through a combination of learning and experience. They also need structured processes based on auditing standards, applied in a controlled manner to slow things down by, for example, standing back to take a broader look at the financial statements as a whole, challenging key assumptions, and highlighting the

inherent biases of information preparers. These processes also help auditors focus on the information needs of primary users. The idea of fast and slow thinking earned Kahneman the Nobel Prize for economics.

Most interviewees believed that you can teach scepticism, but only to an extent. Only a few thought an individual's innate scepticism made much difference. All agreed that there is no substitute for experience, and that effective reviews are the only way to deal with its absence. Furthermore, many made the point that scepticism can also be 'unlearned' or lost if not maintained, and all admitted that firms do in fact sometimes send out mixed messages.

'It's definitely the case that some people get it and some don't, and for those who don't, you can train them up to an extent. For them, the main thing is not taking things at face value, and encouraging them to think carefully about what might be missing from an explanation, what the client didn't say, why they might want to present something in a particular way, what's in it for them, and why they might not be telling you the whole story.' ER

'You can give license to people to exhibit scepticism and encourage that by war stories but it's difficult to teach scepticism except by experience.' JK

One interviewee emphasised the importance of the experience of individual team members and communication within the team. Scepticism is harder to exercise in non-routine situations. If the firm is auditing a housebuilder building 200 identical houses, the firm as a whole is likely to know where to look for stretched assumptions. But if the entity is building large bespoke houses, it is harder to know where to start on assumptions. Most of the audit team probably knows little or nothing at all about house building to start with, which is why effective communication within the team is so important.

FILE REVIEWS AND SCEPTICISM

The vast majority of audits have long been conducted on a fixed fee basis and firms have to work hard to recover overruns. Many interviewees noted the importance of good quality supervision and timely reviews in this climate. In practice, because it is often quicker and easier to review an entire file towards the end of the audit than on a day-to-day basis, better incentives to 'do the right thing' are needed.

'Project management can have a significant impact on the ability to apply scepticism properly. On a small, one-week audit job, if the manager leaves the review to the end of the week there's often no audit team members left on site to clear the review points. But if the manager takes 15 minutes every day to review, it works better for everyone and the threat to scepticism never even arises. It's all about the manager's mindset. We teach the importance of project management and the linkage to the effectiveness of the review process.' DI

'Timing is everything. Firms are spending less time on site and by the time the file gets back to the office, it's often too late. I hear the word audit 'efficiency' a lot in this context but it often comes at the cost of audit file quality.' DS

'We can sense when a review we are asked to do is going to be difficult. Firms call late in the day wanting an unplanned hot file review, often as a result of pressure from other partners. Firms often don't give themselves enough time to provide proper feedback which is why juniors don't progress. Jobs get pushed through and no-one sits down with the team to discuss the job.' AG

Several interviewees suggested that engagement quality control reviews could be improved, particularly reviews of the extent to which the team has challenged management. Where teams are pressed on this, there can be a significant improvement to a file, especially in terms of the quality of documentation.

Interviewees also noted the value and quality of external file reviews provided by training organisations. Some felt that they were more relevant to the firm than regulatory reviews and that independent audit inspection bodies might do more to share their insights.

'Audit teams are often young and they're no match for older more experienced staff at the client. There needs to be good quality team briefings, planning and communications to compensate for this, and stronger files always show this up in the planning: we will be sceptical in the following areas and this is how we will do it. The partner needs to set out the areas in which the client needs to be challenged, not leave it to the team.' DC

'Problems can arise where the junior concerned doesn't have any real understanding of the business and doesn't realise that assumptions about revenue growth don't make sense. If there's insufficient partner involvement or ineffective review processes, the fact that the individual concerned may simply be too junior to understand that the client's explanation was duff might not get picked up.' GS

'There's a difference between scepticism and challenge: challenge is primarily about looking at what's there and questioning it. Scepticism is about the bigger picture, about the alternatives and what isn't there at all. Documenting the alternatives is important because it's documenting a line of thought, rather than anything anyone said.' MS

TALKING POINTS FOR AUDITORS, AUDIT COMMITTEES, MANAGEMENT AND INVESTORS

Auditors

- If contemporaneous reviews are better than reviews conducted later, how do we incentivise teams to make sure that they happen sooner?
- Are we recruiting people who can be taught to ask difficult questions effectively, as well as good technicians? How can we do this better?
- How can we assess the effectiveness of briefings, methodologies and review processes to counteract the lack of experience among junior staff?

Auditors, audit committees, management and investors

- How can we flex fees, time and budgets to allow for junior staff to be properly briefed, to enable them to learn?

3. *Embedding scepticism in the field*

The world's greatest footballers are only great if they can work within a team in a 90-minute timeframe. The success of high-altitude mountaineering is massively dependent on the weather. Auditors work under real economic and business pressures. Being realistic about what can be expected, and what can be achieved, requires the acknowledgement of these and other demands. Audits have to be completed within a timeframe and budget, using available staff. To conduct them effectively, auditors also have to maintain a reasonable working relationship with management, and deal with competing priorities within audit teams.

Firms do their best in education and training to explain what scepticism is and emphasise its importance. However, the pressure to get the job done sometimes pulls in the opposite direction. The effective exercise of scepticism in the field, towards the end of a listed entity audit, requires more than training. Staff are not actively encouraged to 'head down rabbit holes' close to the reporting deadline. If they do, they learn not to repeat the experience because, in practice, most 'rabbit holes' are dead ends, and junior staff backing out of them are often greeted with an irritable 'I told you so', at best.

'No-one will ever say 'don't be sceptical', but if staff go down too many dead ends, managers can find it hard to disguise their annoyance. Junior staff learn this very early on.' DC

'One of the most significant threats to scepticism is probably last minute audit issues. Human nature resists looking for issues the night before you sign off, but sometimes they come looking for you, and you have to have the right culture and controls in place to ensure that you can deal with them properly.' DI

'There's an innate tension between the need to remain appropriately detached and independent and fostering a productive working relationship with management and those charged with governance. They're both important foundations for audit quality.' DI

CHALLENGING MANAGEMENT

Many interviewees thought that if auditors challenged management more effectively, it would be unnecessary to suggest that they look for contrary or conflicting evidence. Several noted the importance of being willing and able to manage conflict with the client.

'We sometimes see throwaway lines in files to the effect that 'we will maintain an appropriately sceptical attitude at all times', with no indication as to where, or how. We come across the same areas all the time: estimates, where directors value an investment property and the firm has done little or nothing to assess it, and where the firm hasn't questioned the overhead absorption rates in the stock valuation, or the basis for maintaining retention balances included in debtors. The explanation when you query this sort of thing is almost always the same - 'management said there isn't a problem' - and as file reviewers, our question is pretty much always the same as well, ie, what can you do to prove it? The carrying value of investments in subsidiaries and the recoverability of inter-group debtor balances are other areas where there's been no real discussion about how the key audit assertions have been addressed. The reason is always the same, the firm or the individual doesn't seem to like conflict and is avoiding a difficult conversation and a potential confrontation with the client. It's not sustainable in the long run. I also look at the overall size of the representation letter early in the review - if it looks like it's trying to cover too many areas in the balance sheet, it puts me on alert.' DS

'We've all heard the excuses for not providing for bad debts, '... it's fine, I spoke to them last week and they have another order in from that customer'. You always need more than that and you need quite a lot more where they are in breach of their own systems by going above the insured levels.' PH

‘Of course there is always the risk that management may have some bias – whether conscious or unconscious – and that is why scepticism is so important in challenging the basis of management’s position. But there are always shades of grey, and you have to call clients out if you think they’re at the overly optimistic or pessimistic ends of the range. But precisely because there is often a range of valid answers, you can have a difference of views with management without either your own or their viewpoint being wrong.’ KW

Many interviewees suggested that the exercise of scepticism is about overheard conversations, things seen out of the corner of an eye and a sense that something is wrong, ie, the type of ‘fast thinking’ that comes with experience. Not everything in an audit can be reduced to timed and costed programmable procedures, but overheard conversations are hard to deal with organisationally and particularly difficult to document.

An audit cannot be conducted on the basis of hunches alone, but all interviewees believed it was important to respond to the faint alarm bells, and to hone those instincts in more junior staff by exposing them to what can and does go wrong.

‘One of our firms had a client with a property investment company owned 80/20 by a husband and wife who were getting divorced. The valuation hadn’t moved much but they’d disposed of 8 out of 100 properties at an average of 12% higher than carrying value in the previous year. It wasn’t picked up as an indication of undervaluation despite the motive because the manager simply hadn’t joined the dots. I can remember the expression on his face when this finally dawned on him. The silo mentality where you ‘just’ audit fixed assets or stock isn’t just a problem in larger firms. Everyone on the team should be encouraged to think across the business.’ AG

‘Scepticism is when someone tells you something, you don’t just take it at face value, and you doubt it a little bit. There’s often no substitute for being in a room with someone. A questionnaire you send to the client through the post may well achieve exactly the same words on the file as a face to face interview would, but they might not be of equal value in terms of audit evidence. Your interpretation of them could be completely different because, if your experience is just a questionnaire, you lack other indicators such as a tone of voice, a hesitation, someone blinking or any of the other twitches that might tell you so much. It’s not just about writing down explanations. An interview provides a much richer environment and a better opportunity to exercise scepticism.’ DI

‘One of our firms had sent someone to do a stocktake for a group of petrol stations. She was watching staff dip the tanks and, looking at the records, the dip showed that the tanks were full. She tripped over an inspection hatch by accident and heard it clang and asked the manager if she could see inside. He refused, and you know the rest: there was a fraud.’ AG

Documenting a tone of voice, body language, overheard conversations, accidental discoveries and a feeling that something isn’t right may not be appropriate. An objective approach is actively encouraged in many professions and is a requirement in many cases, for obvious reasons. Similarly, documenting dead ends has always been a challenge. It can appear to be a waste of time as the evidence required on file is evidence to support the audit opinion. But regulators do want to see contrary and conflicting evidence, and attitudes among practitioners are changing.

Interviewees thought that requiring auditors to seek out contrary or conflicting evidence would result in a fundamental shift towards a more adversarial approach that would at best inhibit the open, robust and frank dialogue between auditors and management and, at worst, close it down. But they also thought that auditors should be required to provide a robust challenge to management, to test assumptions and consider in detail what it would take to invalidate management’s assertions, and the chances of this happening.

'Most of the time, teams do a lot of things but don't write them up. They write down where they got to, but not how they got there. This always ends up looking like confirmation bias. We only document what makes us happy and what points us in the right direction. We don't record all the dead ends, what made us unhappy and what made us ask more questions. Dead ends are a challenge, but they are important. They prove we thought about the alternatives, and demonstrate why they weren't the right ones. It's a misunderstanding about what the audit file is for and what evidence really is. Evidence is incomplete if it doesn't include the challenges you encountered in getting to the right position. There's no need at all to go out looking for evidence that things are wrong; all you do need to do is explain clearly how you arrived at the view that the alternatives weren't right.' DC

'Scepticism is fundamental to what the profession does and to what regulators expect. And, like all firms, we're continuously looking at what more we can do to improve. We're also operating in a more challenging environment and there are more fair values, models and assumptions to deal with. However, it's vital that the profession continues to demonstrate and evidence scepticism where it has been exercised, which means explaining the questions asked, the conflicting evidence considered and the processes teams have gone through, not just focusing on the end outcome. The key question we encourage our teams to consider is: is it clear what our challenge and thought processes were?' JB

'It's about understanding the quality of the supporting evidence and documenting the contradictory evidence. It's hard to persuade people to do that because I think people feel there is a risk this undermines their judgement, rather than strengthen the robustness of it. But that is what we need to do more.' KW

TALKING POINTS FOR AUDITORS, AUDIT COMMITTEES, MANAGEMENT AND INVESTORS

Auditors

- Do we understand the extent to which we simply accept management assertions at face value? How can we measure this and how can we encourage a greater level of challenge?
- Do we have a strategy for dealing with last minute changes? If not, should we develop one?
- How can we improve the way we manage conflict between ourselves and management?
- How far can we reasonably be expected to go in documenting subjective perceptions, contrary and conflicting evidence, and the alternatives considered but rejected, including the dead ends?
- How do we avoid mixed messages about scepticism? How do we encourage junior staff to express their concerns without getting in the way of deadlines?

Audit committees, management and investors

- Do we have a policy or process for dealing with last minute changes? If not, should we develop one?
- How can we improve the management of conflict between ourselves and our auditors?
- What level of tolerance do we have for 'non-essential' development work within the audit?



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4. Other stakeholders

REGULATORS

Constructive criticism of auditors by regulators should involve a dialogue about what good looks like. If auditors are failing to exercise or demonstrate scepticism, what do they need to do to respond to that criticism? Most interviewees felt strongly that regulators, including international regulators, have the capacity to share more of their practical experience.

'It's about separating things out as well as looking at the big picture and the granularity of work on constituent elements, particularly in inherently complex areas. What we're looking for is evidence that a series of steps has been taken to deal with individual elements. The question we ask ourselves when we're thinking about 'how much is enough', is 'what would users expect?' So for estimates it's often about the stand back and looking for evidence of bias across the piece. But for derivatives on the back of syndicated commercial mortgages, say, it's not just about looking at the overall picture, and neither is it just about understanding the implications of the economically separable elements that work in different ways, auditors need to show how they have challenged the underlying assumptions.' MB

Many interviewees noted the fact that challenging an assumption about a sales projection 'mentally' is good but not good enough. It has to be articulated, be documented and make sense in context.

'We need everyone, standard-setters, regulators and the people negotiating fees included, to acknowledge the importance of documenting the dead ends, and the cost of it. There's a growing body of evidence in the pharmaceutical industry that it's dangerous to publish only those theses you tested successfully. Gaining evidence is an exercise in failure: trying to prove something is wrong and failing. Auditors don't need to go out and look for contradictory evidence, but if they don't test assertions by trying to prove them wrong, they're not being sceptical enough.' DC

'It's about seeing the wood for the trees, seeing the significance of something because of context. The technical guidance is there, but people need to find a way to make the right linkages.' MS

'We're trying to help people focus on understanding which assumptions impairment models are most sensitive to, and tailor the work accordingly. Focus is the key to an effective audit, but will also drive efficiency in this case.' JB

What may need to be considered in this context are the logistics of opening the databases of information held by national and international regulators – safely – to demonstrate more clearly what they believe good looks like, and of applying analytics and machine learning to that data.

PREPARERS

There was a strong view among all interviewees that scepticism is not just for auditors and that many of those calling for more auditor scepticism need to display it themselves. Scepticism is for audit committees, management and internal auditors to exercise, before the information they produce is handed over to external auditors.

'Auditors need to distinguish between companies that spend way too much effort justifying their positions, and better controlled and governed companies that have readily available information to support their critical judgements and estimates. Audit Committees have a role to play here. Too many Board papers state a position, rather than supporting it by articulating the challenges and controls put in place to evaluate and arrive at that position. Auditors should be evaluating this at the planning stage because it gauges the level of scepticism needed.' JK

'We spend a huge amount of time on impairments. The main question is always whether the assumptions make any sense in the context of the business. If management is making claims about industry-specific sales trends and they or the experts they employ have 30 years' experience in the industry, it is hard for us to challenge that. The critical thing is for them to help us, by challenging themselves.' DC

'Business members need to be sceptical, not just auditors. It's a fundamental principle that applies to all accountants. Accountants in business shouldn't be gaming the auditors. What makes a difference in a firm is its focus on behavioural and cultural issues, not just technical knowledge. That's also what distinguishes a Chartered Accountant; it's the questioning state of mind.' SA

TALKING POINTS FOR AUDITORS, AUDIT COMMITTEES, MANAGEMENT AND INVESTORS

Auditors, audit committees, management and investors

- How can regulators be encouraged to safely share their knowledge and understanding of 'what good looks like' in the context of scepticism?

Audit committees, management and investors

- How do we incentivise ourselves - management, audit committees and internal auditors - to adopt an appropriate attitude of scepticism?

List of interviewees

Sue Almond, Partner, Grant Thornton (SA)

Mark Babington, FRC (MB)

Justine Belton, Partner, EY (JB)

David Chopping, Partner, Moore Stephens (DC)

Lesley Clarke, QAD (LC)

Adrian Gibbons, Managing Director, SWAT (AG)

Peter Hollis, Hollis and Co (PH)

David Isherwood, Partner, BDO (DI)

Jack Kelly, Partner, Deloitte (JK)

Alex Peal, Partner, James Cowper Kreston (AP)

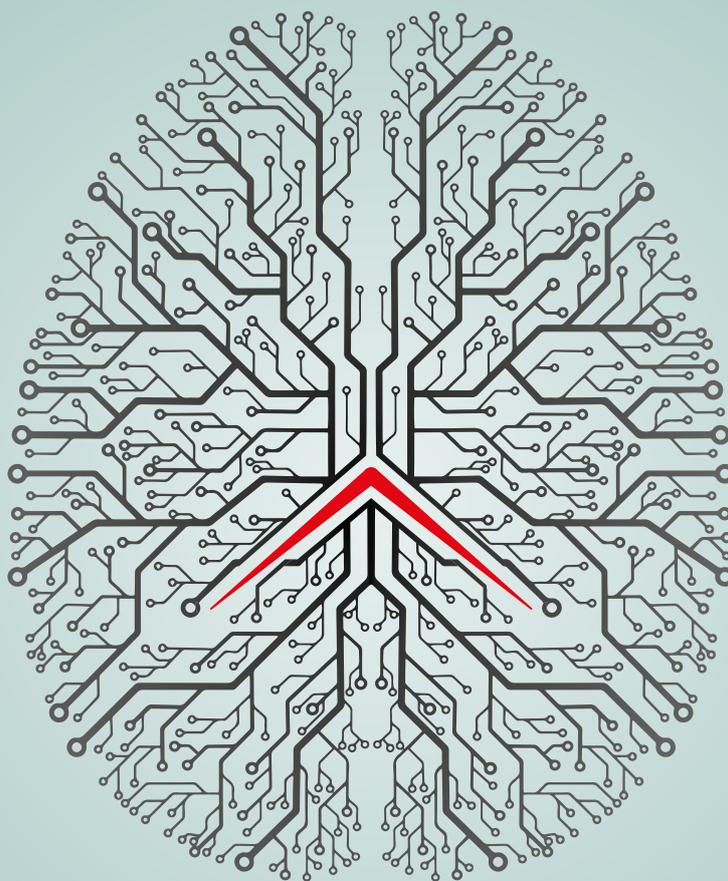
Ed Rands, Partner, PKF Cooper Parry (ER)

Matt Stroh, Director, Grant Thornton (MS)

David Southern, Head of Audit Quality Review, Mercia (DS)

Geoff Swales, Director, PwC (GS)

Karen Wightman, Partner, KPMG (KW)



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