



ICAEW Audit and Assurance Faculty (AAF) videos

Professional scepticism and other key audit issues

Transcript

Speakers:

John Kellas CBE, POB Chairman (JK)

Martyn Jones, ICAEW Vice-President (MJ)

Myles Thompson, Chairman of the AAF Technical and Practical Auditing Committee (MT)

Introduction

JK

Welcome to these short videos. As chairman of the Professional Oversight Board, or POB, I am grateful to the Institute of Chartered Accountants in England and Wales for the suggestion that I should deliver a few messages arising from audit inspections.

MJ

My name is Martyn Jones and I am the Vice President of ICAEW. I have been heavily involved in ICAEW's work in the audit area for many years, most recently in our programme to support member firms as they implement the clarified ISAs.

MT

My name is Myles Thompson and I am the chair of ICAEW's Technical and Practical Auditing Committee, or TPAC. I am also an audit partner and I would like to give you my views on what we as auditors should be doing in the key areas identified by the AIU.

About the Professional Oversight Board (POB)

JK

The POB's primary role is the independent oversight of the regulation of statutory audit. Our authority comes from powers delegated to us under the Companies Act to oversee the bodies that do two things:

- first, grant audit qualifications, and
- secondly, be responsible for monitoring and disciplining statutory auditors.

Of course, the ICAEW is one of those bodies.

We belong to the Financial Reporting Council, which brings together our activities, those of the Accounting Standards Board and the Auditing Practices Board, and the Accounting and Actuarial Discipline Board, which deals with serious professional disciplinary cases. You can find out much more about us from the FRC's website, and about the important changes proposed to how the FRC is structured to make it more efficient and effective.

The POB is also home to the Audit Inspection Unit. By law, the Institute must monitor the audit work of the statutory auditors registered with it. In the case of audits of so-called Public Interest Entities, this monitoring must be done by a body independent of the profession, and the AIU is that body. Where a firm undertakes ten or more such audits, the AIU inspects both a sample of relevant audits and the firm's quality control policies and procedures; it issues regular reports on those firms, together with an overall annual report on its inspection activities for the year. This overall report includes the main messages arising from inspections at all firms auditing public interest entities.

Audit Inspection Unit (AIU) Findings (as per Annual Report 2010/11)

JK

I want to explain some of the more important findings included in the AIU's report for the last year. First the good news: UK auditors can and do perform excellent audit work - some of the time. In fact, of the audits inspected, about half only require at most limited improvements to the parts inspected by our teams. The other half, however, do require more improvement and in a small (but too large) proportion of cases that improvement necessary is significant. And most firms have at least one audit in the poorest category. So my first message is this: auditors can do good work, but we want to see them do so more consistently so as to raise the overall standard of auditing in the UK.

What I think this finding shows is the importance of individual behaviours; most firms have satisfactory procedures in principle, so if an individual audit falls short it is probably down to their application by the individual audit team, and in particular the audit partner who is responsible for the work - from planning through execution to conclusions.

Professional Scepticism

JK

A healthy scepticism is a fundamental part of any audit; we need to see more of it, and many of the AIU's findings suggest that there is sometimes a lack of scepticism. This is not just a problem in the UK - other audit regulators have noted it also, and see the need for improvement.

It is not a total distrust of everything you see and hear on an audit. But it requires an enquiring mind that is open to the possibility that something may be wrong or not as it seems. Is what you see and hear reasonable or appropriate, and is it supported by evidence, the surrounding facts and circumstances, or consistent with what is known from elsewhere?

You would expect in the current climate that the AIU has been looking at how auditors are testing asset impairments and the going concern assumption. These are areas where the client's assumptions about the future will be very important. The auditor needs to know what the key assumptions are, but finding out what the client has done is not the same as auditing it. The auditor also needs to consider whether they are reasonable in the circumstances. So the AIU expects to see not only a record of what the assumptions are, but also some indication that the auditor has challenged them and understood how they affect the conclusions the client has come to. Too often it seems that the auditor is looking for reasons why assumptions can be supported, without also considering facts that might suggest they are not appropriate - too optimistic, for example.

There are other ways in which a lack of scepticism is apparent. Has the auditor sought sufficient evidence for what the client says? For example, a summary by the client of an important matter is not a substitute for the auditor's examining the underlying evidence. And if an auditing standard requires a certain presumption - for example, of a significant risk of fraud in the case of revenue recognition - does the auditor too easily find reasons for overriding the presumption?

Firms often suggest that the auditor has been sceptical, but that this is not something that can be explicitly documented. There may be some truth in that, but it ought to come through in what has been recorded and how; in the evidence that has been sought; and in what is reported to the audit committee or board of directors.

MJ

The proper application of professional scepticism is clearly on the radar screen of the Professional Oversight Board and other members of IFIAR, the International Forum of Independent Audit Regulators.

ICAEW agrees that the application of professional scepticism is fundamental to auditing and we want to do whatever we can to help firms meet increasingly demanding professional requirements in this area.

The challenges auditors face are compounded by the difficult economic environment, and the complex financial reporting regime in which they operate. The ongoing financial crisis is increasing the risk of misstatements, particularly those arising from fraud. The increasing

emphasis on fair values and other estimates, where there may be no definite 'right answer', also increases the risks auditors face.

Professional scepticism is a cornerstone of good auditing. Effective audits should enhance confidence in the financial reporting process. For this process to work, stakeholders need to be satisfied that auditors are applying appropriate professional scepticism.

As auditors we should stand back and look at the overall picture:

- Does the reporting reflect the substance of what has happened?
- Does it make sense?
- Is the evidence too thin?
- Are we focussing on the things that **are** there but missing the things that are **not** there – but should be?
- Are there limitations on the scope of our procedures?
- Are management's assumptions and forecasts appropriate?
- Are the assumptions still appropriate given the changing economy?
- What evidence is there besides what management has provided to us?
- Is the evidence contradictory?
- Do we really understand enough about potentially complex group structures or potentially sensitive related party relationships and transactions?
- Do we need more time to complete our audit?
- Is the reporting biased?

Being sceptical is a key element of every ISA audit. Scepticism is central to what an audit is all about. Rather than approaching audit work in an unthinking box-ticking way, the auditor should always be challenging information he or she is given and the evidence he or she obtains. We need to step back, look at the wider context, and ask "does that make sense?".

Because of this, scepticism is more a behavioural issue for the **entire** audit team than an issue that can be addressed solely through specific requirements in standards.

In fact, this is one of the reasons why auditing is an exciting career. It requires the application of critical thinking in real-life situations. And this critical thinking shouldn't just happen behind a computer screen in the audit room. It includes walking the floors, communicating effectively with the client's staff and challenging what you are being told if it doesn't quite make sense.

Because scepticism is an attitude of mind, it is a difficult thing to measure. It can sometimes seem a difficult thing to document, unlike some of the more specific processes or actions that are required by ISAs. However, when there is a significant matter, the act of developing a document which sets out the evidence obtained independently of management, the

counter-evidence and the rationale, can help identify things that don't make sense, areas that require more work, and when to say no.

So rather than simply reminding staff to comply with the relevant standards, firms need to look at a much bigger picture - and at people issues in particular - when they address the topic with their audit staff. And the level of work carried out by auditors needs to be appropriate to the risks they identify.

We are not saying that firms should be doing more than is set out in the clarified ISAs, but they should be bringing the ISAs to life by ensuring that all auditor behaviours and actions flow from, and are informed by, a sceptical mindset.

ICAEW and other similar professional bodies play a key part in helping auditors develop the necessary sceptical mindset. As far as ICAEW is concerned, the ACA's practical training and initial professional development requirements help develop students who act with professional scepticism as a matter of course when carrying out their audit work. Scepticism, together with related issues of ethics and professional judgement, are key components of the ACA. For example, three of the skills assessed in the Case Study are:

- displaying an enquiring and questioning mind;
- identifying faults or gaps in arguments; and
- applying a sceptical and critical approach.

For those who have already qualified, the continuing professional development (CPD) requirements should help develop their scepticism. As scepticism is really a behavioural issue, auditors should be encouraged to find practical ways to develop sceptical behaviours.

Firms can help their staff through including appropriate mentoring arrangements in the Quality Control policies and procedures. This should help to embed a culture of scepticism within audit teams.

The recently revised ICAEW Audit and Assurance Faculty publication *Quality Control in the Audit Environment*, now available in an international edition, reminds firms that they need to have policies and procedures to demonstrate that audit staff and partners will develop a mindset of professional scepticism. A key thing is that firms need to have an ongoing commitment to modify both behaviour and internal culture.

The Audit and Assurance Faculty is planning to issue further related practical guidance on Quality Control in the near future. This guidance will take into account findings from audit inspections.

MT

Audit firms and auditors are responsible for conducting their audits with professional scepticism in accordance with the relevant standards, and selecting audit teams with the appropriate experience and skills. This usually involves a whole range of activities including pro-active leadership from the top, the development of policies and procedures in line with the requirements of the clarified ISAs to be sceptical, and human resources policies and procedures that emphasise the importance of the personality traits that are required in order

to have a sceptical mind. This involves many processes in our firms including recruitment, appraisal, mentoring and training and development.

The sort of personality traits that can benefit a sceptical attitude of mind include determination, intellectual curiosity, clear headedness and the ability to see the big picture and to make connections between seemingly unconnected pieces of information. A key element of a sceptical attitude of mind is the ability and instinct to *challenge*, where appropriate. Firms may try to target their recruitment efforts to attract individuals with the *ability* to challenge (which typically will require intellectual curiosity, a certain amount of self-confidence, and good communication skills) but the *instinct* which will tell those individuals when it is appropriate to challenge needs to be honed through training – both theoretical (providing them with the technical knowledge that might help them recognise inconsistencies or risks) and practical on the job training. The role of mentoring is very important in helping junior members of audit teams hone their instincts to challenge. These individuals also need to feel that they are working in an environment where it is encouraged for them to ask questions, consult with more senior team members, and where there will be no penalty for asking advice. This will enable them to maintain the confidence that is necessary to develop a sceptical attitude of mind.

One area that should be prioritised is personal skills training that is tailored to develop the abilities of the individual auditor to obtain the necessary mindset. An example of this would be interviewing skills training where an individual can gain skills on how to formulate probing questions and to identify situations where perhaps they are not being told the full story. These are key skills that all auditors need to have.

Firms' audit methodologies should also encourage a sceptical and thoughtful approach to the audit that will allow flexibility to deal with the specific circumstances. This is not straightforward and firms need to give considerable attention to the programmes they already have and improve them as necessary.

In addition to the AIU, ICAEW's Quality Assurance Department, or QAD, tells us that where there is a shortfall in performance in this area, it is often in the audit file documentation. Often in these cases it becomes apparent to the QAD reviewer that judgements have been made demonstrating appropriate scepticism, perhaps arising from long conversations with clients, but there is little documentation of this.

It is relatively simple to write brief notes immediately after a conversation has taken place, including details of who was present, what was said, and, if challenges were made, what these were and how they were expressed. It is sometimes tempting to note down the resolution of a matter without including any mention of the time spent discussing the issue before the resolution was finally achieved. If a file is going to give a fair representation of the scepticism that was applied in arriving at the conclusions that were reached, this sort of 'background' information is as vital to include as the final resolution of contentious (or even not so contentious) issues.

An important part of professional scepticism is challenging management's assumptions. As auditors we are often provided with, for example, an impairment calculation that we challenge as the discount rate looks out of line. The client changes this to a more reasonable assumption and this is what we audit and document on our audit file. We do not often document that we made the client change the discount rate in the first place. In these cases a useful file note will explain what issues were discussed, what the client staff said, what evidence was offered, what questions the auditor then asked, how their concerns, if any, were addressed, what further information was provided, how the auditor verified this, and then the final conclusion.

Another area in which we need to be sceptical is the consideration of fraud risks. This is a key part of the audit and this has been highlighted in inspections as a common area of weakness across firms of all sizes. There is often little evidence of thoughtful consideration of fraud at the engagement team meetings. This can be driven by a mindset issue – ‘I know this client inside out and I know there’s not a problem’. In many cases this might actually be a fair judgement, but we always need to be on our guard and assess the risks each year, as there is always a risk of management override.

Moving on to going concern. The QAD, like the AIU, emphasises the need to give attention to going concern assumptions. On smaller audits, there will typically be little detailed management information (for example, detailed forecasts) so considerations will need to be more broadly based. In these cases it is important to document the specific circumstances which relate to the client and the issues they are facing, and the conclusions reached after consideration of all the evidence.

Finally, I would like to just stress the importance of good audit planning and making sure that it happens on a timely basis. An effective audit needs to include space for proper consideration and challenge and this can become tricky to preserve when the auditor is under pressure to make quick decisions.

As part of this process audit team meetings are clearly important. They can also play a helpful role in discussing and identifying the key audit risks. There needs to be a culture within the audit team that supports challenge of the judgements of the more senior members of the team - this might not be easy to achieve. Even if these challenges are encouraged, it still requires more junior members to have the personal skills that give them the confidence to do this. And so it goes back to all the issues we spoke about earlier on the personal qualities that auditors, that is senior and junior auditors, need to have.

Group Audits

JK

Most of the audits within the AIU's scope are group audits, and the control and execution of the group audit are fundamental to audit quality. Where much of the audit is overseas, this becomes even more important.

The new auditing standards should help, and this year's inspection results will let us know if there has been significant improvement. But although the new standards are more detailed than the old ones, they do reflect what was UK best practice; and fundamental to that is that the group auditor should be firmly in the driving seat, planning what is important to the audit of the group and making sure that it has been done.

This requires the group auditor to give clear and sufficiently detailed instructions, based on an appropriate understanding of the client, and better reporting back so that the group auditor can be confident that the planned audit has been carried out. The group auditor needs to have sufficient involvement in the audits of components, and needs to know what the component auditors will do in key areas and be satisfied that it is enough in the light of the audit risks. This will almost certainly require some visits to significant components and their auditors.

Sometimes the AIU has found that group auditors have visited component auditors and their local clients, even for fairly lengthy periods (which is good), and yet it can be very hard to see what the auditors did on those visits. Was that visit to Bermuda as productive as it might have been? Has too much been left to the discretion of the component auditors? Another problem is a failure to follow up loose ends - such as issues reported by component auditors that seem to be unresolved, or a failure to chase outstanding reports from component auditors, or to get up to date post balance sheet events reviews.

MT

On group audits, the ICAEW's Technical and Practical Auditing Committee, or TPAC, is considering a number of the tricky ISA 600 issues that are creating practical challenges for both group and component auditors. The ICAEW Audit and Assurance Faculty did of course issue its publication *Auditing in a Group Context: Practical Considerations for Auditors* when there was an exposure of ISA 600 and this contained recommendations for both group and component auditors. These are still relevant but in 2012 we plan to issue a revised version of the publication. In the short-term TPAC will consider and then issue some answers to frequently asked questions covering the main thorny issues for firms.

We agree with the AIU that group auditors need to be involved in audits performed by component auditors. We need to ensure that we do document all this involvement – whether it be telephone conversations or visits to see them. And yes, if the components are equally significant, that trip to Kazakhstan may be just as important as the one to Bermuda!

Quality Control and Audit Discipline

JK

The end of an audit is often a rush, but this is just when errors can creep in. The AIU sees evidence of this in cases where it seems that not all relevant reviews had been completed, or all evidence received, before sign off. And in some cases, changes have clearly been made to the financial statements after the date when they were said to have been signed off.

A particular concern for the AIU is that engagement quality control reviews - the important second partner hot review - are not always up to the necessary standard. A number of problems are seen - sometimes, the scope is inadequate, and does not cover (for example) planning; in other cases, it just does not look to be challenging enough. Some firms used to call these "concurring partner reviews", but it is now accepted that this term gives quite the wrong impression. The reviews are expected to be challenging, and in particular the audit team's judgements should be tested by the reviewer.

And while I am on the subject of audit completion, I might just mention file completion. Standards acknowledge that there may be some tidying up of files necessary after the audit has been completed, and they therefore allow a period for the files to be closed down. But this is purely for administrative purposes, and does not grant permission to complete substantive work or reviews after the opinion has been given. At some firms, electronic working papers seem to have created some problems - these teething troubles need to be resolved. But in general, electronic working papers enable their preparation and review dates to be clearly seen by the AIU, and this should help to ensure that everything necessary has been done by the audit report date.

MT

Quality control and the role of the engagement quality control review, or EQCR, are important. The ICAEW Audit and Assurance Faculty recently issued an international version of its *Quality Control in the Audit Environment* publication. This picked up many of the important issues that concern the audit regulators. We are planning to issue further, more detailed guidance, on specific topics in the near future. One area we've identified is how to review files. We believe there is a need for good training and support from ICAEW and from the firms to help performance here. Of course there are different types of review: partner reviews, cold file reviews and EQCRs. Each type of review needs the appropriate training and support. These reviews should provide real value to the audit and should never just be done in a 'going through the motions' type of way. Issues arising from inspections will help to shape the guidance we issue.

We also agree with the emphasis on good audit planning and making sure everything is done to minimise the risks of last-minute panics.

Audit Committee Reporting

JK

For listed and other public interest entities, audit committees play an important role in the quality of financial reporting, and of the audit. To do this, they need appropriate information about the audit and the financial statements. In particular, they need to have the unambiguous views of the auditors on important elements of the financial statements including the key areas of judgement.

How the auditors communicate these to the audit committee is to some extent a matter for agreement between the audit committee and the auditors. Occasionally, the AIU has seen a single report from management to the audit committee that has incorporated the views of the auditors. This does not strike us as best practice, and it does not seem to convey the correct impression of independence. Besides, subtleties of drafting can be quite important and so the audit committee needs to be sure that the auditors' views are being conveyed in the auditors' words. The principal point, however, is that while there is nothing wrong with auditors agreeing with management where that is justified, audit committees need to know where the auditors have different views, or need further information to complete their audit.

MT

On audit committee reporting I agree that attention should be paid to ensuring effective communication with those charged with governance. Where there are audit committees, they play a crucial role in the governance process and the audit profession and ICAEW are very supportive of exploring new ways in which this important role can be enhanced still further. A good flow of information from the auditors is critical and this should be transparent on the main issues of concern identified during the audit. I also believe there is a need for the outputs of an audit to have a real beneficial impact on the financial reporting process and for this to be transparent to everyone with an interest in the audit process.

We support POB's work in this area in seeking ways to improve transparency and to enhance the confidence in the audit committee and the external auditing process.

Audit Documentation

JK

Standards are quite clear about the need for files to contain a sufficient record to enable an independent reviewer (who is an experienced auditor) to understand the audit and confirm that standards have been followed. But this should not be understood to mean that the files are mainly for the benefit of the Audit Inspection Unit; the primary role of documentation is to drive audit quality and assure the firm that an appropriate quality has been achieved.

For the individual auditor the preparation of good documentation makes a real contribution to quality. In particular, a good note of how a judgement was reached will help the auditor to ensure that he or she has thought the matter through and has considered all relevant aspects. Likewise, any significant discussion or meeting is best rounded off with a good note: it helps ensure that the auditor understands what was said, and that all important points were covered.

Documentation also helps both to encourage and demonstrate scepticism: is the documentation an appropriate combination of what the client has done (for example, to support an impairment review), and a record of how the auditor discussed, challenged and obtained evidence for important assumptions?

It is sometimes suggested that points raised by the AIU on their reviews are really “just” documentation points and do not indicate any real audit failing. This is not the case. The AIU listens closely to what auditors say to supplement the evidence of their audit files and tries to form a view of what the auditors have really done and how they have challenged management’s judgements. But these matters really should be documented properly, and the quality of audits would be improved if they were.

MJ

Because scepticism is an attitude of mind, it is a difficult thing to measure. It can sometimes seem a difficult thing to document, unlike some of the more specific processes or actions that are required by ISAs. However, when there is a significant matter, the act of developing a document which sets out the evidence obtained independently of management, the counter-evidence and the rationale, can help identify things that don’t make sense, areas that require more work, and when to say no.

MT

In addition to the AIU, ICAEW’s Quality Assurance Department, or QAD, tells us that where there is a shortfall in performance in this area, it is often in the audit file documentation. Often in these cases it becomes apparent to the QAD reviewer that judgements have been made demonstrating appropriate scepticism, perhaps arising from long conversations with clients, but there is little documentation of this.

It is relatively simple to write brief notes immediately after a conversation has taken place, including details of who was present, what was said, and, if challenges were made, what these were and how they were expressed. It is sometimes tempting to note down the resolution of a matter without including any mention of the time spent discussing the issue

before the resolution was finally achieved. If a file is going to give a fair representation of the scepticism that was applied in arriving at the conclusions that were reached, this sort of 'background' information is as vital to include as the final resolution of contentious (or even not so contentious) issues.

An important part of professional scepticism is challenging management's assumptions. As auditors we are often provided with, for example, an impairment calculation that we challenge as the discount rate looks out of line. The client changes this to a more reasonable assumption and this is what we audit and document on our audit file. We do not often document that we made the client change the discount rate in the first place. In these cases a useful file note will explain what issues were discussed, what the client staff said, what evidence was offered, what questions the auditor then asked, how their concerns, if any, were addressed, what further information was provided, how the auditor verified this, and then the final conclusion.

Ethical Matters

JK

Ethical standards require conflicts and similar threats to independence and objectivity to be identified, along with related threats and safeguards, and for these to be reported to the audit committee. The AIU finds that this is not always done properly.

There are a number of problems. First, auditors do not always think through the actual threats that a particular piece of work might give rise to; and as a result, they do not give sufficient attention to the type of safeguard that would be appropriate. Secondly, even where a threat has been identified, there is a tendency to assume that existing procedures (such as Engagement Quality Control Review) already cover off the relevant risks. Sometimes this will be the case - but usually, something more is required. Finally, the reporting of threats and safeguards to the audit committee is often rather formulaic, and does not deal with the specifics of the case - this is probably an inevitable consequence of the underlying failure to think the position through rigorously.

Concluding Remarks

JK

There are many other points of detail arising from inspections that I could have discussed, but the points I have covered today, if properly reflected in each of your audits, would go a long way to raising the standard of audits in the UK - which is precisely the aim of the Audit Inspection Unit.

MJ

Before finishing, it would be worthwhile to summarise some of the material and support that practitioners might find most helpful in seeking to carry out effective audits:

The UK and Irish Auditing Practices Board, part of the Financial Reporting Council, has issued a document called Practice Note 26 providing guidance on smaller entity audit documentation. This has proved very helpful in the UK and Ireland in demonstrating how smaller entity audits can be tailored to different circumstances and has generated a great deal of interest internationally and helped to counter the view that ISAs are only designed for larger entity audits.

The ICAEW Audit and Assurance Faculty has been very involved in helping successful ISA implementation and this has included international publications *Right First Time with the clarified ISAs* and *Quality Control in the Audit Environment*. An international version of the faculty's related parties publication will also be issued shortly, and later next year there will be a revised version of the faculty's group audits guide.

ICAEW also provides an ISA coaching service, tailored to firm circumstances to help with implementation of the clarified ISAs.

The final thing I want to mention here is the ICAEW ISAs programme. This is an online learning and assessment programme covering the key principles of the clarified ISAs. More information regarding the programme is available from icaew.com/isas.

Finally, back to scepticism. We hope that the resources we have mentioned will be useful to firms and individuals, but ultimately, scepticism is a behavioural issue. An issue that requires continuing reinforcement – for example, through a firm's Quality Control procedures and policies, and through an on-the-job mechanism such as mentoring and team briefings. The proper application of scepticism in audits cannot be achieved through one-off actions. The key driver in improving the application of scepticism by individual auditors is the culture within their firm. This will require an ongoing commitment.