Professional scepticism is central to audit quality, but a balance must be struck between doubt and practicality.

BY ZOWIE MURRAY CA

Professional scepticism is a skill considered by many as the cornerstone of audit quality. A review of the International Standards on Auditing (ISAs) reveals the need for auditors to "exercise professional judgment" more than 200 times. To assist assurance providers to enhance their professional scepticism, the New Zealand Auditing and Assurance Standards Board (NZAuASB) is developing an Explanatory Guide which contains references to practical guidance on professional scepticism in an audit of financial statements.

The essence of scepticism is doubt, and that doubt stimulates informed challenge and inquiry. Doubts often arise from apparent conflicts between what drivers exist in the wider environment in which a client operates (ie macro level) and how clients believe they have performed within the context of that environment (ie micro level). Professional scepticism encourages a structured consideration of an alternative point of view.

However, being too sceptical can be detrimental to the audit. Too much scepticism can lead to over-auditing, which can lead to problems meeting deadlines and with the overall economics of the audit engagement. Therefore, just as it is important to demonstrate scepticism, it is also important to ensure the level of scepticism is appropriate in the circumstances — achieving the right balance.

BARRIERS TO SCEPTICISM

The audit scepticism issue is not confined to New Zealand. In their recent auditor inspections, the UK Audit Inspection Unit (AIU) and the US Public Company Accountants Oversight Board (PCAOB) cited a lack of professional scepticism as a serious problem for auditors.

A common argument as to why professional scepticism is not as prevalent as it should be is that the barriers are too high. A number of barriers have been identified internationally.

• There is the potential for auditors not to be sceptical, or thought not to be sceptical, because they are engaged and paid by the company in a way that is relatively detached from shareholders. In addition they have little, if any, direct contact with shareholders throughout the audit process. As a result, shareholders have no way of observing and thereby gaining trust in the audit process.

• Auditors necessarily have strong working relationships with management and audit committees, which may lead them to develop trust that may result in either a lack of, or reduced, scepticism. Auditors can become predisposed to their clients in a manner that can inhibit sensitivity to red flags, which highlights why familiarity is a threat to independence.

• The audit firms' business models encourage a culture of building strong relationships with audited entities. This introduces the risk of the auditor...
putting his or her interests ahead of those of shareholders and could lead the audit firm and the auditor to develop trust or self-interest motivations that may compromise either their objectivity or willingness to challenge management to the extent required.

Some may also argue that the tangible demonstration of professional scepticism is difficult, but there are mechanisms that indicate that a process has taken place. Audit documentation is a tool for demonstrating the rigour of challenges made and there may be no single way in which the auditor's professional scepticism is documented. The auditor's documentation of audit judgments should be conclusive, setting out not only the auditor's conclusion but their rationale for this. The opposite of a sceptical audit might be one in which the auditor merely rationalises and documents management's assertions.

**ENABLING SCEPTICISM**

The challenge for audit firms is to identify, develop and retain people with the necessary skills to undertake audits with a sceptical mindset. It also involves nurturing the conditions that allow professional scepticism to flourish. Several areas may contribute to improved professional scepticism.

Firstly, human resource procedures perform a key part in identifying the important personality traits that are associated with appropriate levels of professional scepticism in candidates and employees. Such procedures might include recruitment, appraisal, mentoring, training and development. It is important that targeted recruitment efforts are made to attract individuals with the qualities that all auditors need to display, including determination, self-confidence, intellectual curiosity and good communication skills. One tool regularly used by many firms is psychometric testing.

A second area that may contribute to better levels of professional scepticism within the audit profession is education. NZICA performs a key role in helping auditors develop the necessary sceptical mindset with an emphasis on developing the ability to think critically. Scepticism, along with ethics and professional judgement, are considered important qualities in people studying to be chartered accountants. For those who have already qualified, the continuing professional development (CPD) offerings will help auditors continue to develop professional scepticism.

A third area is mentoring, which is very important in helping junior members of the audit team hone their instinct to challenge. Juniors

**THOUGHTS FROM CRAIG FISHER FCA**

_Audit Director, Hayes Knight and NZAuASB Member_

In my view, professional scepticism is the key audit skill. With it, an auditor is a powerful independent safeguard. Without it, the auditor risks being reduced to a mere compliance "rubber stamper". The Global Financial Crisis has sharply focused the attention on many areas of the financial information supply chain. As a result certain regulators and other stakeholders around the world have been questioning the performance of auditors in recent times. Therefore it is not too surprising to see a renewed focus on the importance of scepticism in auditing. This has resulted in some useful guidance and explorations of the topic. The Explanatory Guide the NZAuASB has been working on aims to summarise the key concepts and to alert New Zealand auditors to some helpful international publications on the topic for more detail. These are publications of the International Auditing and Assurance Standards Board (IAASB), the UK’s Auditing Practices Board (APB), the Canadian Auditing and Assurance Standards Board (AASB), and a publication from our cousins over the ditch, the Australian Auditing and Assurance Standards Board (AASB).

I believe professional scepticism is a mindset issue. It is about having the self-confidence and strength of character to retain an enquiring mind and to resist the temptation to just accept the easy answer – especially when management presents it to you on a plate.

One technique that has worked for me is to always imagine the worst and work from there in exploring the possible options. In my experience “black hat” thinkers, for those familiar with Edward de Bono’s thinking hats, generally make good auditors. As a result we have always tried to train our audit team to have an attitude of “think the worst, and prove the best”. Is scepticism especially hard for New Zealanders? Possibly yes. As a nation, we are generally a very trusting lot. Yet a robust sceptical view requires one to suspend trust and to rationally and logically consider all the likely options, not just the one that is being put in front of you. Sadly the experience of being exposed to the occasional liars, rogues, and fraudsters helps hone one’s sense of scepticism. As any auditor knows, never is a governing body more receptive to an auditor’s sceptical view and to seeking to understand internal controls than when they have just been ripped off by someone they trusted. I also think that the economics of auditing poses a threat to a thorough application of professional scepticism. A reality of audit is that it is often seen as a grudge purchase. Accordingly “buyers” of the service generally seek to reduce the audit cost to a minimum. This puts considerable pressure on the auditor to do their work on compliance with all the standards as efficiently as possible. Most auditors utilise a variety of time-saving checklists and templates to help achieve this efficiency. Yet the striving for efficiency can also increase the “tick the box, get it done” mentality. Hence good auditors also recognise that the crucial final step in any audit is to stop and reflect on their work – to ensure they are applying an appropriate level of professional scepticism.
need to be encouraged to consult with more senior team members in order to develop their interpersonal skills, such as the ability to ask probing questions. It is equally important to spend time in planning audits to ensure that such mentoring can take place and an appropriate mix of experience and skills exists.

**BRINGING THE ISAS TO LIFE**

It is sometimes argued that the ISAs are not prescriptive enough; however, it is also widely believed that a rigid box-ticking methodology would not allow the auditor to apply a sceptical mindset which rigorously questions and challenges management's assertions. The perspective of shareholders and other stakeholders is reflected within the ISAs, and appropriate levels of scepticism must accompany that perspective in the making of all audit judgements. What would the users of the financial statements expect the auditor to ask? What matters would they expect them to challenge and what evidence would they need to satisfy those challenges?

A number of critical audit activities will underpin appropriate scepticism in the audit, including:

- developing a good understanding of the business of the audited entity and of the environment in which it operates
- actively considering the risk of material misstatement and designing audit tests to respond to these identified risks
- documenting work to underpin transparency and repeatability of the audit work

Proactive leadership from senior members of any audit firm is essential to every audit. In particular, the audit partner must place a high emphasis on an attitude of professional scepticism that will ideally disseminate throughout the team. During an audit the team must set aside beliefs that the management and those charged with governance are honest and have integrity. There still needs to be a balance though, as being too sceptical can impair the objective to perform an effective and efficient audit and may result in overruns or expensive audits that may not be completed on time.

While the sceptical mindset is a constant, the degree of action taken by a sceptical auditor (by way of inquiry, challenge and testing) is responsive both to the expectations of the users, and to what emerges as the audit proceeds. Professional scepticism is a complex interplay of factors that cannot be remedied with a simple checklist. In order to get it right it needs to be addressed from a number of different angles. The NZAuASB will be considering the Explanatory Guide References to Practical Guidance on Professional Scepticism in an Audit of Financial Statements at its December meeting, with a view to publishing in due course.

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