


Auditor Objectivity and Skepticism

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The views I express today are mine alone, and do not necessarily reflect the views of the Board, other Board Members, or PCAOB staff.

Auditor Skepticism

- Today, I will discuss:
 - PCAOB standards related to auditor professional skepticism and
 - Staff Audit Practice Alert No. 10, “Maintaining and Applying Professional Skepticism in Audits,” issued December 4, 2012.

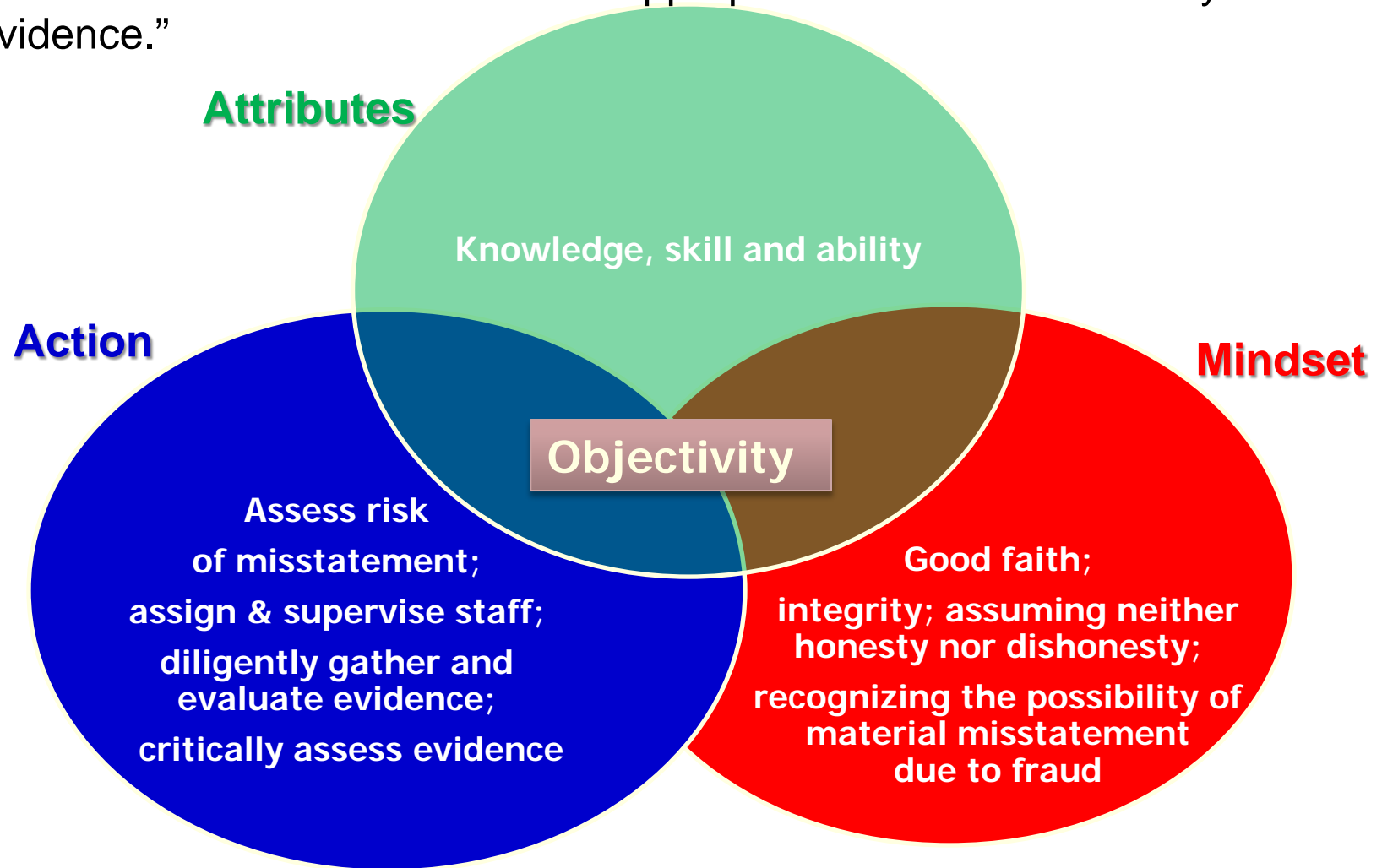
PCAOB Standards: Professional Skepticism

- “Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.” AU § 230.01.*
- “Due professional care requires the auditor to exercise *professional skepticism*.” AS 13.7; AU §§ 230.07, 316.13.
- The standards describe professional skepticism using three elements:
 - **Attributes**
 - **Mindset**
 - **Action**

* References to AU sections are to PCAOB Interim Standards that were adopted in April 2003.

PCAOB Standards: Professional Skepticism

“Professional skepticism is an **attitude** that includes a **questioning mind** and a **critical assessment** of the appropriateness and sufficiency of audit evidence.”



PCAOB Standards: Professional Skepticism

Attributes, Mindset, and Action --

- “Professional skepticism is an **attitude** that includes a **questioning mind** and a **critical assessment** of the appropriateness and sufficiency of audit evidence.” AS 13.7; AU §§ 230.07, 316.13.
- “The auditor **uses** the **knowledge, skill, and ability called for by the profession of public accounting** to **diligently perform, in good faith and with integrity,** the **gathering** and **objective evaluation of evidence.**” AU § 230.07.

PCAOB Standards: Professional Skepticism

- **Attributes (“knowledge, skill, and ability”):**
 - “The audit is to be **performed** by a person or persons having **adequate technical training and proficiency as an auditor.**” AU § 210.01.
 - “Auditors should be **assigned** to tasks and **supervised commensurate with their level of knowledge, skill, and ability** so that they can evaluate the audit evidence they are examining.” AU § 230.06. *Also, AS 13.5 (knowledge, skills, and abilities of engagement team members should be commensurate with assessed risks).*

PCAOB Standards: Professional Skepticism

- **Mindset (an “attitude”):**
 - “The auditor **neither assumes that management is dishonest nor assumes unquestioned honesty**. In **exercising** professional skepticism, the auditor should **not be satisfied with less than persuasive evidence** because of a belief that management is honest.” AU § 230.09.
 - “The auditor should **conduct the engagement** with a **mindset** that **recognizes the possibility that a material misstatement due to fraud could be present**, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.” AU § 316.13.

PCAOB Standards: Professional Skepticism

- **Action (a “critical assessment”):**
 - “**Gathering** and **objectively evaluating** audit evidence requires the auditor to **consider** the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be **exercised throughout the audit process.**” AU § 230.08.

Staff Audit Practice Alert No. 10 – *Maintaining and Applying Professional Skepticism in Audits*

- PCAOB oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism.
- Practice Alert No. 10 includes examples in which the engagement teams failed to:
 - obtain an understanding of the specific methods and/or assumptions underlying fair value estimates for hard-to-value financial instruments;
 - evaluate effects of management's determination to not test assets for impairment, despite indicators that the carrying amount may not have been recoverable;

Staff Audit Practice Alert No. 10 – *Maintaining and Applying Professional Skepticism in Audits*

(cont.)

- consider the implications of negative financial performance on the team's sensitivity analyses and its conclusions regarding the issuer's compliance with debt covenants, ability to continue as a going concern, or impairment of long-lived assets; and
- perform procedures, beyond inquiries, to test significant management assumptions for calculating inventory reserves.

In addition, PCAOB inspections have identified deficiencies in audit firms' systems of quality control related to insufficient emphasis on the application of professional skepticism by engagement teams.

Practice Alert No. 10: Impediments to Professional Skepticism

Practice Alert No. 10 lists challenges that auditors may confront in exercising professional skepticism:

- Unconscious human biases and other circumstances can cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.
- Scheduling and workload demands can cause pressures that might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable; to obtain less evidence than is necessary; or to give undue weight to confirming evidence without adequately considering contrary evidence.

Practice Alert No. 10

Impediments to Professional Skepticism

- Conditions inherent in the audit environment can create incentives and pressures that serve to inhibit professional skepticism. These pressures and incentives may include:
 - avoiding significant conflicts with management;
 - providing an unqualified audit opinion by a deadline;
 - achieving high client satisfaction ratings;
 - keeping audit costs low;
 - building or maintaining a long-term audit engagement; or
 - cross-selling other services.
- In addition, auditors may sometimes develop an inappropriate level of trust or confidence in management.

Practice Alert No. 10

Promoting Professional Skepticism

- Practice Alert No. 10 offers actions for firms to promote the application of professional skepticism, including:
 - Set a strong “tone at the top” that emphasizes professional skepticism (and avoid messaging that could create contrary pressures);
 - Design and execute performance appraisal, promotion, and compensation systems and processes that foster skepticism;
 - Enhance professional competence and the supervision and assignment of staff; and
 - Monitor the firm’s quality controls and respond appropriately to deficiencies, including those involving a lack of appropriate professional skepticism.

Practice Alert No. 10

Promoting Professional Skepticism

- Practice Alert No. 10 offers actions for engagement partners to promote the application of professional skepticism, including:
 - Set an appropriate tone that emphasizes a questioning mind throughout the audit and the exercise of professional skepticism in gathering and evaluating evidence;
 - Encourage confidence in engagement team to challenge management representations;
 - Be actively involved in planning, directing, and reviewing the work of the engagement team; and
 - Appropriately leverage the knowledge and experience of engagement team members in supervising junior staff and when it is necessary to challenge the assertions of senior levels of management.

Practice Alert No. 10

Promoting Professional Skepticism

- Practice Alert No. 10 offers actions for individual auditors to promote the application of professional skepticism, including:
 - Understand and properly apply PCAOB's risk assessment standards, including –
 - Considering events and conditions that create incentives or pressures on management, and
 - Obtaining a thorough understanding of the company and its environment as a basis for identifying unusual transactions or matters that warrant further investigation;
 - Appropriately apply PCAOB standards related to testing and substantive analytical procedures and the characteristics of reliable audit evidence; and,
 - Adequately consider all relevant audit evidence, whether it corroborates or contradicts management's assertions.