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International Auditing and Assurance Standards Board
529 5th Avenue
New York, New York 10017

Re: Invitation to Comment: Enhancing Audit Quality in the Public Interest

To Whom It May Concern:

I am delighted to have this opportunity to submit my thoughts on professional skepticism in response to the International Auditing and Assurance Standards Board (the "Board") Invitation to Comment ("ITC") and thank the Board for soliciting input on whether it should undertake a project to improve the application of professional skepticism in the audit. I am very interested in this subject and wrote an article on professional skepticism that was published in the January 2015 issue of The CPA Journal.

The IAASB could achieve a number of positive outcomes in this important area. I have outlined some important objectives of such a project, below, and have made several recommendations. I have done my best to organize my thoughts under the questions you pose in the ITC. I also suggest that you refer to my article, which I have also attempted to upload to your comment file.

PS1. Is your interpretation of the concept of professional skepticism consistent with how it is defined and referred to in the ISAs? If not, how could the concept be better described?

Response:

The language currently used in ISA 200 the auditing standards to describe professional skepticism is quite good. I also like the description provided in the PCAOB's AS 1015.07, which contains the essential elements of what it means to be skeptical. It states:

"Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. 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."

This language properly points to the objective of skepticism, that is, to "diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence." Supporting the independent, objective and critical evaluation of audit evidence is ultimately what the Board should strive for in any project on skepticism. The application material in ISA 200 also points in this direction.

There remain several opportunities to improve the discussion around professional skepticism.

Help to Improve the Clarity of Discussions About Professional Skepticism

When audit failures are discovered, we sometimes hear that the auditor “was not skeptical enough” or that the situation required “a higher level of professional skepticism” or that “the auditor’s skepticism should be enhanced.” I am guilty of the same thing, as is evidenced by some of the language I used in my article referenced above. This variation in the way skepticism is described is not helpful, and the Board has the opportunity to provide needed leadership in how this concept is discussed.

Eliminate Unneeded or Contradictory Guidance

A particular passage in some auditing standards sets the wrong tone. For example, the PCAOB’s standards include this passage, which is that, “The auditor neither assumes that management is dishonest nor assumes unquestioned honesty.”¹ This language apparently directs the auditor to be neutral. By definition, skepticism is not a neutral mindset. Merriam-Webster defines skepticism as, “an attitude of doubt or a disposition to incredulity either in general or toward a particular object.”²

The profession is aware of many instances in which management was dishonest. Although that does not mean the auditor should always assume management is dishonest, the auditor should accept that there always is a possibility that management is dishonest. Stating this fact in the auditing standards is appropriate and would be helpful.

Eliminate Passive Guidance and Direction

The ITC says that, “Professional skepticism includes being alert to, for example, audit evidence that contradicts other audit evidence obtained, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence.” ISA 200 also uses this type of language. I do not believe that it is not strong enough to tell the auditor to be “alert.” A critical evaluation of audit evidence should include the auditor *actively* evaluating whether the evidence obtained is consistent with management’s assertions in the financial statements and with other audit evidence obtained.

In my The CPA Journal article, I recommended that auditors must “be alert” to contradictory audit evidence, etc. As discussed in the preceding paragraph, I now believe the Board should consider a more active approach to the guidance.

Keep Things Simple

A point of discussion is whether an auditor can and should *vary* the amount of professional skepticism applied depending on the facts and circumstances at hand, or whether, more simply, the auditor is either skeptical or he is not. It is not clear that this difficult question

¹ PCAOB, AS 1015.09.

² <http://www.merriam-webster.com/dictionary/skepticism>.

needs an answer, if the Board were to focus instead on what it expects auditors to do (that is, to objectively and critically evaluate all audit evidence obtained).

There has been at least one recommendation that auditors implement a professional skepticism continuum. The Board naturally will consider this idea if it undertakes a project in this area. I have serious doubts about whether such a continuum can be effectively understood and implemented and believe that it would not be helpful to place another layer of complexity over an already complex process.

Focus on Outcomes, What the Board Wants Auditors to Do

As the Board works through this project, it should remain focused on how the description of professional skepticism (including any related standards and guidance) will affect the auditor's behavior and attitude. The following are the types of auditor behaviors and attitudes that should be expected from an auditor who is appropriately skeptical:

- The objective and critical evaluation of all audit evidence obtained
- An understanding that there always is a possibility that audit evidence will be contradictory to management's assertions in the financial statements
- An understanding that there always is a possibility that the financial statements could be misstated due to fraud or error
- A continuous assessment of whether sufficient appropriate audit evidence has been obtained

PS2. What do you believe are the drivers for, and impediments to, the appropriate application of professional skepticism? What role should we take to enhance those drivers and address those impediments? How should we prioritize the areas discussed in paragraph 37?

Response:

The Principal Driver of Skepticism is Independence

Auditors must be *willing* to recognize when audit evidence is contradictory or inconsistent with management's assertions, and when additional audit evidence is needed. This is why an independent mental attitude ("independence of mind") is so important.

In the context of an audit, the concepts of independence and skepticism are very closely related. Accordingly, it is appropriate to discuss independence in connection with providing guidance on the application of professional skepticism. (Taken to an extreme, one might even argue that the concept of professional skepticism is unnecessary: independence of mind combined with an objective and critical evaluation of all audit evidence obtained should uncover contradictory audit evidence and identify the need for additional auditing procedures. I am not recommending this, however, as the notion of skepticism can help to foster an appropriate attitude.)

Impediments to Professional Skepticism

The PCAOB, in Staff Audit Practice Release No. 10, “Maintaining and Applying Professional Skepticism in Audits” (“SAPA 10”), identified a number of impediments to professional skepticism, including:

- incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services,
- over time, develop an inappropriate level of trust or confidence in management,
- feelings of pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management), and
- scheduling and workload demands.

I believe the foregoing are significant impediments to the exercise of professional skepticism. Also, people may be predisposed to trust. As I discussed in my article, an academic study published in 2013 suggests that presumptive trust – a predisposition to believe interviewees – is the prevailing mental perspective of auditors, even when information available to the auditor suggests that there is a risk of deception.³ This finding is consistent with academic studies on deception detection, which provide abundant evidence that people tend to have a mindset of presumptive trust.⁴ Another academic study indicates that expectations are driven primarily by previous client experience; accordingly, because most auditors are not exposed to negative prior experiences, their natural traits prevail.⁵

PS3. Is the listing of areas being explored in paragraph 38–40 complete? If not, what other areas should we or the Joint Working Group consider and why? What do you think are the most important area to be considered?

Response:

The list of items included in paragraphs 37 through 40 is a good list. I do believe that care should be taken to avoid over-responding to this issue and providing too much guidance. I believe that providing clarity, as discussed in my response to your PS1, will go a long way in helping auditors to appropriately apply professional skepticism.

As discussed in my responses to the previous questions, I do not believe it is worthwhile to develop and publish a framework on professional skepticism. Rather, I believe it would be far more useful to describe what it means to exercise skepticism. A similar discussion about what it means to exercise professional judgment also might be helpful.

³ Lee, C., Welker, R. B., Wang, T., (2013) “An Experimental Investigation of Professional Skepticism in Audit Interviews”, *International Journal of Auditing*, Vol. 17, pp. 213-226.

⁴ Ibid.

⁵ Popova, V., (2013) “Exploration of Skepticism, Client-Specific Experience, and Audit Judgments”, *Managerial Auditing Journal*, Vol. 28, No. 2, pp. 140-160.

It would be useful to explore whether auditors should document their exercise of skepticism. In my article I made the following recommendation:

The audit partner on each audit engagement could be required, either by the audit firm as a matter of policy or by regulators as a part of professional standards, to document how the engagement team overcame each of [the] impediments [to skepticism] on the audit. For example, what steps did the audit partner and other engagement team members take to ensure the team was able to and did exercise sufficient skepticism in light of tight filing deadlines or strenuous workload demands? Is the engagement partner satisfied that the steps taken were sufficient? Did the engagement team work with client management to ensure that information was provided to the auditor with sufficient time to appropriately evaluate it? How did the team address the possibility that incentives or pressure to maintain or enhance the firm's relationship with the client would impair their judgment? What did the team do to resist developing an inappropriate sense of trust in management? Discussing these matters as a part of the audit engagement planning meeting also may enhance the professional skepticism exercised by engagement team members.

PS4. Do you believe the possible actions we might take in the context of our current projects relating to quality control and group audits will be effective in promoting improved application of professional skepticism? If not, why?

Response:

Yes, I believe changes, as discussed, below, in the systems of quality control of audit firms can help to improve the exercise of professional skepticism.

Tone at the Top. Perhaps most important to the appropriate exercise of professional skepticism is the tone set by top management of the audit firm that is carried down through the leadership ranks and embraced by the engagement partners. The partners and staff need to know they are expected to be skeptical and that their decisions to seek more evidence in response to their professional skepticism will be supported and rewarded. Communications from top management about audit quality must be substantive and sincere, and not overshadowed by communications on other firm goals, such as growth, profitability and maintaining or enhancing client relationships. Sharing examples of situations in which audit teams discovered important information through their exercise of professional skepticism may enhance these communications.

The PCAOB has recently recognized that some auditing firms have improved in this area.

Inculcate Skeptical Behavior. Auditing standards and academic research both acknowledge that the personal traits of the auditor are important to the auditor's ability to exercise professional skepticism. An academic study published in April 2010 by Baylor University Professor Kathy R. Hurrt identified six personal traits, or characteristics that define professional skepticism. These include a questioning mind, suspension of judgment, search for knowledge, interpersonal understanding, autonomy, and self-esteem. Educators, the profession and firms can all play a role in training and instilling these characteristics and

associated behaviors in auditing professionals. A recent academic study provides evidence that a course that emphasizes forensic accounting appropriately influences students' fraud-related judgments (e.g., it resulted in higher initial risk assessments relative to potential fraud risk factors and increased the students' skepticism) and that the trained students' improved performance could persist.⁶ This suggests that auditor can be trained to behave skeptically.

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I was formerly Chief Auditor and Director of Professional Standards at the Public Company Accounting Oversight Board in Washington, DC, a national office partner with KPMG LLP, the Director – Audit and Attest Standards at the American Institute of Certified Public Accountants, and a former auditing practitioner with Grant Thornton LLP. I currently teach auditing at Baruch College, City University of New York.

Please do not hesitate to contact me if you would like clarification with regard to the contents of this letter. It was my pleasure to have this opportunity to provide input to the Board.

Very truly yours,

A handwritten signature in black ink that reads "Thomas Ray" followed by a horizontal line.

Thomas J. Ray

⁶ Carpenter, T. D., Durtschi, C., Milici Gaynor, L., (2011) "The Incremental Benefits of a Forensic Accounting Course on Skepticism and Fraud-Related Judgments", Issues in Accounting Education, Vol. 26, No. 1, pp. 1-21.