Professional scepticism: its implications on audits of financial statements

Professional scepticism, which should never be a new term to any accounting student, is often perceived as the cornerstone of audit quality. As the business environment is getting complicated, whether auditors have demonstrated sufficient professional scepticism during the audit of financial statements gained prominence from the eyes of the regulators. The 2015 Quality Assurance Report published by the Hong Kong Institute of Certified Public Accountants ("HKICPA") highlighted a number of deficiencies in practice which hindered audit effectiveness. One of them is the auditors' failure in maintaining an appropriate attitude of professional scepticism. This article discusses the definition of professional scepticism and its underlying implications on the audit of financial statements. To make the discussion more practical, some examples are quoted from the 2015 Quality Assurance Report.

Definition of scepticism: ethical and professional perspectives

The objective of an audit of financial statements is to form an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The financial statements are prepared by the directors while the shareholders entrust the auditors to express an opinion by obtaining audit evidence and questioning the management on behalf of the shareholders. Such trust is fundamentally built on the auditor's independence.

The HKICPA Code of Ethics for Professional Accountants emphasizes that independence of mind is critical to the auditor when carrying out their role. There are three components for independence of mind:

- a state of mind;
- permitting the expression of a conclusion without being affected by influences that compromise professional judgment; and
- allowing an individual to act with integrity and exercise objectivity and professional scepticism.

One of the ingredients for independence (of mind) is to maintain an attitude of professional scepticism. HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* further defines professional scepticism as an attitude that includes:

- a **questioning mind**;
- being **alert** to conditions which may indicate possible misstatement due to error or fraud; and
- a **critical assessment** of audit evidence.

The above discussions bring to a conclusion that the following three elements are interrelated:

How to maintain an attitude of professional skepticism

HKSA 200 suggests that an auditor should consider the following in order to be sceptical during an audit of financial statements:

1. Questioning mind

Professional scepticism is fundamentally a mindset. This mindset leads auditors to be open to the possibility that something may go wrong throughout the audit engagement, in particular, when gathering audit evidence and forming conclusions in order to exercise professional judgment.

2. Alert to conditions which may indicate possible misstatements due to error or fraud

Auditors need to be alert to the following circumstances which may indicate possible misstatements due to error or fraud:

- Audit evidence that **contradicts** other audit evidence obtained;
- Information that brings into question the **reliability** of documents and responses to inquiries;
- Indication of possible **fraud** exists;
- Circumstance that suggest the need for **audit procedures** in **addition** to those required by the HKSAs.

3. Critical assessment of audit evidence

Throughout the engagement, an auditor obtains a lot of audit evidence on which to base their opinion; therefore, an auditor needs to critically assess whether the information supports and corroborates management's assertions. An auditor is expected to perform the following procedures:

Procedures	Elaborations
Question contradictory audit evidence and reliability of responses to inquiries	Sometimes, audit evidence may be contradictory (or conflicting). For example, when an auditor obtains audit evidence through enquiry of staff members, inconsistent information may have been gathered. This may suggest that a problem actually exists. An auditor needs to critically investigate the nature and cause of such deviation. The 2015 Quality Assurance Report revealed that, in an investigation relating to evaluation of a valuation report performed by the client's expert (Expert A), the engagement team did not take into consideration the information obtained from another expert (Expert B) based on the reason that the newly obtained information from Expert B contradicted some key assumptions used in the valuation report issued by Expert A. The engagement team failed to question contradictory evidence under this circumstance.
Consider whether the records and documents are genuine	This is of particular importance when the auditor is doubtful about the reliability of information or when there is an indication of possible fraud. For example, if the management was only able to provide a photocopy of a significant sales contract, the auditor should consider performing further audit procedures by either (i) confirming directly with the third party or (ii) using the work of an expert to assess the document's authenticity.
Consider whether the audit evidence is sufficient and appropriate	Auditors need to critically assess the quantity and quality of audit evidence, especially when fraud risk factors exist or when a single document is the sole supporting evidence for a material amount. For example, if management simply provided the auditor with a summary of an ongoing court case, such summary cannot serve as a substitute of the auditor's work on examining the underlying evidence.
Consider whether past experience of the honesty and integrity of the management can be relied on	HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that an auditor's professional scepticism is of particular importance in considering the risks of material misstatement due to fraud because there may have been changes in circumstances. This is particularly critical when the client is a long-standing audit client as the auditor may have built up strong working relationship with the management. Under these circumstances, it is easy for the auditor to lose a sceptical mindset to critically assess the audit evidence or lose their willingness to challenge the management.

When professional skepticism is necessary

HKSA 200 explicitly requires that an auditor should plan and perform an audit with professional scepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated. An auditor needs to apply professional scepticism **throughout** the audit engagement. Specifically, the term "professional scepticism" is often quoted in other HKSAs and there are circumstances where the auditors have to demonstrate extra professional scepticism.

1. Fraud

Fraud is considered as an intentional act that can result in a misstatement in the financial statements and may involve actions taken by the individual to conceal the fraudulent activity. It may involve collusion with other individuals which makes it even more difficult to be discovered or detected. Further, management is in a unique position to commit fraud due to their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls. HKSA 240 therefore requires auditors to maintain professional scepticism in identifying and assessing risks of material misstatement due to fraud and in designing procedures to detect such misstatement. The auditor should:

- consider the potential for management override of controls;
- recognize the possibility that a material misstatement due to fraud could exist;
- question the management, in an ongoing manner, on whether a material misstatement due to fraud may exist; and
- consider how the overall conduct of the audit can reflect *increased* professional skepticism through, for example, increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.

The auditor should also recognize and presume that there are risks of fraud in **revenue recognition** which may lead to overstatement of revenues through premature revenue recognition or recording fictitious revenue. Such risk may be even greater when an entity generates a substantial portion of revenues through cash sales. The auditor, during the assessment of risk of material misstatement due to fraud, should maintain professional scepticism and try not to look for reasons to override such presumption.

2. Fair value estimation

The financial reporting regime is becoming more complicated. One of the reasons is the increasing involvement of fair value estimation which may be highly subjective. Auditors are advised to exercise professional scepticism in the audit of accounting estimates, for example in:

- testing impairment of goodwill and other intangible assets; and
- auditing the fair value of investment properties.

HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* requires auditors to apply professional scepticism in identifying circumstances or conditions that increase the susceptibility of accounting estimates to **possible management bias** by, for example, conducting a review of prior period accounting estimates. In practice, auditors need to:

- understand what the key assumptions in the making of accounting estimates used by the management are;
- review the judgments and decisions made by the management in the making of accounting estimates;
- challenge rigorously whether the assumptions used by the management are reasonable or plausible; and
- assess critically whether sufficient evidence has been obtained to support that the management's assumptions are reasonable or, more importantly, to suggest that the management's assumptions are not appropriate or too optimistic.

The 2015 Quality Assurance Report highlighted one finding demonstrating that an engagement team did not exercise sufficient professional scepticism in auditing the value of a cash-generating unit ("CGU"). In that investigation, the management adopted the high end of the range of possible values as the recoverable amount of the CGU and concluded that no impairment was required. Although there was production delay within the CGU, the key assumptions used in the previous year valuation report were again applied in the current year without any changes. It was concluded that the engagement team failed to critically challenge: (i) the appropriateness of the management's choice of selecting the high end point estimate for the valuation of the CGU; and (ii) the key assumptions used in the valuation.

3. Going concern

The going concern assumption is the fundamental basis in preparing the financial statements. The auditor has to, in accordance with HKSA 570 (Revised) *Going Concern*, "obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern". Specifically, the auditor needs to evaluate the management's plans for future action and whether such plans are feasible in the circumstances. This may include:

- evaluating critically whether the management's assumptions and forecasts about the future are appropriate;
- considering whether the discount rate in conducting the cash flow forecast makes sense; and
- assessing whether the outcome of the management's plan can improve the current situation to support the appropriateness of the going concern assumption.

4. Related party relationships and transactions

Related party relationships may not be readily apparent to the auditors, especially if there is deliberate concealment from the management. The nature of related party relationships and transactions may therefore lead to higher risks of material misstatement. Specifically, the auditor should be alert to significant transactions which are **outside the normal course of business** of the entity, for example, transactions with offshore entities in jurisdictions with weak corporate laws and sales transactions with unusually large discounts or returns. These may further raise the auditor's attention on whether there is possible fraudulent financial reporting or misappropriation of assets, other than undisclosed related party relationships and transactions.

This area has been highlighted in the 2015 Quality Assurance Report as a finding demonstrating audit ineffectiveness. It was suggested that auditors should carry out procedures in addition to standard audit procedures that apply to normal transactions to address such additional risks.

Documentation of application of professional skepticism

It is inherently difficult to evidence the application of professional scepticism during planning and performing the audit engagement as it is problematic to document the "mindset" of the auditor at the point at which the work was performed. The auditor should provide documentation which evidences:

- discussions with the management of significant matters and key audit issues, particularly what the management said, what questions the auditor asked to challenge the management and what evidence was provided by the management;
- evaluation on the appropriateness and sufficiency of the audit evidence (i.e. the strength of the audit evidence), including any specific procedures performed to corroborate management's responses to the auditor's enquiries; and
- how the issues are addressed, why the auditor concurs with the management's views or whether alternative views have been assessed, together with a rationale for such conclusion.

Conclusion

Maintaining professional scepticism is necessary to reduce the risks of overlooking unusual circumstances and over generalizing when drawing conclusions from audit observations. It also helps an auditor to avoid using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results.

References

HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*

HKSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

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HKSA 570 (Revised) *Going Concern*

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