About The Author

Ralph Nach is the founder and CEO of SkillSmart LLC, a technical advisory and training firm. Mr. Nach also currently serves as a Senior Course Facilitator and Instructional Designer for 20-20 Services LLC., and as a consulting expert and technical advisor on litigation and financial forensics matters.

Mr. Nach has served the accounting profession for over 35 years in a variety of capacities including auditor, quality control director, and external peer reviewer. He also served as a national office quality control partner for the fifth largest international accounting firm. Mr. Nach is also dedicated to the learning and development profession and served as the U.S. Chief Learning Officer for American Express Tax and Business Services, Inc.

He is a sought-after conference speaker and course facilitator on technical topics including the application of U.S. and international accounting, auditing, financial reporting and quality control standards; forensic accounting; and nontechnical topics related to leadership and interpersonal development.

He has co-authored several books including the popular Wiley GAAP: Interpretation and Application of Generally Accepted Accounting Principles and has served as an adjunct lecturer in accounting and finance at Northwestern University in Evanston, Illinois.

Mr. Nach is a member of the American Institute of Certified Public Accountants and the Illinois CPA Society and an associate member of the Association of Certified Fraud Examiners.

Ralph Nach, CPA
SkillSmart LLC
Glenview, Illinois USA
RNach@SkillSmartLLC.com
About the Institute of Singapore Chartered Accountants

The Institute of Singapore Chartered Accountants (ISCA) is the national accountancy body of Singapore. ISCA’s vision is to be a globally recognised professional accountancy body, bringing value to our members, the profession and wider community.

Established in 1963, ISCA shapes the regional accountancy landscape through advocating the interests of the profession. Possessing a Global Mindset, with Asian Insights, ISCA leverages its regional expertise, knowledge, and networks with diverse stakeholders to contribute towards Singapore’s transformation into a global accountancy hub. Our stakeholders include government and industry bodies, employers, educators, and the public.

ISCA is the Administrator of the Singapore Qualification Programme (Singapore QP) and the Designated Entity to confer the Chartered Accountant of Singapore - CA (Singapore) - designation.

It aims to raise the international profile of the Singapore QP, a post-university professional accountancy qualification programme and promote it as the educational pathway of choice for professional accountants seeking to achieve the CA (Singapore) designation, a prestigious title that is expected to attain global recognition and portability.

There are about 28,000 ISCA members making their stride in businesses across industries in Singapore and around the world.

For more information, please visit www.isca.org.sg.
<table>
<thead>
<tr>
<th>CONTENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction And Background</td>
</tr>
<tr>
<td>Worldwide Regulatory Inspection Findings</td>
</tr>
<tr>
<td>Declining Efficacy Of External Audits In Detecting Fraud</td>
</tr>
<tr>
<td>Possible Reasons For Suboptimal Levels Of Skepticism</td>
</tr>
<tr>
<td>Inconsistencies, Terminology, And Mixed Messages</td>
</tr>
<tr>
<td>Commercial Considerations</td>
</tr>
<tr>
<td>Profession-Wide Structural Issues</td>
</tr>
<tr>
<td>Regulatory Response To Inspection Findings</td>
</tr>
<tr>
<td>Promising Academic Research</td>
</tr>
<tr>
<td>Actions That Could Potentially Mitigate The Problem</td>
</tr>
<tr>
<td>Conclusions</td>
</tr>
<tr>
<td>Bibliography</td>
</tr>
</tbody>
</table>
PROFESSIONAL SKEPTICISM: An Essential Attitude

I. INTRODUCTION AND BACKGROUND

A. In the aftermath of the spate of high-profile corporate frauds of the early 2000s and the economic devastation caused by the Great Recession, the auditing profession is being criticized by many of its regulators worldwide for exhibiting too little skepticism when performing its work.

B. ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, states at ISA 200.15:

   The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

C. The exercise of professional skepticism is fundamental to the successful performance of auditors, audit firms, and the audit profession as a whole in discharging their responsibilities to capital markets and to society at large.

D. The auditors' opinion is intended to instill confidence in the fairness of management's financial statements and, when required by law or regulation, the operating effectiveness of the auditee's system of internal control over financial reporting.

   1. In order for auditors to live up to their responsibilities to the capital markets, the auditors' work must be performed with complete objectivity and an appropriate level of professional skepticism.

   2. Should the auditors' level of skepticism be compromised, this would result in substandard audits that are potentially ineffective in detecting the errors or fraud that could result in materially misstated financial statements.

E. The purpose of this paper is to explore these criticisms, consider the potential root causes of the problem, and offer suggestions for how audits and the auditing profession might be improved in order to mitigate these problems.¹

¹ The research that was performed for the purposes of writing this paper covered audits by the largest worldwide audit networks on the financial statements of their publicly held and/or publicly accountable clients. However, many of the ideas and concepts set forth in the paper can be expected to be applicable to audits of private and not-for-profit enterprises as well.
II. WORLDWIDE REGULATORY INSPECTION FINDINGS

A. Arguably, the audit profession has now become the single most regulated profession in terms of both the number of active regulators and the degree of scrutiny that CPA firms’ audit practices are subject to, as illustrated in the table on the following page.²

<table>
<thead>
<tr>
<th>Firms Subject to Inspection</th>
<th>Number of regulator-members of the International Forum of Independent Audit Regulators (IFIAR) Who Perform Inspections of the Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annually</td>
</tr>
<tr>
<td>“Big 4” Firms</td>
<td>17</td>
</tr>
<tr>
<td>BDO and Grant Thornton</td>
<td>8</td>
</tr>
<tr>
<td>Other Firms</td>
<td>4</td>
</tr>
</tbody>
</table>

B. The audit and assurance practices of the largest U.S.-based firms (those that audit 100 or more public companies) are required to be inspected annually by the Washington, D.C.-based Public Company Accounting Oversight Board (PCAOB, or as pundits often refer to it, “peek-a-boo”). As illustrated in the table above, inspections are also carried out in other parts of the world by other jurisdictional audit regulators, many of which are members of IFIAR.

C. The inspection findings of regulators in countries such as Canada, Germany, the Netherlands, Singapore, Switzerland, and the United States have all identified concerns regarding the lack of professional skepticism in audits. This consensus is disturbing because, as previously discussed, professional skepticism is a necessary condition for performing a thorough, objective, unbiased audit.

D. The PCAOB described their findings in Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits,

> Observations from the PCAOB’s oversight activities continue to raise concerns about whether auditors consistently and diligently apply professional skepticism. Certain circumstances can impede the appropriate application of professional skepticism and allow unconscious biases to prevail, including incentives and pressures from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management.

E. In its Audit Quality Inspections Annual Report 2013/14, issued on 28 May 2014, the U.K. Financial Reporting Council (FRC) declared that:

> …we are concerned to see insufficient evidence of firms applying professional skepticism, robustly challenging management’s assumptions, or requesting that adjustments be made to the financial statements.

² Report on 2013 Survey of Inspection Findings, dated 10 April 2014, issued by the International Forum of Independent Audit Regulators (IFIAR), which was established in 2006 by independent audit regulators from 18 jurisdictions, and now comprises regulators from 50 jurisdictions. IFIAR’s objectives are the sharing of knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms; the promotion of collaboration and consistency in regulatory activity, and the providing of a platform for dialogue with other international organizations that have an interest in audit quality.
F. The Canadian Public Accountability Board (CPAB) describes the optimal circumstances:

   An engaged auditor is an important component to a high quality audit. If the auditor approaches the audit with an appropriate degree of professional skepticism, engages the right specialists, develops and implements an effective audit plan, and challenges management throughout the process, it will have done its part to ensure a quality audit. (Emphasis added.)

G. Globally, of 23 audit firms for which the scope of the inspection included the “sufficiency of challenge and testing of management's judgments and assessments,” 10 firms (43% of the firms for which the topic was inspected) had at least one finding that the challenge and testing were insufficient.

H. The accompanying bibliography cites numerous other reports and practice alerts issued by regulators worldwide, intended to caution audit firms and auditors regarding these disturbing findings, and to provide guidance on how this situation might be reversed.

I. The inspection findings have revealed numerous examples of scant skepticism in the performance of audit work, a few of which are:

   1. Failure of the engagement team to obtain an understanding of the specific methods and/or assumptions underlying fair value estimates obtained from pricing services and other third parties that were used in testing certain Level 2 financial instruments. Further, the engagement team used the price closest to management's recorded price in testing the fair value measurements without evaluating the significance of differences between the other prices obtained and management's prices.

   2. Management discontinued a significant product line during the prior year and replaced it with a new product line, but inventory pertaining to the former product line remained on the balance sheet. During the last nine months of the year under audit, there were no sales of the discontinued products. The engagement team did not test, beyond making inquiries of management, the significant assumptions used to calculate the inventory valuation allowance for the discontinued product line.

   3. Management determined it would not test a significant portion of its property and equipment for impairment, despite the presence of indicators that the carrying amount may not have been recoverable from future cash flows. The impairment indicators that were present included operating losses experienced by the relevant business segment for the prior three years, a projected loss for the segment for the upcoming year, substantial impairment charges for goodwill and other intangible assets during the year, and reduced and delayed customer orders.

J. The issues raised by these regulators are not new and, in fact, have been reported repeatedly over a period of many years.

   1. However, many instances of such failings are not fully disclosed.

   2. For example, the PCAOB, under its standard operating rules, provides a one-year period to inspected firms during which the firm is expected to remediate systemic problems that the PCAOB identifies during the inspection. If, in the opinion of the PCAOB inspection team, the inspected firm makes sufficient progress in remediating the findings during the one-year period, the systemic findings are never released to the public.

K. Nevertheless, to date, three of the “Big Four” firms had not made sufficient progress during the one-year period that succeeded one or more of their annual inspections and, consequently, the PCAOB released information about the systemic findings that covered those periods to the public.
L. Quoting from one of these reports:

The inspection results indicate that the Firm, in certain instances, relied heavily on evidence that supported the issuer’s [auditee’s] conclusion, without sufficiently taking into account new or contrary evidence that was available to the Firm at the time of the audit. This tendency frequently contributed to the concerns noted in prior inspection reports related to a lack of professional skepticism and deficiencies in auditing accounting estimates.

These deficiencies indicate that some of the Firm’s professionals may lack professional skepticism when new or contrary information is identified, or when considering whether recent events (such as current economic conditions) or current-year transactions may constitute such contrary information. The deficiencies may result, in part, from the Firm’s professionals placing too much reliance on their perceived knowledge of the issuer obtained during the course of their tenure on the engagement.

III. DECLINING EFFICACY OF EXTERNAL AUDITS IN DETECTING FRAUD

A. According to statistics cited in the bi-annual 2014 Report to the Nations on Occupational Fraud and Abuse, published by the Association of Certified Fraud Examiners (ACFE), the percent of fraud cases that are uncovered as a result of the work of external auditors has steadily declined from a peak of 12% in 2006 to a mere 3% in 2014.

1. Thus, despite all of the bad publicity regarding the number of frauds occurring and the severity of the losses from those frauds, the seeming efficacy of external auditors in detecting frauds has significantly declined by about 75% from what it was eight years ago (although the improved performance of others, such as internal auditors and employee whistle-blowers, could have contributed to the apparent decline in outside auditors’ contributions).

2. The auditors’ role in fraud detection, even at its historical highest level, was only minor – and this has long been a source of criticism, as well as a cause of significant litigation against auditing firms.
B. An important matter to consider is whether the lack of auditor skepticism is linked to audits that are not thorough or robust enough to detect fraud. If this is true, audits would rightly be perceived as being of less value to users today than they had been in the past.

C. In this environment, as a matter of professional survival, it is critical that we ask ourselves and our leaders some hard and uncomfortable questions about the work we do, how we do it, and how it can be improved.

IV POSSIBLE REASONS FOR SUBOPTIMAL LEVELS OF SKEPTICISM

A The current auditing environment.

1. In his formal testimony to the PCAOB, Dr. Larry E. Rittenberg articulately characterized the current audit environment as follows:

Auditing is a difficult task that should not be underestimated. The audit environment is characterized by increased risk taking by organizations, complex transactions where the economic benefits may be difficult to ascertain, highly technical accounting standards, increased dependence on information technology and related data repositories, increased globalization of commerce, and the speed of change.

2. This characterization of the current audit environment raises questions for consideration regarding whether auditors and their skills, competencies, tools, methods, and thought processes have kept up with the velocity of change.


1. As new and complex types of economic transactions are being invented in real-time and the volume and velocity of those transactions have multiplied, accounting standards setters have struggled to ensure that accounting frameworks have kept up.

2. In that evolutionary process, several trends have emerged that are worth noting:

a. Standards are necessarily more complex since the transactions they are designed to depict have become more complex.

b. Increasing use of fair value measurements has resulted in substantial increases in both quantitative and qualitative information that is now required to be provided to the users of the financial statements.

i) Frequently, the choice and application of appropriate models and reasonable assumptions will necessitate the use of specialists by company management and/or the auditors.

ii) Accompanying the need for consultation with competent specialists is the equally important need, when circumstances warrant it, to consult with in-firm or external experts in financial accounting and reporting, information systems, or other disciplines to obtain expertise that otherwise does not reside in the engagement team.

1 Rittenberg, Dr. Larry E. (Professor Emeritus, University of Wisconsin-Madison, and former Chairman of The Committee of Sponsoring Organizations of the Treadway Commission (COSO)), Comments on Governance, Professional Skepticism, and Auditor Independence; 18 October 2012; http://pcaobus.org/Rules/Rulemaking/Docket037/js_Rittenberg.pdf

2 Fair value measurements are intended to represent hypothetical transactions in orderly markets between marketplace participants. In the absence of observable data, the measurement may require management to make the assumptions that marketplace participants would make, thus requiring the auditor to understand the economic behavior of third parties in assessing the reasonableness of management’s inputs.
3. Standards are intended to be principles-based and, frequently, they:
   a. Involve estimates and assumptions that require the exercise of sound management judgment;
   b. Provide lists of factors or indicators for qualitative consideration;
   c. Involve the application of valuation models and the development of subjective probability assumptions;
   d. Are sometimes based on management’s intent with respect to a particular assertion (e.g., whether it intends to hold an investment until its maturity or to sell it); and
   e. May result in different presentations of information depending upon the business model that management purports to follow.

4. IFRS continues to permit accounting policy alternatives that, if elected by management, can be used as tools for financial statement engineering. For example, a company may choose to revalue its long-lived tangible assets (thus requiring an incremental use of fair value as discussed in 2. above) or to apply a depreciated-cost/impairment model.

5. Little if any attention is being paid by accounting standard-setters to the vital issue of auditability. This results in a schizophrenic profession whereby those who are responsible for maintaining and improving the framework used for accounting are insensitive to the operational difficulties that arise from application of the framework in situations where little, if any objective evidence exists to corroborate significant amounts presented and disclosed in the financial statements.

V. INCONSISTENCIES, TERMINOLOGY, AND MIXED MESSAGES

A. Inconsistencies in auditing standards.

1. Audit standards and the related implementation guidance can send mixed messages to auditors. For example, examine the following two quotes (emphases added):

   The auditor neither assumes that [management] is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.\(^5\)

   Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.\(^6\)

\(^5\) International Auditing Practice Statement (IAPS) 1005, The Special Considerations in the Audit of Small Entities; paragraph 18; International Federation of Accountants (IFAC)

\(^6\) International Standard on Auditing (ISA) No. 240, The Auditors’ Responsibilities Relating to Fraud in an Audit of Financial Statements; paragraph 31; IFAC
2. The first quotation asserts that the auditor should remain neutral and neither believe that management is honest nor dishonest. The second quotation, inconsistent with its predecessor, asserts that the auditor should assess the risk of misstatement due to fraud as a significant risk. Making such an assessment is, in the author’s judgment, inconsistent with and contradictory to the neutrality mandated by the first quotation.

3. The language in the auditors’ report itself may contribute to the confusion. The standard auditors’ report, under the caption, “Auditors’ Responsibility” states (emphasis added):

   Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

4. This language asserts to the user of the financial statements that there is an absence of material misstatements. An auditor that starts with that premise may be susceptible to confirmation bias.7

5. This can result in the auditor believing that the purpose of the audit is to prove that the financial statements are correct instead of detecting and correcting material misstatements expected to exist in the financial statements as a result of error or fraud.

B. Terminology and mixed messages arising from the use of the term “client.”

1. Most auditors refer to the organization whose financial statements are being audited as their firm’s “client.”

2. The definition of the noun “client” is as follows8:

   a. The party for which professional services are being rendered, as by an attorney.

   b. One that depends on the protection of another.

3. This definition is inconsistent with the actual role of independent auditors.

   a. The professional services rendered by auditors are not for the company being audited but rather are expressly for the benefit of investors, lenders, sureties, trade creditors, and other third parties.

   b. Further, auditors are not advocates (as an attorney would be) for the companies whose financial statements they audit, and thus it would be inappropriate for us to assume a role that results in our protecting the company (or its board of directors or management). The protection we provide is to third parties. Among all the professions, this is a unique role that requires auditors to understand their duty to the public above all else.

C. Messages from management of the audit firm, largely for promotional purposes, may diverge from the traits required by independent auditors.

---

7 Confirmation bias is a tendency to search for and give greater weight to evidence that supports a person’s preconceptions and, conversely, avoid searching for or giving lesser weight to evidence that contradicts those preconceptions.

1. Many public accounting firms’ websites, mission statements, and internal communications tout the fact that they are “trusted advisors” to their clients – with little or no verbiage that discusses the important role that they play on behalf of investors, lenders, and other third parties.

2. Either explicitly or implicitly many of these statements can be construed by less-experienced staff members as conveying a role as an advocate for the client.

3. Further, many of the types of services that firms cross-sell to their audit clients (when such cross-selling is permitted by independence rules) are advocacy-oriented services which can put the firm in a position of providing both advocacy and non-advocacy services for the same client.

D. There are other messages from audit firm leaders can detract from emphasis on professional skepticism, e.g.

1. “I’ve audited this company for many years and have always found management to be honest and ethical.”

2. “This is a ‘clean’ audit. They’ve never had fraud and are unlikely to ever have it.”

VI. COMMERCIAL CONSIDERATIONS

A. Audit firms (and, by extension, individual auditors) are under significant economic, regulatory, and competitive pressure.

B. Various internal and external incentives and pressures can compromise professional skepticism and audit quality:

1. Emphasis on completion of audit work (or portions thereof) within a certain time budget irrespective of results of performing audit procedures that might be indicative of a need to extend procedures.

2. Emphasis on completion of audit work by specified deadlines (whether imposed by law, regulation, contract, or client).

3. Reluctance to engage internal or external specialists due to budgetary and/or deadline considerations.

4. Use of maximum staffing leverage that results in audit work being executed by the least experienced staff members and that can result in insufficient partner and manager attention to review and supervision activities.

5. Emphasis on maintaining and enhancing client relationships that make it unlikely that a client position would be challenged.

6. Emphasis on selling additional, non-attest services to clients.

7. Incentives, rewards, and advancement decision-making systems designed to be more lucrative for those who maintain and grow business than those whose primary contributions are to audit quality.

8. Incentives to obtain favorable ratings on “client satisfaction” surveys from members of management of audited companies that make it less likely that the audit team members will challenge management.

9. For high-performing auditors who successfully cultivate relationships with their audit clients, there are frequently opportunities available for employment with the company being audited.
10. Familiarity threats associated with longstanding tenure by the audit firm and members of the engagement team.

VII. PROFESSION-WIDE STRUCTURAL ISSUES

A. In examining the legal, regulatory, and commercial characteristics of the audit market, a fundamental issue must be discussed and given serious consideration: Is it realistic to expect skepticism and objectivity in a model where the company being audited makes the decisions regarding hiring, retention, compensation, and dismissal of the auditors?

1. Stated another way, does the current system create a commonality of interests between the audit firm and the company being audited (and its management) that presents an insurmountable barrier to professional skepticism?

B. The IAASB attempted to address this issue in International Standard on Quality Control (ISQC) No. 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.9

1. ISQC 1 discusses the responsibility of firm leadership for quality. In that context, it identifies the need for the firm’s leadership to “. . . recognize that the firm’s business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs."

2. ISQC No. 1 further prescribes that management responsibilities are to be assigned “so that commercial considerations do not override the quality of work performed.”

C. The manner in which firms build and maintain their structure and culture will determine whether they are successful at achieving the goals of ISQC 1 with respect to putting quality first. It is incumbent on leaders of the audit profession to either make a strong case, backed up by sound research and improved inspection results, that this structural barrier can be, and is being, overcome or to collaborate with legislators, regulators, and others to design and implement reforms to the system that would be responsive to the problem.

VIII. REGULATORY RESPONSE TO INSPECTION FINDINGS

A. Regulators have expressed their grave concerns about this situation (i.e., the failure to maintain professional skepticism) and have been working with a sense of urgency in a number of ways to attempt to remediate it:

1. Developing individualized action plans with inspected firms to address shortcomings,10

2. Authoring and widely disseminating whitepapers, practice alerts, and Q&A documents to stakeholders that include lists of action items that firms, engagement partners, and individual auditors can take to enhance their level of professional skepticism11
3. Strengthening professional standards to improve communications between auditors and audit committees regarding matters such as:

   a. Audit strategy;
   
   b. Significant risks;
   
   c. Other firms and specialists participating in the audit;
   
   d. Complex accounting estimates;
   
   e. Significant unusual transactions;
   
   f. Disputes over accounting matters; and
   
   g. The auditors’ evaluation of the company’s ability to continue as a going concern.

4. Pursuing initiatives to expose for public comment and seriously consider structural changes such as:

   a. Expansion of the auditors’ standard report to include critical matters that arose on the audit and other informative language that conveys auditor insights gained during the conduct of the engagement.
   
   b. Identification of the lead engagement partner.
   
   c. Indication of the extent to which components in a group audit were audited by other component auditors that were not part of the group auditors’ organization.
   
   d. Requiring periodic rotation of the audit firm (not just the engagement partner).
   
   e. Requiring periodic “re-tendering” of the audit.
   
   f. Insulating the audit firm from being terminated (thus attempting to avoid retaliation by management for not assenting to their desired accounting treatment of particular items) without due cause.

5. Pursuing research and field testing for the purpose of identifying “audit quality indicators” -- quantitative measures that could potentially be used to determine the optimal firm environment for ensuring, among other things, the robust exercise of professional skepticism.

   a. One promising undertaking now ongoing by the SEC is the creation of a new Financial Reporting and Audit Task Force, and a related Center for Risk and Quantitative Analytics.

      i) Together, these efforts at creating and employing a new quantitative data and analysis model may result in devices useful in profiling high-risk behaviors and transactions, with the aim of developing a methodology for the earlier detection of financial reporting misconduct.

      ii) The ultimate goal is to identify a set of “red flags” that would trigger closer examinations of submissions for those entities deemed as having a higher risk of being the perpetrator or victim of financial reporting fraud.
b. The objective of the foregoing is to develop tools and techniques that will enhance the Enforcement Division’s efforts related to accounting and disclosure fraud. Once these diagnostic indicators have been developed, it is hoped (but not certain) that these will be shared with the private sector, becoming available for auditors to employ in the routine course of audits.

c. Another current undertaking (April 2014) that may provide insights for auditors is the creation by the (U.S. Department of Justice’s) U.S. attorney’s office in Chicago of a new section to focus on prosecuting securities and commodities fraud, which may incorporate to some extent the criminal side of the financial reporting fraud pursuits of the new SEC unit. (The SEC has only civil enforcement powers, and routinely refers matters it has identified to the DOJ for criminal prosecution, if circumstances warrant.)

i) Cooperation between these agencies will be important, and it may also be useful to tap into the private sector for input on possible approaches.

ii) Assistance may reasonably be sought from academia, where research on fraud deterrence and detection has long been pursued.

iii) It might also be sought from the auditing profession itself, which has seemingly struggled for decades in developing and creatively applying analytical techniques that could possibly enhance auditors’ effectiveness in conducting routine annual examinations where anomalies that could be “red flags” of improprieties now go largely unappreciated.

IX. PROMISING ACADEMIC RESEARCH

A. With independence and skepticism being unique attributes of effective and standards-compliant auditors, it is not surprising that academic researchers are devoting considerable time and resources to researching these characteristics.

B. Two studies hold particular promise to assist in improving performance in these areas.

1. Research on defining professional skepticism and training auditors to be more skeptical.

a. An encouraging research paper, Training Auditors to Think Skeptically (by Plumlee, Rixon, and Rosman), supported by a grant from the Center for Audit Quality (CAQ), was issued in April 2012.

b. From the research reported in this paper, Training Auditors to Think Skeptically, the authors concluded that skepticism can be viewed as a diagnostic reasoning process, and they were able to develop training materials that could successfully train auditors to improve their use of these skills.

c. The authors represented professional skepticism as a diagnostic reasoning process that incorporates both divergent and convergent thinking. The authors found that training in divergent and convergent thinking can provide a structure for auditors to be more professionally skeptical.

i) Specifically, auditors that were trained in using both divergent and convergent thinking increased both the number and quality of explanations in response to evidence not consistent with their expectations.

ii) The auditors who completed the training demonstrated a greater ability to generate and ultimately choose the correct explanation.
d. Exhibit I on the following page (p. 10) illustrates how the thinking process might be demonstrated in performing planning analytical procedures.

2. Toward the measurement of professional skepticism.

a. In her 2001 paper, Development of an Instrument to Measure Professional Skepticism, R. Kathy Hurtt of the University of Wisconsin – Madison developed a 30-item instrument for measuring whether a person possesses the characteristics of a skeptic. The instrument is derived from a model that identifies both the characteristics of skeptics and their behaviors, as presented in Exhibit II, on page 11:

b. An instrument of this nature could provide a good starting point for measuring a baseline of a firm’s audit personnel to determine the extent to which they presently possess the characteristics of skeptics to examine whether there is any correlation between skepticism and the firm’s perception of person’s skills as an auditor.

i) This can serve as a needs analysis for developing targeted training as well as for identifying individuals that possess the characteristics that can serve as mentors to those who require development in this area.

ii) It also could potentially be used in the recruiting and hiring process to identify individuals who are more likely to be skeptical auditors.
<table>
<thead>
<tr>
<th>Cognitive Processing Activity</th>
<th>Description</th>
<th>Example of Application to a Financial Statement Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Problem Identification and Construction</td>
<td>Recognize items or situations that should be considered unusual.</td>
<td>The auditor develops expectations and compares those expectations to the amounts recorded in the financial statements. The auditor would consider it unusual if there was a significant difference between the amount expected and the recorded amount.</td>
</tr>
<tr>
<td>Divergent Thinking</td>
<td>Generate potential solutions to the problem by recognizing cues and links between available information to find explanations that might not otherwise be discovered. Consider plausible, multiple explanations for the unusual item encountered without an explicit, stringent effort to ensure that each explanation is logically valid in light of other knowledge and evidence. Similar to brainstorming, except that brainstorming is a group activity whereas divergent thinking occurs at the individual level.</td>
<td>The auditor considers the various factors that potentially could cause the identified difference (including reconsideration of whether the auditor identified all of the relevant factors that influence the recorded amount). To comply with ISA 240, the auditor ensures that explanations considered include both intentional and unintentional misstatements.</td>
</tr>
<tr>
<td>Convergent Thinking</td>
<td>Focusing the search for a solution. In problem solving, convergent thinking facilitates recognition of weaknesses and limitations in the generated explanations for the purpose of eliminating those explanations that should not be pursued. Convergent thinking enables decision makers to recognize potential areas in which to concentrate their effort and to arrive at a satisfactory solution.</td>
<td>Auditors use convergent thinking to test the plausible explanations they generated during divergent thinking. The auditor makes additional inquiries, gathers additional evidence that either supports or contradicts the various explanations. In light of the evidence gathered, the auditors’ knowledge of the business and industry, and considering knowledge gained in performing other segments of the audit, the auditor considers the plausibility of the various alternative explanations generated during the divergent thinking process.</td>
</tr>
<tr>
<td>Solution Development</td>
<td>Conclude whether the unusual items or situations warrant additional consideration or if additional evidence needs to be obtained.</td>
<td>The auditor concludes as to whether or not there are any material misstatements in the audit assertions relevant to the account balance or class of transactions being tested. If a misstatement is detected, the auditor proposes an adjusting journal entry to correct the misstatement, and considers whether the failure of the reporting entity to detect and correct the misstatement represents an internal control deficiency.</td>
</tr>
</tbody>
</table>
X. ACTIONS THAT COULD POTENTIALLY MITIGATE THE PROBLEM

A. Actions for consideration by audit firms.

1. Actions to transform firm culture and the “tone at the top”
   
   a. Use unambiguous language and refer to the company whose financial statements are being audited as “the auditee.” When the words “client” or “customer” or “consumer” are used, limit the discussion to third-party financial statement readers.

   b. Ensure that there is alignment of rewards systems with desired audit behaviors. As required by the International Quality Control Standards (ISQC 1.A5), firm management is responsible for assigning management responsibilities so that commercial considerations do not override the quality of work performed.

   c. Administer an anonymous survey of staff and partner attitudes and perceptions. Include in the survey a question such as\(^\text{12}\):

   \[
   \text{In your experience, what is the level of importance placed on meeting time budgets versus delivering quality (circle one)?}
   \]

   \[
   \begin{array}{cccccc}
   \text{Time is the most important factor} & 1 & 2 & 3 & 4 & 5 & 6 & 7 \\
   \text{Time and quality are equally important} & & & & \hspace{2cm} & \hspace{2cm} & \hspace{2cm} & \hspace{2cm} \\
   \text{Quality is the most important factor} & & & & \hspace{2cm} & \hspace{2cm} & \hspace{2cm} & \hspace{2cm}
   \end{array}
   \]

\(^{12}\) Unless it would compromise anonymity, the author recommends asking respondents for their job title. In pilot testing this questionnaire with personnel of several firms, it was found that the less experienced personnel were more likely to score time as the most important factor as a number less than 4 and that the more senior the person answering the question (in terms of job title, not firm tenure), the more likely the answer was in the range of 4 or over. This could indicate that more senior personnel are conveying intended or unintended messages in their interactions with those who they supervise.
2. Human capital management.
   a. Consider using an assessment instrument to measure auditors’ individual skepticism, to develop individualized learning and mentoring plans, and to evaluate potential new employees.
   b. Review the firm’s compensation and employee evaluation programs and protocols to ensure that the firm is not rewarding sales more lucratively than technical skills.
   c. Ensure that all audit-related training emphasizes the attributes of skepticism necessary for a quality audit.

3. Audit engagement performance.
   a. Despite the aforementioned challenges presented by the current audit environment, the tools, techniques, and methodologies used by auditors have largely remained static.
   b. Many if not most firms have automated the methods they use to document their audit processes, without changing the fundamental methods that those processes entail.
   c. At a minimum, firms should be using templates for documenting key audit decisions that include appropriately captioned sections that prompt the auditor to document such matters as:
      i) The rationale for selecting the alternative course of action that was ultimately concluded to be the most suitable.
      ii) The counter-arguments that were rejected: the alternative courses of action or conclusions that were considered and rejected and the reasons for rejecting them.
      iii) Counter-evidence that was examined, that contradicted management’s assertions or supported opposing arguments, and the reasons why such evidence was not given greater weight.
   d. Consider holding “challenge meetings” where key audit decisions are discussed and specific individuals are expected to make sound counterarguments to those decisions.
      i) Minutes should be taken and included in the engagement documentation to memorialize the fact that alternative viewpoints were expressed, considered and rejected.
   e. Individuals performing engagement reviews should be encouraged (and rewarded) for:
      i) Being thorough,
      ii) Asking probing questions and challenge staff to develop alternatives,
      iii) Thinking critically, to obtain credible, high-quality corroborative evidence, and
      iv) Obtaining from engagement staff well-crafted narratives describing the work performed, evidence examined, and conclusions reached.
   f. Explicit documentation should be created on each audit that accumulates the results of performing retrospective audit procedures on significant prior year estimates, as required by ISA 240.32.
i) This enables the auditors to review the variations between the prior year estimates and actual experience summarized by the member of management that originated the estimates.

ii) This is a critically important step in applying professional standards to evaluate whether management’s estimates are consciously or unconsciously biased towards desired results.

B. Actions for consideration by legislators, regulators, standard-setters, and stock exchanges

1. Funding of significant research and development into:
   a. New audit methods,
   b. Electronic evidence,
   c. Data analytic tools,
   d. Fraud detection methods,
   e. Ways of minimizing bias,
   f. Audit decision-making frameworks,
   g. Effective training on skepticism and critical thinking processes, etc.

2. Individual firms or networks cannot be relied upon to do this due to commercial considerations, so this needs to be a partnership between academic researchers and those government and private organizations that serve the public interest.

3. Accounting standards-setters and regulators must engage with their auditing counterparts and develop action plans by which accounting standards are amended to make them more objective and less subjective and to consider auditability as a fundamental requirement when considering potential new standards.

4. Consider changes to the auditors’ unqualified report that emphasize that financial statements are likely, prior to audit, to contain misstatements and that the audit is designed to detect and correct those misstatements:

   *Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether that misstatements contained in the financial statements are free from material misstatement have been detected and corrected in a timely manner.*

5. Amend auditing standards to refer to the company being audited as the auditee rather than the “client” with explicit language explaining the rationale for this and emphasizing the auditors’ duty to the public.

6. Identify and resolve inconsistencies in auditing standards between those passages that imply the auditor should be neutral regarding the honesty and forthrightness of management and those that require the auditor to plan and perform the audit with management override of controls as a significant risk.
7. Consider requiring every audit to include forensic audit procedures directed towards the areas that, based on the auditors’ fraud risk assessment, pose the highest risk of material misstatement.

8. Prohibit the use of “client satisfaction surveys” to avoid independence problems and conflicts of interest.
   
   a. This would guard against the threat of audit personnel succumbing to implicit or explicit pressure by the auditee to achieve their desired accounting results.
   
   b. If firms wish to obtain feedback from customers, surveys should be taken regarding the esteem in which third-party users hold the firm’s audit opinions.

9. Consider prohibiting an audit firm from performing any services for an auditee that would put the auditor in a role of being an advocate on behalf of the auditee or its board members or members of management.

10. In tandem with the academic community and professional associations, perform research on implementing an international audit quality framework accompanied by transparent reporting of audit quality indicators with the eventual goal of developing best practices for matters such as:
    
    a. Partner to staff ratio;
    
    b. Partner and staff utilization percentages/workloads;
    
    c. Average experience level of firm staff on individual engagements;
    
    d. Expected charge hours per professional;
    
    e. Staff retention rate;
    
    f. Industry experience;
    
    g. Training hours per audit professional and curricula that support enhancing of professional skepticism;
    
    h. FTEs devoted to technical resources; and
    
    i. Specialist hours as a percentage of overall engagement hours.

11. Consideration should be given to pilot testing, initially on a voluntary basis, structural changes to the audit model, many of which have been suggested in the past:
    
    a. In the public company environment, strengthening audit committee oversight of the audit process including augmenting the accounting expertise on audit committees by requiring that one or more members possess audit expertise.
    
    b. Consideration of creating a quasi-public organization that would appoint auditors of public companies and would adjudicate disputes between auditors and auditees.
c. Conducting research into a model for private company assurance whereby the party needing assurance (in most cases, banks or sureties) decides on the scope of the work sufficient for their decision-making purposes (agreed-upon procedures) and contracts with the firm to perform the work.

i) This type of model can be analogized to the purchase of insurance and would align the interests of the auditor with the interests of the party seeking assurance.

ii) Presumably, under a model of this nature, auditors who were thorough and found errors and fraud more frequently would be rewarded by obtaining more work at higher fees than those auditors that failed to find misstatements that resulted in the bank or surety incurring credit losses.\(^\text{13}\)

XI. CONCLUSIONS

A. It is clear that the status quo is not acceptable and that the perceived value and very existence of the audit are threatened should actions not be taken in a timely manner to greatly improve performance in this vital area. Global capital markets require credible and reliable financial reporting.

B. It is commercially devastating to stakeholders when financial statements containing fraudulent representations, or material inadvertent errors or omissions, are issued and relied upon. Consequently the audit profession owes a duty to the public to do everything in its power to reduce the incidences of this occurring.

\(^{13}\) A great deal of excellent academic work has been done in this area by Professor Joshua Ronen of the Stern School of Business at New York University.
BIBLIOGRAPHY

Academic Research Papers and Journal Articles

Corporate Audits and How to Fix Them; Professor Joshua Ronen, Professor of Accounting, New York University Stern School of Business; Journal of Economic Perspectives; Volume 24, Number 2, Spring 2010; Pages 189-210

Development of an Instrument to Measure Professional Skepticism; R. Kathy Hurt; University of Wisconsin – Madison; 2001 November

Training Auditors to Think Skeptically; David Plumlee, Brett A. Rixom, Andrew J. Rosman; Center for Audit Quality (CAQ); April 2012

Documents and Reports Issued by Regulators and Standards-Setters

IAASB Staff Questions and Answers, Professional Skepticism in an Audit of Financial Statements; Staff of the International Auditing and Assurance Standards Board (IAASB); 28 February 2012

PCAOB Staff Audit Practice Alert No. 10, Maintaining and Applying Professional Skepticism in Audits; Public Company Accounting Oversight Board (PCAOB); 4 December 2012

Report on 2013 Survey of Inspection Findings; International Forum of Independent Audit Regulators (IFIAR); 10 April 2014

Audit Quality Indicators and Audit Firm Transparency

PCAOB Discussion Paper: Audit Quality Indicators, prepared for the purpose of the meeting held 15-16 May 2013 of the PCAOB Standing Advisory Group

Framework for Audit Quality: Key Elements That Create an Environment for Audit Quality; IAASB; 2014 February

Consultation Report: Transparency of Firms that Audit Public Companies; Technical Committee of the International Organization of Securities Commissions (IOSCO); 2009 September

Other Documents and Reports

Select Auditing Considerations for the 2013 Audit Cycle; Center for Audit Quality (CAQ); 17 December 2013

Enhancing Auditor Professional Skepticism; Professors Steven M. Glover and Douglas F. Prawitt of Brigham Young University; published and funded by the Standards Working Group (SWG) of the Global Public Policy Committee (GPPC) that is comprised of BDO, Deloitte, EY, Grant Thornton, KPMG, and PWC

Reform of the EU Statutory Audit Market – Frequently Asked Questions; European Commission Memo/14/256; 3 April 2014

Summary of the KPMG Professional Judgment Framework – Understanding and Developing Professional Judgment in Auditing and Accounting; KPMG LLP; 2013
About ISCA Technical Standards Development and Advisory

The Technical Standards Development and Advisory (TSDA) team is part of the Technical Knowledge Centre and Quality Assurance division of the Institute of Singapore Chartered Accountants (ISCA). It is committed to supporting the Institute in advancing and promoting technical developments within the profession as part of the effort to transform Singapore into a leading global accountancy hub by 2020.

ISCA TSDA engages external stakeholders in soliciting meaningful feedback on accounting and auditing related issues to develop a consistent approach to addressing industry issues identified. It also prescribes auditing and assurance standards that are closely aligned to international best practices, champions thought leadership initiatives with key stakeholders and drives projects in collaboration with various ISCA technical committees.

It actively engages international standard setters and strives to be an advocate of matters pertinent to the development of Singapore’s accountancy profession. Furthermore, it aims to cultivate a mindset change and raises awareness of new and revised standards through the publication of articles authored by the team.

Additionally, ISCA TSDA seeks to empower members and the profession at large to achieve their aspirations by equipping them with relevant technical expertise and this is achieved through the development of a range of resources that they can tap on.

Knowledge sharing with the accounting community is facilitated through a variety of print and online channels including the sharing of regular updates and thought leadership articles via in-house publications like the journal, “IS Chartered Accountant”, the E-newsletter, “ISCA Weekly”, and various online knowledge centres and a technical forum. Seminars and workshops are regularly organised and ISCA TSDA also provides value added technical clarification services to assist the profession in resolving accounting, auditing and ethics related issues.

© 2014 by Ralph Nach

Disclaimer
This document contains general information only and the author and ISCA are not, by means of this document, rendering any professional advice or services. This document is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a professional advisor. Whilst every care has been taken in compiling this document, the author and ISCA make no representations or warranty (expressed or implied) about the accuracy, suitability, reliability or completeness of the information for any purpose. The author, ISCA, its employees or agents accept no liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.