

Professional scepticism: inside the mind of the auditor"

Explore the impact of cognitive biases on the audit!

REPORT

On 17 October 2017 ACCA (the Association of Chartered Certified Accountants) organised a conference called **Professional scepticism: inside the mind of the auditor"**.



The issue of professional scepticism in audit remains a critical area. Auditors' perceived lack of professional scepticism is seen by audit oversight bodies and the public as being at the root of issues with audit quality. This criticism has risen in importance since the global financial crisis, and auditors and standard-setters are under pressure to enhance professional scepticism.

As part of efforts to enhance audit quality, the IAASB, IESBA and the IAESB issued a joint publication called ['Toward Enhanced Professional Skepticism'](#), in which they note that the importance of enhanced professional scepticism is underscored by the increasing complexity of business and financial reporting.

ACCA is also shedding some light on the debate, from the perspective of cognitive biases. The global accountancy body published a report called ['Banishing bias? Audit, objectivity and the value of professional scepticism'](#), which was the basis of a lively experts debate in Brussels.

Arnold Schilder, Chairman IAASB, opened the discussion and the ACCA report was presented by Andrew Gambier, Head of Audit and Assurance, ACCA. **Maggie McGhee**, Director Professional Insights, ACCA, moderated the panel that was comprised of **Lieve Cornelis**, EY, Partner, **Anne-Hélène Monsellato**, ecoDa (Chair of its Working Group on Audit Committees) / Chair of Audit Committees in various companies, **Kristian Koftvedgaard**, IESBA CAG Chair & BusinessEurope, and **Prof. Dr Kris Hardies**, Department Accountancy and Finance, University of Antwerp.

Discussions revealed that everybody has a role to play in supporting the exercise of professional scepticism: auditors can do more but others must support them too. The debate clearly revealed that bias is everywhere in human decision-making. Stakeholders need to work with natural human biases, rather than ignoring them. It was also stressed that awareness of bias can help to mitigate it, and several speakers acknowledged the contribution of ACCA's report towards improving the exercise of professional scepticism.



Main highlights

Maggie McGhee, Director Professional Insights, ACCA

- ACCA's report *Banishing Bias* is an important piece of research for ACCA not only for looking at the future of the audit profession but also for responding to current concerns. It seeks to untangle the meaning of professional scepticism by looking through the lens of cognitive bias, a growing body of academic literature on psychology. The concept of professional scepticism is also intertwined with the issue of audit quality.
- There is public demand for higher quality audit. Auditors' lack of professional scepticism is often seen by audit oversight bodies and the public as being at the root of issues with audit quality. This criticism has risen in importance since the global financial crisis. Auditors and standard-setters are under pressure to enhance professional scepticism.
- Audit quality will only be improved further when all actors in the financial reporting process understand how cognitive bias impacts the use of information in decision making process.
- Finding ways for auditors to apply higher levels of professional scepticism is a key challenge facing the profession. *Banishing Bias* report aims, first and foremost, to outline some ways that auditors can go about this.
- But it's not all up to auditors. The report identifies that sometimes standards are written in a way that may – inadvertently – undermine the application of professional scepticism as a result of cognitive biases. So, to the extent that standard-setters can be aware of bias and try to avoid it, they should.
- Other stakeholders should also be aware of bias and how it might be affecting them. Good regulators recognise the danger of hindsight when monitoring audits. But we do still see some commentators jumping to the unfair conclusion that whenever a company does something wrong, the company's auditor must somehow be to blame. ACCA's report suggests that a more measured dialogue is necessary to deliver improvements in audit quality.
- As part of its efforts to enhance audit quality, the IAASB issued a joint publication called '[Toward Enhanced Professional Skepticism](#)', prepared jointly with IESBA and the IAESB, in which they note that the importance of enhanced professional scepticism is underscored by the increasing complexity of business and financial reporting.

Arnold Schilder, Chairman IAASB

- Professional scepticism is about asking ourselves 'how do we know and how can we be so sure?'. It is about asking critical questions. Audit quality is best achieved in an environment where there is both support and challenge from other participants. Auditors also should be challenged by other stakeholders”.

- We need to talk about this topic because of two factors: complexity and uncertainty. Auditors need to share and explain to people the complexity of judgments behind numbers. We are humans, therefore biases cannot be avoided. We can only minimise the risks but we need to be more proactive and learn how to ask the right questions. Professional scepticism must be incorporated into daily practice that is understandable – it cannot only be a high-level concept.
- IAASB published [Observations](#) of the IAASB-IAESB-IESBA Professional Scepticism Working Group. Seven key observations from the publication: Increased attention to business acumen is central to the exercise of professional scepticism; Environmental factors can influence the ability to exercise professional scepticism; Awareness of personal traits and biases is essential; Building in professional scepticism from the outset is key; There is more that the three standard-setting boards can do, both in the immediate term and the longer term; Beyond audit, aspects of the concepts underlying professional scepticism may be relevant to all professional accountants; Standard setting alone will not be enough.
- High quality audit is a top priority for auditors. Each stakeholder plays an important role supporting high-quality financial reporting. Audit quality is best achieved in an environment where there is support and challenge from other participants.
- Increased interaction is promoted in the IAASB's [Framework for Audit Quality](#).
- Research has showed that if a junior auditor has found and addressed a fundamental error, it has positive outcomes in the rewarding system. However, if it turns out that if the discovery didn't have any impact on the final result and the junior auditor has spent additional time on the audit, it affects the reward negatively. Therefore, reward systems should be balanced and professionals shouldn't feel that they are at risk of negative consequences.
- The tone at the middle, not only at the top is important. An appropriate culture where difficult things can be discussed needs to be created.
- Professional scepticism is about 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 evidence. We need to have in mind a much broader audience here, not just the auditors.
- The IAASB data analytics group has published a year ago a [discussion paper](#) that called for more guidance on how to apply data analytics and artificial intelligence in audit.
- How can investors play a role in encouraging professional scepticism? In the past few years, awards have been issued by several stakeholders, including IMA, for the most insightful and innovative audit reports. This is an important exercise in stimulating professional scepticism.

Andrew Gambier, Head of Audit and Assurance, ACCA

- The main issue behind the ACCA report [Banishing bias? Audit, objectivity and the value of professional scepticism](#) is that professional scepticism is an issue that the public remains very much interested in.
- ACCA's study first looks at the audit process and the constraints that auditors face when they perform the audit. A key constraint for them is information. Management knows much more about the company than the auditor.
- Another issue is resources. In the auditing standard it is accepted that the engagement partner has to take responsibility for the entire engagement. As a result, there are limits to how large the central team and the extended team can be in order for that process to work.

- Thirdly, there is pressure of time. If auditors would have unlimited time to go about the audit, it would be very easy to be sceptical and challenge everything. Because investors need timely reporting, auditors only have limited time in order to make the necessary professional judgement to complete their audit.
- We know from psychology literature that when people make decisions under constraints, they use certain shortcuts. These shortcuts often bring with them flaws that we call cognitive biases.
- The ACCA report identifies 12 cognitive biases that are particularly important to the audit process: hindsight bias; outcome bias; confirmation bias; anchoring bias; availability heuristic; groupthink; overconfidence; recency; conjunction bias; selective perception; stereotyping; blind-spot bias.
- For example, outcome bias is a phenomenon where people tend to assess interventions based on their outcome rather than on whether it appeared reasonable at the time. For example, in reviewing the work of more junior staff, audit managers may judge the work on whether it identified a misstatement. This can mean that interventions that do not identify misstatements are criticised. The anticipation of outcome bias may discourage junior staff from questioning client evidence, in case they are criticised for it, even though it would be professionally sceptical to seek further corroboration. This can be further compounded at the firm level, where the engagement team may be challenged by the firm's leadership over audit efficiency in cases where audit testing has not led to the identification of misstatements. Audit regulators may assess audit quality on the basis of the outcome of a matter, rather than assessing objectively whether the audit judgements were reasonable.
- Another example is groupthink is when a group of people gets together and takes on its own dynamic. Sometimes the group can have views that perhaps the individuals of the group wouldn't subscribe to. In addition, groups may become dominated by an overbearing individual, who can sometimes crowd out some of the minority views on the team. This is not an ideal scenario in a group of people – we want a team of individuals with diverse views that are heard.
- The report didn't just look at auditors – it is important to recognise that cognitive bias can also affect other people in the financial reporting chain. Everybody in the regulatory process is a human being, therefore everybody can potentially be biased. That means that managers bring bias when they prepare financial statements. Audit committees can be biased, as well as regulators and audit standard setters. Even the public can be subject to cognitive bias.
- The report calls for everybody in the financial reporting chain to work together, to think what would really make meaningful improvements in audit and to improve professional scepticism.
- Auditors can do more but everyone needs to support them. Bias can be found everywhere in human decision-making. We need to accept that and work with it. Awareness of bias can help in mitigating it. We are never going to completely mitigate bias but if we are aware if it we can do something about it.

Lieve Cornelis, EY, Partner

- The audit profession has changed enormously over the past ten years. Several trends can be noticed that are impacting professional scepticism. The first trend is that the profession has been very much impacted by the financial crisis and other significant events. As a result, new regulation has been issued over the past years, oversight boards have been established and internal quality programmes have been set up. All this has been done to meet the expectations of stakeholders.

- The environment is rapidly changing. Businesses and technology are evolving very fast. The IT platforms of companies are changing year after year and companies are producing massive amounts of data that needs to be audited.
- Another aspect that influences the professional scepticism is the time spent with the client. This time is always limited – in the short time frame auditors need to understand the client business, identify the main risks, develop an appropriate audit strategy, execute it, document the audit and communicate it.
- Auditors find themselves in a fast-moving business environment in which they need to understand the impact of all these changes within a limited period of time with limited resources and by taking into consideration the flow of new guidance and regulation while maintaining professional scepticism.
- Auditors are taking internal and external measures to meet these challenges. As regards to internal measures, there is a major awareness in the profession on the need for professional scepticism. It is crucial to maintain the right level of professional scepticism. Professionals need to be trained constantly and tools have to be developed in order to support it. Quality assessment programmes have to be increased as well.
- As regards to external measures, regulation is being put in place. There are also new standards and guidance for auditors.
- The new regulation on auditors' rotation in place will definitely help to stimulate professional scepticism. However, practice shows that despite the regulation, audited companies in Belgium are not very much in favour of the rotation. As long as the audited company is not required to change auditor, it will not do it. It takes time to benefit from the regulation and to demonstrate its impact
- Auditors get constantly influenced by many parties. There is a lot of regulation that auditors need to adhere to. On the other side, the auditors' clients do not always understand the benefits of all the regulations and auditors' work.
- It is the auditors' duty to communicate to the clients what is being done and why it is being done. We need to move to a more extensive reporting in order to demonstrate how we use the right professional scepticism.
- It is important to stress that the more checklists we develop, the more difficult it is for professionals to apply the professional scepticism. Checklists often put more burdens on auditing and it might be counterproductive. Communication is the most important solution.
- Auditors obviously need more time and resources but we need to be practical – it often might not be an option. When participating in quality assessment programmes we should also assess things that we shouldn't be doing. There is a major opportunity in taking a step back and reflecting on past actions.
- On a question on the risks and opportunities of new technologies for the profession, she stressed that a lot of data analytics tools are being developed to retrieve data but auditors' work only starts once you have retrieved the data. It is about being able to understand the data, identifying exemptions and further investigating. We need to be sceptical about the information the data analytics tools provide.

Anne-Hélène Monsellato, ecoDa (Chair of its Working Group on Audit Committees) / Chair of Audit Committees in various companies

- How an audit committee will address and understand professional scepticism is highly dependent on its background. The concept of professional scepticism might often not be understood, however board and audit committee members are usually familiar with the underlying concept of questioning mind and critical assessment.

- A lot is implicit in the way we communicate. Auditors need to beware of boilerplate wording and provide examples that demonstrate professional scepticism. More explicit communication highlighting the level of attention put into audit exercise is needed.
- As a specific example on cognitive biases, awareness alone might not be sufficient and there are some techniques that should be learned and implemented.
- Auditors' communication is currently focused a lot on unusual large transactions, difficult audit matters and a lot less on regular audit execution. This certainly has to change.
- It is not an easy task to check if professional scepticism has been properly applied in audit exercise. Audit committees will never have the full view. They can collect information and have indicators of possible good or bad audit, however, they will not know whether professional scepticism has been exercised consistently throughout the audit and whether relevant judgments have been made.
- Audit committees will turn to audit firm internal and external inspections for more positive assurance. The audit reform enabled the audit committee to get access to the assessment by audit regulators of the efficiency of the quality control process in audit firms and detailed inspections results on audit clients. This will help in forming audit committee's views.
- Auditors need to be proactive in demonstrating to audit committees how they have applied professional scepticism in their audit.
- As part of their assessment of auditor performance, audit committees will also want to form views on a certain number of conditions which should lead to better audit quality. For example, is everybody in the team on the same page (right level of training, right level of supervision). Also, what is the internal culture of the audit firm; how much focus is there on non-audit services; is the quality control structure sufficiently and timely embedded in the audit process without losing sight of independence; will the audit committee be informed if there are difficulties, what are the major backstage discussions.
- There is no magic bullet to ensure audit quality and we need to approach the system as a mosaic of checks and balances which together contribute to better audit quality. Better communication between management, CFO, audit committee and auditors will be key for audit quality. Monitoring of this dialogue will help the collective leverage of best practices.

Kristian Koltvedgaard, IESBA CAG Chair & BusinessEurope

- We probably don't all have the same understanding of professional scepticism. The attitude of professional scepticism is important but it cannot be discussed in isolation. It is a multi-faceted topic that is affected by traits, training and culture. Is professional scepticism only applicable to auditors or do we need to address it in a broader ecosystem?
- Important aspects of being a professional accountant are their ethical starting points – their Code. The IESBA Code establishes the foundation for codes of ethics for all professional accountants and is the bedrock of public trust in global accountancy profession
- Public expects that all professional accountants exercise something, which the lay-man understands to be “professional scepticism” in order to make decisions and in exercising professional judgments. The way such exercise of professional scepticism is demonstrated would likely vary depending on the type of service being provided.
- It is important to explore the issue of whether the qualities are different when you are a PAIB compared to a PAPP (public practice).

- The broader question is what we actually want to achieve. Maybe it is not just about meeting the requirements. IESBA is planning on exploring some of these topics in a future Consultation document.
- We also need to ask ourselves how professional scepticism relates to the fundamental principles in the Code of Ethics. When we say that we need to enhance professional scepticism, we need to ask ourselves what is it that we need to enhance. Maybe we need to go beyond standard setting and focus more on education and qualification. The professionals need to learn how to ask the right questions.
- We need to address whether the rules are too complicated and we forget to think and reflect in order to ensure compliance.
- From the business side, we naturally expect auditors that are educated and knowledgeable of the provisions in the Code and auditing standards. We also expect auditors to understand the business to the core. It often happens that when an auditor transitions to business it is the first time it can actually understand it and ask the right questions.
- The codes and the profession are not static – auditors need to be able to adjust to new norms.
- One of the main factors to ensure that you don't give in to group pressure is to have a very good education in order to be able to draw your own conclusions. The more knowledgeable you are, the easier it is to stand your ground.
- Some would argue that if you live up to fundamental principles, you wouldn't need to define professional scepticism. Some people argue that it works the other way around. But we need to come back to the issue of what is actually expected from professional scepticism.

Prof. Dr Kris Hardies, Department Accountancy and Finance, University of Antwerp.

- This emphasis on professional scepticism is fairly recent. Professional scepticism was mentioned for the first time in an audit standard in 1977 (SAS No. 16, on auditors' responsibilities with regard to fraud), but only after the financial crisis it has been starting to get real attention.
- This is also reflected by the attention academics have paid to the topic: 65% of all research on professional scepticism stems from the last 5 years. This highlights one important thing: research on professional scepticism is in its infancy, and our understanding of professional scepticism is limited.
- There are two important components in professional scepticism. Most academics have looked at professional scepticism as being a personality characteristic, something on which individual might differ: some people are inherently more sceptical than others.
- Another aspect is that it is not just about the people – it is often about the context. Certain people might be more sceptical depending on the circumstances.
- Professional scepticism has often been defined as attitude. It would make sense to say that professional scepticism is the product of individual differences and environmental factors. Regulators and standards setters might not understand it in the same way (as academics).
- There has not been much research of environmental factors that impact professional scepticism. We do know for certain that the way the audit partner communicates about professional scepticism is important. Auditors perform better if the partner stresses the importance of professional scepticism and is supportive of team members being professional sceptic. We also know that professional scepticism increases when the control environment of the client is weak.

- Prof. Dr Kris Hardies is currently working on a project, in collaboration with the *Foundation for Auditing Research* and the Dutch audit firms, which is investigating what sort of environmental factors contribute to professional scepticism. Even if auditors are capable of professional scepticism, the environment might hinder them from exercising professional scepticism, so it is important to know what sort of factors can help foster professional scepticism. At the same time, there might be large individual differences in the extent to which people will display professional scepticism even under the right environmental conditions. This could be a problem, but we have actually no idea whether it really is a problem.
- Knowledge and education doesn't necessarily increase the awareness of cognitive biases. Research clearly shows that just being smarter does not eliminate cognitive biases. The most important thing is being aware that cognitive biases are there. Getting feedback might also help in avoiding making the same mistakes in the future. The audit profession can learn a lot from other professions in this area.