

SPOTLIGHT

Professional Competence
and Skepticism Are Essential
to Quality Audits

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Periodically, the staff of the Public Company Accounting Oversight Board (PCAOB) provides reminders to auditors on applying specific PCAOB requirements, including relevant examples. PCAOB staff reminds auditors of the importance of critically assessing the firm's capabilities, obtaining proper understanding of the company they are auditing, and performing work with due professional care and professional skepticism. These matters are particularly important in circumstances where changes to economic conditions or other factors affect the company.

The application of professional skepticism – an attitude that includes a questioning mind – is critical to planning and performing high quality audits and ensuring investors are protected. To apply professional skepticism effectively, auditors should have the necessary industry expertise and knowledge of the companies they audit. Although an auditor's specialist can assist an auditor in various aspects of an audit, the auditor is required to have sufficient knowledge of the subject matter being addressed to properly supervise the engagement. Without the necessary expertise, firms should not accept such engagements.

CLIENT ACCEPTANCE OR CONTINUANCE

PCAOB standards require audit firms to have policies and procedures for deciding whether to accept a new audit client or continue a relationship with an existing client. The policies and procedures should provide the firm with reasonable assurance that it undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.

PCAOB staff emphasizes that the knowledge, skill, and ability of the firm's staff – along with their expected workload – are among key factors affecting the firm's ability to complete audit

engagements with professional competence. Insufficient technical knowledge of matters relating to a particular audit and competing demands on the staff's time are detrimental to the quality of the firm's work, especially if it concerns senior engagement personnel and engagement quality reviewers. Further, changes to a firm's structure or size (e.g., through merger or acquisition) may have a significant effect on staff workload and allocation.

Before accepting a new client or continuing an existing relationship, it is critical that the firm determine whether it already has in place or can obtain sufficient capacity to plan and perform the audit in compliance with PCAOB standards. The auditor's determination is informed, in part, by obtaining a sufficient understanding of the prospective or existing client's business to an extent that enables the firm to make a reasoned assessment of the firm's capacity to properly plan and perform the work. For example, changes in a company's operational strategy (e.g., investment in digital assets) might create new business risks and necessitate changes to staffing and other resources (e.g., audit software) in order to properly conduct the audit.

AUDIT PLANNING

The process of obtaining an understanding of the company's business continues after the auditor decides to accept the audit engagement. An audit engagement should be properly planned to be conducted effectively. Under PCAOB standards, audit planning involves establishing the overall audit strategy for the engagement and developing an audit plan, which includes risk assessment procedures and responses to risks of material misstatement.

PCAOB staff highlights that planning should not be considered as a discrete phase of an audit but rather a continual and iterative process that continues until the audit's completion. Similarly, the auditor's assessment of the risks of material misstatement continues throughout the audit.

For example, when an auditor obtains audit evidence during the course of the audit that contradicts the audit evidence on which the auditor's risk assessment was originally based, the auditor should revise the risk assessment and modify planned audit procedures or perform additional procedures in response to the revised risk assessment.

When planning the audit, the auditor is required to evaluate whether certain matters relating to the company's business are important to the company's financial statements and internal control over financial reporting (ICFR) and, if so, how they will affect the auditor's procedures. To do that effectively, auditors should have a strong understanding of the company's business and the environment in which the company operates, including, for example:

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure
- The extent of recent changes, if any, in the company, its operations, or its ICFR
- Legal or regulatory matters of which the company is aware

For multi-location engagements, the auditor should assess the risks of material misstatement to the consolidated financial statements associated with the selected locations or business units and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

In audits that involve other auditors, the lead auditor is required to, among other things, obtain an understanding of the knowledge, skill, and ability of the other auditor's engagement team members who assist the lead auditor with planning or supervision.

An integral part of audit planning is determining whether specialized skill or knowledge, including relevant knowledge of foreign jurisdictions, is needed to perform appropriate risk assessments, plan or perform audit procedures, or evaluate audit results. Some audit engagements may necessitate using the work of an auditor-employed or engaged specialist (i.e., a person possessing specialized skill or knowledge in a particular field other than accounting or auditing). If the auditor determines that a person with specialized skill or knowledge should participate in the audit, the auditor should have sufficient knowledge of the subject matter to be addressed by such a person to enable the auditor to:

- Communicate the objectives of that person's work;
- Determine whether that person's procedures meet the auditor's objectives; and
- Evaluate the results of that person's procedures as they relate to the nature, timing, and extent of other planned audit procedures and the effects on the auditor's report.

The auditor is responsible for supervising the work of an auditor-employed specialist or performing procedures specified in PCAOB standards when using the work of an auditor-engaged specialist. Such procedures include assessing whether the specialist has the necessary degree of objectivity to exercise impartial judgment on all issues encompassed by the specialist's work related to the audit.

IDENTIFYING AND ASSESSING RISKS OF MATERIAL MISSTATEMENT

Risks of material misstatement can arise from a variety of sources, including external factors, such as conditions in the company's industry and environment, and company-specific factors, such as the nature of the company, its

activities, and ICFR. Properly performed risk assessment procedures should provide the auditor with information about the company and its business that is necessary for the auditor to identify the likely sources of potential misstatements that would cause material misstatements in the company's financial statements and assess the identified risks.

Under PCAOB standards, when identifying and assessing risks of material misstatement, the auditor is required to consider information about the company's business that the auditor obtained during the client acceptance or continuance procedures and audit planning. The auditor is required to build on this knowledge and perform risk assessment procedures that are specifically designed to provide the auditor with further information about the company, its environment, and ICFR.

In particular, obtaining an understanding of the company includes understanding:

- Relevant industry, regulatory, and other external factors;
- The nature of the company;
- The company's selection and application of accounting principles, including related disclosures;
- The company's objectives and strategies and those related business risks that might reasonably be expected to result in risks of material misstatement; and
- The company's measurement and analysis of its financial performance.

The auditor should obtain a sufficient understanding of each component of ICFR to identify the types of potential misstatements, assess the factors that affect the risks of material misstatement, and design further audit procedures. The nature, timing, and extent of the procedures necessary to obtain this understanding depend on the size and

complexity of the company, the auditor's knowledge of the company's ICFR, the nature and extent of changes in systems and operations, and the nature of the company's documentation of its ICFR.

PERFORMING THE WORK WITH DUE PROFESSIONAL CARE

PCAOB standards require the auditor to exercise due professional care, including professional skepticism, in planning and performing the audit. In particular, engagement team members should be assigned to tasks and supervised commensurate with their level of knowledge, skill, and ability so that they can evaluate the audit evidence they are examining.

Exercising professional skepticism is important in all aspects of the audit. It is particularly important in those areas of the audit that involve significant management judgments (e.g., significant assumptions used in an accounting estimate) or transactions outside the normal course of business (e.g., unusually complex financing transactions). When auditors do not appropriately apply professional skepticism, they may not recognize or address situations that can cause the financial statements to be materially misstated or may rely on evidence that is less than persuasive.

Professional skepticism is also important as it relates to the auditor's consideration of and response to fraud risks. Examples of the application of professional skepticism in response to the assessed fraud risks are (a) modifying the planned audit procedures to obtain more reliable evidence regarding relevant assertions and (b) obtaining sufficient appropriate evidence to corroborate management's explanations or representations concerning important matters, such as through third-party confirmation, use of a specialist engaged or employed by the auditor,

or examination of documentation from independent sources.

The engagement partner is responsible for the engagement and its performance. Among other things, the engagement partner is responsible for setting an appropriate tone among the engagement team that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence. This includes being actively involved in planning, directing, and reviewing the work of engagement team members so that matters requiring audit attention are identified and addressed appropriately.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including, for example, by implementing and maintaining appraisal, promotion, and compensation processes that promote rather than discourage the application of professional skepticism and taking necessary corrective actions to address instances in which engagement teams do not apply professional skepticism.

EVALUATING THE RESULTS OF THE AUDIT

In closing, auditors are reminded of their responsibility to take into account all evidence obtained when evaluating the results of the audit, including information regarding potential bias in management's judgments about the amounts and disclosures in the

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financial statements. Examples of forms of management bias include bias in accounting estimates (considered individually and in the aggregate), bias in the selection and application of accounting principles, the selective correction of misstatements identified during the audit, and identification by management of additional adjusting entries that offset misstatements accumulated by the auditor. When evaluating management bias, it is important for auditors to consider the incentives and pressures on management to manipulate the financial statements.

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