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**STAFF AUDIT PRACTICE ALERT NO. 10**  
**MAINTAINING AND APPLYING**  
**PROFESSIONAL SKEPTICISM IN AUDITS**

**December 4, 2012**

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

**Executive Summary**

Professional skepticism is essential to the performance of effective audits under Public Company Accounting Oversight Board ("PCAOB" or "Board") standards. Those standards require that professional skepticism be applied throughout the audit by each individual auditor on the engagement team.

PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. The standards also state that professional skepticism should be exercised throughout the audit process. While 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 or transactions outside the normal course of business. Professional skepticism also is important as it relates to the auditor's consideration of fraud in an audit. When auditors do not appropriately apply professional skepticism, they may not obtain sufficient appropriate evidence to support their opinions or may not identify or address situations in which the financial statements are materially misstated.

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 resulting from certain conditions inherent in the audit environment, scheduling and workload demands, or an inappropriate level of confidence or trust in management. Audit firms and individual auditors should be alert for these impediments and take appropriate measures to assure that professional skepticism is applied appropriately throughout all audits performed under PCAOB standards.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including setting a proper tone at the top that emphasizes the need for professional skepticism; implementing and maintaining appraisal, promotion, and compensation processes that enhance rather than discourage the application of professional skepticism; assigning personnel with the necessary competencies to engagement teams; establishing policies and procedures to assure appropriate audit documentation, especially in areas involving significant judgments; and appropriately monitoring the quality control system and taking necessary corrective actions to address deficiencies, such as, instances in which engagement teams do not apply professional skepticism.

The engagement partner is responsible for, among other things, setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations. It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention, such as unusual matters or inconsistencies in audit evidence, are identified and addressed appropriately.

It is the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including in identifying and assessing the risks of material misstatement, performing tests of controls and substantive procedures to respond to the risks, and evaluating the results of the audit. This involves, among other things, considering what can go wrong with the financial statements, performing audit procedures to obtain sufficient appropriate audit evidence rather than merely obtaining the most readily available evidence to corroborate management's assertions, and critically evaluating all audit evidence regardless of whether it corroborates or contradicts management's assertions.

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on

the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

### **Professional Skepticism and Due Professional Care**

Professional skepticism, an attitude that includes a questioning mind and a critical assessment of audit evidence, is essential to the performance of effective audits under PCAOB standards. The audit is intended to provide investors with an opinion on whether the financial statements prepared by company management are presented fairly, in all material respects, in conformity with the applicable financial reporting framework. If the audit is conducted without professional skepticism, the value of the audit is impaired.

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.<sup>1/</sup> This responsibility includes obtaining sufficient appropriate evidence to determine whether the financial statements are materially misstated rather than merely looking for evidence that supports management's assertions.<sup>2/</sup>

PCAOB standards require the auditor to exercise due professional care in planning and performing the audit and in preparing the audit report. Due professional care requires the auditor to exercise professional skepticism. PCAOB standards define professional skepticism as an attitude that includes a questioning mind and a critical assessment of audit evidence. PCAOB standards require the auditor to exercise professional skepticism throughout the audit.<sup>3/</sup>

While professional skepticism is important in all aspects of the audit, it is particularly important in those areas of the audit that involve significant

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<sup>1/</sup> Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

<sup>2/</sup> See, e.g., paragraph 3 of Auditing Standard No. 8, *Audit Risk* and paragraph 3 of Auditing Standard No. 14, *Evaluating Audit Results*.

<sup>3/</sup> See paragraphs .01 and .07-.08 of AU sec. 230, *Due Professional Care in the Performance of Work*.

management judgments or transactions outside the normal course of business, such as nonrecurring reserves, financing transactions, and related party transactions that might be motivated solely, or in large measure, by an expected or desired accounting outcome. Effective auditing involves diligent pursuit of sufficient appropriate audit evidence, particularly if contrary evidence exists, and critical assessment of all the evidence obtained.

Professional skepticism is also important as it relates to the auditor's consideration of fraud in the audit.<sup>4/</sup> Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.<sup>5/</sup> Company personnel who intentionally misstate the financial statements often seek to conceal the misstatement by attempting to deceive the auditor. Because of this incentive, applying professional skepticism is integral to planning and performing audit procedures to address fraud risks. In exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.<sup>6/</sup>

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.<sup>7/</sup>

PCAOB inspectors continue to observe instances in which the circumstances suggest that auditors did not appropriately apply professional skepticism in their audits.<sup>8/</sup> As examples, audit deficiencies like the following

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<sup>4/</sup> See paragraph .13 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

<sup>5/</sup> AU sec. 316.08.

<sup>6/</sup> See AU secs. 230.07-.09.

<sup>7/</sup> Paragraph 7 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

<sup>8/</sup> The PCAOB is not alone in identifying concerns regarding professional skepticism in audits. Regulators in countries such as Australia, Canada, Germany, the Netherlands, Singapore, Switzerland, and the United

raise concerns that a lack of professional skepticism was at least a contributing factor:

- For certain hard-to-value Level 2 financial instruments, the engagement team did not obtain an understanding of the specific methods and/or assumptions underlying the fair value estimates that were obtained from pricing services or other third parties and used in the engagement team's testing related to these financial instruments. Further, the firm used the price closest to the issuer's recorded price in testing the fair value measurements, without evaluating the significance of differences between the other prices obtained and the issuer's prices.
- The issuer discontinued production of a significant product line during the prior year and introduced a new product line to replace it. There were no sales of the discontinued product line during the last nine months of the year under audit. The engagement team did not test, beyond inquiry, the significant assumptions management used to calculate its separate inventory reserve for this product line.
- The engagement team did not evaluate the effects on the financial statements of management's determination not to test a significant portion of its property and equipment for impairment, despite indicators that the carrying amount may not have been recoverable. These indicators in this situation included operating losses for the relevant segment for the last three years, substantial charges for

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Kingdom have cited concerns about professional skepticism in public reports on their inspections. See, e.g., the Financial Reporting Council's *Audit Quality Inspections Annual Report 2011/12*, available at <http://www.frc.org.uk/Our-Work/Publications/AIU/Audit-Quality-Inspections-Annual-Report-2011-12.aspx>, the Canadian Public Accountability Board's, *Meeting the Challenge "A Call to Action" 2011 Public Report*, available at <http://www.cpab-ccrc.ca/en/content/2011PublicReportEN.pdf>, the Australian Securities & Investments Commission's Report 242, *Audit inspection program public report for 2009 – 2010*, available at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/\\$file/rep242-published-29-June-2011.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep242-published-29-June-2011.pdf/$file/rep242-published-29-June-2011.pdf), and the Accounting and Corporate Regulatory Authority *Practice Monitoring Programme Sixth Public Report*, August 2012, available at <http://www.acra.gov.sg/NR/rdonlyres/E7E2A4BF-EC46-4AB2-877D-297D4E618042/0/PMPReport2012170712finalclean.pdf>.

the impairment of goodwill and other intangible assets during the year, a projected loss for the segment for the upcoming year, and reduced and delayed customer orders.

- After the date of the issuer's balance sheet, but before the release of the firm's opinion, the issuer reported that it anticipated that comparable store sales for the first quarter of the year would be significantly lower than those for the first quarter of the year under audit. The engagement team had performed sensitivity analyses as part of its assessment on the issuer's evaluation of its compliance with its debt covenants, the issuer's ability to continue as a going concern, and the possibility of the impairment of the issuer's long-lived assets. The engagement team did not consider the implications of the anticipated decline in sales on its sensitivity analyses and its conclusions with respect to compliance with debt covenants, the issuer's ability to continue as a going concern, and impairment of long-lived assets.

The PCAOB's enforcement activities also have identified instances in which auditors did not appropriately apply professional skepticism. For example, in one recent disciplinary order, the Board found, among other things, that certain of a firm's audit partners accepted a company's reliance on an exception to generally accepted accounting principles ("GAAP") requirements for reserving for expected future product returns even though doing so conflicted with the plain language of the exception and the firm's internal accounting literature. The partners were aware of, but did not appropriately consider, contradictory audit evidence indicating that the returns were not eligible for the exception. This illustration of a lack of professional skepticism reappeared in the firm's response when the issue was questioned by the firm's internal audit quality reviewers. Although certain of the partners involved determined that the company's reliance on the exception to GAAP did not support the company's accounting, they, along with other firm personnel, formulated another equally deficient rationale that supported the company's existing accounting result.<sup>9/</sup>

### **Impediments to the Application of Professional Skepticism**

Although PCAOB standards require auditors to appropriately apply professional skepticism throughout the audit, observations from the PCAOB's

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<sup>9/</sup> See *In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA, Respondents*, PCAOB Release No. 105-2012-001, (Feb. 8, 2012).

oversight activities indicate that, as a practical matter, auditors are often challenged in meeting this fundamental audit requirement. In maintaining an attitude that includes a questioning mind and a critical assessment of audit evidence, it is important for auditors to be alert to unconscious human biases and other circumstances that can cause auditors to gather, evaluate, rationalize, and recall information in a way that is consistent with client preferences rather than the interests of external users.

Certain conditions inherent in the audit environment can create incentives and pressures that can serve to impede the appropriate application of professional skepticism and allow unconscious bias to prevail. For example, incentives and pressures to build or maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer's filing deadline, achieve high client satisfaction ratings, keep audit costs low, or cross-sell other services can all serve to inhibit professional skepticism.

In addition, over time, auditors may sometimes develop an inappropriate level of trust or confidence in management, which may lead auditors to accede to inappropriate accounting. In some situations, auditors may feel pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management) instead of representing the interests of the investors they are charged to protect.

Other circumstances also can impede the appropriate application of professional skepticism. For example, scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, which might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable, to obtain less evidence than is necessary, or to give undue weight to confirming evidence without adequately considering contrary evidence.

Although powerful incentives and pressures exist that can impede professional skepticism, the importance of professional skepticism to an effective audit cannot be overstated, particularly given the increasing judgment and complexity in financial reporting and issues posed by the current economic environment.<sup>10/</sup> Auditors and audit firms must remember that their overriding duty is to put the interests of investors first. Appropriate application of professional skepticism is key to fulfilling the auditor's duty to investors. In the words of the U.S. Supreme Court:

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<sup>10/</sup> See Staff Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (Dec. 6, 2011).

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>11/</sup>

However, inadequate performance of audit procedures may be caused by factors other than the lack of skepticism, or in combination with a lack of skepticism. As discussed further below, firms should take appropriate steps to understand the various factors that influence audit quality, including those circumstances and pressures that can impede the application of professional skepticism.

### **Promoting Professional Skepticism via an Appropriate System of Quality Control**

PCAOB standards require firms to establish a system of quality control to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality.<sup>12/</sup> This includes designing and implementing policies and procedures that lead engagement teams to appropriately apply professional skepticism in their audits.

Firms' quality control systems can help engagement teams improve the application of professional skepticism in a number of ways, including the following:

- *"Tone-at-the-Top" Messaging.* The PCAOB's inspection findings have identified instances in which the firm's culture allows or tolerates audit approaches that do not consistently emphasize the need for professional skepticism. Consistent communication from firm leadership that professional skepticism is integral to performing a high quality audit, backed up by a culture that supports it, could improve the quality of work performed by audit partners and staff. On the other hand, messages from firm leadership that are

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<sup>11/</sup> *U. S. v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

<sup>12/</sup> See paragraph .03 of Quality Control ("QC") sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.



excessively focused on revenue or profit growth over achieving audit quality, can undermine the application of professional skepticism.

- *Performance Appraisal, Promotion, and Compensation Processes.* An audit firm's performance appraisal, promotion, and compensation processes can enhance or detract from the application of professional skepticism in its audit practice, depending on how they are designed and executed. For example, if a firm's promotion process emphasizes selling non-audit services or places an undue focus on reducing audit costs, or retaining and acquiring audit clients over achieving high audit quality, the firm's personnel may perceive those goals as being more important to their own compensation, job security, and advancement within the firm than the appropriate application of professional skepticism.
- *Professional Competence and Assigning Personnel to Engagement Teams.* A firm's quality control system depends heavily on the proficiency of its personnel,<sup>13/</sup> which includes their ability to exercise professional skepticism. To perform the audit with professional skepticism, it is important that personnel assigned to engagement teams have the necessary knowledge, skill, and ability required in the circumstances,<sup>14/</sup> which includes appropriate technical training and experience. Professional skepticism is interrelated with an auditor's training and experience, as auditors need an appropriate level of competence in order to appropriately apply professional skepticism throughout the audit. In addition, it is important for the firm's culture to continually reinforce the appropriate application of professional skepticism throughout the audit.
- *Documentation.* It is important for a firm's quality control system to establish policies and procedures that cover documenting the results of each engagement.<sup>15/</sup> Although documentation should support the basis for the auditor's conclusions concerning every

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<sup>13/</sup> QC sec. 20.11.

<sup>14/</sup> See QC sec. 20.12.

<sup>15/</sup> See QC secs. 20.17-.18. Also, see *generally* Auditing Standard No. 3, *Audit Documentation*.

relevant financial statement assertion, areas that require greater judgment generally need more extensive documentation of the procedures performed, evidence obtained, and rationale for the conclusions reached. In addition to the documentation necessary to support the auditor's final conclusions, audit documentation must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions.<sup>16/</sup>

- *Monitoring.* Under PCAOB standards, a firm's quality control policies and procedures should include an element of monitoring to ensure that quality control policies and procedures are suitably designed and being effectively applied.<sup>17/</sup> If the firm identifies deficiencies, the firm should evaluate the reasons for the deficiencies and determine the necessary corrective actions or improvements to the quality control system.<sup>18/</sup> Accordingly, if a firm identifies deficiencies that include failures to appropriately apply professional skepticism as a contributing factor, the firm should take appropriate corrective actions.

### **Importance of Supervision to the Application of Professional Skepticism**

The supervisory activities performed by the engagement partner and other senior engagement team members are important to the application of professional skepticism.<sup>19/</sup> The engagement partner is responsible for the proper supervision of the work of engagement team members.<sup>20/</sup> Accordingly, the

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<sup>16/</sup> See, e.g., paragraphs 7-8 of Auditing Standard No. 3.

<sup>17/</sup> See QC sec. 20.07 and paragraph .02 of QC sec. 30, *Monitoring a CPA Firm's Accounting and Auditing Practice*.

<sup>18/</sup> See QC sec. 30.03.

<sup>19/</sup> Besides supervision by the engagement partner and other engagement team members, the engagement quality reviewer also plays an important role in assessing the application of professional skepticism by the engagement team. In particular, the engagement quality reviewer is required to perform specific procedures to evaluate the significant judgments made by the engagement team.

<sup>20/</sup> Paragraph 3 of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

engagement partner is responsible for setting an appropriate tone that emphasizes the need to maintain a questioning mind throughout the audit and to exercise professional skepticism in gathering and evaluating evidence, so that, for example, engagement team members have the confidence to challenge management representations.<sup>21/</sup>

It is also important for the engagement partner and other senior engagement team members to be actively involved in planning, directing, and reviewing the work of other engagement team members so that matters requiring audit attention are identified and addressed appropriately. In directing the work of others, senior engagement team members, including the engagement partner, may have knowledge and experience that may assist less experienced engagement team members in applying professional skepticism. For example, senior engagement team members might help more junior auditors identify matters that are unusual or inconsistent with other evidence. In addition, senior members of the engagement team might be better able to challenge the assertions of senior levels of management, when necessary.

### **Appropriate Application of Professional Skepticism**

Although a firm's quality control systems and the actions of the engagement partner and other senior engagement team members can contribute to an environment that supports professional skepticism, it is ultimately the responsibility of each individual auditor to appropriately apply professional skepticism throughout the audit, including the following areas among others:

- Identifying and assessing risks of material misstatement;
- Performing tests of controls and substantive procedures; and
- Evaluating audit results to form the opinion to be expressed in the auditor's report.

#### *Identifying and Assessing Risks of Material Misstatement*

By its nature, risk assessment involves looking at internal and external factors to determine what can go wrong with the financial statements, whether due to error or fraud. When properly applied, the risk assessment approach set forth in PCAOB standards should focus auditors' attention on those areas of the

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<sup>21/</sup> See paragraph 53 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

financial statements that are higher risk and thus most susceptible to misstatement. This includes considering events and conditions that create incentives or pressures on management or create opportunities for management to manipulate the financial statements. The evidence obtained from the required risk assessment procedures should provide a reasonable basis for the auditor's risk assessments, which, in turn, should drive the auditor's tests of accounts and disclosures in the financial statements.

The risk assessment procedures required by PCAOB standards also should provide the auditor with a thorough understanding of the company and its environment as a basis for identifying unusual transactions or matters that warrant further investigation. They also provide a basis for the auditor to evaluate and challenge management's assertions.<sup>22/</sup> It is important to note that the auditor's understanding should be based on actual information obtained from the risk assessment procedures. It is not sufficient for auditors merely to rely on their perceived knowledge of the industry or information obtained from prior audits or other engagements for the company.

#### *Performing Tests of Controls and Substantive Procedures*

Appropriately applying professional skepticism is critical to obtaining sufficient appropriate audit evidence to determine whether the financial statements are free of material misstatement and, in an integrated audit, whether internal controls over financial reporting are operating effectively. Application of professional skepticism is not merely obtaining the most readily available evidence to corroborate management's assertion.

The need for auditors to appropriately apply professional skepticism is echoed throughout PCAOB standards. For example, PCAOB standards caution that representations from management are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.<sup>23/</sup> Also, the standards warn that inquiry alone does not provide sufficient appropriate evidence to support a conclusion about a relevant assertion.<sup>24/</sup>

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<sup>22/</sup> For example, risk assessment procedures may provide the auditor a basis for challenging management's responses to the required inquiries of management in Auditing Standard No. 12.

<sup>23/</sup> See paragraph .02 of AU sec. 333, *Management Representations*.

<sup>24/</sup> Paragraph 39 of Auditing Standard No. 13.

In addition, PCAOB standards require auditors to design and perform audit procedures in a manner that addresses the assessed risks of material misstatement and to obtain more persuasive evidence the higher the assessment of risk.<sup>25/</sup> The auditor is required to apply professional skepticism, which includes a critical assessment of the audit evidence.<sup>26/</sup> Substantive procedures generally provide persuasive evidence when they are designed and performed to obtain evidence that is relevant and reliable.<sup>27/</sup> When discussing the characteristics of reliable audit evidence, PCAOB standards observe that generally, among other things, evidence obtained from a knowledgeable source independent of the company is more reliable than evidence obtained only from internal company sources and evidence obtained directly by the auditor is more reliable than evidence obtained indirectly.<sup>28/</sup>

Taken together, this means that in higher risk areas, the auditor's appropriate application of professional skepticism should result in procedures that are focused on obtaining evidence that is more relevant and reliable, such as evidence obtained directly and evidence obtained from independent, knowledgeable sources.<sup>29/</sup> Further, if audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should perform the audit procedures necessary to resolve the matter and should determine the effect, if any, on other aspects of the audit.<sup>30/</sup>

The following are examples of audit procedures in PCAOB standards that reflect the need for professional skepticism:

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<sup>25/</sup> See paragraphs 8-9 of Auditing Standard No. 13. For fraud risks and significant risks, the auditor also is required to perform procedures, including tests of details, that are specifically responsive to the assessed risks.

<sup>26/</sup> See AU sec. 230.07.

<sup>27/</sup> Paragraph 39 of Auditing Standard No. 13.

<sup>28/</sup> See paragraph 8 of Auditing Standard No. 15, *Audit Evidence*.

<sup>29/</sup> See paragraph 9.a. of Auditing Standard No. 13.

<sup>30/</sup> Paragraph 29 of Auditing Standard No. 15.

- Resolving inconsistencies in or doubts about the reliability of confirmations;<sup>31/</sup>
- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;<sup>32/</sup>
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud;<sup>33/</sup>
- Evaluating the business rationale for significant unusual transactions;<sup>34/</sup> and
- Evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.<sup>35/</sup>

*Evaluating Audit Results to Form the Opinion to be Expressed in the Audit Report*

When professional skepticism is applied appropriately, the auditor does not presume that the financial statements are presented fairly in conformity with the applicable financial reporting framework. Instead, the auditor employs an attitude that includes a questioning mind in making critical assessments of the evidence obtained to determine whether the financial statements are materially misstated. PCAOB standards indicate that the auditor should take into account all relevant audit evidence, regardless of whether the evidence corroborates or contradicts the assertions in the financial statements.<sup>36/</sup> Examples of areas in the evaluation that reflect the need for the auditor to apply professional skepticism, include, but are not limited to, the following:

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<sup>31/</sup> See, e.g., paragraphs .27 and .33 of AU sec. 330, *The Confirmation Process*.

<sup>32/</sup> See AU secs. 316.58-.62.

<sup>33/</sup> See AU secs. 316.63-.65.

<sup>34/</sup> See AU secs. 316.66-.67.

<sup>35/</sup> See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

<sup>36/</sup> See paragraph 3 of Auditing Standard No. 14.

- *Evaluating uncorrected misstatements.* This includes evaluating whether the uncorrected misstatements identified during the audit result in material misstatement of the financial statements, individually or in combination, considering both qualitative and quantitative factors.<sup>37/</sup>
- *Evaluating management bias.* This includes evaluating potential bias in accounting estimates, 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.<sup>38/</sup> When evaluating bias, it is important for auditors to consider the incentives and pressures on management to manipulate the financial statements.
- *Evaluating the presentation of the financial statements.* This includes evaluating whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework.<sup>39/</sup>

When evaluating misstatements, bias, or presentation and disclosures, it is important for auditors to appropriately apply professional skepticism and avoid dismissing matters as immaterial without adequate consideration.

## **Conclusion**

The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits, which includes an attitude of a questioning mind and a critical assessment of audit evidence. The timing of this release is intended to facilitate firms' emphasis in upcoming calendar year-end audits, as well as in future audits, on the importance of the appropriate use of professional skepticism. Due to the fundamental importance of the appropriate application of professional skepticism in performing an audit in accordance with PCAOB standards, the PCAOB also is continuing to explore whether additional actions might meaningfully enhance auditors' professional skepticism.

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<sup>37/</sup> See paragraph 17 of Auditing Standard No. 14.

<sup>38/</sup> See paragraph 25 of Auditing Standard No. 14.

<sup>39/</sup> See paragraphs 30-31 of Auditing Standard No. 14.

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