Critical Thinking & Professional Skepticism
Key Skills for Auditors
Discussion Areas

- Relevant IIA Standards
- Definitions of key concepts
- Thinking frameworks
- Application to the audit process
Relevant IIA Standards

- **1100** – … must be independent, and be objective in performing work.
  - Objectivity is unbiased mental attitude … perform engagements in such a manner that they believe in work product and that no quality compromises are made. … do not subordinate judgment on audit matters to others.

- **1220.A1** – … must exercise due professional care by considering:
  - Extent of work needed to achieve engagement’s objectives;
  - Relative complexity, materiality, or significance of matters to which assurance procedures are applied;
  - Adequacy and effectiveness of governance, risk management, and control processes;
  - Probability of significant errors, fraud, or noncompliance; and
  - Cost of assurance in relation to potential benefits.
Relevant IIA Standards

- 2120.A2 – … must evaluate the potential for occurrence of fraud and how organization manages fraud risk.

- 2210.A2 – … must consider probability of significant errors, fraud, noncompliance, and other exposures when developing engagement objectives.

- 2310 – … must identify sufficient, reliable, relevant, and useful information to achieve the engagement’s objectives.
3.11 Auditors’ objectivity in discharging professional responsibilities is basis for credibility... Objectivity includes independence of mind and appearance when conducting engagements, maintaining attitude of impartiality, having intellectual honesty, and being free of conflicts of interest. Maintaining objectivity includes continuing assessment of relationships with audited entities and other stakeholders ...

8.71 Auditors should assess risk of fraud occurring that is significant within context of audit objectives... Auditors should gather and assess information to identify the risk of fraud that is significant within scope of audit objectives or that could affect findings and conclusions.

8.72 Assessing risk of fraud is ongoing process throughout audit...

8.90 Auditors must obtain sufficient, appropriate evidence to provide reasonable basis for addressing audit objectives and supporting findings and conclusions.
Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is attitude that includes questioning mind and critical assessment of audit evidence. The auditor uses knowledge, skill, and ability ... to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence. ...requires auditor to consider the competency and sufficiency of evidence. ...professional skepticism should be exercised throughout the audit process. Auditor neither assumes management is dishonest nor assumes unquestioned honesty. ...auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. [AS 1015.07]

Most problems auditors face from litigation do not result from a failure to apply necessary auditing procedures — or to apply them properly. The problems usually stem from the way auditors react — or don’t react — to information at hand when they accept or retain clients, or when auditors evaluate evidence developed during their examinations.

Components of Professional Skepticism

- Knowledge and reasoning
  - Technical and auditing skills
  - Industry knowledge and experience
  - Objective and rational thinking

- Interpersonal skills
  - Reading other people, their approach to their jobs, lifestyle, and personality traits
  - Effectively communicating with others, regardless of their position or power
  - Probing or questioning others
  - Dealing with conflict

- Personal outlook

<table>
<thead>
<tr>
<th>Accepting</th>
<th>Open-Minded</th>
<th>Critical of Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Optimistic</td>
<td>Realistic</td>
<td>Pessimistic</td>
</tr>
<tr>
<td>Disinterested</td>
<td>Curious</td>
<td>Suspicious</td>
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</tbody>
</table>
Professional Judgment

**Process** used to reach well-reasoned conclusion
- based on the relevant facts and circumstances
- sufficient knowledge and experience
- identification (without bias) of alternatives; consideration of information contradictory to desired conclusion
- objectivity and professional skepticism essential
“Why Good Accountants Do Bad Audits”

- Basic theory that we all have self-interest, desire for achievement and success.
- See ourselves as knowledgeable in our own areas of interest, and tend to interpret and apply prior experiences to new ones.
- Risk discounting facts that contradict our conclusions and embracing facts that support our viewpoints.

<table>
<thead>
<tr>
<th>Aspects that “amplify unconscious bias”</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Familiarity</strong></td>
</tr>
<tr>
<td>That auditors are less willing to find discrediting information on individuals or organizations that they know well.</td>
</tr>
<tr>
<td><strong>Discounting</strong></td>
</tr>
<tr>
<td>The fact that immediate consequences tend to receive more emphasis than delayed outcomes, particularly when the delayed outcomes are uncertain.</td>
</tr>
<tr>
<td><strong>Escalation</strong></td>
</tr>
<tr>
<td>Minor indiscretions and errors created by unconscious bias may evolve into conscious corruption.</td>
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</tbody>
</table>

Professional Evaluation Framework

The auditor’s thought process when encountering an unexpected result …

<table>
<thead>
<tr>
<th>What have we seen like this?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Should we accept the results?</td>
</tr>
<tr>
<td>What will be the result of accepting?</td>
</tr>
<tr>
<td>How does this compare with previous experience?</td>
</tr>
<tr>
<td>What is your opinion based on the above?</td>
</tr>
<tr>
<td>Is there something to report? … To whom?</td>
</tr>
</tbody>
</table>

Potential Options

| Accept and close | Inquire for further explanation | Expand the examination | Report the situation |

Professional Skepticism Recommendations - PCAOB

- Set appropriate tone; emphasize questioning mind throughout audit and exercise of professional skepticism in gathering and evaluating evidence
- Design and execute performance appraisal, promotion, compensation systems that foster skepticism
- Enhance professional competence and supervision and assignment of staff
- Appropriately leverage knowledge and experience in supervising junior staff and, if necessary, to challenge assertions of senior management
- Partners actively involved in planning, directing, and reviewing work
- Encourage confidence of engagement team to challenge management representations
- Monitor firm’s quality controls and respond appropriately to deficiencies, including those involving a lack of appropriate professional skepticism
Planning Process
Applying Critical Thinking
Interview Considerations

- Pre-interview preparation
  - Location of interview
  - Attendees
  - Homework

- Interview conduct
  - Open-ended questions
  - Avoid leading questions
  - Take notes — but use caution
  - Hold conversation, not question & answer session
  - Be willing/able to change direction; flip questions
Test Design Considerations

- Understanding linkage between organization’s strategies, objectives, associated risks and risk mitigation activities BEFORE developing test plan.
Fieldwork Process
Applying Critical Thinking
## Evidence Considerations

<table>
<thead>
<tr>
<th>Less Persuasive</th>
<th>More Persuasive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subjective Evidence</td>
<td>Objective Evidence</td>
</tr>
<tr>
<td>Undocumented Evidence</td>
<td>Documented Evidence</td>
</tr>
<tr>
<td>Created Within the Organization</td>
<td>3rd Party Evidence</td>
</tr>
<tr>
<td>Smaller Samples</td>
<td>Larger Samples</td>
</tr>
<tr>
<td>Non-statistical Samples</td>
<td>Statistical Samples or Data Mining</td>
</tr>
<tr>
<td>Uncorroborated Evidence (i.e., interviews)</td>
<td>Corroborated Evidence (i.e., substantive testing)</td>
</tr>
</tbody>
</table>

- **Interview**
  - Uncorroborated Untested
- **Observation**
- **Analytic Review**
- **Vouch/Trace**
- **Reperform**
- First Hand Direct Factual
Test Results or Business Issues?

Objectives

Risks

Risk Mitigation

• Controls plus

Control Design?

- Good?
- Control
- Substantive

Bad?

Test Plan

• Level of reliability?
• Type of objective?

Test Results

Business Impact & Conclusion
Understanding Test Results

WHY

Cause

- Ignorant of policy
- No time
- Ignorant of importance
- No consequence
- Not trained

Effect

- Supervisors not reviewing
- Form 123 not in use
- Reconciliations not prepared

Impact/Risk

- Unauthorized purchases processed and not detected

SO WHAT

Focus Observation on Impact

Focus Recommendation and Action Plan on Cause
Communicating Results

Applying Critical Thinking
Sharing Insights

- Context
- Business issue
- Action plans to address cause
- Themes
- Viewpoints

Business acumen and critical thinking required!
Final Thoughts
Conclusions

- Professional skepticism and critical thinking skills fundamental to effective auditing – at all stages of the audit
- Effective audit starts with understanding objectives and risks to achieving objectives, not with identifying existing controls
- Appropriate test design fundamental to reliable conclusions
- Communicate results with context, clear business issue, and effective action plans
- Don’t ignore your ‘sixth sense’!