



# CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

May 16, 2016

## EXECUTIVE DIRECTOR

Cynthia M. Fornelli

## GOVERNING BOARD

Chair

Cathy Engelbert, CEO  
Deloitte LLP

Vice Chair

Joe Adams, Managing Partner and CEO  
RSM US LLP

Wayne Berson, CEO  
BDO USA LLP

Lynne M. Doughtie, U.S. Chairman and CEO  
KPMG LLP

Michele J. Hooper, President and CEO  
The Directors' Council

Stephen R. Howe, Jr., U.S. Chairman and  
Managing Partner, Americas Managing  
Partner, EY

J. Michael McGuire, CEO  
Grant Thornton LLP

Barry C. Melancon, President and CEO  
American Institute of CPAs

Robert E. Moritz, Chairman and Senior  
Partner  
PricewaterhouseCoopers LLP

Lynn S. Paine, Senior Associate Dean  
Harvard Business School

James L. Powers, CEO  
Crowe Horwath LLP

Mary Schapiro, Vice Chairman Advisory Board  
Promontory Financial Group

Ms. Kathleen K. Healy  
Technical Director  
International Auditing and Assurance Standards Board  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA

Re: *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*

Dear Ms. Healy:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs.

The CAQ appreciates the opportunity to respond to the International Auditing and Assurance Standards Board's (IAASB) *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (the ITC). The IAASB's work on professional skepticism as an essential input to audit quality correlates with work undertaken by the CAQ. For example, through collaborative initiatives with other stakeholder groups, the CAQ has contributed to market-based tools and resources aimed at reinforcing the need for professional skepticism throughout the financial reporting supply chain.<sup>1</sup> As noted in the IAASB's *A Framework for Audit Quality*, while auditors are primarily responsible for delivering on their commitment to audit quality, "audit quality is best achieved in an environment where there is support from other participants in the financial reporting supply chain."<sup>2</sup> The CAQ encourages the IAASB to continue

<sup>1</sup> For example, the CAQ participates in the Anti-Fraud Collaboration with Financial Executives International, the National Association of Corporate Directors, and the Institute of Internal Auditors, to leverage existing resources and facilitate the development of tools, resources and other information targeted to each member of the financial reporting supply chain to assist them in their role in deterring and detecting fraud. More information on the Anti-Fraud Collaboration is available at <http://www.thecaq.org/policy/anti-fraud-collaboration>. See also, the Audit Committee Collaboration at <http://www.auditcommitteecollaboration.org/>. The CAQ also worked with the Standards Working Group of the Global Public Policy Committee to commission and distribute the paper *Enhancing Auditor Professional Skepticism* in November 2013. That paper, co-authored by Professors Douglas F. Prawitt and Steven M. Glover, provides ideas and recommendations on how the application of professional skepticism might be enhanced by auditors. The paper is available at <http://www.thecaq.org/docs/research/skepticismreport.pdf>. See also, *Professional Judgment Resource* (2014), which is designed to provide auditors with an example of a decision-making process to facilitate important auditing and accounting judgments in a professionally skeptical manner. The paper is available at <http://www.thecaq.org/reports-and-publications/professional-judgment-resource>.

<sup>2</sup> IAASB, *A Framework for Audit Quality* (2013), p. 3, available at <http://www.ifac.org/system/files/publications/files/A%20Framework%20for%20Audit%20Quality.pdf>.

its work on developing a holistic global view of audit quality and applauds the IAASB's outreach to gather multi-stakeholder input on these important topics. The auditing profession is committed to working with all stakeholders to continually improve audit quality and enhance the confidence investors and others place in the integrity of audited financial statements.

Our comments are specifically focused on our views related to professional skepticism and quality control. We are not providing comments on group audits at this time in anticipation of developing a CAQ response to the U.S. Public Company Accounting Oversight Board's (PCAOB) *Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm*.<sup>3</sup> This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

### Summary of key recommendations

As we explain in further detail in this letter, the CAQ believes that the IAASB should consider implementing the following measures to enhance the consistency of execution by auditors of an appropriate level of professional skepticism and application of ISQC 1. It is important to highlight that although we believe that more clarification and interpretation through additional guidance on how auditors can appropriately apply professional skepticism under the standards is needed, we feel it is essential that auditing standards continue to be principles-based and non-prescriptive. The amount of additional guidance should be sufficient to make the standards operational, but should not seek to answer every possible question. Also, at this time we are not proposing that any of the auditing standards need to be revised. Rather, as the IAASB considers revisions to existing standards or the development of new standards, the IAASB should consider whether to include application material within the standard that would help guide the auditor's appropriate application of professional skepticism.

- As a first step, supplement the IAASB staff's guidance that was issued in February 2012 to provide clear direction and practical application examples on what behaviors and actions constitute appropriate professional skepticism in executing an auditor's responsibility to obtain sufficient appropriate audit evidence across a range of risk scenarios for different assertions and accounts.
- Over the longer term and as the IAASB revises existing standards and develops new standards, the IAASB should consider whether the concepts included in the international standard for auditing accounting estimates can be incorporated into those standards. This includes both performance standards and those dealing with a firm's system of quality control.
- Establish a process to carefully consider the potential impact of proposed standards based on existing drivers of and impediments to professional skepticism.
- Offer supplemental guidance to the quality control standards that provides examples of how firms can meet the objectives of ISQC 1, such as by using a Quality Management Approach, and incorporate methodologies for identifying root causes and approaches to remediation that includes discussion on how various factors can impact skepticism, and on how a firm may utilize information about underlying causes of both negative and positive quality events to enhance the firm's quality control system.

### Appropriate application of professional skepticism requires more than a questioning mindset

While the CAQ views a questioning mindset as a starting point for appropriate application of professional skepticism, auditors must also understand that even the best managed organizations can be susceptible to

---

<sup>3</sup> PCAOB Release No. 2016-002 (April 12, 2016), available at <http://pcaobus.org/Rules/Rulemaking/Docket042/2016-002-other-auditors-proposal.pdf>.

misstatement or fraud. The appropriate application of professional skepticism requires the auditor to apply critical reasoning throughout the audit of financial statements; it is embedded in the process of finding a supported conclusion, not a biased justification of management's assertion. An auditor's fortitude to challenge management and gather additional audit evidence, as needed based on the auditor's risk assessment, is an important part of the auditor's appropriate application of professional skepticism.

Professional skepticism is defined in international auditing standards. The standard requires "a questioning mind" and a "critical assessment of audit evidence."<sup>4</sup> In the CAQ's view, to be operational, these concepts of a questioning mind and critical assessment need to be supplemented with clear direction and practical application examples on what behaviors, actions, and documentation constitute appropriate professional skepticism in executing an auditor's responsibility to obtain sufficient appropriate audit evidence across a range of risk scenarios for different assertions and accounts. The CAQ believes that greater clarity would contribute to more consistency in expectations on how far an auditor needs to go in collecting, assessing, and documenting evidence to demonstrate the skeptical mindset and critical challenge of management's assertions. For example, in some cases, as part of the risk assessment process, the auditing standards require auditors to take a presumptive doubt view with respect to an account or subset of an account in which the auditor presumes a level of fraud risk.<sup>5</sup> When auditing standards do not call for a heightened level of professional skepticism, the auditor approaches the risk assessment with a more neutral perspective.<sup>6</sup>

Regulators and other stakeholders may have expectations about the level of skepticism auditors should apply in evaluating management assertions that differ from those one might interpret from the auditing standards.<sup>7</sup> Independent audit regulators identify a number of root causes related to a lack of professional skepticism in their inspection findings, but it's unclear whether the findings can be attributed to deficiencies in connection with professional judgment, action, or documentation.<sup>8</sup> Regulators and standards-setters could provide more application guidance to auditors that includes examples that illustrate their expectations regarding the appropriate application of professional skepticism in assessing audit risks in certain areas, and how to reflect that in documentation. For example, the UK Financial Reporting Council's *Thematic Reviews* communicate both good practices and areas of common weakness in relation to the application of professional skepticism.<sup>9</sup>

Some academic observers note that the absence of clear direction and practical application guidance on what behaviors and actions constitute appropriate professional skepticism may have led to varied practices by auditors and an environment in which "reasonable observers, professionals, and regulators might understandably disagree."<sup>10</sup> The CAQ believes that, as a first step, the IAASB could provide supplemental guidance which would promote greater consistency and more effective application of professional skepticism, and reinforce its importance to audit quality across the audit profession. For example, in February 2012, the

---

<sup>4</sup> IAASB, ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* (2009).

<sup>5</sup> See IAASB, *Staff Questions and Answers: Professional Skepticism in an Audit of Financial Statements* (2012), p. 9, which cites certain paragraphs of ISA 240 that require presumption that there are risks of fraud in revenue recognition (par. 26-27), the treatment of risks of management override as a risk of material misstatement due to fraud and thus a significant risk (par. 31), and required procedures addressing the review of accounting estimates for biases (par. 32(b)).

<sup>6</sup> *Id.*, p. 4, citing ISA 200, par. A18.

<sup>7</sup> See for example, Basel Committee on Banking Supervision, *External Audits of Banks* (Mar. 2014), p. 28, which establishes that "professional skepticism should manifest itself not only through the auditor obtaining corroborating evidence for management's assertions, but also challenging management's assertions, considering whether there are alternative accounting treatments that are preferable to those selected by management, and documenting the auditing approach, the evidence obtained, the rationale applied and conclusions reached."

<sup>8</sup> See International Forum of Independent Audit Regulators, *Report on 2015 Survey of Inspection Findings* (Mar. 2016), p. 23, available at <https://www.ifiar.org/IFIAR/media/Documents/General/About%20Us/IFIAR-2015-Survey-of-Inspection-Findings.pdf>.

<sup>9</sup> UK Financial Reporting Council, *Audit Quality Thematic Review: Fraud risks and laws and regulations* (Jan. 2014), p. 16, available at <https://frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Fraud-Risks-and-Laws.pdf>.

<sup>10</sup> See, for example, Steven M. Glover and Douglas F. Prawitt, "Enhancing Auditor Professional Skepticism" (Nov. 2013), p. 3, available at <http://thecaq.org/docs/research/skepticismreport.pdf>. Also, M.W. Nelson, "A model and literature review of professional skepticism in auditing," *Auditing: A Journal of Practice & Theory* 29 2: 1-34.

IAASB issued *Staff Questions & Answers – Professional Skepticism in an Audit of Financial Statements*, which provides auditors with in-depth information regarding expectations under the standards for the appropriate application of skepticism in an audit of the financial statements. The IAASB staff could build upon this guidance to provide examples of how the concepts articulated in the Q&A could be applied across a range of risk scenarios for different assertions and accounts.

In addition, the CAQ recommends that as the IAASB develops new standards or revises existing standards, the IAASB should consider infusing in those standards application guidance on how skepticism should be applied during the risk assessment at the account and assertion level. The application guidance also could inform the determination of what constitutes sufficient appropriate audit evidence. The “professional skepticism continuum” developed by Professors Glover and Prawitt illustrates how an auditor appropriately applies professional skepticism to the auditor’s assessment of the risk of material misstatement, indicators of fraud, and detection of errors, among others.<sup>11</sup> When the auditor’s assessment indicates low risk, the auditor’s judgment as to what constitutes sufficient appropriate audit evidence for an assertion should be less extensive than when the auditor’s assessment indicates a higher risk. The process of obtaining evidence – and how much to obtain – in the specific circumstances will help auditors demonstrate how they have applied professional skepticism. Glover and Prawitt posit that explicit integration of this skepticism continuum by audit firms, standards setters, and regulators could enhance consistency of appropriate application of professional skepticism by auditors.<sup>12</sup>

A model of how the IAASB might incorporate a professional skepticism continuum into individual auditing standards is the IAASB’s standard on auditing accounting estimates.<sup>13</sup> The standard includes application guidance that provides a roadmap to get the auditor in the appropriate questioning mindset by considering various factors such as, for example, an accounting estimate’s level of estimation uncertainty and susceptibility to management bias or fraud.<sup>14</sup> The guidance provides that the “susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it” and includes examples of factors that may influence the degree of estimation uncertainty and subjectivity of an accounting estimate.<sup>15</sup> Applying Glover and Prawitt’s skepticism continuum to the example of the auditor becoming alert to indicators of management bias, which indicate higher risk and susceptibility of material misstatement, the auditor would alter the nature, timing, and extent of procedures or evidence based on the auditor’s risk assessment.<sup>16</sup>

The application guidance in the standard advises an auditor who has concluded that management bias may exist to design and perform additional audit procedures to obtain sufficient relevant audit evidence. For example, the guidance advises the auditor to consider developing an independent estimate to evaluate management’s estimate and provides examples of approaches, including a point estimate or a range.<sup>17</sup> In such a case, the auditor’s development of an independent estimate may include a review of the evidence that might indicate that management’s assumptions are not reasonable and would demonstrate the auditor’s skeptical attitude.<sup>18</sup> The guidance reinforces the need for auditors to continue to be alert to indicators of management bias throughout the audit and advises auditors to use their documentation of possible

---

<sup>11</sup> See Glover and Prawitt, p. 4.

<sup>12</sup> Id, p. 6.

<sup>13</sup> ISA 540, *Auditing Accounting Estimates, Including Fair Value Estimates, and Related Disclosures* (2009). Although the IAASB is considering changes to ISA 540, the concepts in the standard as currently written provide a general basis for aligning the level of skepticism required with the auditor’s assessment of risk.

<sup>14</sup> ISA 540, par. A12-A51.

<sup>15</sup> ISA 540, par. A9, A45.

<sup>16</sup> Glover and Prawitt, p. 4-5.

<sup>17</sup> ISA 540, par. 16, A111-A112.

<sup>18</sup> Glover and Prawitt, p. 5

management bias identified during the audit to confirm “whether the auditor’s risk assessment and related responses remain appropriate.”<sup>19</sup>

According to Glover and Prawitt, always applying a presumptive doubt mindset in the absence of conditions that suggest susceptibility of material misstatement “may lead to unnecessary costs being imposed on the reporting entity and ultimately on investors.”<sup>20</sup> Conversely, overreliance on a neutral approach, which Glover and Prawitt define as “neither assuming management dishonesty nor unquestioned honesty,” may result in situations in which the audit evidence gathered is insufficient to support a conclusion that rules out fraud or material misstatement.<sup>21</sup> The CAQ believes that infusing auditing standards with additional application guidance that provides examples of how the auditor can demonstrate that he or she has addressed the assessed level of risk in a professionally skeptical manner is a step the IAASB can take to enhance the consistency and effectiveness of the appropriate application of auditor professional skepticism in practice.

### Drivers of and impediments to appropriate application of professional skepticism by auditors

The ITC requests input on what commenters “believe are the drivers for, and impediments to, the appropriate application of professional skepticism.”<sup>22</sup> The CAQ, together with the public company auditing profession and other collaborating partners, has studied the role of the appropriate application of professional skepticism in supporting sound auditor judgments and contributing to conditions that might make an organization less susceptible to financial reporting fraud.<sup>23</sup> Through that work, the CAQ has identified both drivers of and impediments to the appropriate application of professional skepticism. The following paragraphs outline what we have learned about drivers of and impediments to the appropriate application of professional skepticism that the IAASB may want to consider as it brings forth new proposals.

Auditor independence, objectivity, and professional skepticism are all critical to audit quality. For auditors to fulfill their duty to apply professional skepticism and obtain reasonable assurance about whether the financial statements, taken as a whole, are free from material misstatement, they must be independent of management and be able to perform their tasks with an objective perspective.

Independence and objectivity are essential to professional skepticism, but there are other drivers that bear on one’s ability to exercise skepticism. The CAQ views drivers of skepticism as a combination of personality traits, learned skills, and incentives.

#### *Personality traits*

Professor Kathy Hurtt of Baylor University utilized six personality traits that contribute to skepticism which she used to develop a scale to measure skepticism.<sup>24</sup> The “Six Characteristics of Skepticism” are:

- Questioning mind – A disposition to inquiry, with some sense of doubt.
- Suspension of judgment – Withholding judgment until appropriate evidence is obtained.

---

<sup>19</sup> ISA 540, par. A125.

<sup>20</sup> Glover and Prawitt, p. 6.

<sup>21</sup> Id.

<sup>22</sup> The ITC, p. 87.

<sup>23</sup> See, e.g., *Professional Judgment Resource* (August 2014), available at <http://www.thecaq.org/reports-and-publications/professional-judgment-resource>, and The Anti-Fraud Collaboration, *The Fraud Resistant Organization* (Nov. 2014), available at <http://www.thecaq.org/reports-and-publications/the-fraud-resistant-organization/the-fraud-resistant-organization>. See, also, *The External Auditor Assessment Tool* (2015), available at <http://www.thecaq.org/reports-and-publications/external-auditor-assessment-tool>, and Professors Steven Glover and Doug Prawitt, *Enhancing Auditor Professional Skepticism* (Nov. 2013), available at <http://www.thecaq.org/docs/research/skepticismreport.pdf>.

<sup>24</sup> R. Kathy Hurtt, “Development of a Scale to Measure Professional Skepticism,” *Auditing: A Journal of Practice and Theory* (May 2010). See also, Mark W. Nelson, “A Model and Literature Review of Professional Skepticism in Auditing,” *Auditing: A Journal of Practice and Theory* (Nov. 2009), p. 2, which includes the traits of “problem-solving ability, ethical predisposition, and other traits like self-confidence and tendency to doubt.”

- Search for knowledge – A desire to investigate beyond the obvious, with a desire to collaborate.
- Interpersonal understanding – Recognition that people’s motivations and perceptions can lead them to provide biased or misleading information.
- Autonomy – The self-direction, moral independence, and conviction to decide for oneself, rather than accepting the claims of others.
- Self-esteem – The self-confidence to resist persuasion and to challenge assumptions or conclusions.

Professor Hurt used her skepticism scale to test the correlation of the presence of these six personality traits in individual auditors with their propensity to respond to “skepticism-inducing audit circumstances” by changing their behaviors to search for more persuasive audit evidence and generate alternative explanations.<sup>25</sup> Hurtt found that, in general, auditors who possessed the characteristics or personality traits of skepticism applied greater levels of skepticism than did those with less of those characteristics when presented with a skepticism-inducing audit scenario.<sup>26</sup>

### *Learned skills*

Auditing skills acquired through education and experience also are important drivers of professional skepticism. Auditors who possess the appropriate knowledge and experience to make judgments can identify those facts and circumstances that impact risks and issues related to the audit. Having this knowledge and experience enables the auditor to focus on gathering evidence that is most pertinent to analyzing those matters. Academic studies suggest that auditors with high levels of industry specialization and other audit experience “are better able to identify high-frequency errors and complex patterns of evidence that indicate error....”<sup>27</sup> Studies also suggest that auditors’ technical accounting knowledge is a critical driver of fortitude in presenting and resolving challenges with management over accounting treatments.<sup>28</sup>

While innate ability or experience can be very helpful in exercising appropriate professional skepticism, they do not always overcome the potential for judgment tendencies and bias. For example, academic literature poses that while auditor knowledge gained through experience and industry specialization can have positive effects on professional skepticism, they also can have negative impacts and contribute to judgment tendencies.<sup>29</sup> Common judgment tendencies that can lead to bias and weaken skepticism are overconfidence, confirmation, anchoring and availability.<sup>30</sup> As Professors Glover and Prawitt note, such “bias-inducing tendencies” can cause “even the brightest, most experienced” auditors to make “suboptimal judgments.”<sup>31</sup>

### *Incentives*

Audit firms, audit committees, and independent audit oversight interact to drive professional skepticism by providing incentives favoring professional skepticism and offsetting potential judgment tendencies and other factors that can weaken professional skepticism. Audit firms’ leadership can promote a firm culture that recognizes and reinforces professional skepticism as being essential – and therefore expected. As noted by

---

<sup>25</sup> R. Kathy Hurtt et al., *Measuring professional skepticism to provide a link to skeptical behaviors* (2009). Working paper, Baylor University, p. 23.

<sup>26</sup> *Id.*, p. 24.

<sup>27</sup> See Nelson, p. 2, 7-8.

<sup>28</sup> *Id.*, p. 16.

<sup>29</sup> *Id.*, pp. 7-8. See also, Glover and Prawitt, p. 11, and CAQ, *Professional Judgment Resource*, pp. 10-11.

<sup>30</sup> See Glover and Prawitt, p. 11, in which they define overconfidence bias as “the tendency of decision makers to overestimate their own abilities to perform tasks or make accurate assessments of risk or other judgments and decisions.” Confirmation bias is “the tendency to seek and overweight confirming information in the information-gathering and evaluation steps, and to favor conclusions that are consistent with initial beliefs or preferences.” Anchoring bias is “the tendency to make assessments in gathering and evaluating information by starting from an initial value and then adjusting insufficiently away from that initial value in forming a final judgment.” They define the availability bias as “the tendency for decision makers to consider information that is more readily available from memory as being more likely, relevant, or more important for a judgment.”

<sup>31</sup> *Id.*, p. 10.

IAASB staff, audit firms have opportunities to set expectations regarding the appropriate application of professional skepticism on audit engagements through their systems of quality control.<sup>32</sup> For example, a firm can emphasize through performance evaluation, compensation, and promotion processes that appropriate application of professional skepticism on all engagements the firm performs is a requirement that overrides other business objectives and pressures, such as budgeting issues.<sup>33</sup> Firms can use internal monitoring of quality controls and engagement performance to reinforce expectations regarding the appropriate application of skepticism.<sup>34</sup>

Firms also can use training and professional development programs to emphasize in their audit professionals the importance of infusing their work with skepticism.<sup>35</sup> Some firms utilize training tools that help engagement teams understand what professional skepticism “looks and sounds like” when auditors apply it.<sup>36</sup> The CAQ believes that auditors who are trained in and use a disciplined and rigorous decision-making process possess an enhanced ability to more easily avoid judgment traps and biases and effectively and efficiently apply professional skepticism and exercise sound judgment. The CAQ designed a *Professional Judgment Resource* to provide auditors with an example of a decision-making process intended to facilitate important auditing and accounting judgments in a professionally skeptical manner.<sup>37</sup>

Audit committees can drive auditor professional skepticism through their important audit and financial reporting oversight responsibilities on behalf of investors. The National Association of Corporate Director’s (NACD) Blue Ribbon Commission on The Audit Committee recommends that audit committees assess skepticism when selecting auditors and evaluating their performance.<sup>38</sup> The NACD Commission also recommends that audit committees “exercise constructive skepticism as they question management and auditors about the quality of management’s financial reporting and the quality of controls.”<sup>39</sup> Given the breadth of the audit committee’s agenda and their limited time, the audit committee chair plays an important role in empowering the audit committee to apply skepticism by working with management, and internal and external auditors in between audit committee meetings to identify issues on which it will be important for the committee to “go deep.”<sup>40</sup> The audit committee chair can facilitate discussions on accounting and audit matters that hone in on red flag areas. By demonstrating an objective attitude and supporting the auditor’s role in gathering sufficient appropriate audit evidence, the audit committee can drive the external auditor to appropriately apply professional skepticism.

Audit committees also can oversee factors related to the audit that can impact auditors’ application of professional skepticism. The U.S. PCAOB and other audit regulators around the world are examining the potential use of audit quality indicators, or AQIs, to assist audit committees in their evaluation of audit quality.<sup>41</sup> The CAQ developed a set of AQIs, as an example of metrics measuring inputs and outputs that may

---

<sup>32</sup> IAASB, *Staff Questions & Answers: Professional Skepticism in an Audit of Financial Statements* (2012), pp. 5-6.

<sup>33</sup> IAASB, ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* (2009), par. A5.

<sup>34</sup> ISQC 1, par. 48-56.

<sup>35</sup> ISQC 1, par. 29 and A25-26.

<sup>36</sup> For example, see S.M. Glover, D.F. Prawitt, and KPMG, *Elevating Professional Judgment in Accounting and Auditing: The KPMG Professional Judgment Framework* (2011).

<sup>37</sup> CAQ, *Professional Judgment Resource* (2014), available at <http://www.thecaq.org/reports-and-publications/professional-judgment-resource>. The professional judgment process discussed in this resource is not the only approach to applying appropriate professional judgment. Other decision-making processes also result in reasonable judgments that are in accordance with the applicable regulatory or professional auditing and accounting standards.

<sup>38</sup> NACD, “Honing Skepticism,” (Jan./Feb. 2013), p. 29, available at <https://www.nacdonline.org/files/NACD%20Directorship%20article%20-%20Honing%20Skepticism.pdf>. The Audit Committee Collaboration’s *External Auditor Assessment Tool* poses questions for the audit committee to ask about the auditor’s skepticism. The Tool is available at <http://www.thecaq.org/reports-and-publications/external-auditor-assessment-tool>.

<sup>39</sup> NACD, p. 30.

<sup>40</sup> Id.

<sup>41</sup> Information about the PCAOB’s AQI initiative is available at <http://pcaobus.org/EconomicAndRiskAnalysis/ORA/Pages/AQI.aspx>. See also, Singapore Accounting and Corporate Regulatory Authority, *Audit Quality Indicators Disclosure Framework* (Oct. 2015), available at [https://www.acra.gov.sg/Publications/Guides/Audit\\_Quality\\_Indicators\\_Disclosure\\_Framework/](https://www.acra.gov.sg/Publications/Guides/Audit_Quality_Indicators_Disclosure_Framework/).

provide insight to audit committees on key matters that may contribute to the quality of the audit.<sup>42</sup> Some of these AQIs measure or describe factors that may drive or impede professional skepticism. For example, some observers have noted that factors such as financial reporting deadlines combined with staff workloads, as well as time and resource constraints more generally could impede the appropriate application of professional skepticism by auditors.<sup>43</sup> Audit committees can use AQIs such as key engagement team members' workloads to maintain awareness of these factors and discuss with the engagement partner whether he or she is keeping them in check. Although AQIs can provide audit committees with additional insight on factors that could affect the appropriate application of professional skepticism on the audit, as data points they cannot adequately communicate whether the presence of those factors drive professional skepticism. Such an understanding requires a two-way dialogue between the auditor and the audit committee.<sup>44</sup>

Independent audit regulatory oversight is an important driver of improvements in appropriate application of professional skepticism and audit quality. External inspections by independent audit regulators provide an assessment of the effectiveness of firms' internal quality control systems and, in most cases, they also assess the firm's performance on specific audit engagements. External inspections also underpin the efforts of audit firms to reinforce in their people the critical need for professional skepticism.

### Collaborative efforts between the public company audit profession and others to promote professional skepticism

Given the importance of the appropriate application of professional skepticism and judgment to audit quality, the public company auditing profession has been proactive in identifying potential enhancements to improve audit quality, including the foundational elements of independence, objectivity, and professional skepticism. To support this effort, the CAQ has worked with members of the financial reporting supply chain to develop tools, research and other materials to support an audit environment that promotes and reinforces skepticism. A description of some of those activities are included below and elsewhere in this letter. The CAQ recommends that the IAASB's Joint Working Group consider these as references as they determine how best to move forward in enhancing skepticism.

- **Anti-Fraud Collaboration (AFC).** Through this collaboration, in which the CAQ participates with Financial Executives International (FEI), the National Association of Corporate Directors (NACD) and The Institute of Internal Auditors (The IIA), tools and information are being developed to increase collaboration and communication among members of the "financial reporting supply chain" to help advance efforts to lessen fraud risk.<sup>45</sup>
- **The Fraud-Resistant Organization: Tools, traits, and techniques to deter and detect financial reporting fraud.** The AFC drew on a wealth of research to provide valuable information about the conditions that might make an organization more susceptible to fraud—and how to mitigate those conditions. The report identifies three central themes that are critical to fraud deterrence and detection—strong tone at the top, skepticism, and robust communications—and explains how financial reporting supply chain participants can incorporate these important traits into their efforts and their organizations.<sup>46</sup>

<sup>42</sup> *Audit Quality Indicators: The Journey and Path Ahead* (Jan. 2016), available at [http://www.thecaq.org/docs/default-source/reports-and-publications/auditqualityindicators\\_journeyandpath2016.pdf?sfvrsn=6](http://www.thecaq.org/docs/default-source/reports-and-publications/auditqualityindicators_journeyandpath2016.pdf?sfvrsn=6).

<sup>43</sup> See, for example, PCAOB, *Staff Audit Practice Alert No. 10*, "Maintaining and Applying Professional Skepticism in Audits" (Dec. 4, 2012), pp. 1-2, Citing scheduling and workload demands among the factors that "can impede the appropriate application of professional skepticism and allow unconscious biases to prevail..."

<sup>44</sup> The CAQ held roundtables around the world with audit committee members to gather their feedback on the CAQ approach to AQIs during which a common theme discussed was the essential need for context, which can only be achieved through dialogue between the auditor and the audit committee, to bring the significance of AQIs to life. As one roundtable participant noted: "I think indicators precipitate important conversations, but those conversations need to be tailored to the individual engagements, voluntary, and very qualitative."

<sup>45</sup> These resources can be found at <http://antifraudcollaboration.org/> and <http://thecaq.org>.

<sup>46</sup> Available at <http://www.thecaq.org/reports-and-publications/the-fraud-resistant-organization>.

- **Audit Committee Collaboration (ACC).** This collaboration is a partnership of leading corporate governance and policy organizations that work together to expand audit committee member access to useful tools and materials with the goal of strengthening audit committee performance and transparency.<sup>47</sup>
- **External Auditor Assessment Tool.** The ACC designed this tool to assist audit committees, or their counterparts, in evaluating the external auditor to assess the quality of the audit, or select or recommend the retention of the audit firm. It is available in versions for U.S. audit committees and audit committees worldwide.<sup>48</sup>
- **Professional Judgment Resource.** This resource is designed to provide auditors with an example of a decision-making process to facilitate important auditing and accounting judgments in a professionally skeptical manner. It outlines an example of a decision-making process grounded in essential actions that include identifying and defining the issue, and reviewing and completing the documentation and rationale for the conclusion. The Resource also identifies several of the more common judgment tendencies and traps that can potentially lead to bias and weaken professional skepticism, and includes illustrative examples of these tendencies, as well as strategies to avoid them.<sup>49</sup>

### Quality Control Standards, the QMA, and Cause Analysis

ISQC 1 requires a firm to develop policies and procedures addressing key elements of a system of quality control. The CAQ supports providing application guidance that offers examples of how firms can meet the objectives of ISQC 1, such as using a Quality Management Approach (QMA). While the QMA could be helpful to some firms in integrating the firm's policies and procedures within its quality control system through the identification of risks relevant to quality, other firms have already developed a robust program for complying with the requirements of ISQC 1 and should be able to maintain that existing program. The CAQ views extant ISQC 1 as providing a sufficiently comprehensive overview of a firm's responsibilities for its system of quality control for audits and reviews of financial statements and other assurance and related services engagements. The relevant requirements, including the elements of a system of quality control, are outlined in a format that gives auditing firms the flexibility to create a framework that incorporates those elements and is appropriately designed from the firm's perspective to meet its specific risks and quality control objectives. The CAQ believes that the flexibility inherent in ISQC 1 allows both smaller and larger firms the opportunity to tailor their application and compliance efforts in an effective and efficient way.

The CAQ also acknowledges that auditing firms could benefit from supplemental guidance on methodologies for understanding causal factors and developing and monitoring remediation efforts in support of their overall system of quality control. The CAQ supports the IAASB providing guidance that outlines overarching principles for identifying causal factors and providing information that firms may wish to consider with regard to the key elements that could be included in such analysis. The guidance should include discussion regarding how various factors can impact skepticism also could assist firms in performing root cause analysis. The guidance also could be instructive on how firms could use the information about the potential underlying causes of both negative and positive quality events revealed during the root cause analysis to undertake remedial acts as part of enhancing their system of quality control.

\*\*\*\*

The CAQ supports the role the IAASB can play in enhancing audit quality in the public interest and commends the IAASB for taking a multi-stakeholder approach to gathering input. Auditors, of course, play a crucial role in enhancing audit quality and we agree with the IAASB's observation in the ITC that "each stakeholder[s]

<sup>47</sup> These resources can be found at <http://www.auditcommitteecollaboration.org/> and <http://thecaq.org>.

<sup>48</sup> Available at <http://www.thecaq.org/reports-and-publications/external-auditor-assessment-tool>.

<sup>49</sup> Available at <http://www.thecaq.org/reports-and-publications/professional-judgment-resource>.

plays an important role in supporting high-quality financial reporting.”<sup>50</sup> The CAQ stands ready to assist the IAASB in further developing its thinking around audit quality, professional skepticism, professional judgment, and quality controls and we would welcome the opportunity to respond to any questions regarding the views expressed in this letter.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

cc:

Arnold Schilder, Chairman, IAASB

PCAOB

James R. Doty, Chairman  
Lewis H. Ferguson, Board Member  
Jeanette M. Franzel, Board Member  
Jay D. Hanson, Board Member  
Steven B. Harris, Board Member  
Martin F. Baumann, Chief Auditor and Director of Professional Standards

SEC

James Shnurr, Chief Accountant  
Wesley R. Bricker, Deputy Chief Accountant  
Brian T. Croteau, Deputy Chief Accountant  
Julie Erhardt, Deputy Chief Accountant

---

<sup>50</sup> The ITC, p. 9.