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Hellenic Accounting and Auditing Standards Oversight Board



**PROFESSIONAL SCEPTICISM AND COGNITIVE BIASES:
LESSONS LEARNED FROM INSPECTIONS FINDINGS**

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The Hellenic Accounting and Auditing Standards Oversight Board (HAASOB – ELTE) is the national supervisory authority for the accounting and auditing profession in Greece.

It is the appropriate body for the adoption and oversight of the correct and effective application of Accounting and Auditing standards. Its mission is to constantly enhance the trust of investors in the operation of the auditing and accounting institution. Its objectives are to secure the auditing services' quality and enhance financial information reliability and transparency. The HAASOB supervises the Accounting Institution through the Accounting Standard Board (SLOT), the Auditing Institution through the Quality Control Board (SPE) and the profession as a whole through the Professional Examinations' Committee (EE).

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PROFESSIONAL SCEPTICISM AND COGNITIVE BIASES: LESSONS LEARNED FROM INSPECTIONS FINDINGS

In this report ACCA, in collaboration with the Hellenic Accounting and Auditing Standards Oversight Board, has continued to research the issue of professional scepticism and cognitive biases. Using examples based on inspection findings in Greece, we discuss how recognising the influence of cognitive biases could have resulted in a more robust exercise of professional scepticism.



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Foreword



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The audit profession is currently undergoing a major reform globally, with the enhancement of audit quality being one of the top priorities. The exercise of an appropriate level of professional scepticism is an integral part of high-quality audits.

In this report, ACCA, in collaboration with the Hellenic Accounting and Auditing Standards Oversight Board (HAASOB), sets out some of the recurring issues, often highlighted in audit inspections, relating to the auditors' performance in exercising professional judgement and professional scepticism, using examples inspired by inspection findings.

Building on the findings of ACCA's report *Banishing Bias? Audit, Objectivity, and the Value of Professional Scepticism* (ACCA 2017), this report highlights the importance of a robust exercise of professional scepticism and emphasises the importance of recognising the influence of cognitive biases on auditors and other stakeholders.

We also refer to some of the latest international standard-setting revisions relating to professional scepticism and cognitive biases, while also noting some relevant national developments, and we emphasise the opportunities for audit firms to enhance their audit methodologies and training.

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Executive summary

Professional scepticism in audit has been the centre of attention for many years. Despite much effort to improve, the inadequate exercise of appropriate professional scepticism, highlighted through the audit inspection process, remains a significant recurring issue for the auditing profession, impairing the overall audit quality.

ACCA's research report *Banishing Bias? Audit, Objectivity, and the Value of Professional Scepticism* (ACCA 2017), considered psychological aspects and how cognitive biases could influence auditors and other stakeholders in exercising professional scepticism at an appropriate level.

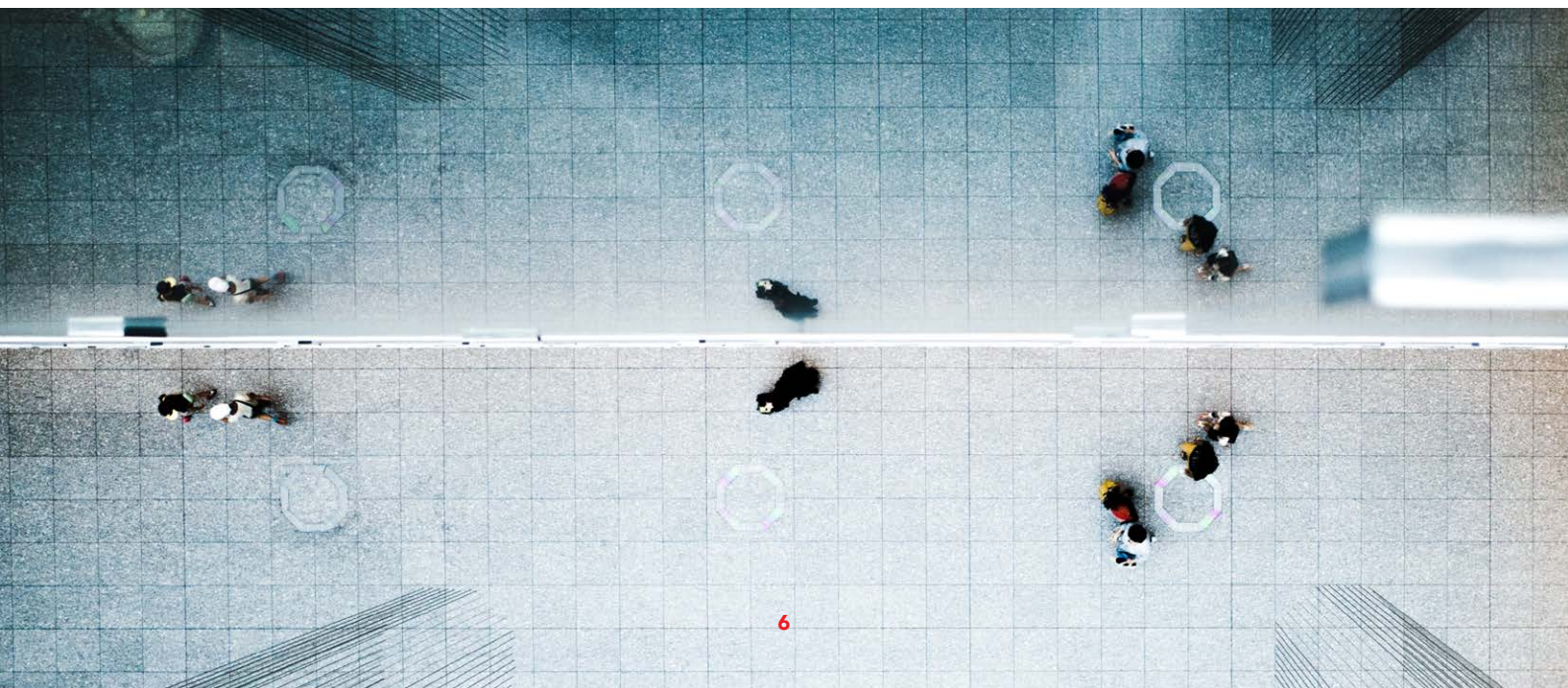
ACCA, in collaboration with the Hellenic Accounting and Auditing Standards Oversight Board (HAASOB), has continued to research the issue of professional scepticism and cognitive biases. Using examples based on inspection findings in Greece, we discuss how recognising the influence of cognitive biases could have resulted in a more robust exercise of professional scepticism in these cases. Our report also emphasises the opportunity for firms to enhance their audit methodologies, training and overall culture to overcome some of these recurring issues.

We also highlight several developments in international standard-setting relating to professional scepticism and cognitive biases, while also noting some relevant national developments. Finally, we note relevant audit policy developments proposed in audit reform reviews in the UK, as well as other relevant publications that we consider to be of global interest.

WE ENCOURAGE FIRMS TO RECOGNISE THE DIFFERENT TYPES OF BIAS, AND FOSTER A CULTURE THAT RECOGNISES AND MITIGATES THE RISKS OF THESE BIASES.

Our research has yielded the following findings:

- Choosing the right resources is vital to achieving high-quality audits. Firms have an opportunity to foster the necessary change with the implementation of the International Standard on Quality Management 1 (ISQM 1), and the International Standard on Auditing (ISA) 220 (Revised).
- We encourage firms to recognise the different types of bias outlined in the standards published by the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) and foster a culture that recognises and mitigates the risks of these biases. The implementation of the International Standards on Quality Management provides a great opportunity for firms to make a cultural shift. Firms' ethical culture and provision of appropriate incentives to manage and reward auditor performance are essential in enhancing audit quality.
- Recognising the importance that authority bias could have in the audit and assurance process is critical, given the extensive use of experts – particularly in specialised sectors and in sustainability assurance engagements. We recommend that standard setters and policymakers take this into account when dealing with the development of future standards.
- While we recognise that cognitive biases may influence the auditor's performance in exercising professional scepticism at an appropriate level, they should not be considered as the sole cause of poor results and/or be used as an excuse. Many other causes, such as the fear of losing an audit engagement and/or independence issues, may lead to a lack of professional scepticism.



1. Introduction

Professional scepticism has been a topic of discussion for many years and has been one of the recurring issues frequently raised by the regulatory community.

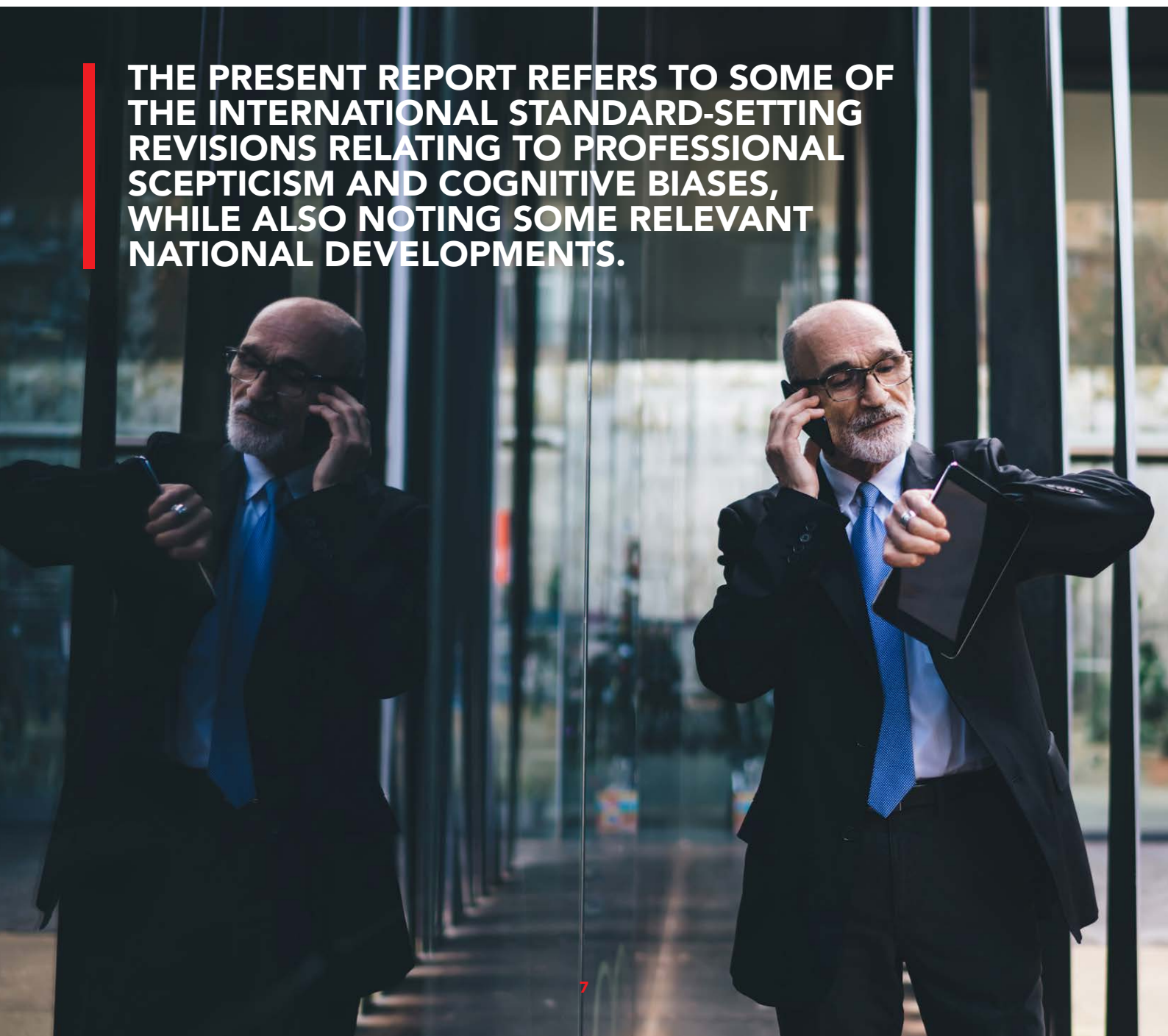
Following our publication *Banishing Bias? Audit, Objectivity, and the Value of Professional Scepticism* (ACCA 2017), ACCA, in collaboration with HAASOB, has continued to examine professional scepticism and cognitive biases, focusing on some relevant recurring issues identified during inspection reviews. This report revisits the cognitive biases introduced and discussed in detail in ACCA's initial report (ACCA 2017) and their importance in practice.

Since the publication of ACCA's 2017 report, there have been several developments in the audit profession and, in particular, standard-setting revisions at national and global levels. The present report refers to some of the international standard-setting revisions relating to

professional scepticism and cognitive biases, while also noting some relevant national developments. The report also refers to audit policy developments relating to professional scepticism proposed in audit reform reviews in the UK, as well as other relevant publications that are of global interest.

While recognising that cognitive biases should not be considered as the sole reason for poor performance and/or be used as an excuse for lack of professional scepticism, we outline some of the recurring issues from inspection findings in Greece that relate to professional scepticism, and discuss how recognising the influence of cognitive biases could have resulted in a more robust exercise of professional scepticism.

THE PRESENT REPORT REFERS TO SOME OF THE INTERNATIONAL STANDARD-SETTING REVISIONS RELATING TO PROFESSIONAL SCEPTICISM AND COGNITIVE BIASES, WHILE ALSO NOTING SOME RELEVANT NATIONAL DEVELOPMENTS.



2. Global developments

Following the publication of ACCA's initial report (ACCA 2017), there have been a series of relevant global developments in the auditing profession. This chapter discusses some of the key developments in standard-setting and audit policy, whether national or international, that relate to professional scepticism and cognitive biases.

'PROFESSIONAL SCEPTICISM' IS DEFINED IN ISA 200 AS AN ATTITUDE THAT INCLUDES A QUESTIONING MIND, BEING ALERT TO CONDITIONS WHICH MAY INDICATE POSSIBLE MISSTATEMENT DUE TO ERROR OR FRAUD, AND A CRITICAL ASSESSMENT OF AUDIT EVIDENCE.

International Ethics Standards Board for Accountants (IESBA)

As we noted in our initial report on professional scepticism, demonstrating the proper application of professional scepticism requires consideration of the IESBA Code of Ethics fundamental principles of professional competence and due care, integrity, professional behaviour and, in particular, objectivity (ACCA 2017).

The IESBA made a number of revisions to the Code of Ethics in relation to professional scepticism, particularly regarding the influence of cognitive biases, following a consultation on the *Proposed Revisions to the Code to Promote the Role and Mindset Expected of Professional Accountants* (IESBA 2019). More specifically, in paragraph 120.12 A1, the Conceptual Framework now recognises that 'conscious or unconscious bias affects the exercise of professional judgement when identifying, evaluating and addressing threats to compliance with the fundamental principles' (IESBA 2020:15, IESBA 2021: 29).

In paragraph 120.12 A2, IESBA includes a list of examples of potential bias that should be recognised when exercising professional judgement (see Table 2.1).

IESBA also included, in paragraph 120.12.A3, a list of actions that might mitigate the effect of bias. These include:

- Seeking advice from experts to obtain additional input.
- Consulting with others to ensure appropriate challenge as part of the evaluation process.
- Receiving training related to the identification of bias as part of professional development' (IESBA 2021: 30).

The IESBA's revisions to the Code of Ethics for Accountants, which explicitly recognise the importance of professional accountants' awareness of cognitive biases when exercising professional judgement, are a great step forward and align well with the revisions in the IAASB standards mentioned later in this report.

Firms should consider the actions listed above and, depending on their circumstances, consider what is appropriate for them. For example, small and medium-sized practices (SMPs) may have a greater need of experts in this field than larger firms and, if so, should seek advice from such experts. Training for the identification of bias, as part of professional development, is relevant for all firms, irrespective of size, and should be taken very seriously.

TABLE 2.1: IESBA examples of potential bias that should be recognised when exercising professional judgement

POTENTIAL BIAS THAT SHOULD BE RECOGNISED WHEN EXERCISING PROFESSIONAL JUDGEMENT	
<ul style="list-style-type: none"> • Anchoring bias, which is a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed. 	<ul style="list-style-type: none"> • Groupthink, which is a tendency for a group of individuals to discourage individual creativity and responsibility and as a result reach a decision without critical reasoning or consideration of alternatives.
<ul style="list-style-type: none"> • Automation bias, which is a tendency to favour output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose. 	<ul style="list-style-type: none"> • Overconfidence bias, which is a tendency to overestimate one's own ability to make accurate assessments of risk or other judgments or decisions.
<ul style="list-style-type: none"> • Availability bias, which is a tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not. 	<ul style="list-style-type: none"> • Representation bias, which is a tendency to base an understanding on a pattern of experiences, events or beliefs that is assumed to be representative.
<ul style="list-style-type: none"> • Confirmation bias, which is a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief. 	<ul style="list-style-type: none"> • Selective perception, which is a tendency for a person's expectations to influence how the person views a particular matter or person' (IESBA 2021: 30).

International Auditing and Assurance Standards Board (IAASB)

The IAASB's commitment to addressing issues relating to professional scepticism dates back to 2015, when the *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Scepticism, Quality Control and Group Audits* (IAASB 2015) consultation was issued. Among the key public interest issues identified that needed to be addressed, professional scepticism featured alongside quality control and group audits.

During its September 2020 meeting, the IAASB approved ISQM 1, ISQM 2 and ISA 220 (Revised) and, following the approval from the Public Interest Oversight Board (PIOB), published the final version of the standards in December 2020, to become effective on or after 15 December 2022. The IAASB also approved ISA 600 (Revised) in December 2021 and, following its approval by the PIOB, published the final version of the standard in April 2022, to be effective on or after 15 December 2023.

Starting with ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*, paragraph 7 recognises that 'the appropriate exercise of professional scepticism may be demonstrated through the actions and communications of the engagement team. Such actions and communications may include specific steps to mitigate impediments to the exercise of an appropriate level of professional scepticism, such as unconscious bias or resource constraints' (IAASB 2020: 6). The standard therefore now explicitly recognises the existence of unconscious bias that could impair the exercise of professional scepticism by the engagement team.

Paragraph A34 lists a range of impediments to the exercise of professional scepticism during an engagement, including:

- 'difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others, which may cause the engagement team to bias the selection of sources of audit evidence and seek audit evidence from sources that are more easily accessible' (IAASB 2020: 20).

In Chapter 3 of this report, we discuss some practical examples based on inspection findings in Greece, demonstrating where the engagement team could have been biased against the selection of certain sources of audit evidence and towards those that are more easily accessible.

Additionally, paragraph A35 adopted the same list of examples of unconscious auditor biases (with the exception

of representation and selective perception biases) noted in para 120.12 A2 of the IESBA's revised Code noted above (IESBA 2021), stating that 'these may impede the exercise of professional scepticism and therefore the reasonableness of the professional judgements made by the engagement team in complying with the requirements of ISA 220 (Revised)' (IAASB 2020: 20). Paragraph A36 now refers to possible actions that the engagement team may take to mitigate impediments to the exercise of professional scepticism at the engagement level, including actions to address conscious or unconscious biases. These actions are shown in Table 2.2, on the next page.

Similarly, ISQM 1, *International Standard on Quality Management 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, references the above-mentioned paragraphs of ISA 220 (Revised) and affirms that unconscious auditor biases may impede the exercise of professional scepticism, and possible actions that the engagement team may take to mitigate such impediments.

We commend the IAASB for making the above revisions to its quality-management standards, in particular, the explicit recognition that unconscious or conscious auditor biases may impair the engagement team's professional judgement and their exercise of professional scepticism is big contribution to mitigating such impairments. The possible actions outlined above are a very useful guide to help auditors to identify and address the related risks to audit quality, and they also address many of the recurring issues identified in inspection findings.

In the UK in 2022, the Financial Reporting Council (FRC) 'performed a thematic review of how audit firms create an environment that promotes professional scepticism and challenge' (FRC 2022a). The review identified good practice in training and in communication from leadership, as well as areas for improvement in the alignment of reward and recognition with desired behaviours (FRC 2022a). The review finds that the biggest barrier to professional scepticism and challenge continues to be a lack of time and resources. The FRC is challenging the way audit firms in the UK are addressing these issues through their operating model and project management. The review notes that some firms are at the start of their 'culture journey', still developing their awareness of culture and behaviours and their link to audit quality, whereas other firms have had culture programmes in place for several years (FRC 2022).

WE EXPECT THAT FIRMS WILL EMBED THESE REVISIONS IN THEIR RESPECTIVE AUDIT METHODOLOGIES AND GIVE THEIR STAFF THE NECESSARY TRAINING ON POSSIBLE ACTIONS THEY SHOULD CONSIDER TAKING, DEPENDING ON THE CIRCUMSTANCES, TO MITIGATE ANY IMPAIRMENT OF EXERCISING OF PROFESSIONAL SCEPTICISM AT AN APPROPRIATE LEVEL WHEN CONDUCTING THEIR AUDIT ENGAGEMENTS.

TABLE 2.2: ISA 220 (Revised) – examples of possible actions that the engagement team may take

POSSIBLE ACTIONS FOR THE ENGAGEMENT TEAM
<ul style="list-style-type: none"> ■ 'Remaining alert to changes in the nature or circumstances of the audit engagement that necessitate additional or different resources for the engagement, and requesting additional or different resources from those individuals within the firm responsible for allocating or assigning resources to the engagement.
<ul style="list-style-type: none"> ■ Explicitly alerting the engagement team to instances or situations when vulnerability to unconscious or conscious auditor biases may be greater (e.g., areas involving greater judgment) and emphasizing the importance of seeking advice from more experienced members of the engagement team in planning and performing audit procedures.
<ul style="list-style-type: none"> ■ Changing the composition of the engagement team, for example, requesting that more experienced individuals with greater skills or knowledge or specific expertise are assigned to the engagement.
<ul style="list-style-type: none"> ■ Involving more experienced members of the engagement team when dealing with members of management who are difficult or challenging to interact with.
<ul style="list-style-type: none"> ■ Involving members of the engagement team with specialized skills and knowledge or an auditor's expert to assist the engagement team with complex or subjective areas of the audit.
<ul style="list-style-type: none"> ■ Modifying the nature, timing and extent of direction, supervision or review by involving more experienced engagement team members, more in-person oversight on a more frequent basis or more in-depth reviews of certain working papers for: <ul style="list-style-type: none"> • Complex or subjective areas of the audit; • Areas that pose risks to achieving quality on the audit engagement; • Areas with a fraud risk; and • Identified or suspected non-compliance with laws or regulations.
<ul style="list-style-type: none"> ■ Setting expectations for: <ul style="list-style-type: none"> • Less experienced members of the engagement team to seek advice frequently and in a timely manner from more experienced engagement team members or the engagement partner; and • More experienced members of the engagement team to be available to less experienced members of the engagement team throughout the audit engagement and to respond positively and in a timely manner to their insights, requests for advice or assistance.
<ul style="list-style-type: none"> ■ Communicating with those charged with governance when management imposes undue pressure or the engagement team experiences difficulties in obtaining access to records, facilities, certain employees, customers, vendors or others from whom audit evidence may be sought' (IAASB 2020: 21/22).

The effective date of ISQM1 and ISA 220 (Revised) for audits of financial statements is for periods beginning on or after 15 December 2022 and, therefore, whether the above revisions will lead to changes in behaviour would be assessed further a few years after this. It is common practice for the IAASB to perform post-implementation reviews following substantial revisions to its standards.

Although the revisions to the IAASB's quality-management standards are explicit and recognise the importance of cognitive biases, the IAASB also revised a number of other International Standards on Auditing (ISAs) to drive a change in behaviour to improve the exercise of professional scepticism.

More specifically, professional scepticism and recognising the existence of bias is now at the heart of ISA 315 (Revised), *Identifying and Assessing Risks of Material Misstatement*

Through Understanding the Business and its Environment. ISA 315 (Revised), paragraph 13 states that 'the auditor shall design and perform risk assessment procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory' (IAASB 2021: 1072)

ISA 315 (Revised) also emphasises explicitly why obtaining audit evidence in an unbiased manner is important. For example, paragraph A14 states that 'Designing and performing risk assessment procedures to obtain audit evidence to support the identification and assessment of the risks of material misstatement in an unbiased manner may assist the auditor in identifying potentially contradictory information, which may assist the auditor in exercising professional scepticism in identifying and assessing the risks of material misstatement' (IAASB 2021: 1084).

ELIMINATING BIAS IS THEREFORE CRITICAL WHEN IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT, TO ENABLE THE AUDITOR TO EXERCISE PROFESSIONAL SCEPTICISM AT AN APPROPRIATE LEVEL WHEN DOING SO.

ISA 315 (Revised) also recognises that bias is not only relevant for the audit engagement team but also for other stakeholders, such as, in this case, management. The standard defines inherent risk factors as ‘characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls’ (IAASB 2021: 1152). Among other factors, that could be the susceptibility to misstatement due to management bias insofar as it affects inherent risk’ (IAASB 2021: 1152).

We would highlight that paragraph A88 states that ‘The greater the extent to which a class of transactions, account balance or disclosure is susceptible to misstatement because of complexity or subjectivity, the greater the need for the auditor to apply professional scepticism. Further, when a class of transactions, account balance or disclosure is susceptible to misstatement because of complexity, subjectivity, change or uncertainty, these inherent risk factors may create opportunity for management bias, whether unintentional or intentional, and affect susceptibility to misstatement due to management bias. The auditor’s identification of risks of material misstatement, and assessment of inherent risk at the assertion level, are also affected by the interrelationships among inherent risk factors’ (IAASB 2021: 1106).

ISA 315 (Revised) came into effect for audits of financial statements for periods beginning on or after 15 December 2021, and therefore the effects of the standard’s revisions, including those relating to professional scepticism, will only be visible a few years after its implementation.

ISA 315 (Revised) is a fundamental standard for the audit process, giving firms an opportunity to enhance their behaviour towards exercising an appropriate level of professional scepticism, recognising the existence of cognitive biases both for auditors and other stakeholders, such as management, among the other substantial revisions required by this standard. This could be achieved by embedding these changes in their methodologies and training.

Similarly, ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, paragraph 32 states that ‘the auditor shall evaluate whether judgements and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias.

When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature’ (IAASB 2021: 493)

ISA 230, *Audit Documentation*, paragraph A7 states that ‘in relation to accounting estimates, when the audit evidence obtained both corroborates and contradicts management’s assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained’ (IAASB 2021: 541/542). The standard also refers to examples of other requirements in this ISA ‘for which documentation may provide evidence of the exercise of professional scepticism by the auditor’ (IAASB 2021: 542). These include the following:

- ‘Paragraph 13(d), regarding how the auditor has applied an understanding in developing the auditor’s own expectation of the accounting estimates and related disclosures to be included in the entity’s financial statements and how that expectation compares with the entity’s financial statements prepared by management;
- Paragraph 18, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory;
- Paragraphs 23(b), 24(b), 25(b) and 32, which address indicators of possible management bias; and
- Paragraph 34, which addresses the auditor’s consideration of all relevant audit evidence, whether corroborative or contradictory’ (IAASB 2021: 542).

Many of the recurring cases identified in inspection findings relate to auditing accounting estimates and their relevant disclosures, and that is because, by nature, accounting estimates require the exercise of significant professional judgement and (on the part of the auditor) professional scepticism. In Chapter 3 of this report, we discuss an example related to accounting estimates inspired by inspection findings.

ISA 540 (Revised) came into effect for audits of financial statements for periods on or after 15 December 2019, and therefore we expect to see how the above-mentioned revisions, alongside the other substantial revisions of the standard, will affect the audit process, and audit quality, through audit inspections from now onwards. As with the other standards discussed in this report, audit firms have an opportunity to enhance their methodologies and training accordingly, to enhance their behaviour in exercising an appropriate level of professional scepticism when dealing with accounting estimates.

Audit reform reviews

Professional scepticism has also featured significantly in audit reform reviews that have taken place across various jurisdictions over the last few years. For the purposes of this report, we discuss briefly what was set out on professional scepticism in the *Independent Review into the Quality and Effectiveness of Audit* by Sir Donald Brydon (the Brydon Review). We also refer to the UK government's response to its consultation on *Strengthening the UK's Audit, Corporate Reporting and Corporate Governance Systems* (BEIS 2022).

The Brydon review recommended a set of 'Principles of Corporate Auditing' and suggested that the Auditing, Reporting and Governance Authority (ARGA)¹ will need to determine the process for establishing them. Among other principles, the list included that 'auditors are appropriately qualified and exercise professional judgment and appropriate scepticism or suspicion throughout their work' (Brydon, 2019).

The Brydon review recommended that corporate auditors² should go beyond professional scepticism and a new concept of suspicion should be introduced. Brydon commented that currently auditors start with a neutral mindset – assuming that neither honesty nor dishonesty with respect to the preparation of the information provided and seek confirmation of its appropriateness (Brydon 2019). However, the Brydon Review suggested that auditors would need to move a step further from the neutral position and implied that they would need to start with a form of suspicion similar to a forensic specialist's mindset.

The UK government consulted on, among other recommendations, the Brydon Review's recommendations noted above, via the Consultation Paper *Restoring Trust in Audit and Corporate Governance* (BEIS 2021).

The co-branded ACCA, CA ANZ, CPA Canada and AASB thought-leadership report titled *Closing the Expectation Gap in Audit – the Way Forward on Fraud and Going Concern: A Multistakeholder Approach* (ACCA et al. 2021) concluded that introducing 'suspicious mindset' as a new concept, as described in the Brydon Review, in addition to professional scepticism, would not necessarily contribute to enhanced fraud identification when planning and performing the audit.

Instead, the report suggested that the IAASB and national standard setters should consider areas where the auditing standards could be enhanced to guide audit practitioners in the application of professional scepticism, rather than introducing a new concept (ACCA et al. 2021).

The UK government's response, published in May 2022, did not support the Brydon Review's recommendation of establishing in law the proposed principles of corporate auditing: it concluded that most of the proposed principles already applied to statutory auditors through current auditing and ethical standards. Instead, it proposed that the regulator should seek to raise standards of auditor behaviour using its existing powers, for example by incorporating into existing standards those aspects of the principles proposed in the Brydon Review that are not already covered, to improve audit quality. An example of this could be developing an agreed framework for the application of professional judgement, including consideration of the public interest (BEIS 2022).

UK Financial Reporting Council (FRC)

Following Brydon's recommendation 2.2.5 that ARGA should revisit the existing definition of professional judgement with a view to strengthening, and demonstrating better, the use of judgement in audit (Brydon 2019), the UK FRC issued guidance on the use of professional judgement by auditors, the first of its kind. The guidance sets out a professional judgement framework and discusses mindset, professional judgement trigger and process, the importance of consultation, and environmental factors. The guidance also includes illustrative examples on how professional judgement is being exercised, highlighting some important aspects of professional judgement (FRC 2022b).

The guidance and illustrative examples refer to cognitive biases and their possible effects on professional judgement and the exercise of professional scepticism among the audit team. We make further reference to the UK FRC's professional judgement guidance in Chapter 3 of this report.

1 As per Sir John Kingman's Independent Review of the FRC, the new regulator that will effectively replace the FRC should be named the Audit, Reporting and Governance Authority (ARGA).

2 As per Sir Donald Brydon's Independent Review into the Quality and Effectiveness of Audit, corporate auditors include statutory auditors of the financial statements, and auditors of other corporate information: for example, information covering cybersecurity or related to environmental measures.



3. Examples inspired by inspection findings

The exercise of professional judgement and professional scepticism is an integral part of high-quality audits.

Recently, in its publication *What Makes a Good Audit?* the UK FRC asserted that, among other characteristics, high-quality audits are supported by rigorous due process and audit evidence, avoid conflicts of interest, have strong quality management, and involve the robust exercise of professional judgement and professional scepticism (FRC 2021).

Cognitive biases can affect the auditor at various stages of the audit. They can also affect other stakeholders in ways that can impair both audit quality and perceptions of audit quality (ACCA 2017). Using examples inspired by inspection findings in Greece, in this chapter we discuss some of the recurring issues for professional scepticism and the relevance of cognitive biases.

As noted in the introduction to this report, while cognitive biases could influence the auditor's performance in exercising professional scepticism, they should not be considered as the sole reason for poor performance and/or be used as an excuse for lack of professional scepticism. There are multiple factors that could impair the auditor's performance in this area, such as independence issues and/or fear of losing the audit engagement to name a few.

The relevant paragraphs of the applicable financial reporting framework for the examples discussed below, can be found in the Appendix of this report.

EXAMPLE 1

Scenario

The financial statements of a public interest entity included intangible assets such as software, licenses, rights and customer relationships constituting 60% of its total assets. Among them, there was also a ten-year extension of the company's exclusive right to provide services to the public, with a total acquisition cost of €450m. To obtain the extension of this exclusive right, the company entered a contract with the Greek Government. According to the contract between the Greek Government and the company, 75% of the total acquisition cost ($€450m \times 75\% = €337.5$) corresponded to an advance payment made by the company against the Greek Government's participation in the gross profit for the period of the ten-year extension.

It was also provided that upon the commencement of the contract, the obligation to pay tax was abolished, in accordance with the legislation in force at the time.

The auditor consulted with the IFRS experts from the audit firm's network regarding the accounting treatment of the ten-year extension.

Materiality level €11.5m

Findings

The company recognised the ten-year extension as an intangible asset at the amount of €450m which was the total acquisition cost.

As per paragraph 4 of ISA 450 a misstatement is defined as 'a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.' (IAASB 2021: 387).

In this example, the engagement manager, who had extensive experience in this industry, demonstrated robust exercise of

professional scepticism and professional judgement regarding the recognition of the ten-year exclusive right extension, by questioning whether the advance payment of €337.5m ($€450m \times 75\%$) also met the definition of a financial asset under IAS 32, *Financial Instruments: Presentations*.

The engagement partner agreed with the engagement manager's initial assessment and decided to consult with the IFRS experts from the audit firm's network regarding the accounting treatment of the €337.5m and more specifically, whether this should be treated as an intangible asset or a financial asset.

According to the conclusion of the consultation, the participation of the Greek Government in the gross profits from services offered to the public is a "shadow tax" for the Greek Government. As a result, the advance payment of €337.5m does not meet the definition of a financial asset because there was no right to set off against tax, given that at start of the contract the obligation to pay tax was abolished.

The engagement partner recognised that this is a challenging area and that he has the ultimate responsibility to evaluate

whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework, irrespective of whether this was also confirmed by the IFRS experts.

Accordingly, the engagement partner discussed this with the engagement manager providing her with the opportunity to further challenge the consultation. The engagement manager was satisfied with the IFRS experts' conclusion. Consequently, the engagement partner concluded that the management's accounting treatment was appropriate in accordance with the applicable financial reporting framework, and that the ten-year extension was correctly treated as an intangible asset at the amount of €450m.

The auditor's considerations and communication among the team were substantiated in the audit file.

The company's financial statements also included a disclosure stating that the balance for 'rights' includes an amount of €337.5m, which is an advance payment by the Company against the levy on the net revenues to the Greek Government for the period, as well as that the future value of said advance payment amounts to €2bn.

The engagement partner had to assess whether the disclosure made by management relating to the balance for rights, provided the required information to the users of the financial statements, and that was free from material misstatements.

As noted earlier in this report, paragraph 4 of ISA 450 states that a misstatement could also be relating to the difference between disclosure of a financial statement item and the disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

In this example according to the facts, the disclosure made by the management appeared to be misleading, because it gave the users of the financial statements the wrong impression that the company had an additional claim of €2bn from the Greek government which would be offset against its future tax obligations.

As per paragraph 11 of ISA 450 'The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

- a. The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- b. The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole' (IAASB 2021: 388-389).

Furthermore, as per paragraph 12 of ISA 450, 'The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they,

individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected' (IAASB 2021: 389).

In this example the misstatement in the disclosure was material and therefore as required by paragraph 12 of ISA 450, the auditor should have communicated the effect that this would have on the opinion in the auditor's report with those charged with governance and request that the disclosure is corrected. However, the auditor did not find the disclosure to be misleading and, therefore, accepted management assertions on this.

Professional scepticism and cognitive biases considerations

Both the engagement manager and engagement partner appeared to be initially sceptical regarding the management's accounting treatment of the ten-year extension as an intangible asset at the amount of €375m, questioning whether that could also meet the definition of a financial asset.

This is an example where the engagement partner had to exercise judgement as to whether the right resources were used and whether the engagement team members had the necessary skills and experience to perform the audit engagement. ISQM1, discussed earlier in Chapter 2 of this report, places a lot of emphasis on using the right resources and is likely to assist in addressing issues with professional scepticism. This also applies for the engagement partner. In our example the engagement partner's judgement is evident by his choice to include a highly experienced manager as part of the engagement team and as we describe below, this has a positive effect in addressing some of the relevant cognitive biases.

CHOOSING THE RIGHT RESOURCES IS OF VITAL IMPORTANCE IN ACHIEVING HIGH-QUALITY AUDITS AND FIRMS HAVE AN OPPORTUNITY TO FOSTER THE NECESSARY CHANGE IN THIS SPACE WITH THE IMPLEMENTATION OF ISQM1 AND ISA 220 (REVISED).

We encourage firms to recognise the different types of bias outlined in the IAASB and IESBA standards, as noted in Chapter 2 of this report, and foster a culture that recognises and mitigates the risks of these biases. The implementation of the International Standards on Quality Management provides a great opportunity for firms to make a cultural shift in this respect. We emphasise that the firm's culture and the use of proper incentives to manage and reward auditor performance are essential in enhancing audit quality.

We find that there are a number of cognitive biases relevant in this example. Starting with **confirmation bias** which as explained earlier in Chapter 2, is a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief. In this example this is mitigated to a certain extent by the involvement of a highly experienced engagement manager who as described earlier used her judgement and questioned management's accounting treatment of the exclusive right's ten-year extension. The engagement manager offered an alternative consideration as to whether the ten-year extension should be treated as a financial asset instead of an intangible asset. Her experience allowed her to mitigate any confirmation bias of simply trying to confirm management's accounting treatment.

Similarly, **anchoring bias**, which is a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed. In this case, anchoring bias could have influenced the engagement manager's judgement by setting an 'anchor' on management's accounting treatment of the exclusive right's ten-year extension. However, the engagement manager's experience allowed her to mitigate any anchoring bias, to a certain extent, by questioning the accounting treatment and suggesting whether an alternative would be applicable in this case. This is irrespective of whether the management's accounting treatment proved to be correct.

Furthermore, **outcome bias** could have been another factor here, whereby senior members of the team in reviewing the work of more junior staff, may have judged the work on whether it identified a misstatement. This can mean that interventions that do not identify misstatements are criticised. The anticipation of outcome bias may discourage junior or even senior staff from questioning client evidence, in case they are criticised for it, even though it would be professionally sceptical to seek further corroboration (Brazel et al. 2016). Applying this in our example, this does not appear to be the case given that the engagement partner carefully considered the views of the engagement manager regarding management's accounting treatment of the exclusive right's ten-year extension and decided to escalate further by involving IFRS experts from the firm's network. Furthermore, even after the conclusion of the IFRS experts, the engagement manager was not discouraged from challenging their work and in fact, the engagement partner provided an opportunity to the engagement manager to further challenge the conclusion of the consultation by the IFRS experts.

We also find **authority bias** to be relevant in this example, another case of the cognitive biases found in psychology. Authority bias is the tendency to attribute greater accuracy to the opinion of an authority figure (unrelated to its content) and be unduly influenced by that opinion (Milgram 1963). In our example, both the engagement manager and engagement partner did not accept the IFRS experts' conclusions without further considerations and this is evident by their communication following the consultation which was documented in the audit file and that is irrespective of whether they agreed in the end.

Recognising the importance that authority bias could have in the audit and assurance process is critical, given the extensive use of experts, particularly in specialised sectors and in sustainability assurance engagements. We recommend that standard setters and policymakers take this into account when dealing with the development of future standards.

Both the engagement manager and the engagement partner did not challenge the management's disclosure in the company's financial statements regarding the balance for 'rights'.

While **confirmation bias** regarding the accounting treatment of the exclusive right's ten-year extension appears to have been mitigated to a certain extent as discussed above, this might have not been the case regarding management's disclosure made for 'rights' in the financial statements. We find that **overconfidence bias** might be closely linked with this example given that the management's accounting treatment of the exclusive right's extension was found to be in accordance with the applicable financial reporting framework. In its turn, this may have led the audit team to feel overconfident regarding the disclosure too, reaching to the wrong conclusions. Cognitive biases should always be in the auditors' mind and how these are interconnected.

Similarly, and in addition to the above, the company's management in this example appeared to be **overconfident preparers** resisting a change in the disclosure on the grounds that this provides users with relevant information regarding the material balance for 'rights' in the financial statements. Management also noted that they were correct before regarding the classification of the exclusive right's ten-year extension strongly supporting that their judgement was appropriate. This could have influenced the engagement partner's judgement in forming a view whether the disclosure was adequate and in line with the applicable financial reporting framework, IFRS in the case.

EXAMPLE 2

Scenario

The financial statements of a company under audit, included an investment in a subsidiary. The financial statements also included goodwill of €2m, which had resulted from the acquisition of the subsidiary company. In the fiscal year 20X1, the year under audit, the company's management carried out a valuation exercise of the subsidiary company using the discounted cash flow (DCF) method.

The auditor engaged an auditor's expert to assess the application of the DCF method by management.

The inspection concerned the audit file of the fiscal year 20X1.

Materiality level €950,000

Findings

In the fiscal year 20X1, the year under audit, the company's management carried out a valuation exercise of the subsidiary company using the discounted cash flow (DCF) method.

In this example, the engagement manager demonstrated the exercise of an appropriate level of professional scepticism and professional judgement in deciding to use an expert to assess the application of the DCF method by the management, recognising that someone with specialised skills should undertake this assessment.

According to the auditor expert's report, the assumptions used by management seemed optimistic, and as a result the margin for impairment was dependent on whether the subsidiary would achieve the projected revenue targets. Thus, a small change in key parameters used for the value in use would result in impairment loss, with the highest impact being attributed to the revenue forecasts.

The engagement manager discussed the auditor expert's conclusion with the engagement partner, and both concluded that they needed to assess management's assumptions and obtain sufficient appropriate evidence, in particular, regarding the projected revenues of the subsidiary company. This would have enabled the engagement partner to form a view on whether that appears to be reasonable or whether an impairment loss should be recognised in accordance with the applicable financial reporting framework. This was also communicated with the rest of the engagement team members.

According to the inspection findings, following the execution of the respective auditing procedures by the engagement team, the engagement partner assessed the company's management estimates of the subsidiary's revenue growth as reasonable. The engagement partner's assessment for this conclusion was based on the expectation and relevant evidence obtained relating to the sign-off of a significant contract of the subsidiary with an existing customer.

The audit evidence provided by the engagement partner to the inspection team to support the aforementioned assessment regarding the increase in the subsidiary company's revenue included the following:

- a. A decision of the board of directors of the parent company which gave the authority to the finance director of the subsidiary to sign a new product supply contract with the customer.
- b. Relevant e-mail correspondence (two months before the end of the audited fiscal year 20X1) between the subsidiary company and the customer regarding the subsidiary's financial offer which included a draft contract.

However, by the time the audit report was issued, three months after the reporting date, no formal agreement had been reached or any progress had been made to sign the expected contract.

As per *ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures* paragraph A82 'audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. Obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence' (IAASB 2021: 521).

As per *ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures*, para A93 'even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with ISA 560. ISA 560 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified and appropriately reflected in the financial statements. Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under ISA 560 is particularly relevant' (IAASB 2021: 524).

In this example, while the engagement team managed to obtain evidence regarding the subsidiary's projected revenue, this could have been further substantiated by seeking to obtain evidence after the year that would have either confirmed and corroborated management's assertions or contradicted such assertions depending on whether the projected revenue materialised.

According to the inspection findings, the auditor's report was issued three months after the reporting date and no agreement had been reached or any progress made on the expected agreement.

In the interim (semi-annual) and annual financial statements of the following fiscal year 20X2, the management of the audited entity announced that after re-evaluating the relevant facts and circumstances concerning the subsidiary, it concluded that the book value of the subsidiary's fixed assets had suffered, already from the previous fiscal year, a significant impairment, and consequently the goodwill of €2m, which had resulted from its acquisition, had been fully impaired. For this reason, the management corrected the financial statements of the previous year.

As per the inspection findings, it was clear that the goodwill and the value of the assets of the cash-generating unit should have been fully impaired. This is because the subsidiary did not sign any contract which would have justified the revenue forecast included in the DCF method. The inspection review concluded that the engagement partner did not obtain sufficient appropriate audit evidence to support her conclusion, based on the documentation found on file, and consequently, that the audit failed to detect a material error in the financial statements.

Professional scepticism and cognitive biases

We find that there are a number of cognitive biases relevant in this example. Starting with **overconfidence bias**, this was mitigated to a certain extent when the engagement manager decided not to solely rely on the management's valuation of the subsidiary. In fact, the engagement manager demonstrated the exercise of an appropriate level of professional scepticism and professional judgement in deciding to use an expert to assess the application of the DCF method by the management, recognising that someone with specialised skills should undertake this assessment. Furthermore, both the engagement manager and engagement partner discussed the findings of the auditor expert's report and remained sceptical about the management's assumptions, given that the revenue forecast seemed to be optimistic. Communication between the audit team members, including the engagement partner, about this matter was recorded in the audit file.

We also find authority bias to be relevant in this example because of the decision by the engagement team to use an expert to assess the application of the DCF method used by management. In this example this was mitigated to a certain extent given that according to the inspection findings both the engagement manager and engagement partner discussed the auditor expert's findings with the rest of the team and sought to obtain evidence regarding the subsidiary's forecasted revenue. This was also clearly documented in the audit file.

However, a number of other cognitive biases were not mitigated, resulting in the auditor's ultimately inappropriately accepting the management's evaluation, which was also evident in the company's goodwill impairment in the interim (semi-annual) and annual financial statements of the following fiscal year (20X2). Starting with Confirmation bias, in this example, the engagement manager and engagement partner failed to assess the post-balance sheet events, which suggested that three months after the year end the contract had not been signed yet and placed more weight on information that supported and corroborated the optimistic revenue forecast, i.e., the evidence received from the management and its board of directors.

Similarly, in this example, there are aspects of anchoring bias, which is a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed. Again, the engagement partner and the team used the initial information provided by the management, the subsidiary's potential contract and its communication in this case, setting this as an anchor and inadequately assessed the subsequent information which suggested that the revenue included in the DCF method is overoptimistic and an impairment might be needed.

While we recognise that cognitive biases may influence the auditor's performance in exercising professional scepticism at an appropriate level, they should not be considered as the sole cause of poor results and/or be used as an excuse. Many other causes may lead to lack of professional scepticism, such as the fear of losing an audit engagement and/or independence issues.



EXAMPLE 3

Scenario

Another issue that frequently forms one of the findings in quality reviews in Greece relates to ISA 570 (Revised) and particularly the inappropriate use of the separate section for ‘Material Uncertainty Related to Going Concern’.

There were several cases in Greece where the auditor concluded that the management’s use of the going concern basis of accounting was appropriate in the circumstances but a material uncertainty on the entity’s ability to continue as a going concern existed and consequently, the auditor included a separate section for ‘Material Uncertainty Related to Going Concern’.

However, the management’s relevant disclosures were not adequate. In all cases the financial statements disclosed some events or conditions that may indicate significant difficulties to the entity, but did not state that there was a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business. Instead, the management explained the reasons why they were certain that the difficulties would be overcome.

Findings

The management’s disclosure about the material uncertainty made in the financial statements was found to be inadequate.

The auditor concluded that the management’s use of the going concern basis of accounting was appropriate in the circumstances but, nonetheless, a material uncertainty on the entity’s ability to continue as a going concern existed.

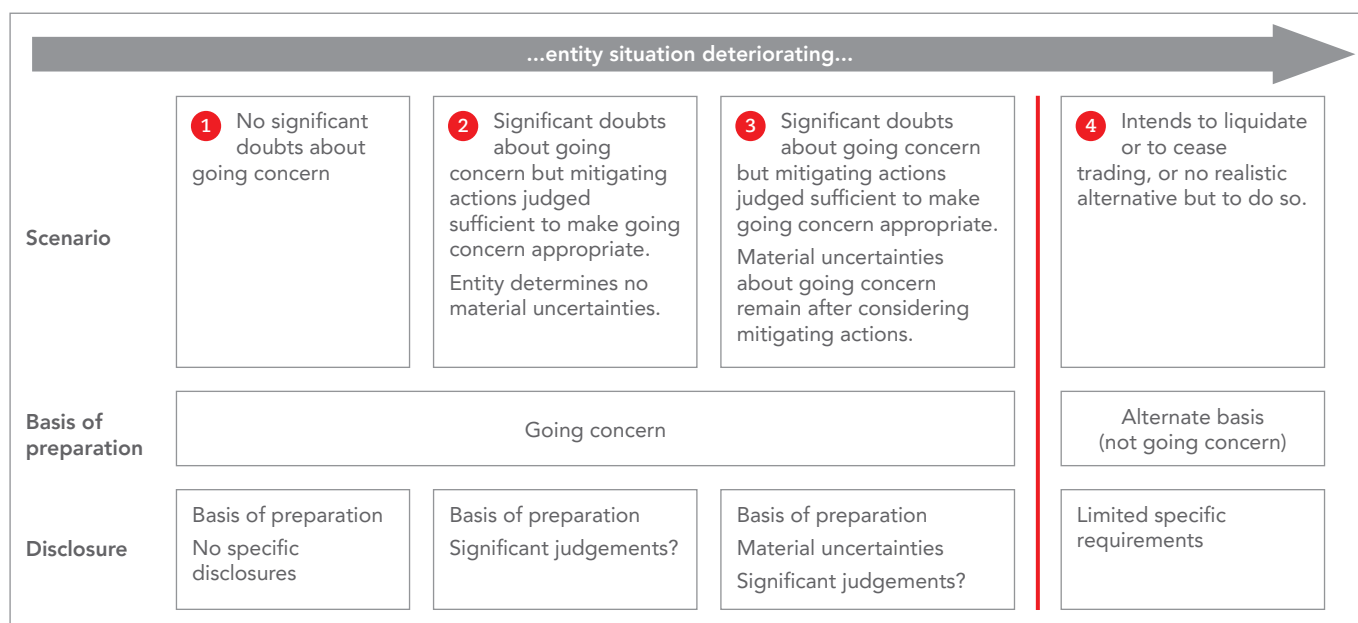
The auditor should have expressed a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705 (Revised), and in the ‘Basis for Qualified (Adverse) Opinion’ section of the auditor’s report, the auditor should have stated that a material uncertainty existed that may cast significant doubt on the entity’s ability to continue as a going concern and that the financial statements did not adequately disclose this matter.

As per paragraph 17 of ISA 570 (Revised), ‘the auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements’ (IAASB 2021: 596).

As per paragraph 18 of ISA 570 (Revised), ‘based on the audit evidence obtained, the auditor shall conclude whether, in the auditor’s judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor’s judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

FIGURE 3.2: Applying the requirements in IAS 1

The requirements in IAS 1 can be depicted as set out in the diagram below:



Source: IASB 2021

- a. In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
- b. In the case of a compliance framework, the financial statements not to be misleading' (IAASB 2021: 596).

As per paragraph 19 of ISA 570 (Revised), 'if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

- a. Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions, and
- b. Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business' (IAASB 2021: 596).

In the example described above, according to the facts, the management's disclosure relating to material uncertainties was inadequate. In such cases, the auditor needs to communicate this to management and note which disclosures are currently missing and/or should be enhanced. If management does not enhance the disclosures and the auditor still concludes that the disclosure on material uncertainties is still inadequate, he or she should consider the impact on the auditor's report.

As per paragraph 23 of ISA 570 (Revised):

'if adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

- a. Express a qualified opinion or adverse opinion, as appropriate, in accordance with ISA 705 (Revised)
- b. In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter' (IAASB 2021: 597)

The auditor in this example found that the management's disclosures required by IAS 1, as described above, to be adequate and hence did not consider the impact on the auditor's report. Hence the requirements of ISA 570 (Revised) paragraph 23, noted above, were not followed.

Professional scepticism and cognitive biases

In all cases, the auditors argued that the disclosures may not have been worded with the accuracy required by ISA 570, but in their professional judgement this was not necessary, because the average reader of the financial statements could understand the entity's difficult situation.

'The engagement partner knows from experience that many investors and potential investors look at the going concern disclosures and so should undertake research on this' (FRC 2022b). In this example, however, the engagement partner did not undertake research and appears to have simply accepted the management's disclosures as being adequate where in fact they were not.

One of the common root causes for shortcomings in relation to going concern noted in the latest Audit Oversight Board annual inspection report 2021 by the Securities Commission in Malaysia, is the lack of professional scepticism combined with a reluctance or inability to adequately challenge the PLC's representations, estimates and/or judgements (Securities Commission Malaysia 2022).

Cognitive biases are relevant in this example: specifically, **overconfidence bias**, where overconfident judgements may undermine the proper exercise of professional scepticism at all stages of the audit. In this case, the engagement partner appears overconfident that enhancing the disclosures was not necessary, arguing that the average reader of financial statement could understand the entity's difficult situation. Overconfidence could have contributed to undermining the exercise of proper professional scepticism by the engagement partner in this scenario.

Similarly, **overconfident preparers** may resist audit adjustments on the grounds that they value their own judgement more highly than their auditor's. Applying this to our example, management might have appeared overconfident and resistant to change, in further enhancing the disclosures in this case, and as a result could have influenced the auditor's judgement in accepting the disclosures as adequate.

We note that the relevant cognitive biases and the responses and/or actions of the characters described in each of the examples discussed above, are only for illustration purposes and should not be considered as a complete list to be used in real life cases.



4. Conclusion and the way forward

Professional scepticism has been a topic of discussion for many years and has been one of the recurring issues frequently raised by the regulatory community. Following ACCA's initial report on professional scepticism (ACCA 2017), ACCA, in collaboration with the HAASOB, has continued to examine professional scepticism, focusing on some of the recurring issues identified in inspection reviews.

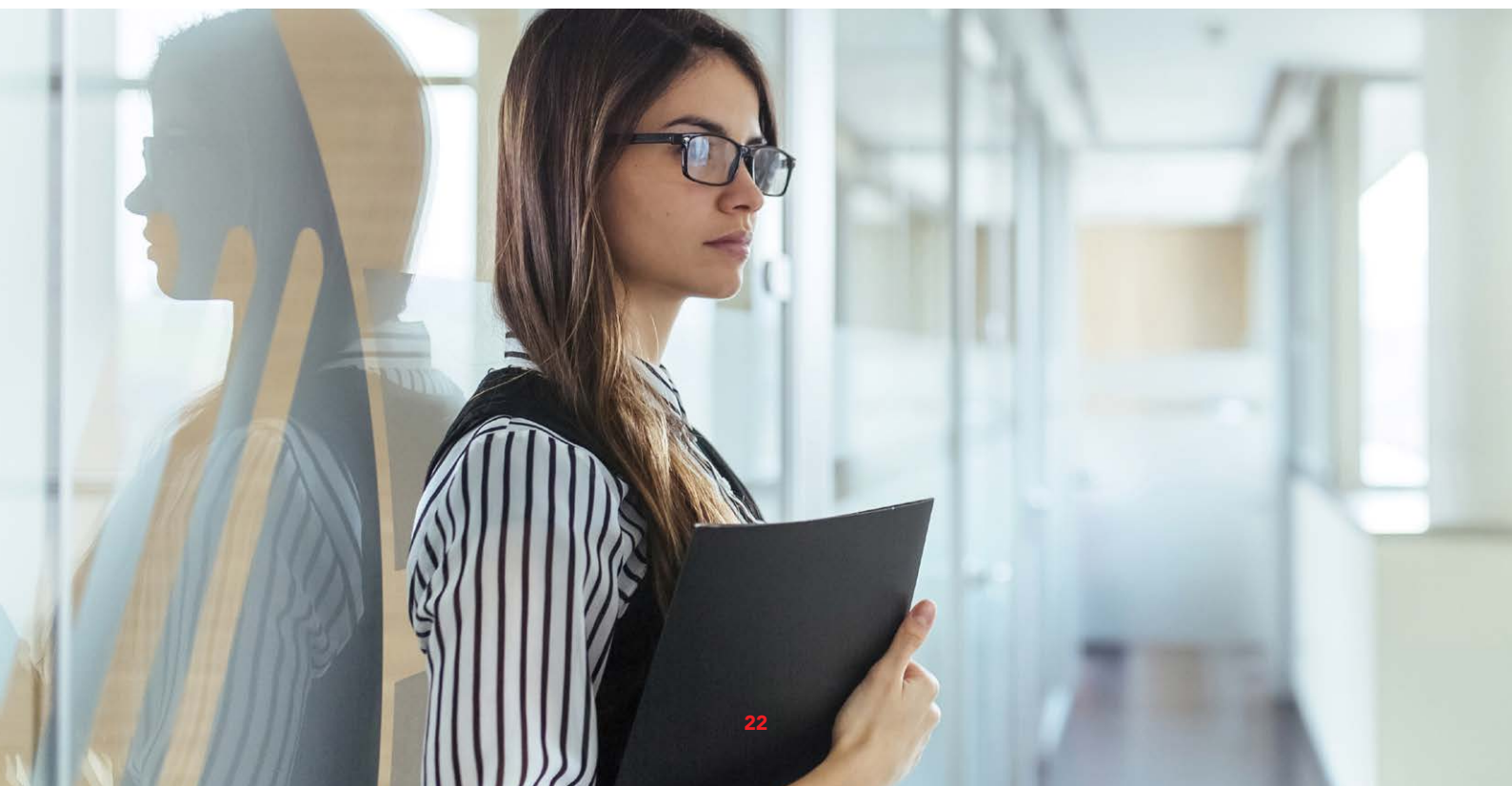
This report discusses the various developments that have happened since the publication of ACCA's initial report (ACCA 2017). These include various revisions to standard setting and proposals discussed in audit reform reviews. These developments show that standard setters and policymakers have taken cognitive biases into consideration and have now embedded the need to tackle these into the revised standards discussed in this report.

This is a significant step forward in addressing issues relating to the exercise of professional scepticism at an appropriate level. Furthermore, as we outline in the report, audit firms have an opportunity via these revisions to enhance their methodologies and their overall culture, recognising the existence of cognitive biases and developing the necessary training for their staff.

With an aim of helping to enhance auditors' performance, using examples inspired by inspection findings in Greece, we have outlined some of the recurring issues relating to professional scepticism and discussed how cognitive biases could have influenced the judgement of auditors and other stakeholders (ie management), which could have resulted in impairing the exercise of professional scepticism at an appropriate level.

We emphasise the following key messages.

- Choosing the right resources is vital for achieving high-quality audits and firms have an opportunity to foster the necessary change here with the implementation of ISQM1 and ISA 220 (Revised).
- We encourage firms to recognise the different types of bias outlined in the IAASB and IESBA standards and foster a culture that recognises and mitigates the risks of these biases. The implementation of the International Standards on Quality Management provides a great opportunity for firms to make a cultural shift. Firms' culture and their appropriate incentives for managing and rewarding auditor performance are essential in enhancing audit quality.
- Recognising the importance that authority bias could have in the audit and assurance process is critical, given the extensive use of experts, particularly in specialised sectors and in sustainability assurance engagements. We recommend that standard setters and policymakers take this into account when dealing with the development of future standards.
- While we recognise that cognitive biases may influence the auditor's performance in exercising professional scepticism at an appropriate level, they should not be considered as the sole cause of poor results and/or be used as an excuse. Many other causes may lead to lack of professional scepticism, such as the fear of losing an audit engagement and/or independence issues.



Appendix: Accounting treatment

EXAMPLE 1 (p14)

As per IAS 38.8, an intangible asset is defined as 'an identifiable non-monetary asset without physical substance.' (IASB 2022a: A1503). 'An asset is a resource that is:

- a. controlled by the entity as a result of past events; and
- b. from which future economic benefits are expected to flow to the entity' (IASB 2022a: A1502-A1503)

In summary, there are three critical attributes:

- identifiability
- control (power to obtain the future economic benefits from the asset)
- future economic benefits (such as future revenues or reduced future costs)

As per IAS 38.12, 'an intangible asset is identifiable when it:

- is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations' (IASB 2022a: A1504).

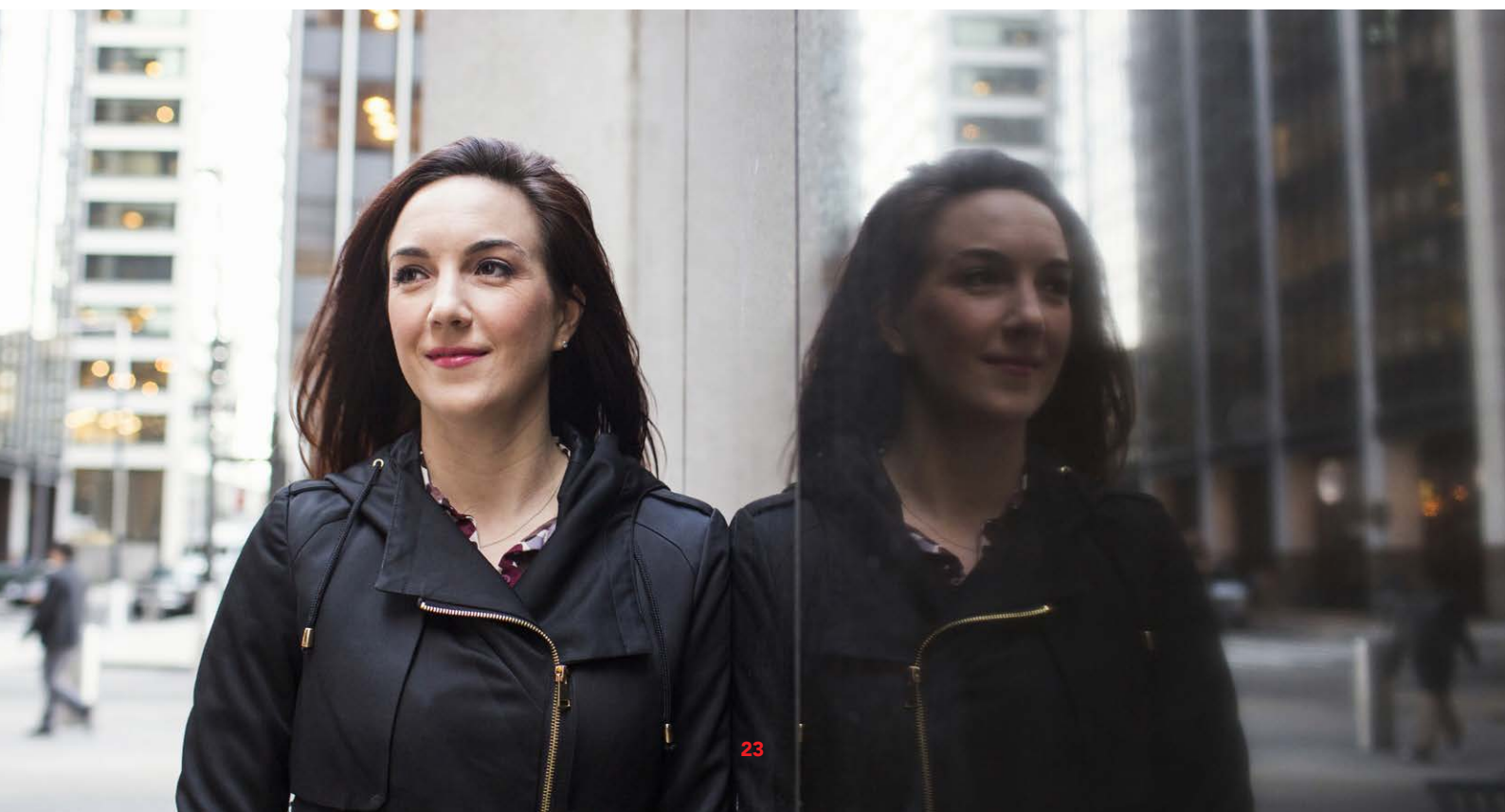
As per IAS 38.21 recognition criteria, an intangible asset shall be recognised if, and only if:

- a. it is probable that the future economic benefits that are attributable to the asset will flow to the entity;
- b. and the cost of the asset can be measured reliably' IASB 2022a: A1506.

As per IAS 38.122 an entity is required to make some general disclosures regarding its intangible assets. These include 'a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements' and a disclosure of 'the amount of contractual commitments for the acquisition of intangible assets' (IASB 2022a: A1526).

As per IAS 32.11 a financial asset is 'any asset that is:

- cash
- an equity instrument of another entity
- a contractual right
 - to receive cash or another financial asset from another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
 - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
 - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments
 - puttable instruments classified as equity or certain liabilities arising on liquidation classified by IAS 32 as equity instruments' (IASB 2022b: A1341).



EXAMPLE 2 (p17)

As per paragraph 8 of IAS 36 'an asset is impaired when its carrying amount exceeds its recoverable amount. Paragraphs 12–14 describe some indications that an impairment loss may have occurred. If any of those indications is present, an entity is required to make a formal estimate of recoverable amount' (IASB 2022c: A1432).

As per paragraph 10b) of IAS 36 'Irrespective of whether there is any indication of impairment, an entity shall also: test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80–99' (IASB 2022c: A1432).

As per paragraph 59 of IAS 36 'If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss' (IASB 2022c: A1442).

As per paragraph 90 of IAS 36, 'a cash-generating unit to which goodwill has been allocated shall be tested for impairment annually and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit.

EXAMPLE 3 (p19)

The example described above falls within scenario 3 of Figure 3.2, where there are significant doubts about going concern but the mitigating actions are judged sufficient to make going concern appropriate. Nonetheless, material uncertainties about going concern remain after considering the mitigating actions.

In such cases 'paragraph 25 of IAS 1 requires an entity to disclose the material uncertainties relating to its ability to continue as a going concern. In doing so, the entity identifies that those uncertainties may cast significant doubt upon its ability to continue as a going concern' (IASB 2021: 3).

- If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired.
- If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognise the impairment loss in accordance with para 104' (IASB 2022c: A1449).

As per paragraph 104 of IAS 36, 'the impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
- then, reduce the carrying amounts of the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units)' (IASB 2022c: A1451).

As per paragraph 105 of IAS 36, 'an entity shall not reduce the carrying amount of an asset below the highest of:

- a. its fair value less costs of disposal (if measurable)
- b. its value in use (if determinable); and
- c. zero' (IASB 2022c: A1451).

'In addition to disclosing the material uncertainties as required by paragraph 25, the entity is also required to apply the disclosure requirements in paragraph 122 relating to the judgement that the going concern basis is appropriate. In applying these requirements, the entity considers what information is material about:

- a. the events or conditions that cast significant doubt upon the entity's ability to continue as a going concern and
- b. the feasibility and effectiveness of management's actions or plans in response to those events or conditions' (IASB 2021: 3).

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