Auditor Scepticism: Raising the Bar

The ABI's Response to the Auditing Practices Board Discussion Paper

Introduction

1. The ABI is grateful to the FRC for the opportunity to comment on its discussion paper on Auditor Scepticism. This paper picks up on a subject that was raised by the FSA and FRC in the recent joint discussion paper DP 10/3 Enhancing the auditor's contribution to prudential regulation to which we recently responded. Our comments reflect our members' interest both as institutional investors in the equity and other securities of UK-listed companies and also as corporate entities that are themselves responsible for preparing accounts that are subject to audit.

General Comments

2. The APB's paper is an overdue examination of a fundamental attribute required of professional audit. The accounting and audit environment has changed markedly over recent decades and this has posed new challenges, in particular the uptake of fair value accounting methods at the same time as downgrading of the concept of prudence. Some of our members, particularly amongst institutional investors, consider that the loss of prudence as a guiding principle has made problematic the application of fair value accounting with its inevitably more subjective and imprecise measurements where open market values are not always readily observable.

3. The paper's observations about the risks of over-reliance on management representations and its suggestion that auditors may be more concerned with finding evidence that corroborates rather than that which challenges accounting figures do resonate. The box-ticking mentality it risks engendering is the opposite of professionalism and the ability of auditors to lend assurance and create value through the performance of quality audit. The need for a measure of "presumptive doubt" where the auditor exhibits a heightened awareness of the risk that the figures could be affected by error or dishonesty is obvious given the role of audit as a safeguard against the risk of fraud.

* The ABI represents the UK's insurance, investment and long-term savings industry. It has over 300 members, which together account for around 90% of premiums in the UK domestic market.

The UK insurance industry is the third largest in the world and the largest in Europe, helping individuals and businesses protect themselves against the everyday risks they face. It pays out over £230 million per day in pension and life insurance benefits and over £50 million per day in general insurance claims. The industry is an important contributor to the UK's economy; it manages investments of £1.5 trillion, over 20% of the UK's total net worth; employs more than 300,000 people in the UK alone; is the fourth highest contributor of corporation tax; and is a major exporter, with one-fifth of its net premium income coming from overseas business.
4. Auditor scepticism is not simply about an attitude of mind, still less is it about the cultivation of bias, but is principally a matter of character as is rightly identified in the discussion paper. The application of a questioning mind, the ability to understand the motivations of others and to pursue the necessary evidence, allied to personal integrity in pursuit of professional audit are of critical significance.

5. The discussion paper, in examining development and promotion of auditor scepticism within firms, makes comparatively little reference to motivation and reward processes. From the point of view of individuals, recruitment and training are of course of major relevance at the start. However, over time, of greater significance is likely to be the way in which particular professional attributes and behavioural characteristics are seen to be rewarded both materially and in contributing to prospects for promotion. It is vital that the exercise of appropriate auditor scepticism is rewarded and viewed as an enhancement to career development. Audit firm culture is critical to ensuring that this is the case and we suggest this may be an appropriate focus for further work in this area by the APB and related bodies under the FRC’s umbrella.

8/11/10
Questions for Consultation

1. Do you agree with the emphasis that this paper places on the importance of auditor scepticism? Are there aspects of the analysis, including the summary of academic research in Appendix 1, with which you particularly agree, or disagree? If so, what are they?

Yes, we see auditor scepticism as a fundamental characteristic exhibited by auditors individually and collectively through their firms and it should be seen as a bedrock of their professionalism.

2. Regulators have recently challenged audit firms on whether sufficient scepticism was demonstrated on some audits:
   • Do you think that this problem is widespread or limited to certain types of audits or circumstances?
   • What factors do you believe do, or could, in practice create disincentives for auditors to apply an appropriate degree of professional scepticism and what should be done about them?
   • In what areas do you think auditors should be more (or less) sceptical in their approach?

Criticism of auditors must be tempered by the recognition that their ability to exercise professional scepticism has been impaired by other changes in the financial reporting framework, in particular the downgrading of prudence at a time of greater use within accounting standards of fair values that may well be of questionable reliability. Selective application by auditors of pressure for greater prudence may also have the further beneficial effect of facilitating greater consistency across companies within a sector which will benefit investors and markets.

3. How do you think audit firms should promote and develop professional scepticism in their partners and staff? Do they need to do more and, if so, what?

Yes, we think it would now be opportune to place greater stress on this though we would see this as more of a reversion to a fuller recognition that has always been appropriate.

4. Do you think that others, including companies, should be doing more to promote, develop and support professional scepticism in auditors? If so, what?

No, not really, as this is quintessentially a matter that relates to the professional attributes of auditors. As such we would look to the professional and regulatory bodies to take the lead. The contents of the discussion paper do seem to provide a good encapsulation of the subject and it thus has merit as an educational document.