

Case 20-9c

Skeptical Lens

Discussion 1

Formulate a definition of professional skepticism.

Discussion 2

Professional skepticism is at the core of performing a quality audit. Below are three case studies that will focus your attention on what it takes to be a skeptical auditor.

Read the specific facts and circumstances of each case study, identify the key red flags that heighten professional skepticism, and evaluate what you would do next.

Case Study A — Anatomy of a Confrontation

I was the audit senior manager on the pursuit team and ultimately, the engagement team of a new client. My team was excited about the win and because year-end was approaching fast; we started the audit within days of our appointment as the company's auditors. Initially, all went smoothly. We met our milestones and quickly developed an excellent working relationship with the company's CFO, who appreciated the quality of our work, our responsiveness, and the questions we asked about the business.

Toward the end of the audit, a staff accountant drew my attention to a material reconciling item that lacked supporting documentation. The client contact responsible for providing the documentation had not responded to our requests for details, so I paid her a quick visit to find out what was causing the delay.

She explained that the reconciling entry went back a number of years and was made up of mainly minor items and it grew slightly year by year. Exact details would take several days, she said, because she'd have to go back years on some of the items. I explained that we would indeed need her help to explain these items even if it did take a few days for her to obtain the supporting documentation. When she still did not respond to our request, we knew we needed to elevate the matter, although we were not yet overly concerned.

That afternoon, I joined the partner in charge for a status meeting with the CFO, since we were approaching the report date. He asked us what was still open to complete the audit. "We're waiting for detail on one reconciling item," I told him. "That's about it."

He promised that his team would provide the information and said he'd get back to me. But he didn't get back to me. A few days before sign-off, the partner and I stopped by his office again.

"Great job, guys," he said with a smile, leaning back in his chair. "But that one item — well, we don't want to make a mountain out of a mole hill, do we? It's been a regular reconciling item forever. Our prior auditors never flagged it even once and it barely changes year to year."

“As you know, the audit report is due tomorrow,” the CFO continued, “and frankly, I’d like us not to delay it by continuing to research that particular item. That OK with you guys?”

Case Study B — Data Analytics and a Skeptical Mindset

I was a senior working on a client for whom a significant revenue contract had favorable pricing terms for the company. However, this contract was approaching its end and the pricing was expected to become less favorable.

During our audit, we decided to use data analytics to assist us in performing preliminary analytical procedures. We started with a simple analytic to analyze days in accounts receivables (A/R) over a multiyear period to determine whether there were unexpected relationships between A/R and the allowance for doubtful accounts (the “allowance”) that would affect our identification and assessment of risks of material misstatement in the allowance. We then used a histogram to visualize the days in receivable over the same multiyear period.

These were pretty standard tests. However, our analysis indicated that while the number of days in A/R remained consistent, the allowance had significantly increased during the current year. This was inconsistent with what we expected to find, so I scheduled a meeting with the staff accountant to discuss the results. The staff accountant was unable to answer my questions, and I left the meeting without obtaining evidence to support the amount booked to the allowance.

My next move was to speak with the accounting manager, but he was also unable to provide any additional information to explain the results of the analytic, only clarifying that he had recorded a journal entry to increase the allowance as instructed by senior management.

Case Study C — Influenced by Incentives?

I was a senior working on a public company audit engagement. As part of our risk assessment, we evaluated the compensation and performance management process of a selection of key employees.

I made selections of employees from many different sectors of the business and evaluated their compensation components, goals for the year, and recent performance evaluations. I was looking for any indicators that might lead to personal bias or a risk of material misstatement (including those resulting from fraud) that we had not previously identified.

When I reviewed the documentation for the tax manager responsible for leading the tax accounting group (specifically focused on bookkeeping the company’s tax transactions) and the company’s tax provision and calculation of the effective tax rate, I noticed that one of her goals for the year was to reduce the effective tax rate by an overly aggressive percentage from the prior year. In addition, the company’s compensation and bonus structure was tied to whether employees met their goals for the year.