



# Skepticism in Practice

September 2020



# About the Anti-Fraud Collaboration

The Anti-Fraud Collaboration is dedicated to advancing the discussion of critical anti-fraud efforts through the development of thought leadership, awareness programs, educational opportunities, and other related resources focused on enhancing the effectiveness of financial fraud risk management.

The Anti-Fraud Collaboration was formed in October 2010 by the Center for Audit Quality (CAQ), Financial Executives International (FEI), The Institute of Internal Auditors (The IIA), and the National Association of Corporate Directors (NACD).

**The 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 that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. For more information, visit [www.thecaq.org](http://www.thecaq.org).



**FEI** is the leading advocate for the views of corporate financial management. Its more than 10,000 members hold policymaking positions as Chief Financial Officers, Treasurers and Controllers at companies from every major industry. FEI enhances member professional development through peer networking, career management services, conferences, research and publications. Members participate in the activities of 65 chapters in the US. FEI is headquartered in Morristown, NJ, with an office in Washington, DC. For more information, visit [www.financialexecutives.org](http://www.financialexecutives.org).



**The IIA** is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today has more than 200,000 members from more than 170 countries and territories. The IIA's global headquarters are located in Lake Mary, Fla. U.S.A. For more information, visit [www.theiia.org](http://www.theiia.org) or [www.globaliia.org](http://www.globaliia.org).



**NACD** empowers more than 20,000 directors to lead with confidence in the boardroom. As the recognized authority on leading boardroom practices, NACD helps boards strengthen investor trust and public confidence by ensuring that today's directors are well-prepared for tomorrow's challenges. World-class boards join NACD to elevate performance, gain foresight, and instill confidence. Fostering collaboration among directors, investors, and corporate governance stakeholders, NACD has been setting the standard for responsible board leadership for 40 years. To learn more about NACD, visit [www.NACDonline.org](http://www.NACDonline.org).



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# Executive summary

- + Fraud can be one of the most significant consequences of failure to exercise skepticism. Skepticism can often be overlooked in mitigating the risk of fraud and misconduct, which illustrates why it is important that companies and their stakeholders should recognize the significance of and challenges associated with exercising an appropriate level of skepticism.
- + Members of the financial reporting supply chain—boards of directors, audit committees, company leadership, management personnel, internal auditors, and external auditors—can use skepticism to spot red flags at points throughout the financial reporting process that others may not be in a position to see, even if it means challenging assumptions and asking tough questions.
- + As individuals assess information, their conclusions and decisions are inevitably subject to their own unique background and biases. The process may be unconscious, unintentional, and naturally instinctive, but members of the financial reporting supply chain should be aware of their biases and the potential hindrance they can have on their ability to exercise skepticism, and work toward mitigating them.

“The appropriate exercise of professional skepticism throughout the judgment process is at the heart of effective auditor decision-making.”

**Professional Judgment Resource,  
Center for Audit Quality**

- + Technologies can also pose a challenge to one's ability to exercise skepticism. The very fact that emerging technologies are greeted with great fanfare and anticipation reinforces the importance of striving to maintain skepticism in considering the information these technologies deliver. While technology is a powerful tool, it cannot replace the professional's knowledge, judgment, and exercise of skepticism.
- + Disruptions, emergencies, or other unexpected crises also pose threats to skepticism because the increased pressure, opportunity, and rationalization for fraud are often heightened in challenging environments. While leaders' attentions are focused on the outcome of a crisis, they can increase their efforts to mitigate fraud and misconduct risk through enhancing skepticism. Rather than relying on assumptions, a leader's decisions should be data driven and evidence based.
- + Enhancing skepticism takes time and requires awareness, continuous training, and execution. Actionable steps to help supply chain members enhance their ability to exercise an appropriate level of skepticism include understanding the limits of one's own objectivity, avoiding jumping to conclusions, keeping an open mind, avoiding unwarranted faith in data, honing critical thinking skills, seeking expert advice, recognizing critical areas, and training employees on the importance of a skeptical mindset and how to mitigate bias.

### **INTENDED AUDIENCE**

This report provides information on the value and implementation of an appropriate level of skepticism for all members of the financial reporting supply chain. This report's insights are also valuable to other key members of an organization who are involved in evaluating and using financial reporting information, as well as regulators, investors, customers, suppliers, anti-fraud professionals, and other stakeholders.



# Introduction

Skepticism can be misperceived as an unwelcome notion in the business environment—whether it be inside a boardroom, on an earning’s call, or during a routine assessment. Company executives may even discourage challenges to financial information, especially when under pressure or in a time of crisis. However, when it comes to the financial reporting process and fraud risk management, skepticism is essential. An appropriate level of skepticism can help members of the financial reporting supply chain and other relevant stakeholders enhance their effectiveness in mitigating the risk of fraud and misconduct.

Skepticism is a key component that can strengthen an organization’s fraud risk management program. If not consistently considered and applied, skepticism can often be overlooked—one of many reasons why it is important for all financial reporting supply chain members to strive to exercise skepticism in their work. Members of that supply chain have a responsibility in promoting integrity in the financial reporting process, whether due to regulatory mandates, codes of ethics, duty to safeguard the organization’s reputation and assets, or other such factors.

There are many examples of the impact of skepticism and of what happens when it is absent. For example, since revenue recognition is frequently subject to manipulation that can result in financial statement fraud, the failure to assess and question a departure from related standards or accounting policy can have serious repercussions. This report explores the importance of striving to exercise skepticism in areas that require tough decision making and judgment calls. It examines the consequences of a lack of skepticism and offers practical steps to maintain skepticism even in the face of evolutionary technology or challenging and disruptive times.

While the term *professional skepticism* has a specific definition within the standards that regulators set for external auditors, the perspectives in this report extend beyond the lens of the auditor. It is intended to inform all members of the financial reporting supply chain—including corporate directors, company executives, financial statement preparers, and internal and external auditors—that each party’s effort in maintaining an appropriate level of skepticism is critical for mitigating fraud risk, deterring fraud and misconduct, and detecting fraud and errors. •



# Using Skepticism to Fight Fraud

Fraud can be one of the most significant consequences of failure to exercise skepticism. One meaningful threat to fraud prevention occurs when those responsible for evaluating financial data are naturally inclined or even tempted to trust information that comes from their own company or from a long-time client without verifying it. In fact, a Crowe [white paper](#) asserts that “trust is a professional hazard.” As the Public Company Accounting Oversight Board (PCAOB) [notes](#), “Company management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.” It adds that, “in exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.” That statement can also apply to other members of the financial reporting supply chain.

Skepticism can be a key asset in ferreting out concealed fraud. “Because fraud is inherently clandestine, a skeptical mind—one that does not automatically take information at face value and that seeks more explanation for things that

do not make sense—is required to overcome a fraudster’s attempted concealment,” according to a [presentation](#) from the Association of Certified Fraud Examiners. It recommends that, throughout the engagement, auditors proactively consider how someone might perpetrate, conceal, or conspire to commit a fraud or how they might override internal controls. Auditors should observe the processes, people, and culture of the organization; be alert to fraud concealment methods in documents; and take note of inconsistencies or contradictions in statements made in interviews. Once again, being alert to the potential for fraud and efforts to conceal it are also important for other members of the financial reporting supply chain.

According to [PCAOB Auditing Standard 1015, \*Due Professional Care in the Performance of Work\*](#), “[d]ue professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence.”

With respect to other members of the financial reporting supply chain, skepticism is crucial in the effort to mitigate the chance that an incorrect assumption or overlooked fraud or error can undermine the financial reporting process. According to a Center for Audit Quality report, *Deterring and Detecting Financial Reporting Fraud: A Platform for Action*, “skepticism throughout the financial reporting supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted.”

Often, the root of fraudulent financial reporting can be traced back to an environment where a company has overly aggressive performance targets and leadership that does not accept anything short of meeting such targets. For example, an individual under time pressure and trying to minimize costs finds an expedient approach to accept financial information at its face value. In another situation, professionals accept a set of data from a respected and typically reliable client or vendor without question, even though some important procedures have been skipped, to avoid being challenged by the client or vendor in response. Elsewhere, because directors have confidence in management, they accept management reports without much scrutiny and do not require sufficient supporting documentation. Each of these cases demonstrates how easy it can be to rationalize certain actions. These examples of failures to address challenges by not exercising skepticism can have significant consequences.

The Center for Audit Quality considers skepticism a vital tool in the toolbox that all members of the financial reporting supply chain can employ in deterring and detecting fraud and misconduct. They can use it to spot red flags at points throughout the financial reporting process that others may not be in a position to see, even if it means challenging assumptions and asking tough questions. This paper covers the roles of members of the financial reporting supply chain in detail in the next section; in brief they include the following:

**+ Boards and audit committees:** Board and audit committee members should question and probe information they receive to understand key risk areas and how management is addressing them. Boards and audit committees have ultimate responsibility for reviewing the information with a skeptical eye.

**The six characteristics of skepticism cited in the Center for Audit Quality's report, *Deterring and Detecting Financial Reporting Fraud: A Platform for Action*, are as follows:**

- + a questioning mind;
- + suspension of judgment until appropriate evidence is obtained;
- + a desire to search for knowledge and corroborate information;
- + the understanding that people's motivations and perceptions may lead them to provide biased or misleading information;
- + autonomy or independence of mind; and
- + sufficient self-esteem to challenge assumptions and resist pressure. •

**+ Management:** Company leaders are responsible for the design, implementation, and assessment of internal control over financial reporting. They should be aware that, even if the company encourages a strong ethical culture, it is still susceptible to fraud.

**+ Internal auditors:** The Institute of Internal Auditors' (IIA's) [International Professional Practices Framework](#) sets guidelines for internal auditors to, among other activities, evaluate the probability of significant errors, fraud, or noncompliance; be able to identify risks and red flags; and be alert to opportunities for fraud, such as control deficiencies.

**+ External auditors:** The auditing standards require auditors to exercise professional skepticism, which means having a questioning mind, being alert to indicators of a possible misstatement due to fraud or error, and performing a critical assessment of audit evidence. The evidence that auditors gather throughout the audit does not always corroborate the anticipated results or available information. Disconfirming evidence obtained might also provide reasons to question the results or information. •



# Who Should Strive to Exercise Skepticism?

## BOARDS OF DIRECTORS

The board of directors should exhibit an appropriate level of skepticism and monitor whether this trait is being demonstrated throughout the organization's financial reporting supply chain. The Committee of Sponsoring Organizations (COSO) noted in its *Enhancing Board Oversight: Avoiding Judgment Traps and Biases* report that an appropriate level of skepticism enhances corporate governance, stating "entities and their key stakeholders are better served when directors effectively challenge management's judgments, explicitly consider alternative perspectives, and engage management in frank and open discussions."

Directors should be aware that culture can have an important impact on the level of skepticism exercised. That begins with a tone at the top that encourages a culture in which everyone in the organization—from directors to employees of all levels—is expected and encouraged to accept information only when they are completely satisfied with the support and reasoning behind it. Among the ways directors can show that tone is to be transparent about questioning information from

The National Association of Corporate Directors (NACD) "has long recognized independence and skepticism as valuable traits for audit committee chairs."

*Honing Skepticism,*  
NACD Directorship

employees, customers, and vendors, and to regularly ask employees about the types of checks being used to assess data validity.

## AUDIT COMMITTEES

The board of directors uses the audit committee to inform themselves of the quality of the financial reporting process. “Audit committees should promote a culture of professional skepticism by challenging the judgments of both management and auditors and encouraging all parties to look at all the potential evidence (both confirming and disconfirming) when decisions need to be made,” according to Brigham Young University Professors [Steven M. Glover and Douglas F. Prawitt](#). Proper audit committee oversight of the internal audit function can promote its effectiveness. The audit committee also hires the external auditor and should assess the work of the auditors to evaluate whether they are exercising an appropriate level of professional skepticism.

“A properly functioning audit committee can help ensure that audits do not suffer from the dearth of skepticism that directly contributes to failures to detect financial reporting and other frauds,” as noted in a *Risk & Compliance* magazine [article](#). The committee members should undertake proper education to support their use of appropriate skepticism.

## MANAGEMENT

Despite their important responsibilities, boards and their audit committees are not the only key players in the financial reporting process. “Effective managers rely on skepticism in all their activities—strategy, risk assessment, goal setting, progress reviews, and evaluation of results,” according to the [Center for Audit Quality](#). In addition to exercising skepticism themselves, “management should encourage employees to feel not only comfortable but also obliged to question and challenge the results for which they are responsible.”

Members of the management team are in the most capable position to directly or indirectly manipulate accounting records and present fraudulent financial information. And collusive fraud is one of the most difficult forms of fraud to detect. With that said, members of management can exercise skepticism

### NACD tips for audit committee members include the following:

**Empower the audit committee.** The committee should be given the authority to ask the right questions of management and the internal and external auditors.

**Learn from the auditors.** Committee members can gain insights from auditors on understanding and mitigating fraud risks.

**Support the internal audit function.** An independent and objective internal audit function contributes to a strong control environment and can be invaluable in deterring and detecting fraud.

**Encourage management to be vigilant.** Financial executives can prevent fraud early in the reporting process.

**Be positive.** It will be easier to ask tough questions effectively if the committee demonstrates and supports proper etiquette and good ethics.

by taking proactive steps to prevent fraud and instituting policies and procedures that will lead to and support complete, accurate, and reliable financial reporting. Undertaking efforts to prevent fraud and other types of misconduct in itself demonstrates a level of skepticism, in that it recognizes that threats exist and missteps may occur.

Those proactive steps could include setting an ethical tone at the top, creating a code of conduct, communicating the code’s importance and benefits to all employees, and requiring staff to certify their understanding of and compliance with the code of conduct. It also means instituting rigorous anti-fraud policies that establish clear guidelines and expectations—along with the consequences if they are not followed—and determining whether staff are aware of and follow these policies. According to an [article](#) in the IIA’s *Internal Auditor* online magazine, other steps can include segregation of duties, rotation of staff, regular background checks for

new and current employees, and employee hotline or whistleblower programs, which can identify and discourage fraud and embezzlement.

### **INTERNAL AND EXTERNAL AUDITORS**

An organization's internal and external auditors are expected to maintain a high level of professional skepticism. The guidance on individual objectivity in the IIA's *International Professional Practices Framework Standard 1120—Individual Objectivity* notes the importance of training that "reinforces the nature of [professional] skepticism and the criticality of avoiding bias and maintaining an open and curious mindset."

The PCAOB recognizes the threats of subjectivity and bias and the importance of professional skepticism when evaluating the reasonableness of accounting estimates and assessing fraud risks. According to [PCAOB Auditing Standard](#)

[2501, Auditing Accounting Estimates, Including Fair Value Measurements](#), which is effective for audits of financial statements for fiscal years ending on or after December 15, 2020, "[r]esponding to the risks of material misstatement involves evaluating whether the accounting estimates are in conformity with the applicable financial reporting framework and reasonable in the circumstances, as well as evaluating potential management bias in accounting estimates and its effect on the financial statements... The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence." The PCAOB's requirement to evaluate potential management bias in the estimation process and its effect on the financial statements also points to the need for management and other members of the financial reporting supply chain to scrutinize their own use of skepticism in their processes. •



# Biases Threaten Skepticism

As individuals assess information, their conclusions and decisions are inevitably subject to their own unique background and biases. Much of individuals' thinking is based on their own experiences and opinions, as well as shortcuts based on implicit knowledge, beliefs, attitudes, and skills. The judgments required are not always black and white. There may be no malice intended and the process may be unconscious, unintentional, and naturally instinctive, but the impact is there nonetheless.

In [“Enhancing Auditor Professional Skepticism,”](#) authors Steven M. Glover and Douglas F. Prawitt acknowledge that “bias-inducing tendencies can lead even the brightest, most experienced professionals, including auditors, to make suboptimal judgments.” An Accounting Education Insights [paper](#) from the International Accounting Education Standards Board notes that unconscious bias can influence professional skepticism. These insights can apply to all members of the financial reporting supply chain. A *Business Insider* article on [“61 Cognitive Biases that Screw Up Everything We Do”](#) provides descriptions of biases that can arise in a day-to-day business environment.

“Trust can lead you to assume that you don’t need to challenge the executive leadership; that you ‘trust’ them to provide you with the information you need as a director; and that everything is precisely as they tell you, without inappropriate bias, omission, or spin.”

**“Trust May Be the Enemy of the Board,”**  
Internal Auditor

Below is an illustrative list of select biases that are inherently instinctive, which can impede judgment and decision making:

- + **Anchoring bias:** Placing too much reliance on initial evidence when considering subsequent data and decisions. For example, the board or management may anchor current-year estimates in the past without carefully evaluating the current environment, forecasts, or assumptions. In another instance, an auditor may rely too heavily on information from past audits.
- + **Blind spots:** Identifying bias in others but failing to see one's own.
- + **Confirmation bias:** Giving greater weight to evidence that supports one's opinion while discounting facts that disagree with it. This can be a common problem across the financial reporting supply chain, and it may be exacerbated by time pressures that increase the temptation to dismiss problematic contradictory information.
- + **Optimism bias:** Tending to assume a favorable outcome. As a result, one might underestimate risks and focus too heavily on potential positive results.
- + **Overconfidence bias:** Overestimating one's ability to make accurate judgments or do something well. As it relates to financial reporting, individuals might believe they know an answer or can assume an answer is right because they have dealt with a similar situation before or have the kind of experience that would enable them to make a reliably accurate judgment. This can occur even if the facts do not fully support an individual's assumption or seem to dispute it. It can be easy to spot overconfidence in others but more difficult to

recognize it in oneself. In addition, when one person is overconfident, especially a group leader, others may hesitate to question him or her.

- + **Survivorship bias:** Paying too much attention to successes while glossing over failures. This bias can lead to becoming overly optimistic because the focus is on those who succeeded as opposed to spending time collecting and analyzing information on failures. This can result in a skewed representation of success that can have an impact at any point in the supply chain.

As an example of how some of these biases might play out, one [study](#) found that three-quarters of Securities and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases could be linked to a mixture of optimism bias and manager overconfidence. While initial misstatements in the SEC study were relatively small, they did subsequently escalate. In another illustration of the impact of bias, according to a [COSO report](#), "overconfidence can result in avoiding, or poorly executing, a sound judgment process in any context."

It is incumbent on all members of the financial reporting supply chain not only to strive to consider the different biases that they—and others in their organization—might unconsciously apply, but also to recognize the potential hindrance these biases can have on their ability to exercise skepticism, and work toward mitigating them.

According to retired Vice President and Chief Risk Officer at Georgia-Pacific LLC and COSO Chairman, Paul Sobel, "these tendencies operate together unless we have the self-awareness and humility to recognize these biases may be influencing our judgment."

## OTHER COMMON TYPES OF BIASES TO CONSIDER



### **AFFINITY BIAS**

Feeling affinity or chemistry with another person based on similar background, life experiences, education, or other factors. This can affect the reliance one places on another's judgments or assumptions.



### **AFFIRMATION BIAS**

Making attributions regarding the cause of one's behavior even though attributions do not always accurately reflect reality. This can cause people to find reasons for their behaviors by placing blame on a convenient cause or one-off event.



### **AVAILABILITY HEURISTIC**

Relying on information that is easily retrieved or recalled from memory. This may occur in practice when an individual relies on memory rather than on documentation and the recollection is incorrect or does not apply to the current situation.



### **GROUPTHINK**

Bringing people together to gain others' perspectives can be beneficial, but the tendency can also lead to an opportunity for bias or poor decision making. It is important to recognize situations when groups might rush to a decision without sufficient discussion or discourage contradictory views.



### **HALO EFFECT BIAS**

Developing a belief about an individual's knowledge, abilities, or reliability based on a positive impression of him or her. The danger here could be applying less skepticism on an individual's actions or the information he or she provides.



### **OUTCOME BIAS**

Judging a decision based on the outcome rather than how the decision was made. This bias has a significant impact on the way decisions are evaluated. This tendency often is revealed in hindsight rather than in the moment.



### **RUSH TO SOLVE BIAS**

Needing to make a quick decision or reach consensus quickly. When an individual is under time pressure, it is easy to see how this bias could affect their actions, especially with respect to the financial reporting process.



### **SYSTEM JUSTIFICATION**

Supporting the status quo. This can happen when employees fail to question existing systems and practices. It can also lead to overlooking new types of fraud because the team checks only for fraud schemes that have occurred in the past.



# Managing the Risks of Emerging Technologies

Like unconscious biases, new technologies can pose a challenge to exercising skepticism that may be easily overlooked. The very fact that emerging technologies are greeted with great fanfare and anticipation reinforces the importance of striving to maintain skepticism in considering the information these technologies deliver. A Center for Audit Quality [report](#) offers guidelines for external auditors that can also be adopted by boards and management:

- + Gain a holistic understanding of changes in the industry and the information technology environment to effectively evaluate management's process for initiating, processing, and recording transactions and then design appropriate auditing procedures.
- + Consider risks resulting from the implementation of new technologies and how those risks may differ from those that arise from more traditional, legacy systems.
- + Consider whether specialized skills are necessary to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls.

“Without proper application of professional skepticism, the effectiveness of audit procedures is diminished. As a result, the sufficiency and appropriateness of audit evidence obtained is negatively impacted.”

**“The Importance of Professional Skepticism in an Audit,”**  
AccountingWeb

## SKEPTICISM IN PRACTICE

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The risks emerging technologies present may include the following:

- + Incorrect processing of data or processing of incomplete or inaccurate data.
- + Unauthorized access to and manipulation or destruction of data, master files, and information systems.
- + Failure to make required changes to data.
- + Insufficient segregation of duties among information technology personnel.
- + Risks associated with third-party service providers.
- + Lack of response to cybersecurity and other information security risks.

Among other recommendations, the publication suggests that auditors “maintain sufficient professional skepticism when reviewing management’s risk assessment for new systems.” Management should also perform due diligence and critically assess the risks of new technology systems. Those in the financial reporting supply chain should be ready to question the inputs, outputs, and configurations of systems to obtain assurance about their reliability and effectiveness. That includes questioning which data are included and whether the logic of the algorithms is independently tested and challenged to consider the various possible outcomes. While technology is a powerful tool, it cannot replace the professional’s knowledge, judgment, and exercise of skepticism. •



# Maintaining Skepticism During Crisis

Disruptions, emergencies, or other unexpected crises also pose threats to skepticism. Companies will face major unprecedented events that can derail normal business operations. In a PwC survey, *Crisis Preparedness as the Next Competitive Advantage: Learning from 4,500 Crises*, in the past five years, 69 percent of 2,084 senior executives had experienced at least one crisis—a situation that has an enterprise-wide, multi-functional impact, creates disruption in normal business operations, or has the potential for reputational damage.

As potential sources of pressure increase significantly during a crisis—whether it is an economic downturn, public health emergency, or industry disruption—executives often need to revise strategies and adapt to a rapidly changing environment while executing a crisis response and recovery plan.

According to a McKinsey & Company article by Chris Bradley, “*How Biases, Politics, and Egos Trump Good Strategy*,” certain biases are more dangerous than others in strategic planning. Biases that are particularly relevant when entering crisis mode include overconfidence bias, the self-reinforcing

tendency to ignore contradictory information; confirmation bias, the belief in favorable information obtained from those with shared interests and goals; survivorship bias, measurement of data that are available rather than data that are not available; and attribution bias, placement of blame and failure dismissal.

Bradley’s article emphasizes that these biases are often aggravated by social dynamics and agency problems, particularly when influenced by external stress. For example, leaders may focus on “the short game” in surviving the crisis so that the executives’ motivations do not align with the long-term strategies of the company and its stakeholders. To mitigate such biases and the risks of forgoing skepticism, companies should use an objective benchmark against which to measure the company’s success during and after a crisis.

Another key element of maintaining skepticism is to continue to ask tough questions. To emerge stronger from a crisis, it is important to focus on both the negative and positive outcomes. For instance, when faced with surprising results, leaders should home in on the results, asking, “how did an individual or

a business unit achieve these exceptional results given the climate we are operating in this quarter?”

Companies and their stakeholders are focused on the outcome of a crisis. Whether assessing company incentives or performance, leaders should challenge their own assumptions to enhance their objectivity. Assumptions are often an instinctive response—people’s brains are wired to make them—but assumptions can sometimes be off base. The desire to hit the “right” targets can lead companies and their leaders down the wrong path. A leader’s decision-making ability is more important than ever during a crisis. Rather than relying on assumptions, a leader’s decisions should be data driven and evidence based.

In its *Managing Fraud Risk, Culture, and Skepticism During COVID-19* report, the Center for Audit Quality stresses the importance of encouraging skepticism to diminish the heightened risk of fraud. With the potential increase in pressure, opportunity, and rationalization during a crisis, leaders should aim to raise their awareness of potential misconduct through enhancing skepticism. Finally, because it is important to balance the positive and negative emotions in the face of uncertainty, companies are likely to fare better in the long term if leaders can provide a point of optimism while also maintaining an appropriate level of skepticism. •

“It’s easy to hold back on skeptical questions when things are going well, but ‘don’t mess with a good thing’ is not a good answer. If it sounds too positive, ask more questions. Insist that the board be informed about anomalies—good ones and bad. Ask for the outliers and have a constructive conversation about them. Be skeptical. That’s the board’s job.”

*Crisis Prevention and Readiness, KPMG*



# Actionable Steps for Enhancing Skepticism

Skepticism is an important tool in deterring and detecting fraudulent financial reporting. When major accounting frauds are uncovered, the analysis of the root cause typically identifies several key factors that contributed to the fraud. For example, unreasonable aggressive growth or performance targets, the pressure put on teams to meet or exceed those targets, and the opportunity to manipulate results. Pressure and opportunity are two sides of the fraud triangle. The third side—rationalization—then comes into play, particularly in organizations in which the tone at the top encourages executives at all levels to do what it takes to meet those targets. Below are several steps that members of the financial reporting supply chain can strive to take to mitigate the risk of fraud.

## **RECOGNIZE THE LIMITS OF YOUR OWN OBJECTIVITY**

The financial reporting supply chain is typically comprised of individuals who have both a professional and financial connection to the organizations' numbers they are calculating or evaluating. Members of the financial reporting supply chain should avoid the assumption that the

numbers are valid based on positive beliefs or past experiences related to a company and its people. They should question or critically assess the validity of data supplied by a third party, a client, a business unit, or management, and address any discrepancies should the results raise concerns or provide contradicting evidence.

### **Steps:**

- + Be aware of the tendency to make assumptions.** These could be based on perceptions of an organization, team, or individual. While it can be difficult to identify and correct assumptions, simply recognizing the problem can help prevent it. As a way to test your perceptions, imagine that the information comes from a different source, one that is unknown to you and of which you have no personal knowledge. Would you still trust that source implicitly? What different actions would you take compared with steps you would follow with a known source?
- + Be prepared to ask tough questions.** That may be difficult for anyone along the supply chain. Pursuing a potential risk or fraud can slow processes and

potentially cause hard feelings. However, being skeptical includes raising the question when there is doubt and doing something about it even if it leads to an uncomfortable conversation.

- + **Be ready to admit that you have done something wrong and to make changes as needed.** This includes admitting to yourself that you have made a decision based on an assumption or failed to maintain adequate skepticism.
- + **Know that the level of skepticism may vary for each individual based on the situation.** Even if you believe you have an appropriate level of skepticism, that level may decline in circumstances when your own biases take over. Although you have high standards, be ready to challenge not only what others say but also your own way of thinking.
- + **Do not get comfortable.** Remember that facts and circumstances are always changing for both

a corporation and the individuals who work there. An individual may perform his or her work without consequential error or committing fraud for several years, and then an opportunity or pressure may develop that causes the individual to engage in misconduct. A system can reliably generate reports, but the output is only as good as the inputs. Do not get comfortable with a report simply because it is automatically generated with minimal human interaction.

### DON'T JUMP TO CONCLUSIONS

Consider all reasonably available information before believing anything. Review the data and evidence, not just what fits with your hypothesis. That includes not accepting an answer because it is what you expected—an example of confirmation bias. This can occur when you have a hunch or educated guess about something, so you accept evidence without questioning it if it confirms your theory.

### ADDITIONAL RECOMMENDATIONS

**Seek expert advice on complex topics.** Everyone in the financial reporting supply chain must be able to objectively assess the limits of their own abilities and expertise, as well as that of others on their teams. “Auditors often need to consider whether the engagement team members collectively have the appropriate knowledge and experience to effectively make the judgment,” according to the Center for Audit Quality’s [Professional Judgment Resource](#). They should be able to recognize the need to bring in a subject matter expert to identify key facts and assumptions and aid in collecting the necessary evidence. For instance, accounting items based on estimates, such as valuations—for which various inputs and assumptions are used—are potential areas where it may be necessary to bring in a subject matter expert. In many instances, management and audit committees can also benefit from seeking expert advice on complex topics.

**Recognize critical areas that are highly subjective.** According to the [PCAOB](#), while professional skepticism is necessary in all aspects of an audit, it is especially important in areas that involve management judgments or transactions that do not fall within the normal course of business. Such areas might include nonrecurring reserves, financing transactions, and related party transactions that could be inspired largely or entirely to manipulate an accounting outcome. Professional skepticism is also crucial in efforts to identify fraud risks and transactions outside the organization’s normal course of business. Other members of the financial reporting supply chain, as appropriate, should also be aware of these potential problem areas.

**Train employees on the importance of skepticism and ways to mitigate bias.** Leaders can set the right tone by recognizing instances for which skepticism is called for or has made an impact when applied. They should be aware that pressuring employees to meet tight deadlines or stay within budget could have an impact on the employees’ level of skepticism and plan to avoid putting employees in that position.\*

**Steps:**

- + **Keep looking.** To avoid believing in a solution that confirms your assumptions or biases, stop and consider whether other answers are feasible. Look deeply beyond the obvious.
- + **Find evidence to confirm answers.** Review initial answers more thoroughly and do not dismiss information that contradicts your assumptions.

**KEEP AN OPEN MIND**

In some cases, this may include doubting that data or reporting are correct just because all the attributes appear to be accurate and reasonable. If the numbers add up, does that guarantee that no fraud or mistakes have occurred? Clearly not. A clever perpetrator would make efforts to cover up for his or her schemes, and even a mistake made by anyone along the financial reporting supply chain may be glossed over. If something has not received scrutiny, take another look.

**Steps:**

- + **Be alert to management actions.** Directors, audit committee members, and internal and external auditors should recognize that management's operational or financial results are subject to errors, manipulation, or even fraud. In addition, understand the motivation of individuals who provide the information.
- + **Be ready to consider disconfirming information.** The information could be details that contradict or fail to support data received from another source, such as management. It may even be information developed by your own team. Do not assume that one set of data is correct without considering the validity of conflicting evidence. Document the analysis of confirming and disconfirming information to demonstrate how skepticism was used to inform judgments in the process.
- + **Encourage opposing ideas.** Those involved in gathering and analyzing information should be urged not just to tolerate questions, but to welcome different perspectives or questioning of decisions or assumptions.

**AVOID UNWARRANTED FAITH IN DATA**

While numbers do not lie, data can be manipulated to present a false narrative.

**Steps:**

- + **Question whether you have the right data.** The volume of information is unimportant if those individuals evaluating it fail to use the judgment and skepticism necessary to ferret out key details.
- + **Demonstrate curiosity about the underlying source.** Ask questions about where and how the data were generated. Consideration should be different when the data are system generated compared with manually compiled.

**HONE YOUR CRITICAL THINKING SKILLS**

Critical thinking allows you to question, assess, and evaluate the information presented to you, and it is a key foundation of skepticism.

**Steps:**

- + **Cultivate critical thinking.** Resist the urge to accept the information you receive as unassailable. Ask questions to get the full story and to better understand aspects that do not make sense.
- + **Review potential risk areas.** Are there weaknesses in the internal controls or other weak links in the financial reporting supply chain? If so, how would these problems impact the reporting process?\*



# Conclusion

IIA President and CEO Richard Chambers [notes](#) that, in addition to fraud considerations, skepticism “can also mean refusing to accept existing practices as the ultimate and always reaching for something better.”

How common is the failure of skepticism? As the exhibit at right indicates, many of those involved in the financial reporting supply chain believe their organizations demonstrate more trust than skepticism when it comes to deterring and detecting financial statement fraud.

This report has outlined the importance of skepticism, described the roles members of the financial reporting supply chain can play in striving toward maintaining it, and examined some of the biases and other threats that can hinder its use. Enhancing skepticism takes time and requires awareness, continuous training, and execution. This report’s recommendations offer readers some of the tools they can use to approach information and the readers’ everchanging environment with a questioning mind. •

## MEMBERS OF EACH ORGANIZATION WHO BELIEVE THEIR COMPANY EXHIBITS...

**MORE TRUST THAN SKEPTICISM**

**31%**  
ALL

CAQ: 22%  
FEI: 31%  
IIA: 42%  
NACD: 21%

**MORE SKEPTICISM THAN TRUST**

**6%**  
ALL

CAQ: 5%  
FEI: 9%  
IIA: 7%  
NACD: 0%

**APPROPRIATE BALANCE**

**60%**  
ALL

CAQ: 70%  
FEI: 58%  
IIA: 46%  
NACD: 79%

Source: Anti-Fraud Collaboration, *Closing the Expectation Gap in Detering and Detecting Financial Statement Fraud: A Roundtable Summary* (2013).

# Resources

Anti-Fraud Collaboration, *Assessing Corporate Culture: A Proactive Approach to Deter Misconduct* (2020)

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NACD, *The Etiquette and Ethics of Skepticism* (2012)

NACD, *Honing Skepticism* (2013)

PCAOB, *Accounting Standard 1015 (AS 1015): Due Professional Care in the Performance of Work*

PCAOB, *Accounting Standard 2501 (AS 2501): Auditing Accounting Estimates, Including Fair Value Measurements (As Amended for FYE 12/15/2020 and After)*

PwC, *Crisis Preparedness as the Next Competitive Advantage: Learning from 4,500 Crises* (2019)



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**WE WELCOME YOUR FEEDBACK**

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