

Keynote address by Paul M Koster - Chief Executive  
Dubai Financial Services Authority (DFSA)  
at the Second Regional Audit Conference  
Dubai  
22 November 2011

\*\*\*\*\*

“Professional Scepticism: raising the bar!”

H.E Yaser Abdulla Amiri, Director General, Financial Audit  
Department, Member of the Executive Council, Government of  
Dubai

H.E Abdulla M Saleh, Governor, DIFC

Mr Saeb Eigner, Chairman, DFSA

Distinguished speakers and participants

Welcome to the Second Regional Audit Conference

“Professional Scepticism: raising the bar!”

First, I wish to wholeheartedly thank His Excellency Sultan Al  
Mansoori, UAE Minister of Economy for co-sponsoring this  
second Regional Audit Conference 2011. Both His Excellency  
and I share a common view: For the UAE to grow into a  
credible and transparent international capital market, it will  
require the auditing profession to be world class. In that way the

financial information which they audit will be readily accepted by all stakeholders.

The UAE Ministry of Economy has emphasized the importance of enhancing national auditing processes and policies to achieve organizational credibility and transparency. I am confident that this year's Regional Audit Conference will prove to be one important step towards enhancing the national auditing process. For this reason, the DFSA is proud to continue with its association with the Regional Audit Conference.

The Ministry of Economy, from time to time, has initiated various programs to improve the national accounting standards and practices. These efforts complement the broader aims of the UAE Government Strategy.

I would like to quote H.E. Mohammed bin Abdulaziz Alshihhi, Undersecretary - Planning Sector, UAE Ministry of Economy: "Although we have set lofty goals and prepared sound strategies to ensure further growth and prosperity, all of these cannot be realized without a genuine commitment from all stakeholders, including the auditing profession, whom I regard as the gatekeepers of integrity and financial security in our economy. The Ministry will continue to explore how it can help the auditing services sector enhance its participation in national progress. We

shall also support initiatives aimed at promoting and enhancing good corporate governance, so that we can expedite the country's quest to become a global business hub."

The Ministry's co-sponsorship to this initiative is a strong indication of support by His Excellency Sultan Al Mansoori.

Some of you may recall the first Regional Audit Conference last December. We had over 150 participants from United Arab Emirates, Saudi Arabia, Qatar, Bahrain, Oman and Kuwait. . I am proud to advise that this year we had over 250 acceptances from 9 countries.

When the DFSA was thinking about the theme for this year's conference, it considered the latest developments in audit monitoring and issues from around the world. One theme repeated itself time and time again: "Professional Scepticism"

## **A DOUBTING ATTITUDE**

The year-end 2011 may be the most challenging auditors have ever faced. After 4 consecutive years of the worst financial crisis we have seen since World War II, auditors will have to make very difficult judgment calls requiring/demanding skepticism which is integrally linked to independence and objectivity.

A sceptic will mistrust until there are good reasons for trusting!  
The position is risk averse – someone needs to be persuaded very hard to change his view.

Let me start by highlighting this complex environment with some recent failures and the loss of confidence as a result in audits!

### Recent Failures

"Where were the auditors?" This is the phrase you will hear every time there is a corporate failure. Despite deep changes in the audit and governance regulations, corporate failures remain a recurring problem

1. The latest (worrying example) is Olympus. The Japanese camera maker admitted to hiding large losses related to securities investments for two decades. You all must have seen statements like this in the last 2 weeks: "**Why didn't the auditors function as a check on the cover-up?** The revelation has cast the spotlight on the role of their auditors during that period.
2. Another recent example is that of MF Global, whose external auditor said, as recently as May, MF's controls

were fine. Now the Regulators who are trying to retrace US\$ 600 million lost client money have said “It seems obvious that they were not keeping very good records.” Again the question is raised: “where were the auditors?”

3. Or think about the implosion at Dexia SA (DEXB), the giant French-Belgian lender that took a government bailout to avoid collapsing. Dexia got a clean audit opinion from its auditor in March 2011. Even worse, in the latest European Banking Authority “stress test”, Dexia was at a healthy spot - No. 9 in the table – yet it collapsed 3 months later. The market eventually started to doubt the balance sheet.
4. The last example I will offer is that of Erste Bank, which was treating credit default swap contracts as financial guarantee, which allowed it to use a less volatile form of accounting. Guarantees are more like straightforward insurance and require claimants to prove a loss – which CDS contracts do not. Therefore, auditors should have caught on to the fact that Erste Bank was essentially misrepresenting the essence of its credit default swaps.

The list is never ending! All of these and more have been caught in accusations of accounting errors and creative accounting that has resulted in alleged frauds and huge losses for shareholders!

It all shows how complicated it has become and the ever increasing demand on audit quality to “protect” shareholders. Auditors must be sceptical.

In its 2009/10 Annual Report, the Audit Inspection Unit (AIU) (part of Professional Oversight Board of the UK Financial Reporting Council) commented on the problem, and one of its findings was that audit firms are not always applying sufficient professional scepticism in relation to key audit judgments.

Similarly, ASIC’s audit inspection program identified a number of instances where they had concerns about the auditors’ judgment and the level and attitude of professional scepticism. Instances were found where auditors sought to corroborate, rather than challenge, the judgment of their clients.

Let me briefly focus on Audit judgments – 2011 as said will prove especially challenging. Take impairment tests of goodwill in today’s environment. The company has to undertake this test on an annual basis - here the auditor will need a true spirit of professional scepticism – management will try to avoid taking an impairment loss by arguing a robust business plan that will make good on a acquisition! The Auditor needs to be in doubt and

challenge management before “trusting” the view of management.

With more risks than ever of further eroding confidence Auditors cannot allow this erosion of trust in their work to continue.

The importance of professional scepticism has been the center stage in many recent public statements by my fellow regulators and others since the global financial crisis. Many have asserted that, in their view, auditors should be exercising increased levels of professional scepticism in performing audits. I would like to take that a **SIGNIFICANT** step further.

Where IAASB talks about audit quality and the importance of auditors prepared to challenge management assertions also to act to a deterrent to fraud, I claim we have come to point where auditors need to include in their annual audit program forensic steps to detect fraud and misappropriation. These should especially include steps to scrutinize “tone at the top” fair valuation, revenue recognition, off-balance sheet items and, as just mentioned, impairment tests. These steps will cost more money in audit fees, but that will pale in comparison to the cost of undetected fraud.

I am inclined to repeat what I said in my keynote address while opening the first Regional Audit Conference last year. “It is very important for an auditor to maintain an attitude of professional scepticism. An attitude of professional scepticism simply means that the auditor makes a critical assessment with a questioning mind, of the sufficiency and appropriateness of audit evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations from management.”

But, we have to take that a step further by including forensic tests and the Accountant taking accountability for detecting fraud with higher fees for additional work and accountability.

There is no consensus in academic literature on the definition and measurement of professional scepticism in the context of an audit. However, conceptually what is meant and understood by scepticism can be thought of along a spectrum. On one end, a presumption of **MANGEMENT’S GOOD FAITH**: one in which the auditor presumes that management prepares the financial statements in good faith unless evidence is obtained to suggest otherwise. In the middle, there is a **NEUTRAL MINDSET**: one in which the auditor attempts to be unbiased in forming his or her beliefs, and takes neither a positive (trusting), or negative (suspicious) position. On the other end, there is **PRESUMPTIVE**



**DOUBT:** a mindset where some level of dishonesty by management is assumed until evidence indicates otherwise, similar to the view as used in forensic audits. In my opinion the current economic climate justifies an auditor's attitude of **PRESUMPTIVE DOUBT**, which as stated at the beginning is the basis of scepticism.

Lets look briefing at what influences skepticism?

In my view there are number of factors that help to get auditors with a sound level of scepticism (also tied to discovering unusual transactions).

- a) Recruitment
- b) Training
- c) Motivation
- d) Audit framework / methodologies and its implementation
- e) Role of regulators

## Recruitment

There are a number of different qualities that audit firms will be seeking in new recruits. Steps should be taken to seek out the character traits underlying sceptical behaviour. If initial recruitment does not focus on scepticism, subsequent promotion/retention policies should be used to promote its importance.

## Training

It is important to identify the characteristics of skepticism that can be built through continuous training and development.

Regardless of effectiveness of the training, it is important to reinforce scepticism through the culture of the firm and its mentoring and reward systems. The culture of the firm is often influenced by the commercial pressure under which the partners and managers operates. A sceptical mind set can be influenced by experience, by direct (and indirect) forms of training and by the cultural environment within the audit firm. The latter one also known as “the tone at the top”.

## Motivation

Application of scepticism may affect short term profitability of the firm resulting in reduced monetary incentives and rewards to those who applied the scepticism characteristics. The fees for most audits are agreed in advance on the basis of time estimates and are often prepared on the basis that the entity's controls are operating effectively. In this environment there may be an incentive for the audit team to adhere strictly to the plan. Keeping to the plan is also a plausible strategy for junior staff that is already working long hours and may not wish to work even longer. These factors may work against sound levels of professional scepticism.

## Audit framework and methodologies and its implementation

Audit firms should be able to invest adequate amounts in their audit methodologies and quality control systems.

The auditing standards are becoming complicated and thus, so are the audits. The large audit firms are able to invest heavily to keep up with the pace. For smaller firms, this is more of a challenge, but this does not discharge them of an obligation to comply with more demanding standards.

## Role of regulators

The role of regulation is very important. Auditors work to technical and ethical standards, including requirements on rotation of partners. These seek to achieve a balance between scepticism, knowledge and over familiarity.

Independent monitoring by regulators also plays a very important role, but still needs to be refined.

There can be various other factors as well that influence the degree of professional scepticism in auditor behavior. These may include knowledge of the auditor, personal traits, incentives and many more. Therefore, it is important to continue to investigate what factors influence the professional scepticism reflected in auditors' judgments and actions.

Now let's go back for a moment to:

## **Forensic v/s Financial Audits and the Appropriateness of Audit Standards**

The objective of a forensic audit in the current literature and audit plans is different from the objective of a financial statement audit. In an audit of financial statements, the auditor's overall

objective is to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. However, in a forensic audit, the objective is to uncover asset-theft fraud.

Under the existing standards, responsibility for preventing and detecting fraud rests with the management. Although the auditor - until now!! -- has not been required to perform work with a forensic mind, he/she still can have a positive role in preventing fraud and errors by deterring their occurrence. The auditor should plan and perform the audit with the recognition that conditions or events may be found that indicate that fraud or error may exist.

The Auditor, as said, currently is not responsible for preventing and detecting fraud, which is a clear departure from where the profession started. But whenever an accounting deception is uncovered, one of the first questions investors ask is, "Where were the auditors?" Many in corporate world are frustrated and concerned about the trend of erosion of trust in Audits.

Recent developments in the auditing standards (Clarified ISAs) have imposed requirements on all auditors to perform enhanced procedures which include mandatory meetings of the audit team to discuss the susceptibility of the entity to misstatements and

fraud or error that could result from related party relationships. However, the recent failures do suggest that further action needs to be taken.

Should the standards include a positive obligation on auditors to perform audit with a forensic mind to discover frauds over a certain threshold?

I say Yes! The audit needs to go back to its root and perform the basics. This is not likely unless there is a strong positive obligation under the standards they have to follow.

### **New Point of Departure**

Let me summarise:

I strongly believe that today we stand at a cross road.

Trust in the audit profession has so much eroded that its added value is questioned in some corners of the market and increasingly so.

Many investors now question the value associated with the auditor's report. The trust levels are dropping. However the continuation of uncertainty in the market due to the financial

crisis should make the auditor's role much more important than ever before!

There should be a new social contract based on pre-defined obligations and rights rather than expecting auditors to act in the more limited role of issuing an audit opinion, as is currently the case.

Emphasizing Professional Scepticism is the path back with an audit work program expanded and attuned to detecting fraud over a certain threshold – depending on size/scope of company.

**PROFESSIONAL SCEPTICISM IS AN ASSET NOT A LIABILITY.**

**TOO LITTLE OR NO SCEPTICISIM IS AN UNLIMITED LIABILITY.**

Before I conclude, I would leave you all with some questions which I am hopeful that we all would try to find solutions over the next two days:

- a) What specific characteristics are needed to detect material misstatements?

- b) How can auditing standards provide better guidance on professional scepticism?
- c) How can auditing standards provide better guidance on how to implement the concept?
- d) Do auditors become more or less sceptical as they gain experience?
- e) What is the role of the audit review process in the auditors' individual scepticism and can it compensate insufficient testing and care?

In conclusion, we do not expect to find magical solutions to the problems which the profession faces in just two days, but by coming together we shall certainly be making an informed start towards finding solutions.

I look forward to two interesting days with such good speakers and your participation although you may be sceptical and reserve judgment till the end of the conference.