Use of a professional judgment framework

In recent years, some firms have adopted the use of a professional judgment framework to provide a systematic way of making professional judgments, for example, theProfessional Judgment Resource created by the Center for Audit Quality (CAQ). Some firms have implemented this or other frameworks into their audit practices.

According to Enhancing Auditor Professional Skepticism, a formal judgment process provides a context in which to understand where and how traps and biases can undermine judgment and professional skepticism. Once such a process is in place, auditors can understand and identify judgment traps and biases and their impact on professional judgment and skepticism.

Once aware, the auditor can take steps to mitigate the impact of these traps and biases by stepping back and reassessing the situation and facts.

Example Prompts

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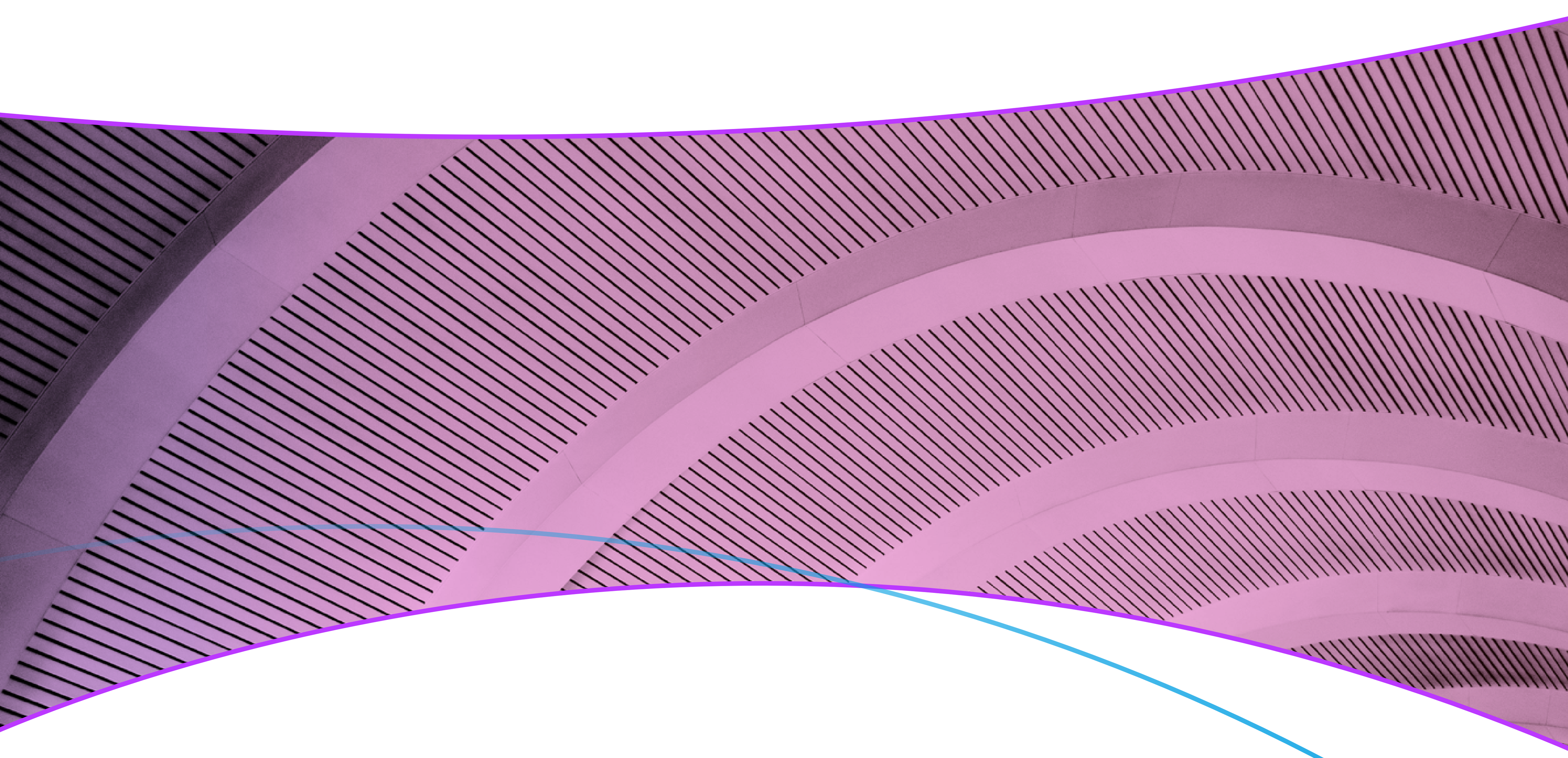

Judgment influences

Not unlike professional skepticism, which is subject to certain biases and influences, the exercise of professional judgment may be influenced by factors such as faulty reasoning, hindsight, hastiness, or self-serving explanations.

Rush to solve

You may want to immediately solve a problem by making a quick judgment and, as a result, you can underinvest in the important early steps of the judgment process, going with the first workable alternative that comes to mind or that is presented. This is called "rushing to solve," and it can be dangerous.

Distorted or motivated reasoning

When analyzing information, you may interpret the information in the way that you think it should be interpreted rather than considering other reasonable alternatives. This is distorted or motivated reasoning. This can result in evaluating information in a way that supports only one expected outcome and therefore greatly diminishes the quality of the judgment.

Self-serving explanations

Another factor that can potentially affect your judgment is a tendency to interpret outcomes in a self-serving way. If the outcome of a judgment is positive, you may tend to take credit for it. If the outcome of a judgment is negative, you may look to other reasons, rather than yourself, to explain the outcome.

Hindsight

Hindsight is the tendency for a person who has been provided with the outcome of an uncertain event to systematically overstate the ability to have predicted that outcome in foresight. In other words, when reviewing the outcome of a judgment, you may think, in hindsight, that that outcome was more probable than you thought it was before you knew the outcome.

Hindsight bias can often occur at a subconscious level.

It can lead to overconfidence, and it can weaken professional skepticism and judgment. Hindsight bias may also exist when one considers a judgment that was made in the past and concludes that it was unreasonable. Absent hindsight bias, the person considering the prior judgment may conclude it was reasonable.

Enhancing auditor professional skepticism

In addition to developing the judgment skills underlying the exercise of professional skepticism, firm training can enhance auditors' professional skepticism by boosting their knowledge in specific areas relevant to the audits to which they will be assigned.

To accomplish this, a firm might employ the following:

- Training specific to industry, operations, valuation methodologies, IT controls, and accounting. Obtaining knowledge and an understanding of the current environment for the client's industry, operations, and accounting helps auditors better identify risks.
- Training about the importance of setting independent expectations of unaudited account balances prior to focusing on the client's recorded amounts. Auditors may sometimes base expectations on client-provided evidence, including the company's unaudited financial results.

Further, there may be times when junior auditors do not have sufficient experience to move beyond an "understanding" mindset to effectively challenge management's views and preferences. It is important that firms assign staff with relevant skill sets to audits and properly mentor junior auditors. Effective review and coaching techniques can help more experienced auditors appropriately supervise and mentor junior auditors. Teams can include these discussions when they meet during the planning phase of the audit to discuss the susceptibility of the company's accounts to fraud or error, which will be very useful to all team members, especially junior staff.

Effective planning can help teams identify situations where threats may arise and how they can be addressed.

The decision-making process

The audit decision-making process can be broken down into five steps:

Step 1: Identify and define the issue

Step 2: Gather facts and identify literature

Step 3: Perform analysis and identify alternatives

Step 4: Make the decision

Step 5: Complete documentation and rationale for decision

Step 1: Identify and define the issue

Key point

First, you must identify and define the issue, which is not always as simple as it sounds.

Make sure you consider the issue (or issues) in its or their entirety and that no facts are being obscured (for example, via biases or blind spots in your own understanding).

One technique for seeing an issue more clearly and completely is to evaluate the issue from multiple perspectives. For example, when you consider an accounting treatment, step back and consider the issue from the perspective of someone other than yourself—perhaps from management's perspective or through the eyes of a regulator, investor, or reporter. Viewing the accounting through many lenses and perspectives (in addition to your own) will force you to consider things you may not have otherwise considered in defining the problem.

At this phase, it's often helpful to consult with others—for background and other insights—so that you fully understand the situation and its potential impact on your audit.

Step 2: Gather facts and identify literature

Once you've identified and framed the issue, you will need to gather the relevant facts and identify the applicable accounting literature. You've already considered information that was readily available, but now it's time to dig deeper.

This will involve consulting with management, internal or external subject matter experts, and possibly others, such as technical experts in your firm or other parties to the transaction.

Key point

At this stage, you should identify key inputs and assumptions in the transaction or event and gain a fuller understanding of the underlying economics.

As you are seeking information, you may find corroborating, conflicting, or even disconfirming information—including information that may contradict what management has told you or documents that management or others have provided you.

You will need to be alert to biased thinking and not ignore or discount information that is inconsistent with management's information and your own expectations.

You should continue to gather facts until you are satisfied that you thoroughly understand all of the relevant issues.

Be sure that you do not prematurely stop seeking information.

Step 3: Perform analysis and identify alternatives

Key point

As you analyze the information you have gathered, it's important to be thorough in considering all of the alternatives.

If you've defined the issue properly and gathered your facts in an unbiased manner (that is, avoided judgment shortcuts), you will be well positioned to do this. Here again, bias may enter into the analysis, and you want to guard against that. It's important to not take shortcuts, be overconfident in what the right answer is, or rely too heavily on previous experience without fully weighing all other options.

Step 4: Make the decision

Key point

Your decision may come from consideration of only one viable response to an issue, or you may have identified many possible responses and selected what you believed to be the best one. Ensure you have considered the overall, big picture.

Step back and reassess the process you've just completed (almost!). Similar to framing the issue at the start, revisit your decision in light of the bigger picture. For example, how does your judgment look in light of the financial statements taken as a whole?

Does your solution result in full and fair representation of the company's financial condition and operations?

Think about the process and whether you completed it properly. For example, did you consider whether you could have been biased in any way, did you consult with others when you had any doubt, and did you gather sufficient and substantive evidence?

Step 5: Complete documentation and rationale for decision

The last step in the process is completing your documentation, including the rationale for your decision.

Consider: If you find it particularly challenging to draft documentation of your decision, consider whether the decision or the process used to arrive at the decision was flawed.

Also, document other viable alternatives not chosen and justify why they were not chosen.

When you document your decision, include a discussion about how you exercised professional skepticism and all supporting evidence, even if not recorded in the current folder or form.

Example Documentation:

This might include situations such as: If you sought evidence to make the opposite case of what management told you, describe what management said, what you did, and what you found. Be as specific as possible.

Documenting your rationale allows you to assess the strength of your evidence and how persuasive it is. If, in the documentation process, you do not believe your evidence or rationale is persuasive enough, you should go back to the process and re-evaluate where the shortfall was and make needed corrections.

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An excellent practice and discipline to develop is to document as you go through the process. This is especially helpful when you are considering various alternative approaches to the issue. You do not need to write long essays. Concise writing that is clear and factual saves review time and is less likely to include extraneous statements that can be misunderstood in retrospect or require clarification in review. Some investigators consider excessive verbiage to be a "red flag" that there may be an underlying issue.

For example, perhaps you did not identify all the possible alternatives for an accounting treatment or did not fully vet certain disconfirming information that came to your attention.

Consideration of fraud in the audit

According to AU-C section 240, Consideration of Fraud in a Financial Statement Audit, auditors should maintain professional skepticism throughout the audit, recognizing the possibility that material misstatement due to fraud could exist.

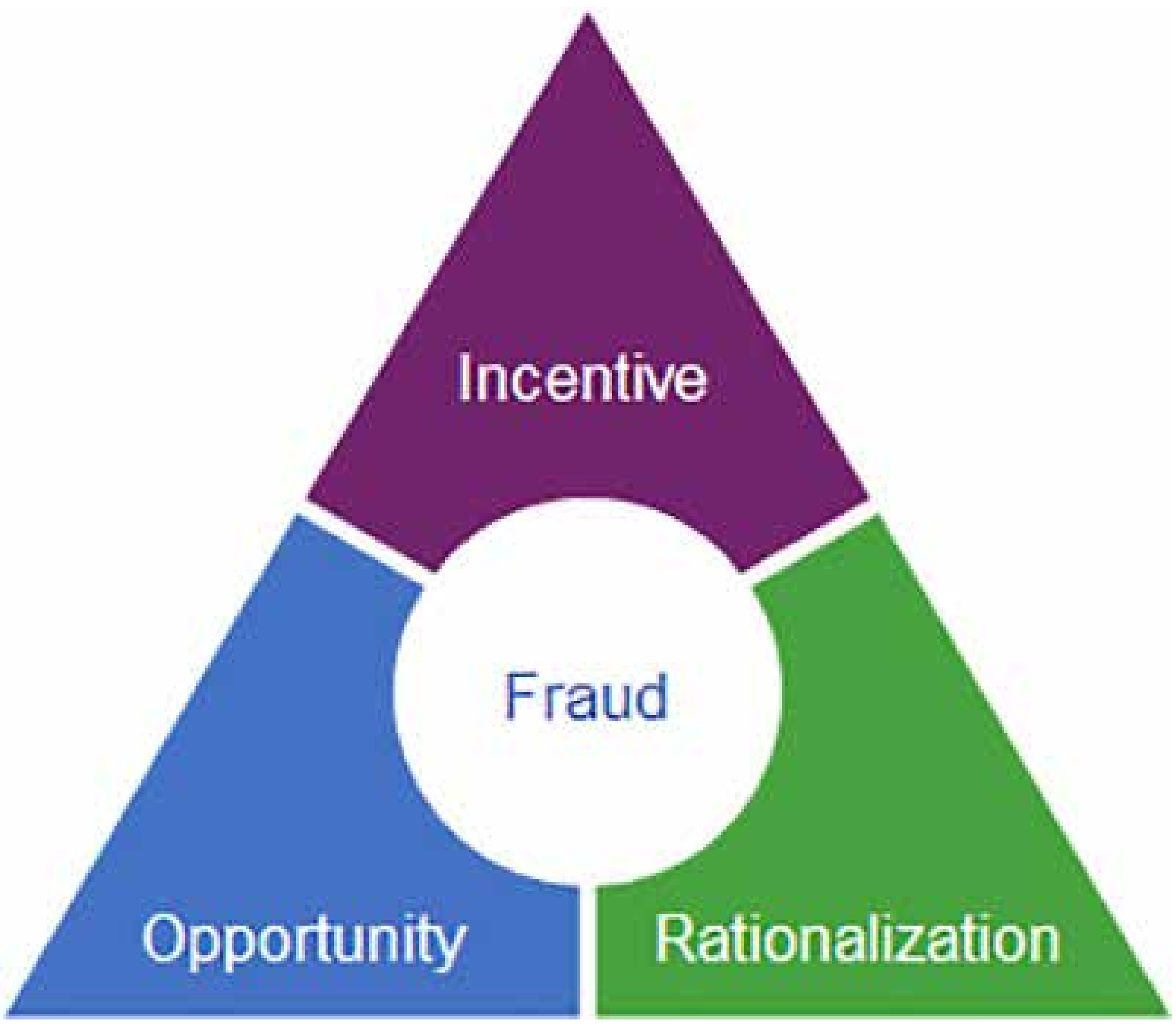
Furthermore, auditors may accept records and documents as genuine unless conditions are identified that cause the auditor to believe otherwise or management's responses are inconsistent or unsatisfactory. In these instances, you should always investigate further.

In considering the possibility of fraud, keep the following few things in mind:

- Fraud can involve collusion and, in some cases, sophisticated methods of concealing transactions, and information from auditors and others.
- Tests that are effective in detecting errors may not be effective in detecting fraudulent activity.
- Due to management's ability to override internal controls, the risk that management may perpetrate fraud that would affect the financial statements or violate laws or regulations must always be considered.
- One tool auditors use to consider the potential for fraud is the fraud triangle.

Fraud triangle

The conditions that may lead to fraudulent behavior that would cause a company's financial statements to be materially misstated are often described in a visual tool referred to as the "fraud triangle."



Incentives

Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure from sources outside or inside the company to achieve an expected, and perhaps unrealistic, earnings target or financial outcome—particularly because the consequences for management in failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets.

This situation may arise when individuals are living beyond their means, severely in debt, or other similar scenarios.

Opportunity

A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden. This may arise, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Rationalization

Some individuals are able to rationalize committing a fraudulent act. They possess an attitude, character, or set of ethical values that allows them to knowingly and intentionally commit a dishonest act.

Key point

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Accounting and auditing issue

Include the accounting or auditing issue identified from the applicable background and facts and information gathered. Be as detailed as necessary to set the stage for the identification and considerations of the applicable standards or other guidance related to the issue.

This space will typically include documentation of the following factors:

- A clear identification and description of the issue to be addressed, including relevant terms and other facts
- Other information that you believe is relevant to the issue

Key point

Include the accounting or auditing issue resulting from the background and facts.

Documentation

How should you demonstrate that you applied professional skepticism in conducting your audit engagement, aside from your obligations under AU-C section 230, Audit Documentation, keeping in mind that comprehensive documentation of judgments and exercise of professional skepticism become more critical as the complexity and significance of matters increases?.

According to the CAQ Professional Judgment Resource

Further, the CAQ developed the following guidelines for documenting your decision-making process when you address accounting or auditing issues during an audit.

All of these concepts are valuable, but we will simply summarize the key points. Take some time to review all of the information.

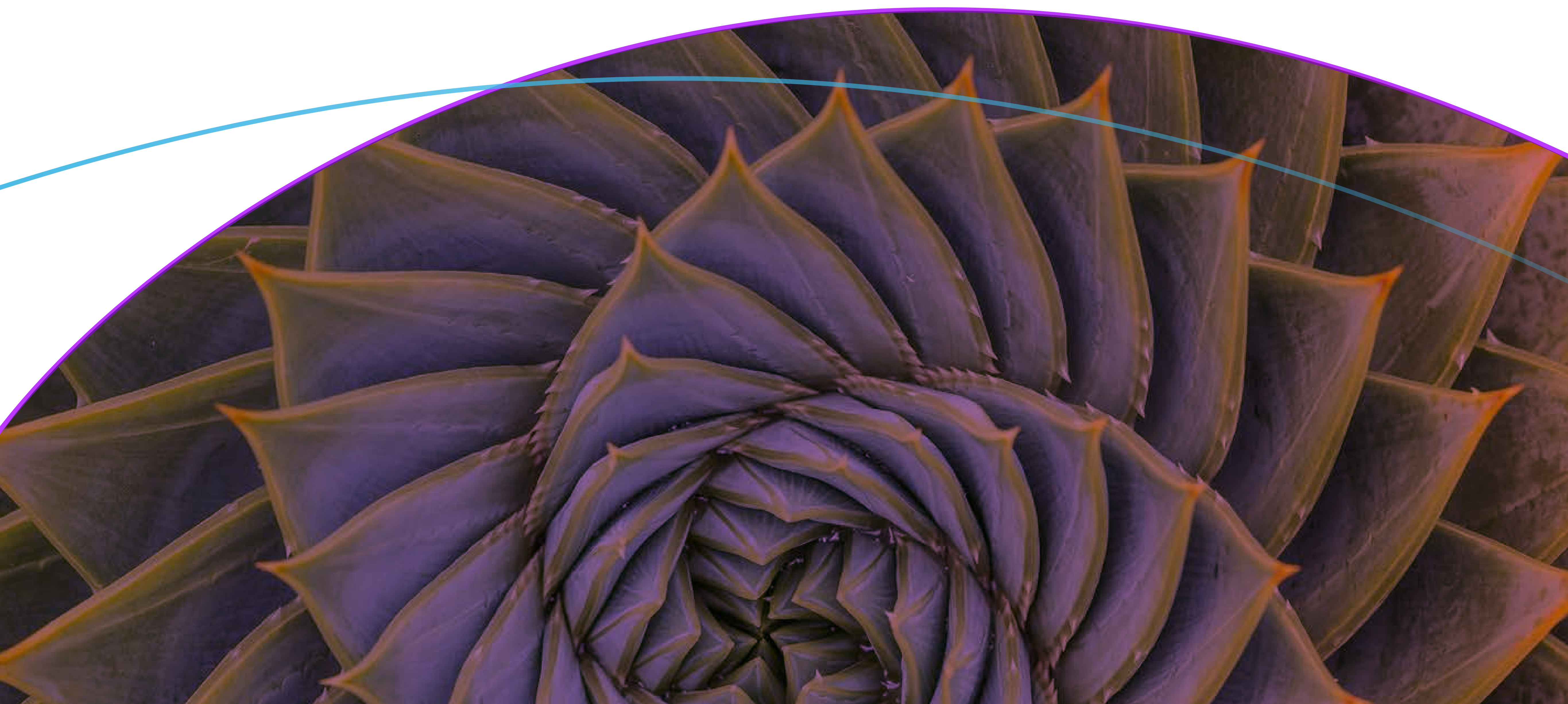
According to the CAQ Professional Judgment Resource

Auditing standards require that an auditor's documentation sufficiently evidence compliance with relevant professional standards and be prepared in sufficient detail to provide a clear understanding of

(1) the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and

(2) information the auditor has identified relating to significant findings or issues that is inconsistent with orcontradicts the auditor's final conclusions.

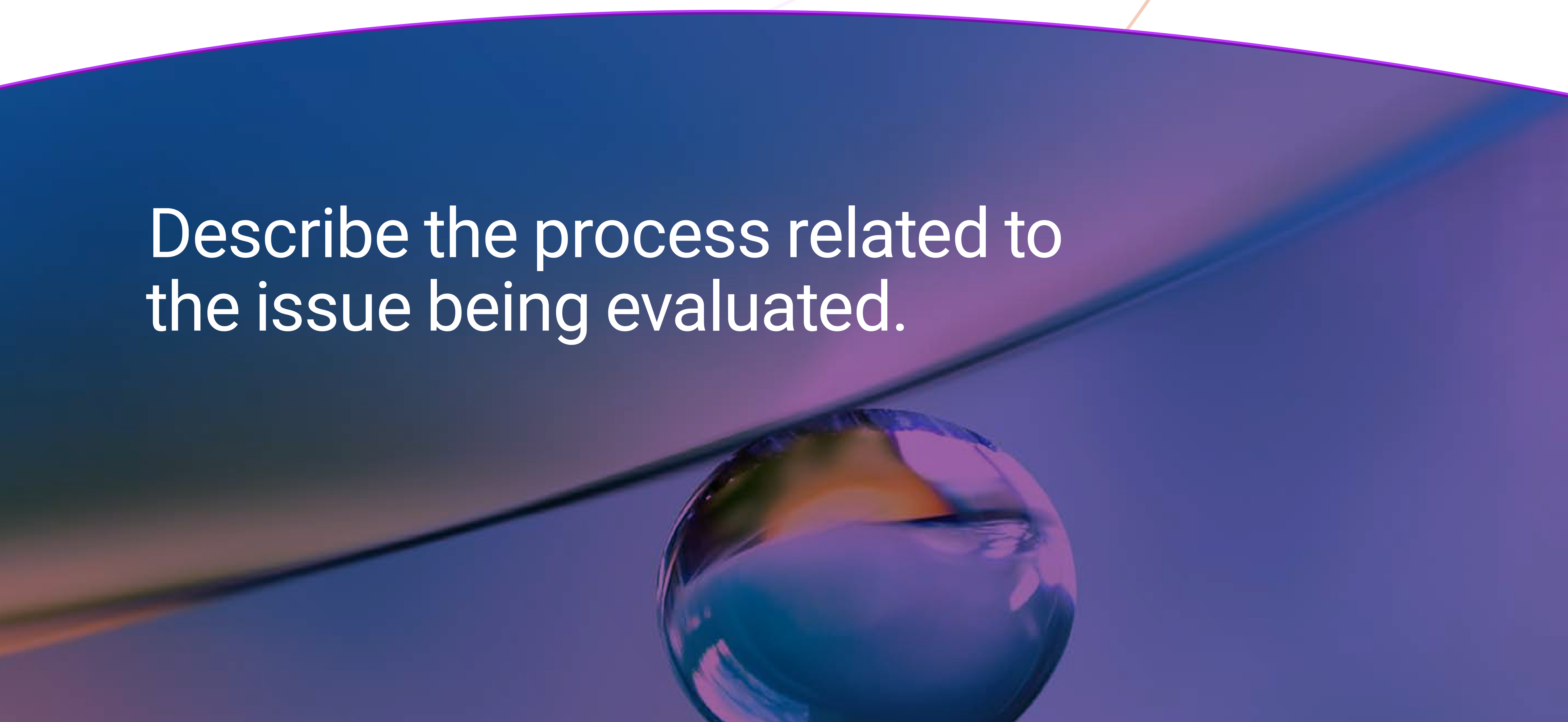
Such auditing standards also point out that timely documentation and reviews of judgments made enhance the quality of the audit. Accordingly, an auditor may find it helpful to document certain decisions throughout the judgment process.



Describe or illustrate the transaction (or process)

Describe verbally or illustrate through a diagram, flowchart, or decision tree the transaction or process related to the issue or issues being evaluated.

Using illustrations and visual displays of the information, instead of or as a supplement to a verbal description, can simplify complex transactions or processes and improve yours and others' understanding of the matter.



Background and facts

Document the background and the relevant, objective facts related to the issue that will be addressed. This will typically include documentation of the following factors:

- The relevant financial statement or account balance information to the issue being evaluated
- A summary of the company's position with respect to the issue and the basis for its position
- The business purpose or economic substance of the transaction and any related or linked transactions or events that need to be considered in determining the business purpose or economic substance
- Reference to company documents the team identified and considered during the analysis (attach, as necessary, copies of relevant contracts and company-prepared documentation or reference page numbers to such documentation to facilitate reviews)
- The assessment of materiality to the financial statements or other financial statement impacts
- As applicable, a description of any current or previous discussions or correspondence with the SEC or other relevant regulators regarding the issue or similar issues
- As applicable, whether the issue (or a related issue) for the company has previously been discussed in a separate national office consultation or separate memo included in the audit files
- Other relevant evidence gathered or key facts identified that underlie the issue identified; include any assumptions made and the basis thereof

Document the background facts related to the issue.

Relevant accounting and auditing guidance

Provide the relevant accounting or auditing standards, regulatory guidance, and other audit firm policies or guidance you considered and ultimately determined to potentially apply to the issue being evaluated.

- The relevant accounting and auditing standards, regulatory guidance, and audit firm policies and guidance (for example, the accounting, auditing, financial reporting, independence, risk management, or other relevant standards or guidance that apply)
- A description of any relevant industry or competitor practices
- Whether the company or the engagement team is aware of any prior SEC staff or other regulatory agency positions on the issue— briefly describe
- Whether the company or the engagement team considered and relied on the expertise of a third-party specialist (for example, a legal, engineering, actuarial, or valuation specialist)—briefly describe

Discuss the relevant standards, guidance, or related policies.

Analysis performed

Document the analysis performed and the reasonable alternatives considered.

This section will often include your evaluation of the relevant facts and information gathered and evidence obtained, the company's work and supporting schedules provided (for example, an internally developed valuation report), or results from the company's or your use of specialists.

Reference any other materials attached or appended to the analysis, such as flow charts, relevant portions of authoritative standards, and relevant company-prepared documentation—for example, contracts.

Provide your analysis and any reasonable alternatives considered.

Documenting the analysis - Factors

Think of good documentation of your analysis as telling your story, in writing, about an event that happened where you know the reader was not present at the event. That story should leave no significant details out. You should fully describe all of the relevant factors. Some examples are described as follows:

- Provide a description of reasonable alternative approaches you considered, supported by reference to the applicable accounting or auditing standards or other relevant guidance. This may include an analysis of the current and future financial statement impact of the alternatives considered.
- Specify how you obtained sufficient, appropriate audit evidence and considered contradictory information during the decisionmaking process; fully describe how you dealt with contradictory information.

An important fact is whether the company or your team requested a specialist or a national office consultation and whether the company or your team may elevate the matter to the SEC's Office of the Chief Accountant for "pre-clearance."[5]

Lastly, describe any disagreements you had with the company on the issue.

[5]The AICPA maintains a hotline that can provide guidance for private and non-issuer companies on accounting related issues.