



Financial Reporting Council





# Professional Judgement Framework



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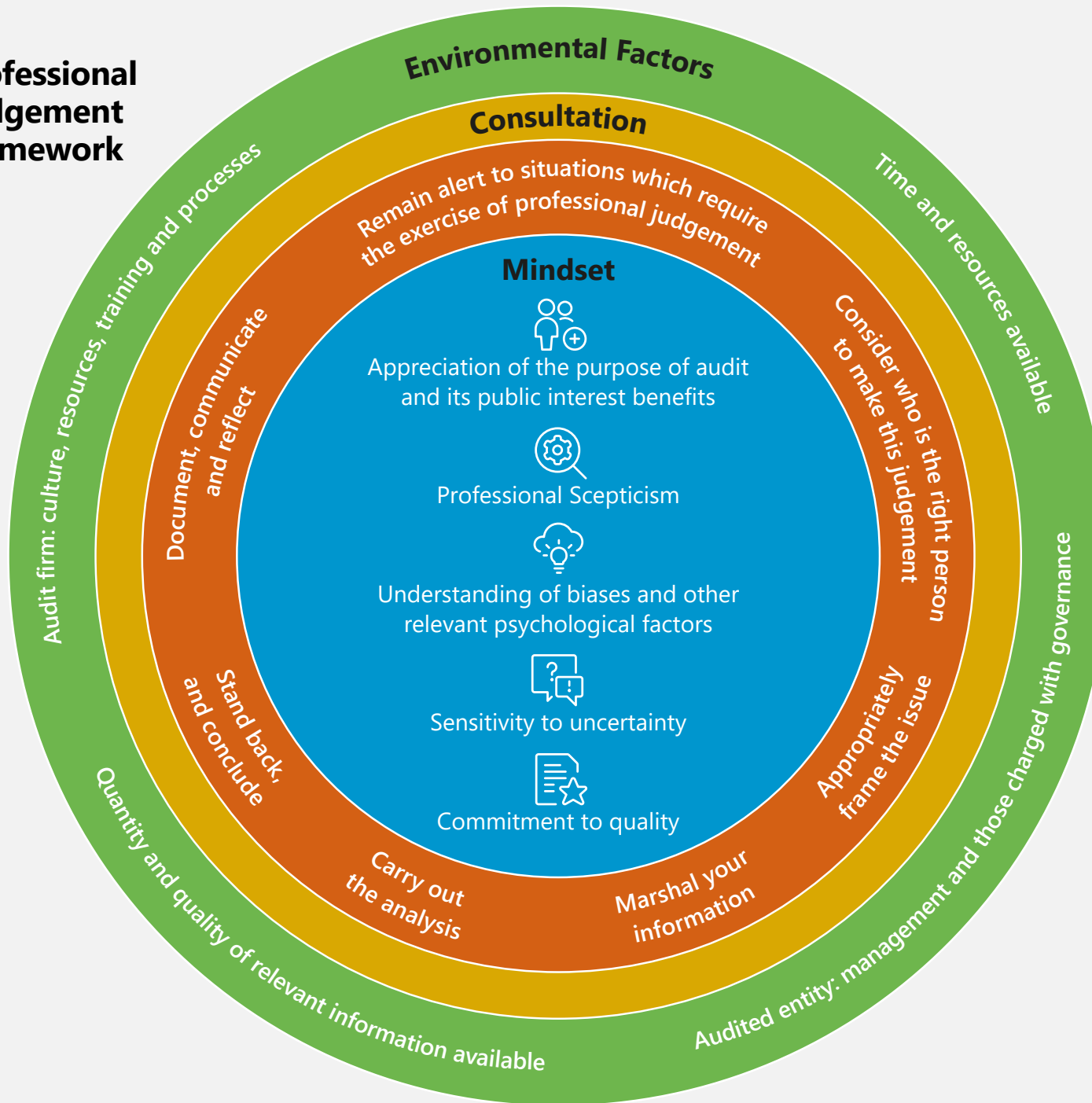
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# Professional Judgement Framework



This framework consists of four main components:

- **Mindset** – An appropriate mindset for auditors exercising professional judgement;
- **Professional Judgement Trigger and Process** – A suggested professional judgement process, together with a reminder to remain alert to situations which may require professional judgement;
- **Consultation** – Effective communication with a range of relevant parties; and,
- **Environmental Factors** – Factors that may be present in the environment of those making a judgement, that can impact on how challenging it is to exercise professional judgement in an appropriate manner.



## Mindset

**This section highlights five aspects of mindset that are especially relevant to exercising professional judgement in an effective manner. These mindset aspects are not only useful for longer, more considered judgement processes but also, when assimilated, can improve the quality of quicker and more intuitive judgements.**

Every professional judgement involves numerous factors to be considered and decisions to be made; each case is bespoke and there is no precise formula for how to make a quality professional judgement. This means there is a great deal of latitude for the individual or team making a professional judgement to decide on the appropriate approach in the circumstances, and a consequence of this is the paramount importance of mindset.

It is vital that the person or people making the judgement have the right motivations, understanding and attitude, to facilitate each element of a judgement process being carried out in a consistent manner that is apt to lead to a reasonable judgement.

### Appreciation of the purpose of audit and its public interest benefits



The purpose of an audit is to enhance the confidence of the intended users in the financial statements.<sup>1</sup> The audit should also enhance their understanding of the financial position and performance of the audited entity.<sup>2</sup> The auditor thus acts for the benefit of the intended users.

The public interest benefits of an audit stem from the intended users having increased confidence in, and understanding of, the financial statements.

Shareholders, potential investors and creditors benefit from the increased transparency over how the audited entity's management have stewarded the assets entrusted to them; this reduces the risk of investing in, or lending to, the entity and lowers the cost of capital. Employees, suppliers and other stakeholders may use the financial statements to learn more about the stability and long-term viability of the entity. All of this helps facilitate a better functioning economy, which benefits the wider public beyond the intended users.

Understanding the intended purpose and beneficiaries of the audit helps emphasise that the interests of the intended users should be paramount when making judgements in the course of an audit engagement. Furthermore, bringing the public interest benefits that are derived from conducting a high quality audit to the front of one's mind may be useful in motivating the auditor to be committed to quality, objective and professionally sceptical.

<sup>1</sup> International Standard on Auditing (UK) 200 (Revised June 2016) (Updated January 2020), Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (UK), paragraph 3.

<sup>2</sup> Revised Ethical Standard 2019, paragraph 11

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## Professional Scepticism



Professional scepticism is a key part of an appropriate auditor mindset, supporting the quality of judgements made on the engagement and, through these judgements, the overall effectiveness of the engagement team. Professional scepticism is defined in ISA (UK) 200 as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.<sup>3</sup>

Professional scepticism may be especially relevant when gathering and analyzing information and evidence, and to effectively challenging management.

### Example



A trainee auditor is working on the audit of a government department, performing procedures over grant expenditure. He identifies a grant payment in the final month of the year which is unusually large, being three times the value of the average monthly payment for the rest of the year. The trainee auditor confirms that the grant expenditure has been recognised with respect to the grant conditions by: confirming that there are no performance conditions in the grant agreement; agreeing the payment to the bank statements; confirming that recognition is in line with the department's accounting policies; and verifying that the total grant expenditure recognised to date is less than the total three year grant award.

However, the trainee auditor remains concerned about the unusual payment pattern, and raises the issue with his manager. The manager is aware from their risk assessment that the department is forecast to underspend against its budgets for the year, and is incentivised to minimise any underspend. The manager agrees that the grant expenditure has been recognised in reference to the grant conditions, but notes the HM Treasury requirements on avoiding payments in advance of need, which are relevant to a separate audit opinion on the 'regularity' of transactions.<sup>4</sup> The manager and trainee agree that further work is required to assess whether a material irregular transaction has occurred.

3 International Standard on Auditing (UK) 200 (Revised June 2016) (Updated January 2020), Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (UK), paragraph 13(l).

4 Practice Note 10: Audit of financial statements and regularity of public sector bodies in the United Kingdom (Revised 2020)

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## Understanding of biases and other relevant psychological factors



There are a range of biases that can hinder logical and objective reasoning. These can subconsciously affect the judgement processes of everyone, including highly skilled and experienced auditors. Such biases may include:<sup>5</sup>

- **Availability bias:** a tendency to place more weight on events or experiences that immediately come to mind or are readily available than on those that are not.
- **Confirmation bias:** a tendency to place more weight on information that corroborates an existing belief than information that contradicts or casts doubt on that belief.
- **Groupthink:** a tendency to think or make decisions as a group that discourages creativity or individual responsibility.
- **Overconfidence:** a tendency to overestimate one's own ability to make accurate assessments of risk or other judgements or decisions.
- **Anchoring bias:** a tendency to use an initial piece of information as an anchor against which subsequent information is inadequately assessed.
- **Automation bias:** a tendency to favor output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose.

Other relevant psychological factors may impact on judgement too. For example, certain personality traits may be detrimental to the exercise of good judgement, such as an undue fear of conflict, unwillingness to challenge figures of authority where appropriate, impatience or stubbornness. Conversely, some are likely to support an effective judgement process, such as perceptiveness and a willingness to consult and listen. Furthermore, an auditor's feelings and beliefs will play an important role in how they go about making a judgement, affecting matters such as where they look to gather information and how susceptible they are to judgement traps such as motivated reasoning, which involves one's motivations unduly influencing how one evaluates information or makes decisions. For example, an auditor may have made decisions in the past that have become politically "associated" with them, and consequently could be motivated to make decisions now that are consistent with those prior decisions or do not cast them in a bad light, which could lead to inappropriate judgements.

Understanding the factors discussed here assists the auditor in developing strategies to mitigate or cultivate such factors as appropriate.

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<sup>5</sup> International Standard on Auditing (UK) 220 (Revised July 2021), Quality Management for an Audit of Financial Statements, paragraph A35. The six biases set out here are not intended to be a complete list of all biases that could affect audit judgements, just an illustrative list of some that might be especially relevant.

## Example



A trainee auditor is using automated tools and techniques, specifically audit data analytics, in the identification of high-risk journal entries. She uses the program's default selection parameters, without tailoring them based on her understanding of the entity and its environment. This generates a selection of "high-risk" journal entries, including several items categorised as such due to having been posted at the weekend by members of the finance team.

The trainee auditor knows from her prior work on the audit that the finance team often work weekends, especially at month-end, and thus had reason not to take the output of the analytic at face value. However, the trainee auditor places a lot of weight on the fact that a specialised piece of software deemed the journal entries unusual, and plans to perform further procedures over all of these journal entries. Thus she relies on the system output without considering whether her wider understanding might imply it is not fit for purpose; this is an instance of automation bias.

## Example



An audit senior manager is involved in the planning of the audit of C plc. He has been tasked with determining performance materiality for the current year's engagement. He starts by looking at the audit file from the prior year, and sees that the engagement team set performance materiality at 75% of materiality. He is aware that a higher than expected number of misstatements were identified in the prior year, and that the control environment remains relatively weak. Therefore, he deems there to be an increased expected risk of misstatements, as compared to that which was determined at the start of the prior year engagement. As a result he resolves to choose a lower percentage of materiality for performance materiality, setting it at 70% of materiality.

His judgement here may have been affected by anchoring bias, if he put undue weight on the initial piece of information gathered, namely the prior year figure. By starting with the figure used last year, and then using that as a base for determining the current year figure, he could have stayed too close to that benchmark. If he had started from a broader consideration of the entity and its environment and a range of factors that affect the expected level of misstatements in the current year, he may have arrived at a different figure.

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## Sensitivity to uncertainty



Examples of ways in which remaining sensitive to uncertainty can contribute to an effective professional judgement process include:

- One of the hallmarks of situations which require the exercise of professional judgement is that they often involve significant levels of uncertainty. Therefore, an awareness of the presence of uncertainty can assist the auditor in identifying when they may need to exercise professional judgement.
- Certain aspects of a situation may be more uncertain than others; for example, some information sources may be more or less reliable than others. An appreciation of this may allow the auditor to direct their work efforts in a more effective way.
- Many biases involve putting undue trust in or weight on certain decisions or pieces of information; appropriately understanding the uncertainty attached to such decisions or pieces of information may help improve the quality of the judgement process.
- When carrying out a step in the judgement process, it is unlikely that the auditor is able to eliminate all uncertainty that may be present. By being aware of this, the auditor may be able to build in mitigating actions into their judgement process, such as considering the need to return to earlier judgement steps when new information comes to light.

### Example



An audit manager is resourcing an engagement and is exercising their professional judgement in determining when staff will be required to be staffed. Based on his previous experience of audits with similar reporting deadlines and anecdotal feedback from colleagues who had worked on prior year audits for this audited entity, he comes to a decision about when they believe the audited entity will provide the bulk of the required information for the audit. Unfortunately, the manager is overconfident in his ability to make this decision. This causes him to not build in any contingencies in the resourcing plan or carry out further information gathering activities to support his decision.

In fact, the management of the audited entity had reorganised their finance team in the year which caused some delays in the year end process and meant significant amounts of information was not provided to the audit team until two weeks after the team arrived onsite. This led to the audit team spending time inefficiently early on in the engagement and then requiring extra resource later on.

If the manager had recognised the uncertainty surrounding their assessment of when the team would receive information, he could have, for example, enquired with management about their plans and timelines, and better planned the audit accordingly.



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## Commitment to quality



In addition to the other aspects of mindset discussed here, it is important that the auditor is committed to making quality judgements, or else the other factors may not be brought to bear in an appropriate way.

The motivation behind such a commitment can stem from many sources, including the ethical values required of professional and trainee accountants, an understanding of the public interest role of audit and appropriately aligned incentives from the audit firm.

### Example



An engagement team are working on the audit of a listed entity, and are nearing the planned signing date that fits with the entity's reporting timetable. However, there is an outstanding issue that requires significant professional judgement. The engagement partner convenes a meeting with team members to discuss the issue; she acknowledges the time pressures but emphasises that reaching an appropriate and reasonable judgement is the priority, and is willing to delay signing the audit opinion to provide the team with enough time to perform a robust professional judgement process.

Here, the partner's commitment to quality facilitates an effective judgement process.



# Professional Judgement Trigger and Process

**This portion of the framework comprises a series of steps which may help to structure the way in which a judgement is carried out and documented, as well as a “trigger” step setting out the importance of staying alert to when professional judgement might be called for, and when a more formal judgement process might be warranted.**

Although the process is split into discrete “steps” for ease of presentation, that is not meant to imply that judgement is a simple linear process. It may be appropriate at any step to return to any other step in the process, for example if new information comes to light.

## Remain alert to situations which require the exercise of professional judgement



As defined in ISA (UK) 200 and ISQM (UK) 1, professional judgement is exercised whenever the auditor makes an informed decision about the appropriate course of action in their role as an auditor.

As mentioned in the introduction, such decisions will vary with respect to the extent to which a formal and considered judgement process is warranted; it is not expected that the professional judgement process presented here will be followed for every professional judgement made by an auditor. In general, the auditor may wish to consider the complexity and importance of the judgement being made, their experience at making similar judgements and the availability of any direct precedents, in deciding whether to use a formal judgement process.

## Consider who is the right person to make this judgement



Having the right person or people making a judgement goes a long way to ensuring an appropriate conclusion is reached. When assessing who is the right person or people to make the judgement, the auditor considers:

- The relevant knowledge, skills and experience required;
- The complexity and importance of the judgement; and,
- The time and resources that would be available to them, including access to coaching, technical advisory services provided by the firm, external experts, training materials and automated tools and techniques.

Where the auditor engages an expert to provide a view on a certain topic, as part of a professional judgement process, it is important to note that the auditor remains responsible for the relevant professional judgement; the expert may provide information to support the making of a judgement, but the judgement itself cannot be delegated to them.<sup>6</sup>

<sup>6</sup> International Standard on Auditing (UK) 220 (Revised July 2021), Quality Management for an Audit of Financial Statements and International Standard on Auditing (UK) 620 (Revised November 2019), Using the Work of an Auditor’s Expert contain requirements relating to the use of auditor’s experts.

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Various pressures and incentives can cloud objective reasoning at this step. For example, an individual may feel pressured into performing a certain judgement themselves, in order to advance their career, or into delegating a judgement to a more junior team member, in order to reduce costs. A focus on the public interest role of audit will help mitigate these risks, leading to audit quality being the primary consideration in determining the right person to make a particular professional judgement.

Overconfidence can be an especially threatening bias at this step, as it may lead the auditor to overestimate their ability to make the judgement at hand.

### Example



A trainee auditor is auditing the bad debt provision of K plc, and notes that there is judgement involved in assessing whether a number of the assumptions made are reasonable, especially around expectations of future economic conditions and whether the debtors have been appropriately segmented. Furthermore, he knows that K plc have a number of loan covenants based on the level of current assets, so there could be an increased risk of management bias.

He decides he should escalate the issue, as the judgements involved are significant for the audit, and he lacks experience making similar judgements. He is aware that the remaining budget for the audit is running low, and is under pressure to minimise the use of partner time. He raises the issue with his manager and, understanding that a misstatement here could well be material, says that he thinks the partner should be involved with these judgements and that budgetary constraints are not an appropriate reason to cut corners on a professional judgement.

The manager agrees, and sets up a meeting with the trainee auditor and the partner to discuss how best to allocate responsibilities for this matter going forward.

## Appropriately frame the issue



Poorly framing the issue being judged can significantly undermine the chances of reaching an appropriate conclusion at the end of the judgement process. For example, if an auditor misunderstands their objectives in making the relevant judgement, or fails to identify a possible alternative that merits consideration, the resulting judgement may fall short of desired standards, even if the other judgement steps are carried out appropriately. Therefore, taking the time to fully define and understand the problem at hand, including relevant risks, is a key part of an effective judgement process.

The main components to this step are:

- Articulating objectives; and,
- Identifying the alternatives.

Professional judgement ultimately involves coming to a decision about what course of action is appropriate in the circumstances; **articulating objectives** clarifies the intended outcomes. Setting out

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these objectives clearly provides a set of criteria against which alternatives will be evaluated later in the judgment process. It is important that the auditor stands back from the specific objectives for an individual judgement, and also considers the wider context of the objectives of the audit or system of quality management as a whole.

## Example



An audit senior manager is using his professional judgment to determine how to appropriately resource an upcoming audit. The audited entity has made a number of complex acquisitions in the year, and the senior manager is required by auditing standards to ensure that the engagement team has the skills to effectively apply professional scepticism and challenge management in this area. He identifies the need for experienced auditors to enhance the team, but does not specify that they require relevant sector experience.

The firm provides experienced auditors, but at the same time re-deploys some less experienced junior team members who nevertheless have direct knowledge of the audited entity. The experience of the new engagement team members is generic rather than specific to complex acquisitions, and the loss of team members with direct knowledge of the audited entity, further undermines the ability of the audit team to apply professional judgement, scepticism and challenge of management.

The issues here may have been avoided if the senior manager had more clearly articulated their objectives when deciding how best to resource the team. He focused on seniority as a proxy for expertise in the relevant subject matter. While imperfect proxies such as this may sometimes be useful and necessary, they can lead to problems if objectives are framed entirely in terms of the proxy metric. If the senior manager had set an objective of the engagement team having sufficient technical skill in the relevant areas, for example, he may have ensured that appropriate skills and knowledge were retained by the team.

Poor objective setting can affect other parts of the framing step, including obscuring viable alternatives. For example, an objective cast in terms of relevant expertise within the engagement team may have led the senior manager to consider alternative team structures, such as the use of an auditor's valuations expert to provide the relevant expertise.

It is important to spend appropriate time and effort **identifying the alternatives** that will be judged between; a judgement may be critically impaired if a viable alternative is missed at this step.

Professional scepticism is especially relevant here, as there may be instances where information has been presented (for example by management of the audited entity) in a way that artificially constrains the range of possible outcomes. It is equally possible that the auditor themselves has been insufficiently aware of mindset traps and biases in defining a range of options to consider. In either case this may be due to bias or error, and the auditor must therefore have an ingrained mindset of professional scepticism in order to assess the appropriate range of possibilities. Many biases can cause the auditor's attention to be unduly narrowed, which could cause them to fail to consider a viable alternative.



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## Marshal your information



Marshalling relevant information is a key step in the judgement process, as it provides the evidence base from which a decision can be made. Care needs to be taken that this also includes information, or “external signals”,<sup>7</sup> that the auditor might reasonably be expected to be aware of from sources external to the audited entity. The effectiveness of this part of the process is directly related to having already identified the right individuals to make the judgement, and proper framing of the issue.

Relevant information may be drawn from various sources, including, but not limited to, the following:

- Enquiries with personnel at the audited entity, including those outside the entity’s finance function;
- Consultation with, and opinions provided by, auditor’s experts;
- Analysis and visualisations obtained from the application of automated tools and techniques throughout the audit;
- Secondary data obtained from reliable sources, including online analysis and relevant news and articles;
- Consultation within the engagement team and the audit firm;
- The auditor’s understanding of the entity and its environment;
- Relevant sectoral knowledge and general business acumen;
- Experience and understanding of similar situations to the one under consideration;
- Knowledge of relevant auditing, accounting and ethical standards and guidance;
- Understanding of the motivations, beliefs and potential biases of various stakeholders; and,
- Insights about the subject matter obtained through professional training.

The agent-principal dynamic inherent in an audit, with the auditor acting for the benefit of the intended users of the financial statements, is an important consideration at this step. The auditor is required by auditing standards to “design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence”.<sup>8</sup> This is ultimately in order to satisfy the legitimate needs and expectations of the intended users of the financial statements.

Professional scepticism is once again a critical aspect of the appropriate mindset for an auditor to have while marshalling information. The auditor should employ a questioning mindset in seeking out information that may contradict as well as corroborate management assertions, while remaining alert to conditions that may indicate a piece of information may not be authentic, and to any apparent inconsistencies that arise between pieces of information.

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7 Sir Donald Brydon, *Assess, Assure and Inform: Improving Audit Quality and Effectiveness* (December 2019), paragraph 16.3.

8 International Standard on Auditing (UK) 500 (Updated January 2020), *Audit Evidence*, paragraph 6.

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Issues around risk and uncertainty are highly relevant here, with the level of risk surrounding the matter being judged, and the relevance and reliability of the pieces of information gathered, affecting the extent of information and evidence that the auditor may deem it appropriate to obtain.

Biases can impinge on the auditor's efforts to be objective at this step, as they can cause certain information sources to be favoured when they should not be. Awareness of relevant biases and consultation within the engagement team are valuable tools for the auditor in resisting these biases.

## Carry out the analysis



This is the culmination of the prior two steps, where the auditor brings the information they have marshalled to bear in evaluating the various alternatives against the objectives articulated for that judgement. Evaluating the various pieces of information gathered in the context of the judgement being made, and in light of each other, will likely lead to a better judgement being made, than if each piece of evidence was simply considered in isolation. The auditor is required by auditing standards to carefully consider the relevance and reliability of the information gathered as audit evidence.<sup>9</sup>

It may be the case that the judgement being made involves assessing one or more pieces of information provided by the management of the audited entity; if such information is not of good quality, the auditor may find the best approach is to ask management to take the issue away and do further work on it, rather than risking inadvertently performing a management function.

The auditor's analysis will in large part depend on their assessment of the sufficiency, relevance and reliability of the information gathered. Biases are especially threatening at this step, as they can affect the weight placed on different pieces of information. That is, they can cause the auditor to falsely judge information of certain types (e.g. information generated via automated tools and techniques or information that corroborates an existing belief) to be more relevant or reliable than they actually are.

Awareness of biases and consultation with others can be supported by an emphasis on professional scepticism to facilitate an objective mindset. The auditor may wish to actively consider the case for conclusions other than the one they have preliminarily reached, as a strategy for uncovering and mitigating biases.

## Stand back, and conclude



It is always important to stand back and consider the full judgement process and any preliminary conclusions in the round. In some specific situations (including when assessing estimates, going concern and the risk of misstatement due to fraud or error) this 'stand back' approach is a requirement of UK auditing standards.

This judgment step includes considering factors such as whether a judgement step has been inappropriately skipped (e.g. due to time pressures); whether all relevant alternatives have been identified and assessed; whether the judgement has been unduly affected by bias; and whether the course of action decided upon might undermine some of the auditor's other objectives.

This is a key part of the judgement process, as an auditor may perform the preceding steps and nevertheless reach a preliminary conclusion that is deemed inappropriate on reflection.

<sup>9</sup> International Standard on Auditing (UK) 500 (Updated January 2020), Audit Evidence, paragraph 7.

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## Document, communicate and reflect



### Document

Effective documentation allows individuals in the engagement team, and relevant third parties (file reviewers for example) to understand how judgements in the audit were made and the rationale and quality of evidence for the decision reached. Documentation can help an auditor to identify flaws in their reasoning, or gaps in evidence. Documentation is unlikely to take place at a single point in the audit, but will iterate over time.

Not every professional judgement made in an audit needs to be documented. It may well also be the case that not all of the judgment steps require documenting. What is important is that an understanding can be gained about the process that was followed, the evidence and alternatives that were considered, and the consistency of a particular judgement with the totality of evidence obtained in the audit (the 'stand back'). The auditor will need to exercise professional judgement in considering the specifics of the situation and the requirements of the ISAs (UK) in order to determine what documentation is required.

### Communicate

The auditor will need to think carefully about how to explain their application of professional judgement to those outside the engagement team who are nevertheless invested in its outcome. In and of itself, the nature and extent of these communications are a matter of professional judgement. Auditing standards set specific requirements covering some key forms of communication, including those to those charged with governance (likely the audit committee),<sup>10</sup> and in the auditor's report.<sup>11</sup> Following a rigorous professional judgment process, such as the one presented here, should assist such communications by providing a structure that allows the auditor to more clearly communicate the process followed and judgment reached.

In the auditor's report, the auditor is required to communicate the key audit matters arising during the engagement, which may include significant professional judgments. The auditor's report is one of the few ways someone outside the audit can obtain information about the significant risks and key audit matters for an audit. Clear and explanatory communication in the auditor's report around professional judgments can therefore be highly useful to users, and the use of boilerplate language is discouraged by auditing standards.

Communicating specific judgments and the processes used to make them within the engagement team, or more widely in an audit firm (through training and guidance for example), can also potentially enhance audit quality by highlighting good practice, or identifying factors that have resulted in a flawed outcome.

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<sup>10</sup> International Standard on Auditing (UK) 260 (Revised November 2019), Communication with those charged with governance, paragraph 16-1 & 16-2, for example.

<sup>11</sup> International Standard on Auditing (UK) 700 (Revised November 2019) (Updated January 2020), Forming an opinion and reporting on financial statements & International Standard on Auditing (UK) 701 (Revised November 2019) (Updated January 2020), Communicating Key Audit Matters in the Independent Auditor's Report, for example.

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## **Reflect**

Having exercised professional judgement, the auditor benefits from reflecting on the process and assessing what went well and what they could seek to improve on in future. This may serve to improve the quality of the auditor's judgement over time.

Furthermore, reflecting on whether the judgement made (or any information they obtained in the course of making it) has implications for other parts of their work may improve the overall quality of the auditor's work. For example, if there is significant uncertainty around the judgement, the auditor may decide it is appropriate to perform additional procedures elsewhere in the audit.

Lastly, for significant judgements, the auditor may wish to periodically return to the "stand back, and conclude" step of the judgement process to reassess whether the conclusion remains appropriate and continues to meet their objectives, for as long as is appropriate in the circumstances (in many cases, this will be until the signing of the auditor's report).





## Consultation

**The quality of an auditor's professional judgement might be significantly enhanced by regularly consulting with others. Ongoing discussion and consultation within an engagement team can assist in promoting a culture of healthy debate and challenge, facilitate the input of those with relevant experience and expertise, help mitigate the risk of biases and provide the opportunity to coach more junior or less experienced members of the team in how to effectively exercise professional judgement.**

It is important that audit teams encourage a healthy culture of debate and challenge to ensure that established professional hierarchies or seniority of certain team members do not hinder the exercise of objectivity and scepticism by everyone on the team.

Consultation outside the engagement team, such as with an external expert or an engagement quality reviewer, can further widen the pool of expertise available to those making the judgement, which can offer a valuable additional source of information.

### Example



The audit team is working on the audit of G plc, and has identified potential impairment indicators around an investment property held by the group. There is significant professional judgement needed here, and the engagement partner initially frames the judgement as being an assessment of whether the property balance should be impaired, with a subsequent simple calculation of whether the misstatement, if there is one, is greater than materiality.

The partner recognises the significance of the judgement and discusses it with the engagement quality reviewer (EQR). The EQR points out that the issue could affect the segmental information presented by the group, and in particular that a misstatement smaller than group materiality could affect the profitability of a segment that the market has identified as playing a significant role in the group's operations. Therefore, a misstatement lower than group materiality could potentially be expected to influence the economic decisions of users, and thus be material.

This causes the engagement partner to reframe the judgement as including a more considered assessment of whether any potential misstatement is material (whether quantitatively or qualitatively), and also whether materiality has been set at an appropriate level.



## Environmental factors

**These are some of the factors that might be found in the environment of the person or team making the judgement, which may impact on how challenging it may be to exercise professional judgement in a quality manner.**

It is important to note that none of these factors can in any way absolve auditors from the responsibility to reach professional judgements that are appropriate in the light of auditing and accounting principles and the relevant facts and circumstances.

## Audit firm: culture, resources, training and processes



An audit firm can facilitate and incentivise quality professional judgements in a number of ways, including by setting an appropriate culture, providing appropriate resources and training to its personnel, and aligning reward structures such as compensation and promotion to behaviors that demonstrate a commitment to audit quality. These are all outcomes of an effective system of quality management.

The firm plays a key role in equipping its personnel with the training, knowledge and experience that facilitate reasonable judgements.

Audit firm culture is especially important, due to its impact on the culture of the engagement team and on mindset. An audit firm culture that recognises and reinforces the firm's commitment to quality will, in particular, promote an understanding of the public interest role of audit, professional scepticism and a willingness to challenge management where appropriate among the engagement team. The firm's leadership plays a vital role in setting such a culture, with their actions and behaviours setting a tone at the top that can permeate throughout the firm.<sup>12</sup>

## Quantity and quality of relevant information available



The amount and quality of information available to the auditor can affect how challenging it may be to exercise professional judgement.

For example, if it is especially challenging to obtain relevant and reliable information, this could cause the auditor to place undue reliance on the few sources of information that are easily accessible, and thus exacerbate the risk of availability bias affecting the judgement. Alternatively, such information constraints could be time consuming to overcome, which can have knock on effects on judgement quality (see Time and resources available below).

The quality of judgement reached should not suffer when information is scarce, though that judgement may have greater uncertainty attached to it. If this is the case, the auditor may wish to consider whether there is a need for further work to be performed elsewhere, and whether there are implications for their report.

<sup>12</sup> Audit Firm Culture: Challenge. Trust. Transformation. August 2021 FRC Conference summary.

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## Time and resources available



Having sufficient time to make the judgement makes it easier for a rigorous professional judgement process, such as the one presented here, to be carried out in full, which should improve the chances that a quality judgement is made. Therefore, if the auditor is under pressure to meet an overly ambitious timeline for making the judgement, either internally or externally, they should push back.<sup>13</sup>

Resources that might be relevant may include: the capacity and capability of the engagement team, access to external auditor's experts and technological resources such as automated tools and techniques. Such resources can significantly improve the quality and range of information and insight available to the person or team making the judgement.

## Audited entity: management and those charged with governance



Various factors relating to the audited entity can have an impact on the auditor's professional judgement. For example:

- Management and those charged with governance at the audited entity play a significant role in setting the culture of the audited entity; a culture rooted in integrity, competence and ethical values will likely lead to a stronger control environment, which may improve the quality and availability of information available to the auditor;
- The audit committee (if there is one) can support or potentially undermine the auditor's attempts to promote a culture of healthy challenge of management and professional scepticism;
- The provision of clear and timely supporting information by management can reduce the risk of unnecessary delays, which could in turn lead to a rushed judgement process.

<sup>13</sup> International Standard on Quality Management (UK) 1, Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements, paragraph 32(d).





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