

Advanced Module 2: Professional Judgement Framework – Understanding and Developing Professional Judgement in Auditing

LO13

KPMG LLP, one of the four-largest international public accounting firms, launched an initiative in 2009 to enhance the professional judgement and professional scepticism of its staff and teams. KPMG collaborated with two professors at Brigham Young University, Professors Steve Glover and Doug Prawitt, to emphasize these skills in its training. The result of this effort is refreshed professional judgement content throughout KPMG’s audit training curriculum for all levels of audit professionals.

KPMG took the additional step of sharing and leveraging its professional judgement training content to create, again in collaboration with Brigham Young University Professors Glover and Prawitt, a monograph to help students accelerate the development of their professional judgement while still in college. The monograph is titled *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*. That monograph is available free of charge on the KPMG Faculty Portal for college students and professors. It is only available in electronic form because it comes as a pdf, with live Internet links and embedded audio files. In addition, there are video files and an instructor’s manual available separately to professors registered on the KPMG Faculty Portal.

This Professional Judgement Module is adapted from the KPMG Elevating Professional Judgment in Auditing and Accounting monograph. It covers some of the topics that are discussed and illustrated in more depth in the monograph. This module can be used as an introductory overview for the monograph or as a brief introduction to professional judgement for those who do not have space in the curriculum to assign the full monograph.

The KPMG Professional Judgment Framework, from which this module is adapted, was awarded the 2013 American Accounting Association/Deloitte Wildman Award. The Wildman award, first presented in 1979, recognizes a work that the judges view as ‘the most significant contribution to the advancement of the practice of public accountancy’ published within the most recent five years.

The Importance of Professional Judgement in Auditing

As you prepare for a professional career, have you ever wondered what characteristics distinguish an exceptional professional from one who is just average? One key distinguishing feature is the ability to consistently make high-quality professional judgements. Professional judgement, which is the bedrock of the accounting and auditing professions, is referenced throughout the professional literature. In some of your accounting or auditing classes, you may have had an instructor respond to a question with the classic answer, ‘That depends; it is a matter of professional judgement.’ This is often true in auditing, but it is not overly satisfying to a student who wonders exactly what good professional judgement looks like, or how he or she can develop the ability to make good professional judgements. The purpose of this module is to provide a very brief overview and introduction to help you understand what a good professional

judgement process looks like, make you aware of common threats to exercising good judgement, and give you a head start in developing and improving your own professional judgement abilities.

A common question people ask is, 'Can you really teach good judgement?' Many believe that it is a gift; either you have it or you do not. Others would say you cannot teach good judgement; rather, it must be developed through the 'school of hard knocks' after many years of experience. There is no question that talent and experience are important components of effective professional judgement, but it is possible to enhance your professional judgement skills through learning and applying some key concepts. As with other important skills, the sooner you start learning how to make good professional judgements, the better – which is why KPMG made a very significant investment of time and resources to produce the monograph from which this module is adapted to help the next generation of professionals get a head start on developing professional judgement.

Research in the areas of judgement and decision making over the last few decades indicates that additional knowledge about common threats to good judgement, together with tools and processes for making good judgements, can improve the professional judgement abilities of both new and seasoned professionals. With the movement in financial reporting toward more principles-based standards and more fair value measurements, exercising good professional judgement is increasingly important for auditors. While this module contains a brief overview of some of the most important topics, KPMG's full monograph contains considerably more in-depth information about professional judgement in auditing, including additional coverage of judgement traps and biases, judgement in groups, and other topics. That monograph is titled *Elevating Professional Judgement in Auditing and Accounting: The KPMG Professional Judgment Framework*; it is available without charge at www.kpmgfacultyportal.com/.

A Model of a Good Judgement Process

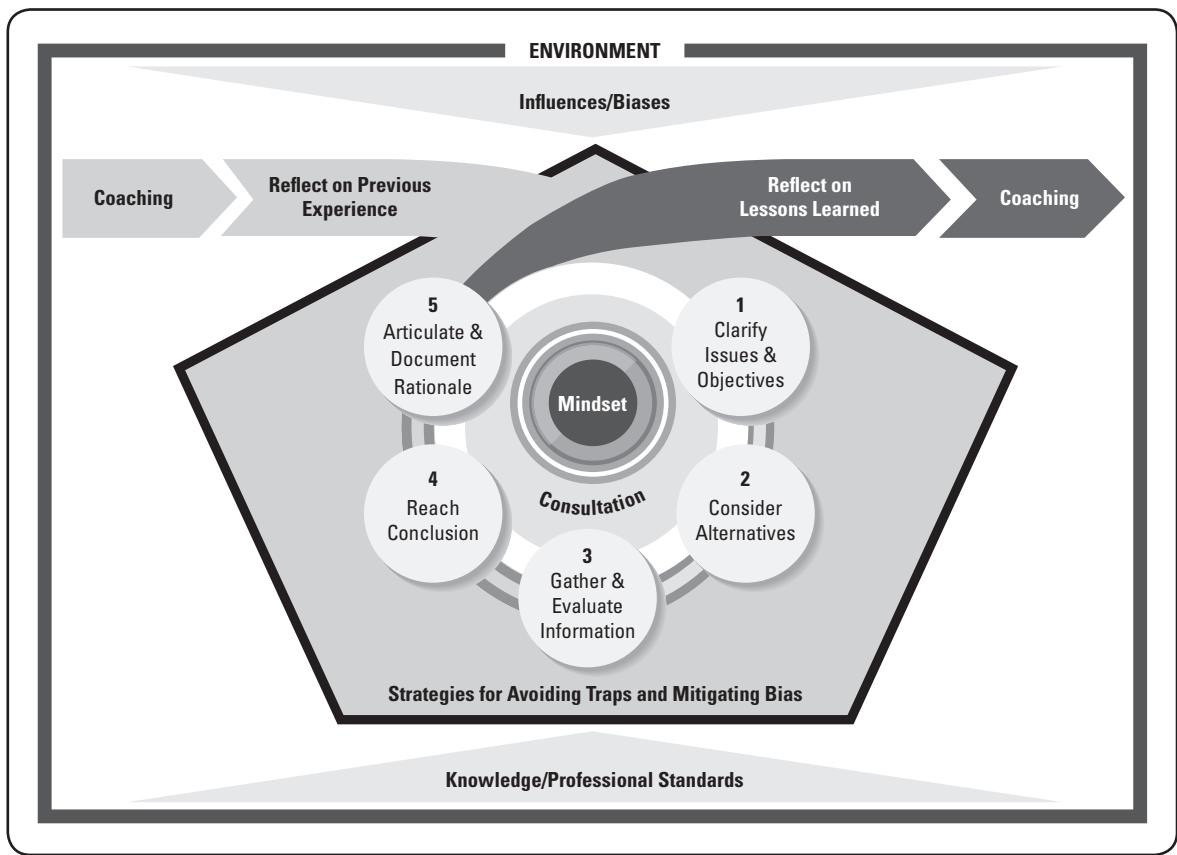
Let us start with a common definition of judgement: judgement is the process of reaching a decision or drawing a conclusion where there are a number of possible alternative solutions.^{xiii} Judgement occurs in a setting of uncertainty and risk. In the areas of auditing and accounting, judgement is typically exercised in three broad areas:

- **Evaluation of evidence** (e.g. does the evidence obtained from confirmations, combined with other audit evidence, provide sufficient appropriate audit evidence to determine whether accounts receivable is fairly stated).
- **Estimating probabilities** (e.g. determining whether the probability-weighted cash flows used by a company to determine the recoverability of long-lived assets are reasonable).
- **Deciding between options** (e.g. audit procedure choices, such as inquiry of management, inspection or confirmation).

Of course, we do not need to invest significant time or effort when making easy or trivial judgements. However, as the judgements become more important and more difficult, it is helpful to have a reliable, tested framework to help guide our judgement process. KPMG's *Professional Judgment Framework* is an example of such a framework. Following a good process will not make hard judgements easy or always guarantee a good outcome, but a well-grounded process can improve the quality of judgements and help auditing professionals more effectively navigate through complexity and uncertainty.

In the figure below, you will see the KPMG *Professional Judgment Framework*. The framework includes a number of components, such as mindset, consultation, knowledge and professional standards, influences and biases, reflection and coaching. At the core of the framework, you will see a five-step judgement process.

Take a moment to examine the steps in the process at the centre of the framework. These steps are rather simple and intuitive. However, while the KPMG *Professional Judgment Framework* provides a good representation of the process we should follow when applying professional judgement, it is not necessarily an accurate representation of the processes people follow consistently. The reality is that, in a world of pressure, time constraints and limited capacity, there are a number of judgement traps we can fall into. In addition, we can be subject to biases caused by self-interest or by unknowingly applying mental shortcuts.



The *Professional Judgment Framework* depicts constraints, influences and biases that threaten good judgement with the box on the outer rim of the framework labelled ‘Environment’ and the triangle at the top labelled ‘Influences/Biases’. At the bottom of the framework, you will see ‘Knowledge/Professional Standards’, as these factors are foundational to quality judgements. These are environmental influences that can affect professional judgement. The ‘ribbon’ of coaching and reflection running through the framework is of great importance to the development of professional judgement in young professionals. In the next section of this module, we will highlight common judgement tendencies and the associated biases that can influence auditor judgement.

At the very centre of the KPMG framework is ‘Mindset’. It is important that auditors approach matters objectively and independently, with inquiring and incisive minds. Professional scepticism, which is required by professional auditing standards, is an objective attitude that includes a questioning mind and a critical assessment of audit evidence. Professional scepticism is not synonymous with professional judgement; rather, it is an important component or subset of professional judgement. Professional scepticism helps to frame our ‘mindset’.

Finally, wrapping around ‘Mindset’ in the framework is ‘Consultation’. At professional services firms like KPMG, consultation with others, including engagement team members, experts or other professionals, is a vital part of maintaining consistently high judgement quality and enhancing the exercise of appropriate professional scepticism.

Traps that Catch Us in the Early Steps of the Judgement Process

As we mentioned earlier, in reality people often do not follow a good process due to common judgement traps and tendencies that can lead to bias. These traps and tendencies are systematic – in other words, they are common to most people, and they are predictable. Some of these tendencies are judgement ‘shortcuts’ that help simplify a complex world and facilitate more efficient judgements. These shortcuts

are usually quite effective, but because they are shortcuts, they can lead to systematically biased judgements. As a simple illustration of how our mental processes that normally serve us very well can sometimes lead to bias, consider 'optical illusions' you may have seen on the Internet.^{xiv} Our eyes and related perceptual skills ordinarily are quite good at perceiving and helping us to accurately judge shape similarity. However, optical illusions can predictably and systematically fool our eyes. Just as with perceptual biases, there are times when our intuitive judgement falls prey to systematic traps and biases. Research provides convincing evidence that even the smartest and most experienced people similarly fall into predictable judgement traps and biases, as described below.

The 'Rush to Solve'

One of the most common judgement traps is the tendency to want to immediately solve a problem by making a quick judgement. As a result, we under-invest in the important early steps in the judgement process and often go with the first workable alternative that comes to mind or that is presented. As a result of the rush-to-solve trap, we sometimes end up solving the wrong problem, or we settle for a suboptimal outcome because we did not consider a full set of alternatives.

Solving the Wrong Problem

Consider the following example. Two snack food companies are competing for market share - let us call them Ax Snack Company and Bobb Goodies. Bobb's executives were convinced that Ax's competitive advantage was attributable to the company's distinctive, highly recognizable individual snack packaging design. The individual snack packages seemed to draw customers to the products. So, Bobb's executives determined that, to gain market share, they would need to develop individual package designs that were equally distinctive. They spent millions on improved packaging appearance for their snack foods to compete against Ax's distinctive packaging. When increased market share did not follow, Bobb's executive team realized that they knew relatively little about what customers really wanted and what drove the consumption of their snack foods. Bobb's executives decided to conduct market research, and along the way they discovered an important and somewhat unexpected aspect of consumer behaviour: regardless of the quantity of product they placed in a home, it would be consumed in relatively short order. Thus, Bobb's executives clarified the decision problem as 'how to get larger quantities of snack products into consumers' homes.' Accordingly, they focused less on the appearance of individual snack packages and instead introduced bulk packaging that made it easier and more convenient to get more snacks into consumers' homes. The resulting gain in market share was dramatic.

This example illustrates one of the biggest traps we run into during the first couple of steps of the judgement process, which is under-investing in defining the fundamental issue. In the example above, Ax Snack Company's distinctive packaging functioned as what could be called a 'judgement trigger', or an assumed or inherited issue that can lead the decision maker to skip the crucial early steps in the judgement process. It caused Bobb Goodies' executives to focus, at first, on the wrong issue or problem. Judgement triggers can often be recognized when a particular alternative is used to define the problem in place of a well-thought-out problem definition. Often, the trigger comes from the way others have defined the issue, which is often formulated in terms of one potential solution. Alternatively, we may create triggers ourselves because we are in such a hurry to 'solve' or to be decisive. Judgement triggers often lead to judgements made on incomplete facts or understanding.

How might you overcome the very common trap of skipping the first couple of elements in the judgement process that comes about through the rush to solve or through judgement triggers? The answer is to ask 'what' and 'why' questions. For example, you might initially answer a 'what' question regarding retirement goals with, 'I want to have a certain amount of money in a retirement fund.' That certainly is a worthy objective, but, as with many initial objectives, it is only a means to an end. Following up by asking why you want a certain amount of money can help you uncover the more fundamental objective, which might be something like, 'to maintain a high quality of life in retirement.' Note that by clarifying the objective in this way, a number of additional approaches to achieving a high quality of life come to mind (such as good health, no debt, cost of living, location, availability of outdoor recreation, and so on). Carefully clarifying underlying objectives by asking 'why' is a key step in making important judgements.

It often does not take a lot of time to consider the first step in the judgement process, but the more important the judgement, the more important it is to invest in clarifying the fundamental issues and objectives. A little extra investment in clarifying the issue and objectives will almost always pay off, sometimes in a big way. One very powerful way to improve your professional judgement is to make sure you are not accepting a judgement trigger in place of a solid problem definition, but rather that you are taking time to ensure your problem definition is complete and correct.

The Center for Audit Quality (CAQ), in its 2010 report on Deterring and Detecting Financial Reporting Fraud, indicates that 'scepticism - a questioning mindset and an attitude that withholds judgement until evidence is adequate - promotes risk awareness and is inherently an enemy of fraud'. The report lists the following characteristics of scepticism:

- *A questioning mind*: a disposition to inquiry, with some sense of doubt.
- *Suspension of judgement*: withholding judgement until appropriate evidence is obtained.
- *Search for knowledge*: a desire to investigate beyond the obvious, with a desire to corroborate.
- *Interpersonal understanding*: recognition that people's motivations and perceptions can lead them to provide biased or misleading information.
- *Autonomy*: the self-direction, moral independence and conviction to decide for oneself, rather than accepting the claims of others.
- *Self-esteem*: the self-confidence to resist persuasion and to challenge assumptions or conclusions.^{xv}

Professional Scepticism and 'Judgement Framing'

At the core of an auditor's ability to effectively question a client's accounting choices is a fundamental but powerful concept called 'judgement framing'. This concept relates to the early steps in the judgement process. The definition of framing follows: frames are mental structures that we use, usually subconsciously, to simplify, organize and guide our understanding of a situation. They shape our perspectives and determine the information that we will see as relevant or irrelevant, important or unimportant. Frames are a necessary aspect of judgement, but it is important to realize that our judgement frames provide only one particular perspective. This is similar to looking out of one window of your home - it provides one view that might be quite different from the view through another window.

Frames are necessary and helpful, but the problem is that we often are not aware of the perspective or frame we are using. Also, our frame can blind us to the fact that there are other valid perspectives. In other words, frames help us make sense of things but they also make it difficult for us to see other views. By being proactive in our use of judgement frames, we can improve how well we do with the initial steps in the judgement process: clarifying issues and objectives and considering alternatives. This is important because a distinguishing characteristic of professionals who consistently exercise sound judgement is that they recognize the judgement frame they are using, and are able to consider the situation through different frames, or what KPMG professionals refer to as a 'fresh lens'. This sounds simple enough, but is not always easy to do! The concept of judgement framing is important because appropriately questioning management's perspective by viewing the situation through other frames is fundamental to professional scepticism.

For example, suppose the results of a substantive analytical procedure suggest that a client's allowance for doubtful accounts is understated. The auditor's approach to gathering further audit evidence will be different if the results are framed in the context of a change in business condition or a change in the client's credit policy as compared to an indicator of a likely error. This is not to say one frame is necessarily better than the other, but the auditor can boost his or her professional scepticism by considering both frames.

A key characteristic of those who make high-quality judgements is that they are frame-aware. They know how to seek and consider different frames to get a fuller picture of the situation. Seasoned, experienced auditors develop this ability and apply it in situations where they need to help client management see an alternative viewpoint on an important accounting issue. For example, alternative frames that auditors might use could be an investor or analyst perspective or a regulator perspective. Or a 'hindsight' perspective may be considered; in other words, how will management's judgement look if a regulator later questions it or if it is reported in the press in six months' time? While experienced auditors are typically quite skilled at challenging frames and considering issues from different perspectives, this is an area where auditors entering the profession typically need improvement.

Judgement Tendencies that Can Result in Bias

People's judgements can be unintentionally biased as a result of underlying self-interest or because they unknowingly use mental shortcuts. For the most part, the shortcuts we use are efficient and often effective, but in certain situations, they can result in systematic, predictable bias. Keep in mind that the tendencies or shortcuts we will discuss are simplifying judgement strategies or rules of thumb that we have unknowingly developed over time to help us cope with the complex environments in which we operate. They are efficient and often effective but, because they are shortcuts, can lead to lower quality judgement in some situations. Here's a quick example of a simplifying shortcut. When crossing a city street, say in London, some people don't wait until the pedestrian crossing light is green; they make the decision to cross by quickly looking to the right for oncoming traffic. If the coast is clear, they will take a step out into the street and then look to the left for traffic coming the other way. This is a very efficient and often effective shortcut strategy. Over time, it can become an unconscious, automatic part of how people cross the street in a busy city. However, if we were to use this shortcut strategy in New York, where they drive on the other side of the street, it could result in a very bad outcome. Even in London, the shortcut can lead to a bad outcome if applied to all streets, since there are one-way streets that come from the other direction.

Similarly, the judgement shortcuts we commonly use are efficient and generally effective. However, there are situations where the use of a shortcut can predictably result in a lower quality or biased judgement. The good news is that, once we understand the implications of a shortcut, we can devise ways to mitigate potential bias resulting from the shortcut. When it comes to crossing the street in London, traffic officials have devised rather ingenious ways to reduce the potentially serious consequences of using the 'American' shortcut to start across the street looking first only to the left. They have placed signs on the pavement, on signposts and even on the road reminding visiting pedestrians of the direction of traffic flow. The signs are an attempt to get visitors out of the subconscious shortcut mode and apply more formal thinking, which is pretty important for the well-being of American tourists in London.

We will briefly introduce four common judgement tendencies that are most applicable and important for audit professionals: the availability tendency, the confirmation tendency, the overconfidence tendency and the anchoring tendency.

The *availability tendency* is defined as: the tendency for decision makers to consider information that is easily retrievable from memory as being more likely, more relevant and more important for a judgement. In other words, the information that is most 'available' to our memory may unduly influence estimates, probability assessments and other professional judgements. Like other mental shortcuts, the availability tendency often serves us well, but it has been shown to introduce bias into business and audit judgements. For example, an auditor may be inclined to follow the approach used in a prior period or on a recent engagement even if the approach is not the best for the current engagement. This tendency is especially powerful if the approach worked well on the prior engagement.

The *confirmation tendency* is defined as: the tendency for decision makers to seek for and give more weight to information that is consistent with their initial beliefs or preferences. You may have heard the old joke, 'My mind is made up; don't confuse me with the facts!' Hundreds of years ago, leading philosophers recognized that once people have adopted a preference or an opinion, they tend to consider and gather information that supports and agrees with their preference. Research in psychology backs

this up: people tend to seek confirmatory evidence, rather than looking for something inconsistent with their opinions or preferences. After receiving this confirmatory evidence, decision makers often are confident that they have adequate evidence to support their belief. The more confirmatory evidence they are able to accumulate, the more confident they become. However, in many instances, we cannot know something to be true unless we explicitly consider how and why it may be false. As an example of the confirmation bias in auditing, research and reviews of working papers find that auditors may be prone to over-relying on management's explanation for a significant difference between the auditor's expectation and management's recorded value, even when the client's explanation is inadequate.

The *overconfidence tendency* is defined as: the tendency for decision makers to overestimate their own abilities to perform tasks or to make accurate diagnoses or other judgements and decisions. When groups of people are asked to assess their own abilities, whether in auditing or in driving a car, a majority of the participants assess themselves as above-average relative to the group being surveyed. But, of course, it is not possible for all participants to be above-average. This is a simple illustration of the fact that many of us are overconfident in our abilities and, as a result, we often tend not to acknowledge the actual uncertainty that exists. Overconfidence is a subconscious tendency that results from personal motivations or self-interest. Importantly, this tendency to be more confident than is justified is likely to affect us even when we are doing our best to be objective. Research indicates that many people, including very experienced professionals, are consistently overconfident when attempting to estimate outcomes or likelihoods. Studies involving practising auditors demonstrate that auditors may be overconfident in their technical knowledge and their competence in auditing risky areas. In addition, partners and managers may be overly confident in the ability of less-experienced people in completing complex tasks. Conversely, associates and senior associates may be overconfident in the competency of more experienced auditors to complete lower-level tasks that they are not accustomed to performing on a regular basis. Such overconfidence can lead to a variety of suboptimal outcomes in auditing, including neglecting to ask for needed help or guidance, failing to acquire needed knowledge, poor task performance, budget overruns, assignment of audit tasks to underqualified subordinates and under-review of subordinates' working papers.

The *anchoring tendency* is defined as: the tendency of decision makers to make assessments by starting from an initial numerical value and then to adjust insufficiently away from that initial value in forming a final judgement. To illustrate the anchoring tendency, managers often make salary decisions by adjusting from the starting point of an employee's previous salary. A prospective employer might quickly realize the unreasonableness of the anchor (e.g. her previous employer only paid her €25,000 before she gained an MBA), but proposes a starting salary irrationally close to the starting point, or anchor. So, in this example, the job applicant is likely to receive a lower salary offer if the prospective employer knows her salary before she gained her MBA. There are two components to anchoring and adjustment: the tendency to anchor on an initial value and the tendency to make adjustments away from that initial value that are smaller than what is actually justified by the situation. The anchoring tendency clearly has direct relevance to auditing in many settings. For example, management's estimate or unaudited account balance can serve as an anchor. The auditor is charged with objectively assessing the fairness of an account balance. But if his or her judgements are influenced by the amount asserted by management in an unaudited account balance, that objectivity might be compromised. In other words, the auditor might become anchored to management's estimate.

Mitigating the Effects of Judgement Biases

The most important step in avoiding judgement traps and reducing bias caused by subconscious mental shortcuts or self-interest is 'awareness'. By better understanding traps and biases, and recognizing common situations where they are likely to present themselves, we can identify potential problems and often formulate logical steps to improve our judgement. If we do not have any idea where the common judgement traps are, or where we are likely to be systematically biased, we do not even have a starting point. As we said earlier, some of the most serious judgement traps have to do with the failure to follow a judgement process. In other words, we might be influenced by a judgement trigger, solve the wrong problem, fail to clarify our objectives or push too quickly through the initial steps in the judgement process because we want to quickly arrive at a solution or conclusion. In terms of mitigating

bias, the first step is to recognize situations where we might be vulnerable. Awareness, coupled with the terminology to identify and label the potential traps and biases, is key to improving judgement. In fact, research exploring mitigation techniques suggests that simply providing instructions to decision makers about the seriousness of a bias can reduce the effect of these biases.

While a thorough discussion of potential ways to mitigate biases is beyond the scope of this module, here are a few examples. Actively questioning our assumptions, which might include considering potentially disconfirming evidence or seeking more complete information, is a key approach in mitigating all of the judgement biases. Consulting with others can go a long way toward mitigating the effects of the availability tendency. Getting an outside view on a going-concern uncertainty assessment can help keep the auditor's judgement from being too optimistic, or pessimistic, given recent, salient experiences. In other judgement and decision tasks, a helpful approach is to ask others to gather and evaluate information without revealing our preference. (We do not want to reveal our preference because it may affect their judgement just like it may affect our own.) Finally, we can also take steps to objectively evaluate the pros and cons for each alternative. In mitigating bias related to the anchoring tendency, it can be helpful to seek out and explicitly consider alternative anchors.

The bottom line is that we need to realize where and how we may be biased in order to develop simple approaches for mitigating the effects of those biases. And the good news is that, once you are aware of traps and biases, the mitigation approach often is a matter of applying logic and common sense. Bias-mitigation techniques are important, but just as important in avoiding traps and mitigating bias is incorporating the steps of good judgement, such as those provided in the KPMG *Professional Judgment Framework*, in your judgement-making process. Thoughtfully applying the steps of a judgement process can in itself mitigate bias. And, finally, in auditing, the requirement to conclude and document provides the auditor with the opportunity to carefully reconsider the preceding steps of good judgement and the possibility that judgement traps or biases may have influenced the final conclusion.

Conclusion

Professional judgement is an increasingly important subject in accounting and auditing. As accounting standards become more subjective and fair value measurement increasingly takes centre stage, professionals will be required to apply more and better professional judgement on a consistent basis. In reality, none of us will ever make perfect judgements or be completely free from bias or from judgement traps. But by becoming aware of where we can fall prey to such influences and by practising common-sense mitigation techniques, including the steps in a judgement process, we can improve the quality of our professional judgement. And this, more than just about anything else you can do, will set you apart as an outstanding professional.

For more in-depth information about professional judgement in auditing, including additional coverage of judgement traps and biases, judgement in groups and other topics, see the award-winning monograph, *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*, available without charge at www.kpmgfacultyportal.com/.