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Introduction

The effective exercise of professional judgement is a critical feature of any audit, and a fundamental requirement of the auditing standards. ISA (UK) 200 defines professional judgement as:

The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.\(^1\) \(^2\)

Professional judgement is relevant to all aspects of an audit. It is likely that the need for professional judgement will appear to be more obvious in areas such as risk assessment, fair values, going concern, interpretations of standards, design of procedures or the assessment of the sufficiency and appropriateness of evidence. However, professional judgement is also critical in making decisions about how an audit is resourced, the allocation of tasks, the need for specialist skills or knowledge, or the time needed to complete an audit. Furthermore, professional judgement is called upon in the design, implementation and operation of a system of quality management at the firm level.

When professional judgement is not exercised effectively, audit quality may suffer significantly. The most significant quality issues identified by the FRC’s Audit Quality Review (AQR) team over a number of years involve the poor exercise of auditor professional judgement in some capacity. In this guidance, we present a framework for making professional judgements, followed by a series of illustrative examples showing how professional judgement might be used in practice. We anticipate that this guidance will improve audit quality by enhancing the consistency and quality of professional judgement exercised by auditors.

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1. 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(k).

2. See 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 16 (o), for an equivalent definition in the context of the design, implementation and operation of a firm’s system of quality management.
Our intent is that this guidance can be used in multiple circumstances and in a variety of ways:

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<td><strong>At a firm-wide level, it may be incorporated into the firm’s training, methodology and other intellectual resources;</strong></td>
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<td><strong>More widely, it may be an important consideration in the design, implementation and operation of a system of quality management in accordance with ISQM (UK) 1;</strong></td>
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<td><strong>It can be used by individual practitioners at any level of seniority in the conduct of an audit or assurance engagement, as a stand-alone guide to the application of professional judgement;</strong></td>
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<td><strong>Although written for auditors, it may be useful for others in the financial reporting chain, or for specialists in other fields providing expert input into an audit, in making their own professional judgements;</strong></td>
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<td><strong>It could be useful for audit committees, and those charged with governance of audited entities more broadly, in enhancing their understanding of an auditor’s judgement process.</strong></td>
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Professional judgement is called for in situations which can vary from more intuitive evaluations and decisions to those which require a more structured approach. This framework, when applied by individual practitioners, can enhance the quality and consistency of the exercise of professional judgement in two ways:

- Understanding the nature of a more structured approach can help individuals and teams improve their more intuitive judgement-making, for example by deepening their understanding of areas where they may be most susceptible to biases and other judgement traps.

- Where a more structured approach is appropriate, this framework can help auditors take account of all relevant considerations and achieve a high quality of judgement.

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3 The FRC’s Glossary of Terms – Ethics and Auditing (Updated December 2019) defines the auditor as “the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm”. References to “the auditor” in this guidance follow this meaning, and will refer to the auditor or auditors making the professional judgement.
This guidance is non-authoritative; it is intended to be persuasive rather than prescriptive, encapsulating good practice. However, practitioners who chose not to use or consider this guidance will need to be prepared to explain how they have complied with the relevant engagement standards.

We do not require firms who already have a professional judgement framework to adopt the FRC’s instead. However, we expect those firms to analyse and understand the FRC’s framework and identify and remedy any areas where their own frameworks could be enhanced. We also encourage those firms to assess how, and in what circumstances, they apply their frameworks. The process for implementing the Quality Management Standards (ISQM (UK) 1, ISQM (UK) 2 and ISA (UK) 220) represents a significant opportunity for firms to ensure that any professional judgement framework that is being applied helps address risks to audit quality within the firm, and to consider more widely how they train professional judgement and incorporate it into their intellectual resources. However, it is important to emphasise that firms’ responsibility to educate their personnel on how to effectively exercise professional judgement is ongoing, and does not cease once a system of quality management is implemented.
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. The audit should also enhance their understanding of the financial position and performance of the audited entity. 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.

4  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.
5  Revised Ethical Standard 2019, paragraph 11
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.\(^6\)

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.\(^7\) The manager and trainee agree that further work is required to assess whether a material irregular transaction has occurred.

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6  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(i).

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

- **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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8 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.
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.
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.⁹

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
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.
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”, 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”. 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.

10 Sir Donald Brydon, Assess, Assure and Inform: Improving Audit Quality and Effectiveness (December 2019), paragraph 16.3.
11 International Standard on Auditing (UK) 500 (Updated January 2020), Audit Evidence, paragraph 6.
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.\(^\text{12}\)

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.

\(^{12}\) International Standard on Auditing (UK) 500 (Updated January 2020), Audit Evidence, paragraph 7.
**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),\(^{13}\) and in the auditor’s report.\(^{14}\)

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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13 International Standard on Auditing (UK) 260 (Revised November 2019), Communication with those charged with governance, paragraph 16-1 & 16-2, for example.
14 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.
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 quantitively 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.15

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.

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.\(^\text{16}\)

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.

\(^{16}\) 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).
## Illustrative Examples

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Illustrative Examples

These examples show professional judgement being exercised in illustrative scenarios, highlighting some important aspects of professional judgement. The characters in the examples are not portrayed as demonstrating perfect judgement, nor do they always employ the professional judgement framework described above.

These examples are simplified and abbreviated as compared to equivalent real life situations and the characters do not always take the most appropriate course of action. Therefore, they should not be taken as purporting to show a complete list of considerations that should or would be considered in a real life judgement process on a similar topic and should not be seen as guidance on the accounting and auditing scenarios covered. The illustrations provided are entirely fictional, and should not be taken to relate to actual scenarios or ongoing FRC inspections or enforcement cases.
Illustrative example 1

F plc (or the company) is a listed manufacturing company, audited by J LLP. Materiality was set at £3 million for the audit under consideration.

At year end, F plc’s cash balance was £25 million, and their loans and other borrowings balance was £33 million, giving them a net debt figure of £8 million. For most of the rest of the year, however, their net debt was significantly higher, fluctuating around £24 million. The primary reason for this change is a significant increase in the cash account balance in the run up to year end, from around £9 million to £25 million. This was caused by a shift in working capital management policies prior to year end. For example, F plc delayed payments to suppliers and offered one-off discounts to customers to pay early.

During the year end audit, each individual relevant account balance was tested and no issues were noted. However, in the notes to the financial statements, F plc calculates and presents the company’s net debt figure as part of their note on capital management. One of the engagement team noticed that the sharp increase in cash just prior to year end would mean that the net debt position disclosed in the notes is different from the level it would have been at for the rest of the year. The engagement team member is aware that this could potentially mislead users of the financial statements, and escalates the issue to the engagement partner, as the judgement as to whether anything should be done is complex, requiring experience and knowledge of the needs and expectations of the intended users.

Here, the engagement team member is demonstrating perceptiveness and professional scepticism in noticing the potential issue, and good awareness of their own skillset as compared to that required for making this judgement.

The engagement partner is aware that professional judgement is called for in assessing what course of action should be taken here. She understands the issue at a high level as being a decision about whether or not to require F plc to change or remove the relevant disclosure, but takes the time to better define the issue and articulate her objectives in making this judgement.

The engagement partner defines the judgement being made as being whether the company’s presentation of the capital management disclosure showing net debt constitutes a material misstatement and, if so, how the disclosure could be modified so that it is no longer materially misstated.

The engagement partner articulates their objectives for this judgement as follows:

- To be able to express the appropriate opinion as to whether the financial statements are prepared, in all material respects, in accordance with UK adopted international accounting standards and are true and fair
That the intended users’ understanding of the financial position and performance of F plc is enhanced

The engagement partner shows good awareness of the purpose of audit in articulating her objectives.

Next, the engagement partner considers the alternatives available to choose between. The engagement partner sees her four options as being:

- The disclosure is not materially misstated
- The disclosure is materially misstated and the information relating to net debt should be deleted
- The disclosure is materially misstated and the information relating to net debt should be modified
- The disclosure is materially misstated and the information relating to net debt should be supported by further clarifying information

The engagement partner knows that IFRS is a fair presentation framework, and that it requires that the financial statements must fairly present the financial position and performance of the entity. IFRS defines the objective of the financial statements as being to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions.

Her concern, then, is that the capital management disclosure referencing net debt obscures useful information, or is actively misleading, regarding the level of net debt that the company carried for most of the year.

If it does so, it is arguably not fairly presented and thus not in accordance with UK adopted international accounting standards. This would be a misstatement, which could be material if it could reasonably be expected to influence the economic decisions of users of the financial statements.

The engagement partner understands that any assessment of whether the disclosure might be misleading requires consideration of the perspectives of the intended users; in order to determine whether they might be misled, she must develop an understanding of how they might take in and use the information.

The engagement partner knows from experience that many investors and potential investors look at net debt levels and the capital structure of companies when making investment decisions, but does not have extensive experience with listed companies in this specific industry, so undertakes to research the matter further.

Here, the engagement partner understands the need to consider the relevance of her knowledge in the specific context of the judgement at hand.

The engagement partner enquires with F plc’s management about their reasoning in presenting the information in the way that they did, and whether they considered adding further disclosures to clarify that the year end position was unusual and transient.
Management offer the following argument for their approach:

We made the relevant transactions that led to this figure for normal commercial reasons, and this is the correct net debt balance based on the year end cash and debt balances, which you have audited and found no issues with. Furthermore, the impacts of our actions prior to year end are visible in other account balances such as revenue, trade receivables and trade payables, and in the cash flow statement, so nothing is being hidden from the intended users.

In considering this argument, the engagement partner realises there are (at least) two different ways the net debt disclosure could potentially mislead users. Firstly, it could imply the company is less reliant on debt and has a stronger balance sheet than has actually been the case for the majority of the reporting period. Secondly, the context in which the net debt figures are presented could mislead users about the company's capital management policies, if it is taken as implying the company's policy is to maintain net debt at roughly the year end level.

Here, the engagement partner realises her framing of the issue was incomplete, and shows good willingness to return to earlier parts of her judgement process when appropriate.

The engagement partner does not think that any of management’s points address the second of these issues. Regarding the first issue, the engagement partner splits the argument into three claims:

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<td>We made the relevant transactions that led to this figure for normal commercial reasons</td>
<td>The engagement partner has some doubt about the claim that the transactions were made for commercial reasons and not to portray financial statement items in a more favourable light; this makes her question the integrity and trustworthiness of management, which could have wider implications for the audit.</td>
</tr>
<tr>
<td>...this is the correct net debt balance based on the year end cash and debt balances, which you have audited substantively and found no issues with.</td>
<td>Furthermore, whatever the motivation for the actions that led to the lower year end net debt figure, they are only temporary in their effects, i.e. there is no reason to assume net debt will not swiftly return to its higher level. The current disclosure does not make this clear (though see the third claim below for further discussion on this).</td>
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The engagement partner notes that the net debt figure can be “correct” but nevertheless misleading.

She understands that the point around having performed other audit procedures over the relevant account balances is irrelevant to the issue at hand, as different assertions were being covered by those procedures.

Continued
### Management claim

Furthermore, the impacts of our actions prior to year end are visible in other account balances such as revenue, trade receivables and trade payables, and in the cash flow statement, so nothing is being hidden from the intended users.

### The engagement partner’s response

The engagement partner accepts that this is a relevant consideration to how intended users might evaluate the net debt figure. In particular, it may be possible for a user to “connect the dots” and understand that net debt may increase significantly soon after year end. However, there are many and varied other factors that influence the levels of these various balances, so it may be highly difficult to actually trace the connection.

Furthermore, it may be the case that the users pay more attention to net debt figures than some other balance sheet metrics.

### The engagement partner demonstrates professional scepticism by critically assessing management’s arguments.

The engagement partner also asks her engagement team to look at the capital management disclosures of similar companies, in an effort to understand whether any peer companies provide information on how net debt had moved throughout the period; this is important in understanding what needs and expectations the intended users might have regarding this disclosure. The team find that some companies do provide such information, for example disclosing the average net debt for the year.

She consults with an internal technical panel of partners who have greater experience in how the intended users of F plc’s financial statements might interpret and use the relevant disclosure. They advise that net debt levels and capital structure ratios do indeed commonly influence investment decisions in this sector, and that there is diversity regarding the extent to which investors take the time to look at other balance sheet metrics with similar interest.

### The engagement partner should be careful here, as there is a risk of both groupthink and confirmation bias affecting her judgement.

Groupthink is possible whenever a group convenes to make a decision. Confirmation bias is a threat here as the engagement partner’s prior experience from other sectors suggested that the intended users would be interested in net debt and capital structure issues, so she could inadvertently place undue weight on the panel’s corroborative evidence.

The engagement partner notes that the change in net debt at year end is many times materiality, so if she decides that the disclosure is misstated, it is likely materially misstated.
The engagement partner weighs the various alternative conclusions against how well they allow her to meet her objectives for the judgement. Having gathered and analysed a range of information, the engagement partner sees the judgement as coming down to two main considerations, reflecting the two ways she identified that the disclosure could be potentially misleading. Firstly, whether the intended users would understand from what is disclosed that the low level of net debt is likely transient and, secondly, whether the context that the net debt figure is shown in makes it appear as though the company’s capital management policy includes keeping net debt at broadly the year end level.

This illustrative example does not contain sufficient detail for the engagement partner’s conclusion to be clear. Irrespective of how she concludes, the engagement partner will ensure that the issue is soundly documented on the audit file.

Reflecting on the judgement, the engagement partner notes that issues have arisen during the judgement process that may trigger further professional judgement processes. These include the need to consider whether other parts of the financial statements could be materially misstated as a result of the unusual working capital policies prior to year end, and to assess how the company’s net debt and capital management policy are discussed in the front half of the annual report.

Furthermore, if she ends up concluding that the disclosure is materially misstated, she will likely wish to consider the possibility that the original disclosure was intentionally deceptive, and the implications of that. This would raise issues around the integrity and values of F plc’s management, which could significantly alter the risk assessment for many areas of the audit, mandate greater professional scepticism and affect the decision as to whether to continue the audit engagement in future years.
Illustrative example 2

XYZ LLP has a long-standing audit engagement to carry out the audit of the ABC Group Limited. The group is financed through a combination of long-term debt and facilities with a reputable bank, equity investment and capital contribution from two individual shareholders and cash from its ongoing trading income. The business is involved in corporate events and other entertainment activities and experienced significant difficulties during the Covid-19 pandemic.

For the year ended 31 March 2021, both management and the auditor concluded that the going concern basis of accounting was appropriate, and that no material uncertainties were identified and reported; ABC’s shareholders had committed to providing additional cash to meet the expected need to June 2022 and the bank had renewed facilities to December 2022.

Emerging from the pandemic, the directors believe that the company can finance its day-to-day operations through its ongoing trade but is not in a position to be able to repay the loan when it falls due and would need to either refinance the borrowing or would need a contribution from the shareholders to meet this liability should refinancing be impossible.

In the current financial year to 31 March 2022, XYZ LLP has assigned a new engagement partner to the engagement. The new partner identifies that there is a close-call scenario with respect to considerations around going concern.

In identifying the close-call nature of the scenario, when no material uncertainties were identified in the prior year, the new partner resists falling prey to anchoring bias or groupthink.

As such, she decides to make a start on going concern work earlier in the process than she would normally. Further, she has identified that this part of the audit requires significant professional judgement. She recognises that there are two main judgements to be made: whether the going concern basis of accounting is appropriate and whether there is a material uncertainty relating to going concern.

As a starting point, the engagement partner requests the directors’ initial going concern assessment, including cash flow forecasts, initial discussions with the bank about potential for refinancing and an initial view from the existing shareholders about ongoing support and their willingness or otherwise regarding entering legally binding agreements in this respect.

The partner exercises enhanced professional scepticism when considering the information provided by management here as she recognises the potential for management bias is pronounced.

These information gathering activities yield the following results:

- Management and those charged with governance have concluded that the going concern basis of accounting is appropriate, and that they have not identified any material uncertainties in respect of going concern.
• Cash flow forecasts show a cash need in month October 2022 in a number of plausible scenarios. The forecasts are complex with a significant number of assumptions (particularly about expected growth and timing of cash flows).

• The bank is willing to hold further discussions about ongoing lending and renewal of facilities and is planning to agree a position on this in advance of audit sign off.

• The shareholders write a letter to those charged with governance expressing their willingness to support as they have in the past but will not enter into a binding agreement, preferring to make live decisions on when and whether to provide cash to the business.

The engagement partner considers that it is appropriate to involve a cash flow modelling expert to interrogate the adequacy and appropriateness of the information used and assumptions made in the cash flow forecasts.

Further, she engages an expert specialising in debt financing to offer insight around the likelihood of the bank renewing the facilities.

Shortly after this, management provide their final going concern assessment, deeming the going concern basis to be appropriate, with no identified material uncertainties, and note that the bank have informally agreed to renew the facilities and are drawing up formal agreements to extend for two years from December 2022.

Those charged with governance concur with management’s opinions; the key piece of evidence that satisfied them is the letter of support from the shareholders indicating their willingness to provide support if necessary.

The auditor’s experts involved in the process come back to the engagement partner with their findings. The cash flow modelling expert has produced a report which concludes positively on the mechanical accuracy of the forecasting model, and on the appropriateness of the assumptions based on previous trading, known facts about the business, known facts about the sector and expected economic conditions. The debt financing expert, however, informs the engagement partner that there are indications that appetite for lending in this sector is decreasing and that there has been a slight but noticeable deterioration in the bank’s own financial position.

The partner is in agreement with management and those charged with governance that the going concern basis is appropriate, as they have no intention of ceasing trading and she does not think the evidence supports a view that they have no realistic alternative but to do so. However, she is much less convinced that there is no material uncertainty around this judgement.

She acknowledges that the shareholders have provided cash if required in the past and have expressed willingness to do so in the future, but the fact that that are unwilling to commit formally here means uncertainty remains around whether they would do so if a need arose for a significant sum. She is satisfied, following investigations, that the shareholders have the wherewithal to provide the funds if they choose to do so.
Similarly, she is aware that the bank have informally agreed to renew the facilities but, in the absence of a formal agreement, together with the insight from the auditor’s expert providing some reason to think the bank’s appetite for lending may be decreasing, leaves her with uncertainty around whether the bank will ultimately sign an agreement.

The partner considers the likelihood of occurrence and potential impact of these negative outcomes, namely there being a cash need and the group not being able to obtain financing from either the shareholders or the bank. If such an outcome were to occur, she thinks the impact would be severe, and so frames the main judgment that now needs to be made as being an assessment of how likely such a scenario is to occur.

Here, the engagement partner recognises the need to return to the framing step, to refocus the judgement.

She is aware that the team are nearing the end of the audit timetable and that she has not yet made a judgement. She communicates her position to management.

Discussions with management are tense. Management are pressuring the partner to conclude on this area, saying any further delay could result in the planned deadlines not being met. In particular, they are pressuring her to conclude that there is no material uncertainty, saying that is what the partner in prior years concluded and pointing out that both the shareholders and the bank had expressed willingness to provide support and renew arrangements respectively. Those charged with governance are exerting pressure on the partner as well, claiming her doubts are unfounded and that she is being unreasonable.

Management have agreed to a draft representation letter which confirms their previous view on going concern and will provide an email from the bank explaining their intentions as alternative evidence. The engagement partner recognises quality risks associated with obtaining information late in the process under time pressure. Furthermore, she recognises that significant pressure is now being asserted on her by management and that she must not unduly rush or take short cuts over her judgement process.

The management of the audited entity are acting in a way that could hinder the partner’s attempts to carry out an effective judgement process, but she is alive to this threat and resolves to continue taking the appropriate actions.

The partner considers whether the level of pressure being exerted remains acceptable and consults with her firm’s ethics team. The ethics team advise that she should put a safeguard in place, namely discussing this significant judgement with the firm’s central technical team and seeing if they concur with whatever judgement she reaches.
Consultation, with both the ethics function and the central technical team, assists the partner’s professional judgement process here, mitigating the threat of management pressure compromising the judgement.

The partner considers whether the lack of disclosure in the financial statements in respect of the uncertainty surrounding the future financing of the business would influence the decisions of users and whether or not the financial statements would give a true and fair view without additional disclosures being made in the financial statements, either to disclose a material uncertainty in respect of going concern or to disclose significant judgments made by management as part of its going concern assessment.

Whether or not the partner concludes that there is a need for additional disclosure, she should ensure the documentation on file is appropriate in light of the significance of the judgement, and should reflect on whether the behaviour of both management and those charged with governance raise any issues around continuance for the following year.
Illustrative example 3

The auditor has just completed the group audit of C PLC for the year ended 31 December 202X, a UK listed entity with operations in the UK and overseas. This was the fourth year that the auditor had been performing the audit and, as in previous years, the audit had been going smoothly and the work performed by the component auditors was completed on time. The group audit team enjoyed working on the audit as they had good relationships with management and the central finance team. In addition, the end of March group accounts signing date meant that there was not significant time pressure on the audit. The audit fee had also been agreed at a reasonable level that meant that the team could undertake the work required and still deliver a good recovery rate.

However, the following issue arose late in the audit:

- Management’s paper on impairment of goodwill, that was provided to the auditor 10 days before the agreed signing date, did not cover some key sensitivities that the auditor felt were required and did not sufficiently support a key assumption. The auditor requested the paper to be updated and more disclosure to be made in the financial statements. This caused delays in the preparation of the annual report and identified new information that showed that the key assumption was optimistic and that a small movement in the assumption could result in an impairment. As a result of this, the auditor needed to perform more work and the time required to complete this work resulted in the company delaying the announcement of their results by a week.

- The audit committee felt that the level of the auditor’s challenge of management on impairment was not justified and complained that the auditor should have completed their work on time. This involved some heated exchanges with the engagement partner, and it was mentioned that the board were considering whether the audit should be put out to tender. In addition, they felt that the completion process that the auditor needed to undertake to complete their audit was too extensive and should have been completed quicker.

- In the end it was decided that the audit would not be put out to tender at this time.

As a result of the above, the audit firm convened an internal panel to decide whether these events would affect the annual decision that the firm was required to make on whether to continue with the audit engagement.

The issues that the panel considered were:

- The reason for the lateness and incompleteness of management’s paper. The panel discern three broad possible categories of explanation for this, noting that they need not be mutually exclusive:
  - There were legitimate business reasons, such as unforeseen exceptional circumstances that affected management’s work. This explanation is made less credible, however, by the apparent lack of communication and warning from the audited entity about the issue.
  - Lack of competence on the part of relevant management personnel led to work of insufficient quality that didn’t meet required deadlines.
  - Lack of integrity or ethical values on the part of management; for example, it is possible that management were attempting to obscure an overly aggressive accounting treatment by limiting the time that the auditors had to look at it.
• The reason for the reaction of the audit committee, namely not supporting the level of challenge of management that the audit team displayed, and going so far as to threaten putting the audit out to tender as a result. The panel again sees three possible non-mutually exclusive explanations here, mirroring the previous point:

- The actions of the audit team were inappropriate in the circumstances. While it is correct to delay providing the audit opinion until the required work is done, it is possible that the work effort went significantly beyond what was reasonable. The panel are conscious of the paramount importance of audit quality, and of the fact that the lateness of the paper could have rightfully increased professional scepticism on the part of the audit team, which may have led them to increase the work effort for appropriate reasons. Therefore, the panel would require a significant body of persuasive evidence to support this explanation before judging it to be a viable conclusion, but it is a possibility and so merits consideration.

- The audit committee may not understand their role or lack the capability to effectively carry it out. This could compromise their ability to support the auditor and challenge management.

- The integrity or ethical values of the audit committee may be lacking. This would compromise the ability of the audit committee to fulfil their role effectively.

• Whether the results of the debate of the first two points have implications for an assessment of whether such a scenario is likely to occur again.

• Whether this raised wider concerns over the governance of the company. Had a heightened risk been created that meant that the auditor did not want to continue to be associated with the entity?

• The fact that this audit was profitable for the business unit. What impact could resigning have on staff resourcing and the business unit?

• The fact that the audit committee chair is on the audit committee of an entity that the firm is tendering for. Could the decision to resign from this audit impact that audit tender?

It appears that the panel has not articulated a clear set of objectives that they hope are achieved by their chosen course of action.

This could cause issues, as it could lead to the panel judging each of the issues discussed to be of equal or similar importance. If the conclusions on each point of discussion do not all point to a consistent course of action being appropriate, the panel may struggle to determine what the best conclusion is, or may reach an inappropriate or unreasonable conclusion.

For example, the panel discussed the possible financial and operational impacts of not continuing with the engagement. These are not irrelevant, but ISQM (UK) 1 is clear that the decision as to whether or not to continue should be based on “information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance) that is sufficient to support such judgements; and the firm’s ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements”, and that “the financial and operational priorities of the firm do not lead to inappropriate judgements about whether to accept or continue a client relationship or specific engagement”.

If the panel had articulated a set of objectives, they may have a better chance of reaching an appropriate judgement. An example of such an objective would be: that the continuance decision is based on the nature and circumstances of the engagement, the integrity and ethical values of the client and the firm’s ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements, such that the firms would not agree to continue if they could not deliver an audit of appropriate quality or if relevant personnel at the audited entity lack integrity or ethical values.

The panel decided that the following information would be important for their continuance decision:

- An independent assessment of the appropriateness of the audit work performed on this issue by the audit team. The panel are conscious of the risks of bias here – in particular, motivated reasoning, confirmation bias, anchoring bias and overconfidence would appear to be especially threatening here – so deem it important for this assessment to be performed by an independent audit partner.

The panel are staying aware of the potential for biases to affect the judgement process, and planning actions to mitigate this risk.

- An assessment of the track record of management and the audit committee at the entity. For management, this will focus on how aggressive their accounting choices have been and whether they have been consistently open and honest with the auditor in the past. In respect of the audit committee, the panel are interested in the level of challenge they have offered management and conversely the amount of support they have provided to the auditor on previous issues of contention.

Despite recognising the threat of bias for the assessment of the audit work, the panel fail to consider the similar risk that could arise around an assessment of the track record of personnel at the audited entity, since those who worked on the audit may be incentivised to find these parties unreasonable, in order to make their level of challenge appear more appropriate.

- Information concerning the integrity and ethical values of the audit committee and management. The firm is required to consider such information in any continuance decision, but a stronger body of evidence is likely to be needed in this case due to the actions of the relevant parties around the goodwill issue.

- Any evidence that investors and analysts are concerned about the Board or the governance of the company; this may serve as useful evidence on the business reputation of the leadership of the entity, which could be relevant to assessing why management and the audit committee acted in the manner described above.
• Information on the market reaction to the delay in the results announcement; e.g. whether there was there any short selling of the shares of the listed entity.

• Information around what financial and operational impacts not continuing the engagement would have on the business unit and the firm as a whole, including consideration of a scenario where the tender involving the audit committee chair is unsuccessful.

Based on the results of these information gathering activities, the panel will decide whether to continue the engagement, not continue, or continue conditionally on some mitigating actions being taken at the audited entity. If the panel judges the audit committee or management to have behaved inappropriately, they will consider whether there is a wider cultural issue at the entity, or if the problem is confined to a limited number of people. This may affect an assessment of whether similar behaviour is likely to happen again.

The panel’s plan for how to conclude does not appear very structured and may run into issues if there is conflicting evidence coming out of the information gathering activities. For example, if it is judged that management lack integrity, but that not continuing the engagement would significantly impact the profitability of the business unit, it is unclear if the panel’s framing of the issue would lead them to judge that they should not continue the engagement.

This may be due to a lack of clear objectives set by those making the judgement, which would act as a set of criteria to judge possible conclusions against.

If the firm does decide to continue the engagement, many of the issues considered in making judgement will be relevant for planning and performing the audit itself. Likewise, if the audit goes ahead, the firm determines that an independent audit partner should have debrief conversations with the Audit Committee Chair, the Chairman and the CFO to ascertain whether they fully understand the firm’s concern with how the issue was dealt with.