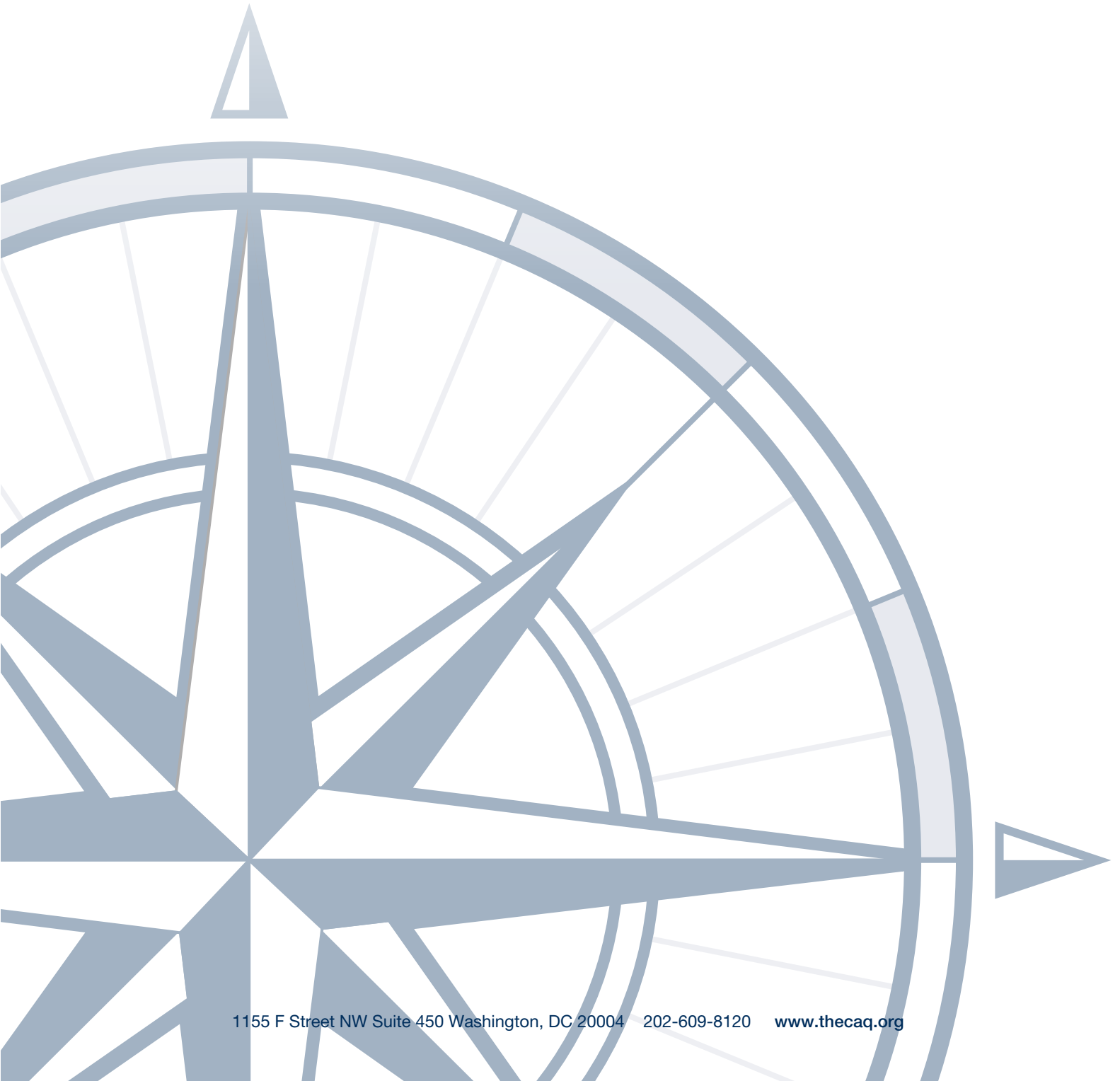




**CENTER
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Professional Judgment Resource



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About the CAQ

The Center for Audit Quality (CAQ) is an autonomous, nonpartisan public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

For more information, visit www.thecaq.org.

Preface

The U.S. public company auditing profession¹ serves the public interest by performing quality audits that enhance the credibility of financial statements for all participants in the capital markets. Carrying out this service would be challenging, if not impossible, without markets participants having trust and confidence in the reasonableness of judgments made by public company auditors (auditors). Moreover, the pillars of audit quality — namely, independence, objectivity, and professional skepticism — are enhanced by an effective auditor decision-making process that strengthens an auditor’s ability to develop and document professional judgments made during the course of an audit.

The Benefit of a Professional Judgment Resource

Auditors are increasingly responding to judgment challenges presented by:

- The development of principles-based (or objectives-based) auditing and accounting standards and a desire for consistent decisions in similar circumstances
- The increasing complexity of business transactions and economic decision-making in a global environment
- The complexity of accounting standards, including standards that require an auditor to consider a number of reasonable alternative approaches
- The increasing focus on, and disclosure of, critical accounting policies, estimates, and other highly subjective elements related to financial reporting
- Inspections and reviews of the auditor’s work

In response to these challenges,² this resource has been designed to provide auditors with an example of a decision-making process intended to facilitate important auditing and accounting judgments in a professionally skeptical manner.³

¹ Although this resource is addressed to public company auditors, this resource can be adapted and utilized by auditors of non-public companies.

² This resource is also responsive to several high-profile reports emphasizing the importance of public company auditor judgment and the accompanying recommendations to policy makers and regulators to comment on the reasonableness of auditor judgment (e.g., refer to the August 1, 2008 *Final Report of the SEC Advisory Committee on Improvements to Financial Reporting*, recommendation 3.5, pages 13–14) and the development of training materials for auditors “...that help to foster a healthy professional skepticism with respect to issues of independence that is objectively focused and extends beyond a “check the box” mentality” (refer to October 6, 2008 *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury*, recommendation 4(b), page VIII:19 through 20).

³ This resource is non-authoritative and it has not been adopted, endorsed, approved or otherwise acted on by the U.S. Public Company Accounting Oversight Board (PCAOB) or the U.S. Securities and Exchange Commission (SEC). The professional judgment process discussed herein is not the only approach to applying appropriate professional auditor judgment. Other decision-making processes also result in reasonable judgments that are in accordance with the applicable regulatory or professional auditing and accounting standards.

Overview

Auditors can enhance their professional judgment capabilities by utilizing an effective decision-making process to guide their thinking and enable them to be aware of and consider their own judgment tendencies, traps, and biases. For the purpose of this resource, the exercise of *professional judgment*⁴ should be:

- Based on the relevant facts and circumstances known and available at the time the judgment is made
- Made after the consideration of reasonable alternatives
- Sensitive to the degree of uncertainty that may be inherent in the judgment
- In compliance with the applicable professional standards

Effective auditor decision-making also requires the application of *professional skepticism*.⁵ Indeed, the appropriate exercise of professional skepticism throughout the judgment process is at the heart of effective auditor decision-making.

Certain decisions, however, can be negatively influenced by judgment tendencies and traps that can potentially lead to bias and weaken professional skepticism when making a judgment. While there is no “silver bullet” that will eliminate all forms of judgment tendencies, traps, or biases associated with decisions requiring judgment, once an auditor has an awareness of them, certain actions can be taken to reduce their impact on, and improve the effectiveness of, the auditor’s exercise of professional skepticism and judgment.

⁴ Professional judgment is referenced throughout PCAOB auditing standards and there are numerous examples in which judgment is used or described in all phases of the audit process. As noted above, this resource is focused on the exercise of professional judgment.

⁵ AU Section No. 230, *Due Professional Care in the Performance of Work* (AU 230), paragraph 7 states that “professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.” AU 230 further notes in paragraphs 7 through 9 that due professional care requires the auditor to exercise professional skepticism and that professional skepticism should be exercised throughout the audit process. In exercising professional skepticism, an auditor should not be satisfied with less than persuasive evidence, as an auditor neither assumes that management is dishonest nor assumes unquestioned honesty.

This resource provides an example of a decision-making process for auditors to consider, grounded in the following essential actions:

- Identify and Define the Issue
- Gather the Facts and Information and Identify the Relevant Literature
- Perform the Analysis and Identify Alternatives
- Make the Decision
- Review and Complete the Documentation and Rationale for the Conclusion

The Use of This Resource

Audit Firms

This resource can be adapted by audit firms to supplement or further support their system of quality control through a decision-making process that strengthens audit engagement performance, or to enhance consistency across internal training materials, audit methodologies, and other internal processes related to audit work. This resource is designed to highlight important considerations that an audit firm can use to refine or enhance its existing professional judgment or skepticism resources.

Auditors

An auditor should employ a disciplined and rigorous decision-making process that enables him/her to consistently approach the decisions regularly required in an audit environment characterized by changing or increasing audit risks, accounting and audit complexities and consequences, and the judgment challenges identified in the Preface of this resource. Thus, this resource has been designed to enhance the effectiveness of an auditor’s response to these decision characteristics by including certain insights, practical considerations, and examples.

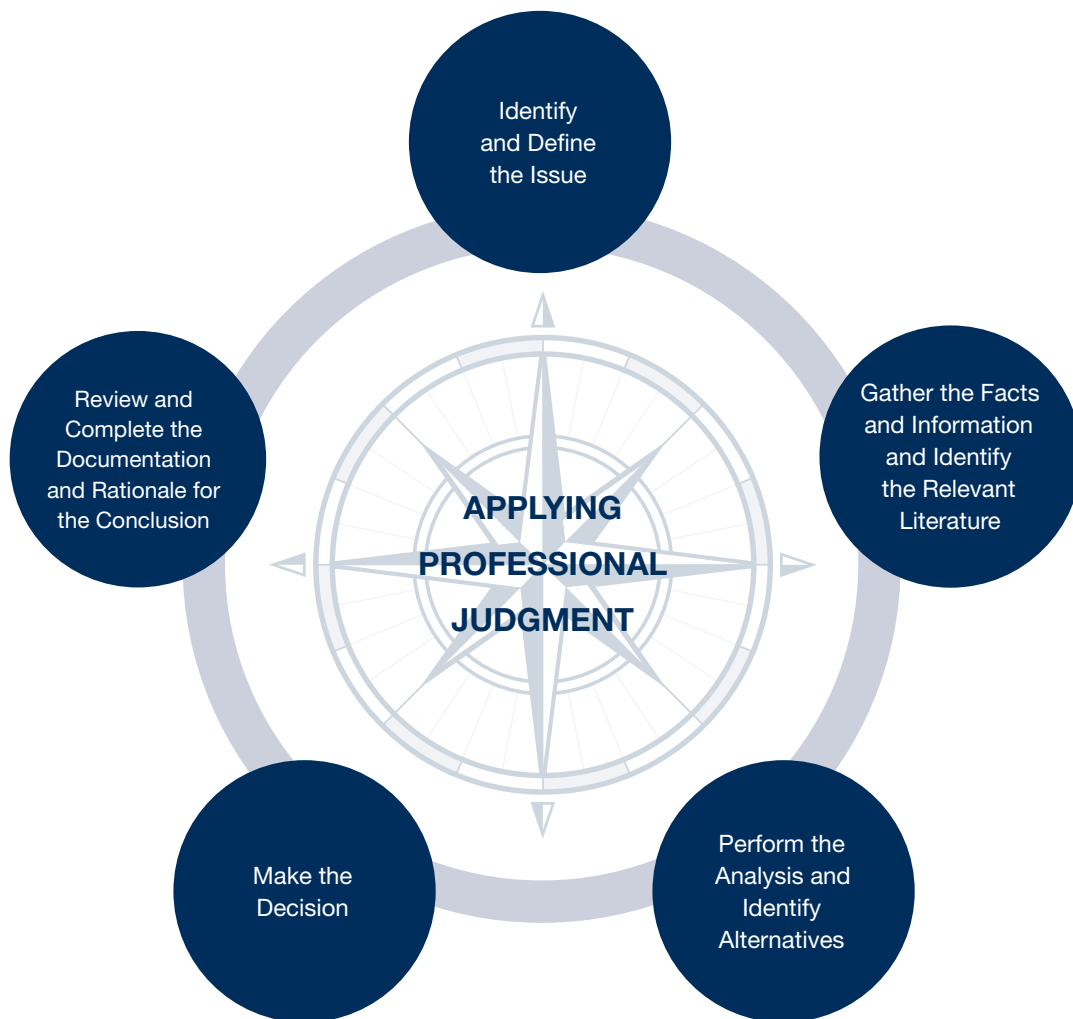
The full scope of this resource may not apply in all judgment situations. An auditor can determine which elements of this resource might be relevant to a particular judgment, and he or she can scale such elements to address the specific facts and circumstances involving a particular judgment. For example, in situations where the auditor believes that the judgment involves a matter that is routine, the need for a more formal, disciplined and rigorous judgment process is likely unnecessary. In other situations, an auditor may determine that only some of the judgment elements or practical insights contained in this resource are relevant or necessary to support the auditor's judgment.

It is important for auditors to recognize that while this resource presents a decision-making process in a series of sequential elements (for ease of presentation, training, and practical use), an auditor's decision-making is often iterative

and may require some steps to be combined, repeated, or considered in a different order. The descriptions on the following pages provide a brief overview of the elements and key considerations of a decision-making process, while also highlighting several of the more common judgment tendencies that can potentially lead to bias and weaken the judgment process.

Finally, it is also important for auditors to recognize that the use of this resource will not eliminate debate on judgments made during the course of an audit. While this resource is designed to assist an auditor in reaching a well-reasoned decision, reasonable minds may differ as to the most appropriate answer in areas involving complex judgment decisions, due to factors outside of the auditor's control, even where a disciplined decision-making approach, such as the one outlined below, and described herein, is followed.

Elements of an Effective Judgment Process



Elements of an Effective Judgment Process

Identify and Define the Issue

Although it may seem intuitive, auditors should not underestimate the importance of appropriately identifying and defining the issue (i.e., the transaction, event, or situation).⁶ This step is not always as easy as it may seem, and it can be susceptible to judgment tendencies, such as *overconfidence* or *anchoring* (discussed in more detail below). Indeed, failing to properly identify the issue (or issues) may lead to incomplete analysis and result in an inappropriate judgment.

Identifying and defining the issue involves careful analysis of the situation and often involves interaction and discussion with others to understand the situation and its potential effect on the audit. While it may not always be possible to identify all of the relevant considerations at the beginning of the judgment process, auditors should take the time to carefully define the primary issue to be addressed, as well as develop perspectives on other considerations that may need to be analyzed to support the overall conclusion.

⁶ For purposes of the resource, identifying and defining the issue is an action that occurs concurrently.



AUDITOR INSIGHTS:

Consider Multiple Perspectives

At the core of an auditor's ability to appropriately identify and define the issue is the ability of an auditor to consider available audit evidence, including information that contradicts management's assertions. Auditors may be able to boost their ability to identify and define an issue by understanding the perspectives of, among others (where appropriate or relevant): providers of capital (e.g., investors and lenders); audit committees or others charged with governance; management; regulators; other auditors; and other parties such as legal counsel, insurers, analysts, customers, or other parties to the company's transaction

An auditor's consideration of the perspectives of these parties can:

- Provide different views which may help an auditor identify the issue
- Help simplify and organize the issue surrounding a judgment by highlighting the more important aspects of the judgment
- Impact the evidence an auditor collects
- Provide a gauge for evaluating the scope of an auditor's considerations



Identify and Define the Issue: Practical Considerations

1. What is the impact to the financial statements?
2. What is the level of complexity inherent in the issue?
3. What is the level of uncertainty that impacts the issue's outcome?
4. What is the impact to the planned audit procedures?
5. Are there any related issues that may need to be considered?

Gather the Facts and Information and Identify the Relevant Literature

Having devoted appropriate time and attention to identifying and defining the issue, an auditor will need to obtain a thorough understanding of relevant facts and information available concerning the issue. This often includes an analysis of the information that is readily available, as well as information that may need to be obtained from others, such as subject matter experts. Gathering the facts and information often entails discussions with those from the company who are knowledgeable of, or who are instrumental to, the execution of the transaction. It may also involve those who were involved with or had oversight of the matter.

Gathering the facts and information also entails identifying the key inputs and assumptions to the transaction, event, or situation. For example, this may include understanding the underlying economic considerations of a particular transaction or series of related events, or consideration of the transaction's legal form and its economic substance. Obtaining such an understanding often includes considering whether other corroborating information exists, as well as identifying disconfirming or conflicting information, and an assessment of the sources of such information and whether those sources may be subject to bias.



AUDITOR INSIGHTS:

Gathering the Facts and Information Is More Than Getting the Company's Story

Gathering information is not limited to "getting the company's story" through discussion only. While evidence from inquiry may be obtained through interviews with applicable company personnel, gathering information also involves obtaining and critically assessing relevant evidence as appropriate (such as contracts, memorandums, calculations, meeting minutes, or external information)

Auditors often need to continue gathering facts and information throughout the decision-making process by developing additional and relevant questions for which additional factual information and evidence may be required. Moreover, it is important to consider potentially disconfirming evidence, including information that contradicts management's assertions. If additional information, particularly disconfirming information, is identified, an auditor should consider its effect on the analysis.

Additionally, auditors often need to consider whether the engagement team members collectively have the appropriate knowledge and experience to effectively make the judgment. In certain cases, specific subject matter experts can help identify which facts and assumptions are particularly important to the decision and help the engagement team focus on gathering the evidence that is most important to appropriately analyzing the matter.

Finally, auditors also should be alert for potential judgment tendencies, traps, and biases that can constrain evidence gathering and evaluation. This is particularly important as it relates to determining whether the evidence gathered is sufficient and appropriately reliable. Auditor judgment tendencies and biases are discussed in more detail below.



AUDITOR INSIGHTS:

Be Alert for and Consider Disconfirming Information

When gathering the facts and information, it is important that the auditor be alert for information that can potentially disconfirm expectations. If an auditor considers management's supporting materials without adequately considering potentially disconfirming information, he or she can quickly fall into the trap of not exercising adequate professional skepticism in evaluating management's positions.

Related to an auditor's need to gather the relevant facts and information is the need to identify the accounting or auditing literature (or other standards and rules) relevant to the issue. This may often involve considering more than one authoritative pronouncement in the applicable accounting framework (e.g., U.S. generally accepted accounting principles (U.S. GAAP) or international financial reporting standards (IFRS)).

The practical considerations box on page 7, while not all-inclusive, provides some common questions an auditor may consider when gathering the facts and information and identifying the relevant literature. These considerations can also serve to mitigate potential judgment tendencies and biases.

Perform the Analysis and Identify Potential Alternatives

This aspect of the decision-making process entails analyzing the issue based on the facts and information gathered, the relevant authoritative literature identified, and prior positions taken in similar situations by the company, the audit firm (e.g., "national office" technical or policy positions), or by the same auditor (though an auditor's analysis of prior positions taken should be carefully evaluated in the full context of the facts and information gathered in order to mitigate potential judgment tendencies that lead to bias). As a result of performing such activities, an auditor is often in a position to identify and assess a reasonable set of plausible alternatives and perform an objective evaluation of the expected outcome of each alternative.

It is important for an auditor to be thorough when identifying potential alternatives, because a decision can be no better than the best alternative considered. Indeed, an auditor's ability to consider reasonable alternatives is directly related to how well the auditor defined the issue (in other words, a set of reasonable alternatives can be constrained depending on how well the issue was defined). In many situations, the identification of a reasonable set of plausible alternatives may require an auditor to apply the relevant literature or audit firm policies or guidance, to the relevant facts and other information gathered.

It is important to be mindful of potential judgment tendencies, traps, and biases that can curtail the identification of a reasonable set of alternatives. For example, the overconfidence judgment tendency (discussed in more detail below) may limit the identification of potential alternatives because it can make one unwilling or unable to see alternatives. Another limitation can be an overreliance on past practice (often referred to as the "same as last year" approach), which may keep an auditor from discovering or considering an alternative. And, while some judgment tendencies, such as "judgment shortcuts," can help simplify complex situations and facilitate more streamlined judgments, they can also lead to suboptimal or ineffective judgments because of experiential or motivational biases, such as when an auditor considers only the alternative that is typically used to solve an issue, or only considers the first alternative that comes to mind (i.e., the availability bias, which is discussed in more detail below).

The table on page 8, while not necessarily all-inclusive, lists some useful questions for an auditor to consider when performing an analysis and identifying reasonable alternatives. Such considerations can serve to mitigate potential judgment tendencies and biases.



Gather the Facts: Practical Considerations

1. Have I considered:
 - The relevant technical literature, professional standards, and industry information, recognizing that reference to more than one source may be appropriate to address the issue?
 - Whether I have understood the form and substance of the transaction?
 - Whether the treatment that results from applying the relevant literature has been applied appropriately to similar transactions, events, or situations?
2. Have I examined source documents and other materials as appropriate (including determining whether such information was independently sourced or prepared by the company), interviewed knowledgeable client personnel, and considered other relevant sources of information, as appropriate?
3. Have I identified the pertinent information needed to address the issue by considering:
 - The business rationale or economics of the transaction, event, or situation?
 - The importance of the issue to the risk of material misstatement to the financial statements?
 - The assessed risks of material misstatement associated with the issue?
 - The importance of the issue to the overall audit plan, including the auditor's ability to obtain sufficient appropriate evidence?
 - The relevant audit observations?
 - The manner in which the company addresses the assessed risk of material misstatement?
4. Have I corroborated the facts or assumptions that are believed to have an important bearing on the analysis?
5. Have I sufficiently assessed, tested, and objectively challenged the appropriateness and reliability of the assumptions and data to be used in the analysis of the transaction or situation by obtaining sufficient appropriate evidence?
6. Have I considered what assumptions, if changed, would have the greatest impact on the judgment?
7. Have I considered potentially disconfirming evidence, including information that contradicts management's assertions? If so, how did I address the impact of such evidence?
8. Have I identified discrepancies or inconsistencies in the facts and information gathered?



Perform the Analysis: Practical Considerations

1. What has the company described as the economic substance or business rationale of the transaction?
2. What evidence have I obtained that supports management's assertions and conclusions? Is there evidence that does not support those assertions and conclusions?
3. What reasonable alternatives, other than those put forward by management, have I considered?
4. Has my analysis identified additional issues that need to be addressed?
5. Am I confident that I have gathered and analyzed sufficient and appropriate evidence, not just what is easily available or that which confirms the company's or my (initial) conclusion?
6. Are there standard industry practices to be considered?
7. Have I considered the underlying standards in the relevant auditing or accounting guidance?
8. Does the applicable authoritative guidance identified address the issue directly, or should other guidance be applied by analogy?
9. Do I (the audit engagement team or the audit firm's national office) have any previous experience with the issue? If so, how does that experience apply in these circumstances? Also, what have I done to consider and respond to potential anchoring bias?
10. If alternative perspectives were raised by members of the audit team or others consulted, have I appropriately considered such perspectives?
11. Have I sought input from others with different perspectives? For example, does the complexity or subjectivity of the matter indicate the need to consult with more experienced engagement team members, specialists within the firm, or external specialists?
12. Have I considered the alternatives in terms of how well they would address the issue?

Make the Decision

Having performed the analysis, an auditor reaches a decision. An auditor's judgment may result in concluding that there is only one appropriate response to an issue, or that there are multiple responses that could reasonably be applied in the circumstances. This involves asking which alternative best addresses the issue identified by the auditor. Making the judgment might involve an auditor's consideration of common judgment tendencies, traps, and biases (discussed in more detail below).

After making the decision, an auditor should step back and evaluate the judgment process from a big picture perspective. In particular, the auditor may consider whether a supportable process has been followed (e.g., has the auditor appropriately performed the activities in the decision-making process above?) and if not, the auditor might need to reconsider the process and the relevant evidence obtained.



Practical Considerations

1. If the decision is not necessarily consistent with the situation's planned economics, are there specific accounting-related requirements that drive such inconsistency or are there other factors the auditor should consider?
2. Have I relied too much upon easily available information, or relied upon the same process or approach used in the prior year (without considering reasonable alternatives)?
3. Are there any signs of potential bias in the analysis or rationale for the decision reached?

Review and Complete the Documentation and Rationale for the Conclusion

Documentation represents the written record of the basis for an auditor's judgment and it ultimately provides the support for the auditor's report. Documentation is also a way to evidence professional skepticism by identifying both the relevant information (which includes contradictory or inconsistent information identified and how the auditor addressed such information) and the reasonable alternatives the auditor identified and evaluated in reaching the conclusion. For example, in the analysis of confirming and disconfirming evidence it is important to document the rationale followed, which helps to show that appropriate professional skepticism was exercised.

Properly documenting and articulating the rationale of the auditor's judgment is particularly important, because it is not uncommon for an auditor, like any individual, to reach an initial conclusion only to find that the reasoning appears potentially faulty or incomplete once the auditor attempts to document his or her rationale. If the reasoning does not appear persuasive, an auditor can proceed to identifying which aspect or aspects of the analysis and judgment process deserves further consideration. This may result in revisiting how the auditor identified and defined the issue or considered the reasonable alternatives. Documentation also provides the auditor the opportunity to carefully reconsider preceding steps in the decision-making process as well as the possibility that judgment traps or biases may have influenced the final conclusion.

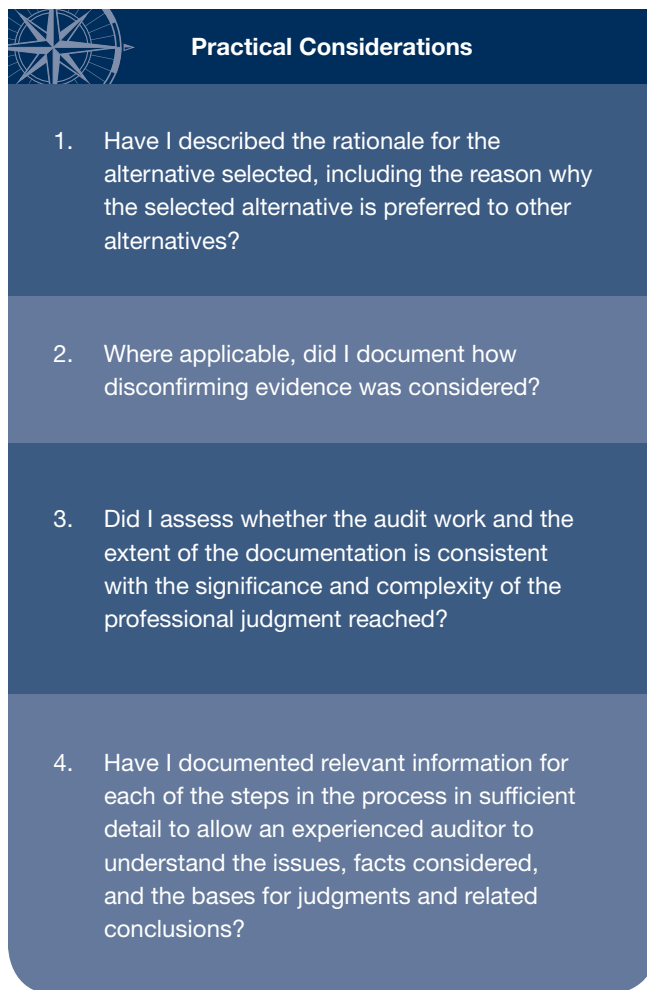
Auditing standards require that an auditor's documentation sufficiently evidence compliance with relevant professional standards and be prepared in sufficient detail to provide a clear understanding of (1) the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached and ⁷ (2) information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions.⁸ Such auditing standards also point out that timely documentation and reviews of judgments made enhance the quality of the audit. Accordingly, an auditor may find it helpful to document certain decisions throughout the judgment process.

⁷ See PCAOB Auditing Standard No. 3, Audit Documentation, paragraph 6.a.

⁸ See PCAOB Auditing Standard No. 3, Audit Documentation, paragraph 8.

Documentation throughout the judgment process can help an auditor crystallize his or her thinking about the issue, particularly as it relates to the consideration of reasonable alternatives. Moreover, documentation throughout the judgment process provides an opportunity for a potentially more objective and complete assessment of the reasoning used to reach and validate the decision.

The table below, while not necessarily all-inclusive, lists some useful questions for an auditor to consider when finalizing his or her audit conclusion and documentation. Such considerations can serve to mitigate potential judgment tendencies and biases.



Practical Considerations

1. Have I described the rationale for the alternative selected, including the reason why the selected alternative is preferred to other alternatives?
2. Where applicable, did I document how disconfirming evidence was considered?
3. Did I assess whether the audit work and the extent of the documentation is consistent with the significance and complexity of the professional judgment reached?
4. Have I documented relevant information for each of the steps in the process in sufficient detail to allow an experienced auditor to understand the issues, facts considered, and the bases for judgments and related conclusions?

Appendix B of this resource provides auditors a sample template that may be used to document the implementation of the auditor’s decision-making process applied to accounting or auditing issue(s) that arise during the audit. An auditor may decide to alter or tailor the template or not to use it at all. There is no “one-size-fits-all” approach to the exercise or documentation of professional auditor judgment.

Potential Judgment Tendencies, Traps, and Biases

All people have an innate process for reaching conclusions on issues. However, when it comes to potential judgment tendencies and traps, innate ability or experience — in and of themselves — do not always overcome the potential for judgment bias. On the other hand, innate ability or experience can be very helpful in exercising appropriate professional judgment.

There are a number of studies⁹ that have identified and analyzed several of the more common potential judgment tendencies that can lead to auditor judgment bias. These common potential judgment tendencies are *confirmation, overconfidence, anchoring, and availability*, and they are briefly discussed below. The description is not intended in any way to suggest that one or more of them exist in any particular audit or that, to the extent one or more of them exist, they cannot be overcome by these or other methods.

1. Confirmation is the potential tendency for an auditor to put more weight on information that is consistent with his or her initial beliefs or preferences. When collecting information (particularly once a preliminary view is developed), an auditor may unwittingly put more weight on information or evidence that supports an initial preference or expectation. As a result, the auditor may rely unconsciously on evidence that is biased toward his or her expected or preferred alternative, rather than objectively evaluating the facts as they exist. An auditor may not adequately consider potentially contradictory information that could result in a valid alternative to a preliminary conclusion.

⁹ See, for example, Glover, S.M. and D.M. Prawitt, “Enhancing Auditor Professional Skepticism.” (2013), and Hurtt, R.K. “Development of a Scale to Measure Professional Skepticism,” *Auditing: A Journal of Practice & Theory* 29, no. 1 (2010): 149–171.

2. **Overconfidence** is the potential tendency for an auditor to overestimate his or her own ability to perform tasks or to make accurate assessments of risks or other judgments and decisions. This may be a prevalent subconscious tendency that results from personal motivation or self-interest. The potential tendency to be more confident than is justified may affect an auditor even when he or she is doing his best to be objective. In some instances, overconfidence can lead to an inability to recognize alternative points of view or contradictory evidence. In addition, overconfidence can affect an auditor's willingness to involve others who could provide meaningful perspective to the analysis. Overconfidence can be caused by a number of factors, including when an auditor has a large amount of information at his or her disposal, even if it is of low quality or redundant. In some instances, when the process to reach a decision is difficult, confidence can give an auditor a false sense of security regarding the quality of his or her judgment.

3. **Anchoring** is the potential tendency to make assessments by starting from an initial numerical value and then adjusting insufficiently away from that initial value in forming a final judgment. The potential tendency may be exhibited when an auditor places too much reliance on one piece of information or set of circumstances. For example, an auditor may be anchored to management's unaudited, current period amounts, or other initial estimates, and an auditor may not sufficiently adjust from them. In such case, anchoring may lead an auditor to biased expectations compared to what an auditor might develop in the absence of management's amounts.

Anchoring may also prevent an auditor from considering other perspectives or data that may confirm or disconfirm a particular position or issue, may cause an auditor to inappropriately associate the information that is most easily available to the issue at hand, and may increase the likelihood that an auditor uses an evidence-gathering technique from a prior engagement, rather than considering objectively a fuller set of techniques.

4. **Availability** is the potential tendency for an auditor to consider information that is easily retrievable (e.g., a vivid or recent memory) as being more likely, more relevant, and more important for a judgment. In other words, the information that is most available to an auditor's memory may unduly influence estimates, probability assessments, and other professional judgments. Like other mental shortcuts, the availability tendency can serve an auditor well, but it can also introduce bias.

Other Potential Judgment Tendencies and Factors

There are several other potential cognitive and environmental factors that can affect professional judgment. While these potential factors are outlined below, the description is not intended in any way to suggest that one or more of them exists in any particular audit or that, to the extent one or more of them exist, they cannot be overcome by these or other methods.

POTENTIAL COGNITIVE TENDENCIES AND FACTORS AFFECTING JUDGMENT

- *Distorted or motivated reasoning* – When analyzing information, one may interpret the information in a way he or she expects should be interpreted, rather than considering other reasonable alternatives. This can result in evaluating information in a way that supports the expected outcome.
- *Hindsight* – Hindsight is the tendency for a person who has been provided with the outcome of an uncertain event to systematically overstate the ability to have predicted that outcome in foresight. In other words, when reviewing the outcome of a judgment, one may think, in hindsight, that the outcome was more probable than he or she thought it was before the outcome was known. Hindsight bias can often occur at a subconscious level, it may lead to overconfidence, and it can weaken professional skepticism. Hindsight bias may also exist when one considers a judgment that was made in the past and concludes that it was unreasonable. Absent hindsight bias, the person considering the prior judgment may conclude it was reasonable.
- *Rush to solve* – A person may want to immediately solve a problem by making a quick judgment, and as a result, he or she can underinvest in the important early steps in the judgment process and often go with the first workable alternative that may come to mind or that may be presented.
- *Self-serving explanations* – Another factor affecting one's judgment may be his or her potential tendency to interpret outcomes in a self-serving way. If the outcome of a judgment is positive, he or she potentially may tend to take credit. If the outcome of a judgment is negative, he or she may look to other reasons, rather than him or herself, to explain the outcome.

POTENTIAL ENVIRONMENTAL FACTORS AFFECTING JUDGMENT

- *Group decision-making* – Seeking the input of others, particularly in group settings, can be appropriate and in some cases very important to the decision-making process. In fact, consultation with the appropriate individuals may often be important to forming the appropriate professional judgment. Decision-making in groups, however, can also stifle critical aspects of the judgment process because of potential common judgment tendencies that are often manifested in groups. The effect of this manifestation is “Groupthink,” which can result in a group tendency toward narrow thinking, suppression of divergent views, and partially considered judgments. Groupthink can occur with different individuals at different times; in other words, the conversations do not need to be had simultaneously for Groupthink to be present. At the same time, groups are usually more effective at making judgments than are individuals, especially when there is a divergence of thought and experience among the members of the group. The key is to harness the power of groups while avoiding the traps that can impact the quality of group judgments.
- *A closed communication environment* – Barriers to open communication or a refusal to share information in a timely manner may present a serious disruption and may create risk of poor decision-making.
- *Misaligned performance expectations and incentives* – An auditor may respond to the rewards and incentives associated with an audit engagement and an auditor may become susceptible to bias when placed in an audit that rewards the achievement of certain performance targets, such as budget and realization thresholds, rather than the appropriate application of professional skepticism and the execution of a high-quality audit.
- *Time pressure and other deadlines* – Whether internal to the audit team, exerted by the company whose financial statements are being audited, or the result of statutory provisions, time pressures and other deadlines may increase the possibility of bias, particularly when identifying and defining the issue. As a result, an auditor may end up solving the wrong issue. The same time pressure may cause an auditor to rush to judgment or accept the first alternative.
- *Limited resources or budget constraints* – These environmental influences may in some cases result in a tendency to cut short the collection of information or further analysis.



Strategies to Avoid Potential Judgment Tendencies and Traps and to Mitigate Bias

Involve the Right People in the Judgment Process

- Know when to involve senior members, such as the lead audit partner, engagement quality reviewer, or appropriate subject matter experts
- The decision to involve others should be based on the significance and complexity of the judgment and the experience of the engagement team members in the area

Encourage Opposing Points of View

- Such an approach can increase the participation of fellow audit engagement team members and encourage a broader and more complete set of perspectives and alternatives, and enhance the quality of final decisions
- Making judgments in groups has the potential to improve judgment quality, but poorly structured group interaction may exacerbate the potential traps and biases

Consider Opposing and Disconfirming Evidence

- In response to the potential confirmation tendency, helpful mitigation techniques include making the opposing case and considering disconfirming or conflicting evidence

Consider Management Bias, Including the Potential for Fraud or Material Misstatements

- Decisions requiring significant accounting judgments often represent areas susceptible to management manipulation
- Auditors should consider indicators of management bias, including potential fraud indicators

Strategies to Avoid Potential Judgment Tendencies and Traps and to Mitigate Bias

Once an auditor is aware of any potential judgment tendencies, traps, and biases, he or she can take steps to mitigate their effects and strengthen the application of professional skepticism. Although it is unlikely that potential judgment tendencies, traps, and related biases can be entirely eliminated, understanding their nature can help an auditor recognize situations in which judgments potentially may be biased and take logical, intuitive steps to mitigate the effects of any potential judgment biases. In addition to awareness, these are some strategies and techniques that can help overcome any potential judgment tendencies and traps. In addition, whether or not a potential judgment tendency or trap exists, one or more of these strategies may be useful for an auditor to consider in exercising professional judgment.

Other Techniques

There are a number of other techniques that can support an auditor's exercise of professional skepticism, help avoid potential judgment tendencies, and mitigate bias. Some of these techniques include, but are not limited to:

- Reassessing how the decision or judgment was reached
- Identifying potential alternatives to protect against inadvertently focusing on one particular set of facts or a singular outcome
- Explaining judgment rationale to others, such as superiors, staff, and subject matter experts, to get their feedback
- Engaging in self-reflection by stepping back and thinking about whether time pressures, self-interest, judgment traps, and biases might have unduly influenced an auditor's judgment

- Deferring final judgment until key facts have been gathered and evaluated can enhance an auditor's objectivity and help ensure he or she has sufficiently identified and evaluated an issue

- Learning from experience by considering what went well and what did not go so well, how an auditor might do something differently the next time how to help reinforce the positive lessons, and what to learn from the negative experiences



Appendix A: Illustrative Examples of Potential Judgment Tendencies

The following are examples that seek to illustrate the existence of potential judgment tendencies in an audit. These examples are intended for informational purposes only. **They are not intended to include all facts and circumstances that may be present on any given audit, including other mitigating factors and areas of concern that could exist, but rather to highlight certain areas relevant to the judgment process.**

Example 1: Confirmation

BACKGROUND

The Fox and Beck Company (F&B or the company) primarily produces and distributes a broad range of equipment used in manufacturing activities. Sales of manufacturing equipment are recorded when persuasive evidence of an arrangement exists, the sales price is fixed or determinable, collectability is reasonably assured and the risks and rewards of ownership are transferred to the purchaser based on the sales agreements in effect. In the United States, and most international locations, this transfer occurs when the manufacturing equipment is delivered. When revenue is recorded by the company, no significant uncertainty exists surrounding the purchaser's obligation to pay and the purchaser has no right of return. The manufacturing equipment is installed by a third party or the purchaser. The purchaser is also responsible for regular maintenance, which can be performed by that entity or a third-party.

In the third quarter of the prior year, the company received a request from its largest customer, Burgess & Wolf Industrials (B&W), to modify (i.e., customize) certain of its manufacturing equipment. F&B determined that the nature of the customization sought by B&W would require approximately six months of significant changes to the company's production facilities and that the time required to produce and deliver such equipment could increase up to five months. F&B and B&W agreed to the new arrangement and a new sales contract for the customized equipment was signed in the fourth quarter of the prior year.

Among other provisions, the new sales contract reflects (1) new terms for submitting purchase orders, (2) written B&W acceptance of the customized equipment, and (3) the requirement for F&B to perform the installation of the manufacturing equipment. The pricing for installation services is fixed and separately stated for each equipment category.

Installation is also required to be completed within 30 days after delivery.

The company completed the necessary capital improvements required to support the new equipment orders by the end of the second quarter of the current reporting year and the company began to perform under purchase orders submitted by B&W during the second half of the current reporting year. Sales from such activities accounted for approximately 15 percent of all revenues for the current reporting year. Additionally, during the fourth quarter of the current reporting year, the company initiated new marketing and promotional activities to highlight its enhanced production capabilities to existing and new customers.

Jonas, the F&B audit engagement partner, was aware of the arrangement based on discussions with management. During the engagement team discussion, they discussed the audit procedures that would be performed related to this new arrangement.

Mila is the F&B audit engagement manager with several years of manufacturing and distribution audit experience, including audit work performed on the F&B audit the past three years. Mila is familiar with the company's revenue recognition policies and in preparation for a meeting Mila has scheduled with Bert, F&B's global corporate controller, Mila has performed certain analytical procedures over the delivery of equipment and payment responsiveness of customers. The company has not had multiple-deliverable elements (e.g., installation or maintenance) in the past. Therefore, the primary focus of the prior year auditing procedures has been on existence and whether or not the equipment has been delivered.

During Mila's meeting with Bert, Bert described the terms of the new contract with B&W. Bert noted that the company will continue to follow its current revenue recognition policy for the customized equipment (i.e., recognize revenue at the point of delivery) because Bert states that the time required to deliver the customized equipment to the final destination and install that equipment would never exceed the 30-day after delivery installation requirement. Accordingly, Bert believes this timing is immaterial as to whether the company's performance obligation has been fulfilled and risk of loss is transferred. Finally, Bert offered Mila evidence of several deliveries to B&W under the new sales contract that indicated goods delivered were installed by F&B within the 30-day window, these deliveries represented 50 percent of the total revenue recognized under the new sales contract in the current

reporting year. Mila is persuaded by the company's position given Bert's explanation and, indeed, her remaining audit test work, which followed last year's audit plan for the unmodified manufacturing equipment, also supported the reasonableness of the company's position.

During his review of the audit procedures performed, as well as previous discussions with management related to the new contract with B&W, and the description of the marketing and promotional activities with other customers on the new production capabilities, Jonas questioned the appropriateness of the company's revenue recognition of the new sales contract with B&W. Jonas recognized that the substance of the company's activities was an important migration of the company's business into new activities. Moreover, Jonas also recognized that the nature of the new B&W contract was, in substance, a new multiple-deliverable arrangement that required additional accounting analysis and audit procedures to determine whether the installation would be a separately recognized deliverable, whether the customization of the equipment specifications created a contract which would require revenue recognition under FASB Accounting Standards Codification 605-35 (ASC 605-35), and whether the proposed timing of the company's revenue recognition for delivery and installation was appropriate under the new contract with B&W.

Jonas determined through some additional audit procedures and sensitivity calculations that the company's revenue recognition policy related to sales under the new contract would likely recognize revenue too early. Specifically, if the company recognized revenue for the customized equipment when the units were delivered, but before they were installed and accepted as of the current balance sheet date under audit, the revenue recognized would be materially overstated by an amount in excess of planned audit materiality.

IDENTIFY THE PRINCIPAL JUDGMENT TENDENCY

Confirmation bias is the tendency for an auditor to put more weight on information that is consistent with his or her initial beliefs or preferences. When collecting information (particularly once a preliminary view or objective is developed or expressed), an auditor may unknowingly search for—and put more weight on—information or evidence that may confirm or support an initial preference or expectation. As a result, the auditor may rely on evidence that is biased toward his or her expectation without realizing it.

An auditor may also fail to identify or adequately consider other contradictory information that may result in a valid alternative to a preliminary conclusion. Considering only confirmatory evidence is a judgment shortcut that can potentially result in biased judgment because, in many situations, an auditor cannot know something to be true unless the auditor explicitly considers how and why it may be false.

In the fact pattern above, Mila was susceptible to the confirmation judgment tendency. She let herself be persuaded by the limited conversation with Bert, reviewing a few deliveries from the second half of the year under the new sales contract (selected and provided by Bert), and relying upon prior year audit procedures to confirm her judgment about the reasonableness of the company's position. Mila failed to critically evaluate the company's position despite the substance of the changes in the B&W contract, the capital improvements made by the company to support the new offering, and the company's description of such matters.

OVERCOME THE JUDGMENT TENDENCY

Once an auditor is aware of potential judgment tendencies and biases, he or she can take steps to mitigate their effects and strengthen the application of professional skepticism. Some common techniques to mitigating the confirmation judgment tendency include considering the input of others, considering any potentially disconfirming evidence, and making the opposing case.

In the fact pattern above, Jonas was successful at demonstrating professional skepticism and considering potentially contradictory audit evidence by following several common strategies and techniques to overcome the confirmation bias. Jonas critically evaluated the company's accounting position by considering an alternative view to that posed by Bert based on his understanding of the transaction and related revenue recognition guidance. He responded by modifying the audit plan to perform different procedures that were designed to identify transactions under the new contract around year-end that had potential to be recorded as revenue by the company based on delivery dates that might not yet be installed and accepted by the customer.

Example 2: Overconfidence

BACKGROUND

Miguel is a partner with over 10 years of experience auditing construction, building, and real estate companies, including work performed in challenging audit areas such as determining the fair value of real estate and real estate funds. Miguel also serves as an engagement quality review (EQR) partner on several other real estate companies and funds audited by his firm. The largest of the companies on which Miguel serves as the lead engagement partner is GGM Properties (GGM or the company).

GGM is a leader in the ownership, management, and redevelopment of single-tenant and multi-tenant office and business properties in the mid-Atlantic region. Historically, the company strategically focused on acquiring and redeveloping properties that the company believed can benefit from its property management expertise and repositioning such properties to increase their profitability and value. The typical redevelopment activities undertaken by the company include the installation of fully reimbursable “normal tenant improvements” (i.e., customized improvements that only the current tenant can utilize), clean-up and routine maintenance. The time to begin and complete these redevelopment activities is usually four to eight weeks.

Historically, these acquisitions, depending on the facts and circumstances of each acquisition, are typically recognized as business combinations where the net assets acquired (including real estate and land) are measured at their acquisition date fair value.¹⁰ The company usually determines the fair value of these properties based on an internally-developed income measurement approach, which is based on the expected future income streams of the property. While GGM competitors often rely on a market¹¹ or cost¹² approach to valuing acquired real estate and land, the company believes that an income measurement approach is the most appropriate valuation technique for properties it typically acquires. The company has asserted that since certain types of income producing assets, such as office buildings, have isolatable and measurable income streams arising from in-place or new lease arrangements, an income measurement best comports with the “highest and best use” notion of fair value for non-financial assets in FASB ASC Topic 820, *Fair Value Measurement*.

GGM believes that, over time, certain industrial properties can be improved by converting them, in whole or in part, into mixed use office and business properties for rent. As such, the company decided to expand its sales and marketing operations

to Florida, focusing on below market industrial properties. The company believes that because office lease rates are generally higher than warehouse lease rates in Florida, the company can add revenue and value by converting industrial space as market demand allows.

Shelly, the chief financial officer (CFO) of GGM, met with Miguel to give him an overview of the details associated with the first acquisition of property in Florida, an industrial warehouse with an adjacent plot of vacant land (the property). During the meeting, Shelly described to Miguel the company’s 15-month plan to renovate the property and land in order to convert it into a mixed use, multi-tenant, ten-story office property. The construction activities necessary to convert the warehouse to office space will include major construction activities such as removing load-bearing walls to reconfigure structural elements of the property, upgrading electrical wiring, replacing the existing HVAC system, and constructing an addition to the property on the vacant land, which will increase the overall property space to be leased by approximately 25 percent. Shelly added that five tenants, concurrent with the acquisition of the property, signed multiyear, market-rate, lease agreements for seven of the ten stories of the property.

Shelly also outlined to Miguel the company’s proposed recognition and measurement treatment for the acquisition of the Florida property. She noted the company would account for the acquisition as a business combination and would follow an income measurement technique, specifically, a discounted cash flow approach, to determine the fair value of the property. Since the acquisition of the property occurred approximately two weeks before the company’s current fiscal year-end, Shelly asked Miguel to accelerate his auditing procedures on the transaction so the company could announce the acquisition in a press release just before the end of the fiscal year.

¹⁰ Under ASC 820-10-35-24 through 24A, like other fair value measurements, the valuation of property is based on observable inputs to the extent possible. If market prices are not available, then valuation techniques such as an income or depreciated replacement cost approach may be used.

¹¹ Under ASC 820-10-55-3A through 3C, a company would use the market approach to value property when there are known (or reasonably obtained) and observable markets for the assets. For example, transaction data for sales of real estate and land generally are available through various data sources.

¹² Under ASC 820-10-55-3D through 3E, using a cost measurement approach, the value of real estate can be measured as an estimate of the current cost to purchase or replace the property, less applicable depreciation and obsolescence.

Miguel is familiar with the company's recognition and valuation policies on acquired and managed properties, particularly as it relates to similar acquisitions executed by the company in the recent past. While Miguel knows that determining the initial fair value of acquired real estate can be complex and highly judgmental, Miguel is accustomed to evaluating similar transactions based on his significant experience with GGM and other real estate audit engagements. Miguel has confidence in his audit judgments because his conclusions on other GGM valuation matters (and on similar matters with other audit engagements) were well-reasoned judgments and they have not been historically questioned. Miguel believes his prior experiences are relevant to the current GGM transaction and he relies upon such experiences to inform his review of the readily available and relevant transaction documentation.

Upon Miguel and his audit team gaining a clearer understanding of the current transaction and performing certain substantive audit test work of the company's income approach, including the testing of management's significant assumptions and the company's internally developed valuation model, Miguel calls Shelly a couple of days later to let her know that he thinks the company's recognition and measurement approach appears reasonable.

After the company announced the transaction and the fiscal year ended, Tracy, the GGM EQR partner, reviewed the audit team's work papers on the transaction. Tracy questioned whether the audit team exercised sufficient professional skepticism in the planning and execution of its auditing procedures with respect to whether the initial measurement of the Florida property should be based upon the market measurement approach.¹³ Namely, Tracy observed that the team did not develop an independent estimate of fair value to corroborate the measurement based on the company's income approach, particularly since the property was acquired in a market (Florida) outside of the company's normal operating geography (the mid-Atlantic region). In response to Tracy's review comments, the audit team evaluated available and comparable sales information in the Florida industrial and office space market and developed an independent estimate,

¹³ Under ASC 820, the fair value of a non-financial asset, such as real estate and land that is in development would be measured and recognized at the amount that the company would be expected to receive from selling the development property to a market participant in its current condition (i.e., a market measurement approach).

determining that the amount estimated by the company exceeded the fair value under ASC 820 by an amount in excess of the GGM planned audit materiality.

IDENTIFY THE PRINCIPAL JUDGMENT TENDENCY

Overconfidence is the tendency to overestimate one's own ability to perform tasks or to make accurate assessments of risks or other judgments and decisions. In some cases, the decision-maker can be so confident in his or her decision that he or she fails to recognize that there may be alternative points of view or to consider evidence that is contrary to his or her thinking. In addition, overconfidence can limit one's inclination to involve others who could provide meaningful perspective to the analysis.

In the fact pattern above, Miguel appeared to exhibit overconfidence by believing that his auditing experience with "similar" transactions executed by the company (and others), and his leadership role as an EQR partner of several other real estate companies, outweighed the need for more comprehensive audit procedures. As a result, he and his audit team did not consider whether the company's measurement was acceptable in light of the important differences in the nature of this transaction compared to prior transactions entered into by the company.

OVERCOME THE JUDGMENT TENDENCY

Once an auditor is aware of potential judgment tendencies and biases, he or she can take steps to mitigate their effects and strengthen the application of professional skepticism. Some common techniques to overcome the overconfidence judgment tendency include considering the input of others, obtaining objective data, and making the opposing case.

In the fact pattern above, Tracy was successful at demonstrating professional skepticism and followed several common strategies and techniques to overcome the overconfidence bias. Namely, she recognized the need to consider independent, third-party data that might have impacted the company's measurement approach. She recognized that the company was following a less reliable measurement approach (income) to determining the fair value of the property, even though the transaction indicated a significantly longer and a more extensive redevelopment effort by the company. Her exercise of professional skepticism of the company's and audit team's judgments also enabled her to make the opposing case about whether it was appropriate for the company to apply a discounted cash flow measurement technique given the significant redevelopment time and effort

required and the delayed commencement and receipt of actual lease payments for at least 15 months after the property acquisition date.

Example 3: Anchoring

BACKGROUND

Wilson is a senior associate with several years of banking and financial services audit experience, including work performed in challenging audit areas such as the auditing of a company's allowance for loan and lease losses (ALLL). He has been recently assigned to the year-end financial statement audit for Keyser-Hinshaw Savings & Loan (K-H or the company), and more specifically, he has been assigned to perform the audit work related to the general reserve component of K-H's ALLL account.

For the period ended December 31, 20X0, the company recognized ALLL of \$1.0 million based on the company's ALLL methodology, which has been consistently applied on a quarterly basis. The company determines the general reserve component of the ALLL by segmenting the company's loan portfolio into groups of similar loans and calculating the historical loss rate for each group of loans. The resulting historical loss rates are then adjusted to reflect current conditions that are different from the historical loss calculation period. The adjustments to historical loss rates are referred to as qualitative factors. An example of a qualitative factor is the level and trend of loan delinquencies and, for example, if delinquencies are higher (lower) at the estimation date than they were during the historical loss period, the historical loss factors will be adjusted upward (downward).

Wilson submitted requests and received documentation and other financial data associated with K-H's preliminary accounting for the ALLL. In preparation for a meeting he scheduled with Crystal, K-H's chief credit officer (CCO), Wilson performed certain initial audit procedures. For example, Wilson tested the reliability of the reports used to calculate the historical loss factors, tested the clerical accuracy of the loss factor calculations, analytically reviewed the qualitative adjustments to historical loan loss rates, and reviewed relevant company-specific and industry trends—all procedures that were also performed as part of the prior year audit work. These procedures generated several questions that Wilson planned to raise with the CCO, particularly as it related to some of the qualitative factors that the CCO used to support the ALLL measurement and recognition.

During the meeting, Wilson asked Crystal about several inputs to the company's ALLL analysis, particularly as it related to the company's qualitative adjustment to the historical loan loss rate for home equity lines of credit (HELOCs). Specifically, the delinquency rate for HELOCs is nearly 9 percent, which is three times the level of delinquencies at the prior year end and K-H has applied a qualitative adjustment of 150 basis points (bps) to the historical loss rate for the HELOC portfolio to reflect the higher delinquency rate. Crystal explained to Wilson that the company determined the 150 bps adjustment based on the charge-off rate that the company experienced during the last economic downturn. Wilson observed, however, that the charge-off rate is based on commercial real estate, not residential, and therefore Wilson believes that Crystal's estimate is low. In fact, Wilson believes the qualitative adjustment should be at least 175 bps since another comparable savings and loan that Wilson is familiar with is experiencing charge-offs at that level.

Wilson performed the applicable auditing procedures following his meeting with Crystal and he determined that the company's ALLL balance related to the HELOC portfolio was understated by 25 bps. Rather than wait for the audit engagement manager, Brian, to review his work, Wilson approached Brian with his findings. Brian agreed with Wilson's concern that the ALLL balance was understated, however, Brian determined that both the company and Wilson had not factored in subsequent events that reflected actual charge offs of HELOC loans at a rate of 250 bps. Wilson was unaware of the subsequent event results because he had not yet reviewed the work of the audit engagement staff that performed those procedures. Brian concluded that the ALLL related to the HELOC portfolio was actually understated by a total of 100 bps.

IDENTIFY THE PRINCIPAL JUDGMENT TENDENCY

Anchoring is the tendency to make assessments by starting from an initial view point and then adjusting insufficiently away from that initial value in forming a final judgment. Anchoring often occurs when an auditor places too much reliance on one piece of information or set of circumstances. In the example above, the company's CCO appeared to exhibit the anchoring tendency. While Crystal used the last known adjustment of 100 bps and adjusted it to 150 bps based on the company's current conditions, she was clearly anchored to the company's historical data and to the company's ALLL estimation process because Crystal did not adjust for recent charge-off data. While this approach was

effective in prior periods and it made Crystal recognize the need to adjust, the adjustment was insufficient in the current period.

Anchoring can also prevent an auditor from considering other perspectives or data that may confirm or disconfirm a particular position or issue. Additionally, it can cause the auditor to inappropriately associate the information that is most easily available to the issue at hand.

The second example of anchoring above was Wilson's determination concerning the CCO's basis-point change. It appears that Wilson was anchored to the CCO's adjustment of 150 bps because, while he knew that it should be more, he did not increase it sufficiently. Wilson only thought it should be adjusted to 175 bps, but in reality it should have been 250 bps. Recall that Wilson believed the qualitative adjustment should be at least 175 bps because the company of another comparable savings and loan that Wilson is familiar with was experiencing charge-offs at that level and because of the prior-year auditing procedures that Wilson followed. Here, anchoring led to biased expectations compared to what Wilson might have developed had he reviewed and considered the other test work of the entire audit engagement team and the circumstances specific to the K-H audit, which found subsequent actual charge offs of 250 bps.

OVERCOME THE JUDGMENT TENDENCY

Once an auditor is aware of potential judgment tendencies and biases, he or she can take steps to mitigate their effects and strengthen the application of professional skepticism. A common technique to overcome the anchoring judgment tendency includes considering the potential for management bias and that management might provide an estimate that serves as an anchor. An auditor may also consider the advice of others, consider benchmarks available from industry sources and develop reasonable alternatives from other, independent sources.

¹⁴ Under FASB ASC 350-20-35-4, the first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill.

¹⁵ Under the DCF method, the company measures the fair value of its reporting units by estimating future cash flows for a forecast period, estimating a terminal value at the end of the forecast period and applying a discount rate to equate the cash flows (including the terminal value) to a single present value.

In the fact pattern above, Wilson was successful at demonstrating professional skepticism because he performed appropriate initial audit procedures, prepared well for his meeting with the CCO, and following those activities, proactively sought input from Brian, which helped him overcome his anchoring judgment tendency.

Brian was also successful at demonstrating professional skepticism and overcoming the anchoring tendency by not limiting himself to the company's anchor of 150 bps or Wilson's anchor of 175 bps; he also looked for additional relevant information that Wilson and the company had not evaluated. Specifically, Brian looked at additional audit evidence outside of the evidence supporting an additional adjustment of 100 bps rather than the additional 25 bps that Wilson suggested.

Example 4: Availability

BACKGROUND

Gcorp, Inc. (Gcorp or the company) is a provider of information technology (IT) and professional services. The company provides a broad array of solutions to a variety of organizations in areas such as consulting and systems integration, business process outsourcing, and intellectual property-based software. Over the past three years, the company has completed several strategic acquisitions designed to complement and strengthen the company's emerging services and associated delivery models. The largest acquisition by Gcorp was the purchase two years ago of Epitome Solutions, Inc. (Epitome), a global leader in next-generation IT services and solutions.

With each acquisition, the company forecasted significant sales growth. The goodwill recognized from each acquisition was typically 70 percent of the assets acquired and was generally attributable to an expected increase in the company's market capabilities, synergies from combining operations, and the value of the acquired at-will workforces. As a result of the significant amount of goodwill recognized from the acquisitions and the limitations on Gcorp's internal resources, the company hired a third-party valuation specialist, ABC Associates LLP (ABC), to assist the company with developing the fair value estimates for its annual goodwill impairment testing process.

For the current period, the company performed its annual impairment test of goodwill by choosing to bypass the initial qualitative assessment and proceeding directly to "step 1" of the goodwill impairment test for each reporting unit.¹⁴ ABC's

valuation methodology for determining the fair value of Gcorp's reporting units has been the discounted cash flow (DCF) method.¹⁵ Similar to the prior year, the company provided ABC the following inputs to be reflected in the Epitome reporting unit valuation:

- No change in the Epitome information technology solution road maps (i.e., customer product development plans) for existing, in-process, and future products and solutions
- Budgets and projected financial performance that reflected the growth rates associated with the original Epitome acquisition date revenue and performance projections, which were the subject of extensive due diligence at the time of the acquisition
- Statements Gcorp has made to the public about the future of its business
- Projected financial information provided to the Gcorp board of directors and other stakeholders

Based on the above considerations and its experience in the industry, ABC developed assumptions related to the discount rate and terminal value. In its signed valuation report, ABC estimated that the fair value of the Epitome reporting unit exceeded its carrying amount by 25 percent.

Fiona is the Gcorp audit team senior manager. She has several years of information technology audit experience, including service on the Gcorp year-end financial statement audit for the last three years. She has the primary responsibility to review the company's goodwill impairment analysis. The audit staff that Fiona supervises performed certain audit procedures associated with the company's goodwill impairment evaluation, all of which were consistent with the prior year audit program. Those procedures include testing the mathematical accuracy of the valuation analysis and assessing the reasonableness of the related valuation assumptions. Fiona recognized that ABC is a well-respected valuation firm, comprised of highly competent valuation specialists with broad software and technology industry experience. Similar to prior years, Fiona determined that the ABC valuation report and the company's "step 1" goodwill impairment analysis were reasonable; accordingly, Fiona also agreed with the company's conclusion that a "step 2" goodwill impairment test was not required.¹⁶

When Naseem, the Gcorp lead engagement partner, reviewed the goodwill impairment test work performed by Fiona and the audit team, he noticed that the company, ABC as the

third-party valuation specialist, and his audit engagement team did not consider the impact of company risk factors and other market data disclosed by the company elsewhere in its previously filed Form 10-K, which remained relevant during the current period. Notably, Gcorp indicated in its Form 10-K risk factor disclosures that since the acquisition two years ago, Epitome had not met its revenue or cash flow projections. In fact, during the current fiscal reporting period, overall actual financial performance and cash flows had declined compared to the prior year and planned projections. Nevertheless, the management of Gcorp was still optimistic that the synergies from the Epitome acquisition would be realized, adding that Gcorp shares were still trading at a premium over their book value.

Naseem identified from additional research, however, that third-party analysts were not as bullish on Epitome's performance. These analysts noted in their published reports that the implied multiples of acquisitions in Epitome's sector had declined as the result of the acceptance of alternative technologies. These analysts added that the equity prices for other public companies in the sector had also steadily declined over the past two years.

Naseem determined through additional audit procedures that the fair value of the Epitome reporting unit was most sensitive to changes in the expected growth rates over the remaining forecast period and that a decline in expected growth rates would result in a significant decline in the estimated fair value of the Epitome reporting unit. Based on Naseem's consideration of Epitome's actual operating performance for the reporting period, as well as third-party data of implied multiples, he developed an independent estimate which indicated that the carrying value of the Epitome reporting unit would exceed its estimated fair value. As a result of his additional audit work, Naseem informed the management of Gcorp that their "step 1" goodwill impairment analysis was not reasonable and it would need to be updated. Moreover, Naseem indicated that "step 2" of the goodwill impairment test will need to be performed by the company.

¹⁶ Under FASB ASC 350-20-35-8, if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss, if any. Under FASB ASC 350-20, paragraph 35-9, the second step of the goodwill impairment test, used to measure the amount of impairment loss, compares the implied fair value of reporting unit goodwill with the carrying amount of that goodwill.

IDENTIFY THE PRINCIPAL JUDGMENT TENDENCY

Availability is the tendency for an auditor to consider information that is easily retrievable (or what's more easily accessible) as being more likely, more relevant, and more important for a judgment. This tendency also increases the likelihood that an auditor relies on the testing approach from a prior audit engagement or a familiar source, rather than considers objectively what testing approach may be appropriate in the current environment. In other words, the availability judgment tendency may also cause an auditor to revert to using the "same as last year" rationale for the current period audit and rely on the easily available explanations provided by management, particularly when that information is supplied by a credible third-party.

In the fact pattern above, there are two examples of the availability judgment tendency that led to bias and insufficient professional skepticism. First, Gcorp management appeared to exhibit the availability tendency given the reliance upon ABC as a valuation specialist. While specialists and experts often add expertise and improve the quality of estimates, it is important for management to critically evaluate the specialist's views before reaching a judgment. In the above case, the management of Gcorp was insufficiently skeptical and relied too heavily upon the prior year valuation assumptions and inputs used by ABC to calculate the fair value of the Epitome reporting unit for the current period. The fact pattern above indicates that such an approach was not appropriate given the decline in Epitome's operating performance and the presence of more objective, third-party analysis and other data.

Second, the senior manager appeared to exhibit the availability judgment tendency, which inhibited her professional skepticism, by concluding the company's analysis, supported by ABC's work and easily available evidence, was reasonable without also considering other evidence that was available.¹⁷ Fiona did not consider objective data such as the third-party analyst perspectives and other market data, or consider the opposing case for the assumptions. The availability of the ABC valuation report, and the firm's strong professional reputation, inhibited Fiona's exercise of professional skepticism.

¹⁷ Under AU 328.05, the auditor's consideration of management's assumptions underlying fair value measurement is based on information available to the auditor at the time of the audit. For the purpose of applying the auditing requirements of AU 328.05, auditors should consider not only the assumptions developed by management, but also the assumptions developed by a specialist engaged or employed by management.

OVERCOME THE JUDGMENT TENDENCY

Once an auditor is aware of potential judgment tendencies and biases, he or she can take steps to mitigate their effects and strengthen the application of professional skepticism. Some common techniques to overcome the availability judgment tendency include considering the input of others, considering any potential alternative evidence, and making the opposing case.

In the fact pattern above, Naseem was successful at demonstrating professional skepticism and followed several common strategies to overcome the company's and Fiona's availability biases. Namely, he recognized the potential impact of the company's significant risk related disclosures on the goodwill impairment valuation and that prompted him to proactively perform research to gain an outside perspective on the company's performance. He also performed additional audit procedures through sensitivity analysis, to make an opposing case against the reasonableness of the company's position.

Appendix B: Template for Auditor Documentation

Company Name: _____

Financial Statement Date: _____

Documentation Date: _____

PURPOSE: Upon identifying an accounting or auditing issue(s) that arises during an audit, the elements of this template could be used to guide efforts to document the implementation of the auditor’s decision-making process to the accounting or auditing issue(s). The accompanying “Documentation Guidelines” expound on the six elements of this template. **Please note that this template was not intended to modify or supplant the requirements of PCAOB Auditing Standard No. 3, Audit Documentation, or other professional standards. Those requirements should be considered in conjunction with the use of this template.**

1. Transaction (or Process) Illustration
2. Background, Facts, and Information
3. Accounting and/or Auditing Issue(s)
4. Relevant Accounting and/or Auditing Guidance
5. Analysis Performed
6. Conclusion

Preparer Name: _____

Preparer Signature: _____ Date: _____

Engagement Supervisor Name: _____

Engagement Supervisor Signature: _____ Date: _____

Specialist Name: _____

Specialist Signature: _____ Date: _____

Engagement Partner Name: _____

Engagement Partner Signature: _____ Date: _____

Engagement Quality Reviewer Name: _____

Engagement Quality Reviewer Signature: _____ Date: _____

Documentation Guidelines

Purpose: The following guidelines have been provided to aid the consideration of documenting the implementation of the auditor's decision-making process to accounting or auditing issue(s) that arise during an audit. These guidelines should not be interpreted as all-inclusive or as factors that are required to be considered and/or documented in all cases.

1. **Transaction (or Process) Description or Illustration:**

Describe or illustrate through a diagram, flowchart, or decision-tree the transaction or process related to the issue(s) being evaluated. Illustrations typically simplify complex transactions or processes and improve the understanding of the matter by the auditor and others.

2. **Background and Facts:** Document the background and the relevant, objective facts related to the issue(s) that will be addressed. This space will typically include documentation of the following factors:

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

Refer to Identify and Define the Issue and Gather the Facts and Information and Identify the Relevant Literature in the Professional Judgment Resource for additional information and practical considerations that may be relevant to include in this section of the template.

3. **Accounting and/or Auditing Issue(s):** Include the accounting or auditing issue identified from the applicable background and facts and information gathered. Be as detailed as necessary to set the stage for the identification and considerations of the applicable standards or other guidance related to the issue(s). This space will typically include documentation of the following factors:

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

Refer to Identify and Define the Issue and Gather the Facts and Information and Identify the Relevant Literature in the Professional Judgment Resource for additional information and practical considerations that may be relevant to sufficiently document this section of the template.

4. **Relevant Accounting and/or Auditing Guidance:** Provide the relevant accounting or auditing standards, regulatory guidance, and other audit firm policies or guidance considered by the auditor and ultimately determined to potentially apply to the issue being evaluated. Include relevant guidance references as applicable to the issue being evaluated and cross-reference when necessary to company's prepared documentation and analysis of the applicable guidance. This space will typically include documentation of the following factors:

- The relevant accounting and auditing standards, regulatory guidance, and audit firm policies and guidance (e.g., the accounting, auditing, financial reporting, independence, risk management, or other relevant standards or guidance that apply)
- A description of any relevant industry or competitor practices
- Whether the company or the engagement team is aware of any prior SEC staff or other regulatory agency positions on the issue

- Whether the company or the engagement team considered and relied upon the expertise of a third-party specialist (e.g., a legal, engineer, actuarial, or valuation specialist)

Refer to Gather the Facts and Information and Identify the Relevant Literature in the Professional Judgment Resource for additional information and practical considerations that may be relevant to include in this section of the template.

5. Analysis Performed: Document the analysis performed and the reasonable alternatives considered. This section will often include, but is not limited to, the auditor's evaluation of the relevant facts and information gathered and evidence obtained, the company's work and supporting schedules provided (e.g., an internally developed valuation report), or results from the company or the auditor's use of specialists. Reference any other materials attached or appended to the analysis, such as flow charts, relevant portions of authoritative standards, and relevant company prepared documentation (e.g., contracts). This space will typically include documentation of the following factors:

- A description of reasonable, alternative approaches that were considered supported by reference to the applicable accounting or auditing standards or other relevant guidance (including an analysis of the current and future financial statement impact of the alternatives considered)
- A specific discussion as to how the auditor obtained sufficient appropriate audit evidence and considered contradictory information during the decision-making process and how that information was dealt with
- Whether the Company (or the audit team) requested a specialist or a national office consultation and whether the company (or the audit team) is considering whether to elevate the matter to the SEC's Office of the Chief Accountant for "pre-clearance"
- Description of any disagreements with the company on the issue

Refer to Perform the Analysis and Identify Alternatives in the Professional Judgment Resource for additional information and practical considerations that may be relevant to include in this section of the template.

6. Conclusion: Include the conclusion reached regarding the issue identified and the basis thereof. This space will typically include documentation of the following factors:

- The assessment of the reasonable alternatives, including whether one alternative is acceptable, preferable, or whether there is diversity in practice
- The assessment of whether the company's judgment on the accounting treatment is reasonable or similar to the auditor's, and if not, what additional actions or steps were followed

Refer to Make the Decision and Document the Process and Rationale for the Conclusion in the Professional Judgment Resource for additional information and practical considerations that may be relevant to include in this section of the template.

Other Documentation Tips

An important aspect of good auditor documentation is to follow widely acceptable principles and practices of good writing. The following tips should help strengthen the quality and effectiveness of an auditor's documentation:

- The background, accounting and/or auditing issue overview, and results of research and communications (internally or with the company) should be succinct, objective, and fact-based.
- Avoid the inclusion of unnecessary or extraneous information.
- Copying paragraphs directly from the literature or other documentation sources (e.g., contracts) may not always be necessary. Alternatives may include incorporating key references to the specific paragraphs in the literature, or placing relevant literature or polices as an appendix to the documentation.



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