

## **The role of professional judgement in improving audit quality**

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### Purpose

This submission addresses the following elements of the terms of reference

- (1) Understanding the needs and expectations of stakeholders
  - (a) the origins and perceptions of the expectations gap
- (2) The scope of audit
  - (b) What assurance investors and other users of corporate information will need
  - (3) How assurance is provided and how that assurance can be made more effective for investors
  - (b) The extent to which auditors can and should assess whether underlying information is reliable:
  - (c) The extent to which auditors can and should assess the impact of uncertain future events
- (6) The potential benefits and opportunities for international engagement and cohesion across the world on auditing standards

### The role of judgement

Judgement permeates audit. Assumptions based on forecasts and probabilities have to be made about all key elements of the balance sheet and profit and loss account. "High quality professional service ...requires ethical behaviour, professional judgment, an objective attitude and an appropriate level of supervision" say the International Accounting Education Standards Board. The 2019-20 strategic plan of the International Federation of Accountants (IFAC) includes professional judgement as one of qualities needed by "tomorrow's professional accountants". "The key to true and fair financial reporting is the balanced exercise of judgement" according to the Institute of the Chartered Accountants of Scotland. Expectations about judgement are set high.

Many of the attacks on the accounting profession, and in particular the audit function, are based on scepticism about the quality of judgement – usually, but not always, labelled professional judgement. Yet most suggested remedial actions to address the problems of recent years are couched in terms of more laws, more rules and different structures. Reading through what is now required, it is difficult not to be impressed (and perhaps a little depressed) at the sheer volume of laws, regulations, rules, and other formal requirements already in force. It may well be that more of each is required, but it is worth pausing to consider why what is already in place has not "worked". This note suggests that addressing

and ensuring the quality of professional judgement should be part of the way forward, regardless of any moves to change laws, rules or structures

### What is professional judgement?

References to professional judgement are scattered throughout the professional requirements and literature. It is either used interchangeably with “judgement”, or as a synonym for choice. However there is no agreed definition, nor does the term mean the same in all parts of the accounting profession. Perhaps this is not surprising, since there are many different definitions of a profession, and not just in accounting. The absence of an agreed definition is evident in other professions. There is also no agreed relationship between professional judgement and its near neighbour professional scepticism. It is sometimes seen as part of professional judgement, sometimes separate from it. The International Accounting and Auditing Standards Board leaves the matter open by referring to it as a “related concept”.

These gaps and ambiguities matter:

- if expectations about professional judgement have been set, it is not surprising that when things apparently relating to it go wrong, the expectations gap becomes wider.
- If there is no agreement about the term, it is difficult to take action to address concerns about this aspect of the expectations gap, either in policy-making or in training;
- regulators are concerned about the quality of professional judgement. Regulatory requirements are peppered with references to it;
- interpreting and applying ethical and environmental issues require it;
- all professions are being disrupted – and will be more disrupted - by the application of artificial intelligence (AI). In the case of accountancy generally and audit in particular, after many types of routine work have been taken over by AI, the profession will have an increasing proportion of its other activities based on professional judgement.

### Action needed

In these circumstances, the profession needs to address a lack of faith in its professional judgement by the wider community in three ways. First, it needs to agree on a definition. Without one, agreed action is more difficult – what exactly is one addressing? Second, it needs to provide a means to identify problems in professional judgement, so that guidance can be given to staff. Third, it needs to improve the quality of professional judgement by training (and, as necessary retraining). Set out below is a framework for doing so. It does not claim to be perfect or universal, but it is intended to answer the assertion that professional judgement is too complex or diffuse to be part of addressing the challenges of confidence and technological change facing the profession – hardly a satisfactory response to something so central to the profession’s standing and credibility.

## 1. Agreeing a definition

Many of those considering the role of professional judgement comment that “I can’t define it, but I know it when I see it”. As noted above, there is no agreed definition within the profession. Those used by the standard-setting boards of IFAC are variants of “The application of relevant training, professional knowledge, skill and experience commensurate with the facts and circumstances, including the nature and scope of the particular professional activities, and the interests and relationships involved”. This may well be the basis of an agreed definition although my own view is that the absence of an explicit reference to personal, including behavioural, qualities is an important omission.

In my work on judgement more generally, I have used “The combination of personal qualities with relevant knowledge and experience to make decisions and form opinions”. Assuming that professional judgement is the application of a general definition to the professions, a working definition might be *“The combination of personal qualities, relevant knowledge and experience with professional standards to make decisions and form opinions.”* Standards here are taken to include ethical standards, and in the way professional judgement is applied it is assumed that expertise and the requirements of process, precedent and accountability particular to the profession are taken into account. Whatever definition is taken:

**An agreed definition by the profession would contribute to improving professional judgement.**

## 2. Guidance on dealing with professional judgement issues

Just as a definition is necessary to know what it is that being addressed, so, in seeking to take steps to improve the standard of professional judgement and mitigate risk, it is necessary to provide an analysis to know what can be improved. By breaking down professional judgement into constituent elements, firms - and the individuals within them - can do so. Such an analysis needs to be a clearer part of a firm’s guidance to its staff.

After discussions with a wide range of people in all walks of life and in many different countries, including several professions, bearing in mind research in a number of different literatures, I suggest that professional judgement has 6 elements:

### (i). What I take in

This is a measure of the quality of understanding. In audit, as in other professional activities, the quality of what is understood is critical to developing a professional judgement. This does not necessarily improve with greater seniority and knowledge – impatience, overconfidence and any increasing rigidity of approach may reduce the quality of what is taken in.

#### (ii). Who and what I trust

A great deal of work is carried out in teams and members of teams are likely to have experience in knowing who is trustworthy. Issues can nevertheless arise, for example if teams are chosen which have, or come to, reflect the point of view of a dominant team leader. Trust in the information is less predictable, particularly in a new client or assignment.

#### (iii). What I know about this

For audit clients struggling to make sense of situations that they have not encountered before, rich professional experience is a great source of value. But professional knowledge is not enough – it is knowing about the issue in context. The quality of professional judgement will be the way in which relevant experience can be brought to bear in a given situation.

#### (iv). How I feel about this

Professional judgement assumes that the professional will be able to be independent and unbiased. But this status cannot be assumed unless the professional is aware of his or her own biases, including risk tolerance or appetite.

#### (v). How I choose

The combination of experience, knowledge and personal qualities comes together to formulate choices. The professional will need to ensure that the choices have been appropriately framed, including the management of risk.

#### (vi). How I carry it out

The professional carrying through a recommendation will have gathered experience on many aspects of execution, but he or she will need to be aware of execution issues, including the management of risk.

#### Timing and risk

Timing issues will need to be addressed as part of elements (i) and (v). Risk issues, as noted above, are within elements (iv), (v) and (vi).

Many of the above appear in different forms in different documents of standard-setters, professional bodies and firms. This makes professional judgement difficult to identify. They need to be brought together in a framework which does so. Further details of this particular framework will appear in an article on judgement in leadership in the November 2019 Harvard Business Review.

**The guidance and practice notes provided by firms for their staff need to be clear about what professional judgement is and provide a framework of how to use it.**

### 3. Educating for better professional judgement

According to IFAC "... member bodies shall provide, through professional accounting education programmes, a framework ....for aspiring professional accountants to ... exercise professional judgment". Bearing in mind the inconsistency (and in some cases absence) of definition, and the variety of measurement frameworks, it is not surprising that educational provision varies in coverage and rigour.

**Education (and where necessary retraining) for professional judgement should be based on an agreed definition and an explicit framework, if possibly consistently across the profession, by professional bodies and firms.**

As illustrative examples for each of the 6 elements of judgement, this would include:

- a. Greater sophistication in assessing the quality of inputs through training in observation skills.*
- b. The quality of team members enhanced through the use of judgement criteria in hiring, appraisal and promotion.*
- c. More systematic use of the lessons from experience, such as the ability to recognise appropriate and inappropriate analogies, by feedback and mentoring.*
- d. Greater awareness of the major biases such as anchoring, representativeness and risk appetite/tolerance.*
- e. Improved ability to frame choices, including in conditions such as stress, emotion and overconfidence.*
- f. Using cases to assess probabilities of success and failure in execution.*

### The Brydon report

Voluminous formal audit requirements over the past few years have evidently not provided the necessary assurance for investors and other stakeholders. Rather than relying only on adding to the crowded field of laws, regulations, rules and structural changes, enhancing the quality of professional judgement would help address a number of underlying issues. These include the expectations gap (Terms of Reference 1), the nature of assurance (ToR 2b and 3), the reliability of information (ToR 3b) and the assessment of uncertain future events (ToR 3c). Agreed definition would provide benefits in terms of international cohesion (ToR 6). This is not an issue for the UK alone, but it is one in which the UK can and should seek to be influential.

And finally, a question. Why would any stakeholder, and particularly auditors themselves, not wish to improve the quality of professional judgement?

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