PROFESSIONAL JUDGEMENT. THE KEY TO A SUCCESSFUL AUDIT

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Abstract

Professional judgement represents the key to a successful audit engagement. In order for the auditors to use their professional judgment correctly, they must know the rules and standards, both those related to accounting and audit. ISA 200 emphasizes the importance of exercising professional judgment in the planning phase and in the auditor's audit work. Judgment is exercised by an auditor whose training, knowledge and experience have assisted in developing the skills needed to achieve reasonable judgments. The article is a theoretical one, its main objective being the study of professional judgement in audit engagements. Professional judgment was analyzed using a qualitative research methodology, taking into consideration definitions from auditing standards and presenting the work of researchers all over the world, while emphasizing specific situations in which judgement is used. Our study draws the attention to the importance of the professional judgement during audit and the obligation of each auditor to use it appropriately.
1. INTRODUCTION

Professional judgement has come into attention of researchers, professors and auditors all over the world. Since the term is not an easy one to define, and it is even more difficult to be applied by auditors, the objective of this article is to understand professional judgement, its characteristics and the practical situations when should be used.

According ISA 200 it is mandatory to use professional in all phases of the audit, beginning with planning phase. It becomes mandatory to understand what professional judgement is, when it is used and by whom.

Our study is a theoretical one, the qualitative research methodology being used. We have researched work of different authors in second part of the paper. The main databases being used are: Emerald, JSTORE, SpringerLink, ScienceDirect. From the work of these authors we have studied the definition of professional judgement and its main characteristics. The third part of the paper refers to the situations in which auditors use professional judgement and mainly professional judgement’s use in audit engagements.

The fourth last part comes with conclusions regarding the theme analyzed.

2. LITERATURE REVIEW

The term “professional judgment” is widely encountered in the financial audit. But what means professional judgment for auditors? According Bourneau (2006), professional judgment consists in applying relevant training, knowledge and experience in the context of audit, accounting and ethical standards, to make informed decisions about the proper procedure in the context of the engagement circumstances.

During the audit of the financial statements, the auditors deal with subjective, non-quantifiable factors, but due to the nature of these factors they cannot be recorded in accounting. Even if the subjective information cannot be recorded, these factors are the base for the auditors’ underlying decisions. Grout et al. (Grout et al., 1994) define professional judgment as the condition to make decisions, to judge precisely these subjective factors. The authors draw attention to the possible differences between the auditor's judgment, and judgment of specialists who prepare standards, auditing standards and accounting ones.

In order for the auditors to use their professional judgment correctly, they must know the rules and standards, both those related to accounting and audit.

Discussing about the auditor's professional judgment, we must also refer to scepticism, a quality of any professional in the field. Kemp (Kemp, 2012) describes scepticism as a mood. Although widely discussed in various articles and studies, scepticism is a quality the junior auditor learns from the senior auditor, a quality coming from the interaction that occurs between the skills learned and individual personality.

Large audit firms have in their culture this side of judgment, being aware that without scepticism we cannot speak of a default judgment and implicitly, of a quality audit.

Accuracy and confidence in one’s own judgment are important in decision making (Arkes, 1991). The auditor takes decisions using his judgment, which is in turn influenced by independent factors such as trust in own judgment. A person who has confidence in his own judgment, unequivocally, will act on it accordingly. Such an auditor who reviews a going concern problem causing inability of the entity will issue an opinion, while another auditor may issue an opinion that does not contain this qualification (Chung and Monroe, 2000).

Chung and Monroe (Chung and Monroe, 2000) examines the effects of audit experience and the difficulty of the analysed subject, on auditor’s confidence in his own professional judgment. As expected, the study revealed a significant negative relationship with difficulty audited area and a significant positive relationship with the auditor's confidence in his own judgment.

The results of the article “The Impact of Guanxi on the Ethical Decision-Making Process of Auditors - An Exploratory Study on Chinese CPAs in Hong Kong” (Au and Wong, 2000) confirms the following hypotheses: (1) there is a relationship between ethical judgments and the level of moral reasoning of auditors; (2) there is a relationship between an auditor's ethical judgment and the existence of guanxi (the term guanxi is defined by the authors as interpersonal relationship that is formed in business relations, this term being inconsistent with formal relations); and (3) the impact of guanxi on the auditor's judgment is dependent on the level of ethical reasoning. These findings have important implications for the accounting profession as a whole, because both guanxi and ethical reasoning level can influence professional judgment. It is therefore important investigating the ethical interventions of accountants, with a relatively low level of moral development.

Percy claimed that auditing is based on the professional judgment, which ultimately requires individual analysis, expert opinion with personal responsibility (Percy, 1996).

Audit of financial statements is thus seen inherently as a judgment (Hatherly, 1999). It requires consideration of the application of accounting principles, standards and the specific rules governing the entity being audited. The process of gathering audit evidence involves the application of audit principles and standards. The audit has as
essential characteristic the professional judgment. Such item should be distinguished from a product based on regulatory compliance and procedures, a product of judgment based solely on experience, and a creative product, creativity may involve deviations from accepted norms (Hatherly, 1999). Hatherly (1999) defines judgment as the interaction between the individual auditor’s judgment, experience, personality traits and audit environment, which can be expressed in terms of the auditor’s responsibilities both inside and outside the company where they work.

Donnel’s study (Donnell, 2004) presents evidence that auditors can rely on progressive reasoning (which looks forward), in diagnosing potential problems during the analytical procedures. These findings are consistent with the evidence of other research models, including field interviews of Hirst and Koonce (Hirst and Koonce, 1996). Use of progressive reasoning (forward reasoning) or regression one (backward reasoning) is important in making decisions, taking into account that these types of judgments are influenced differently by two levels: individual and factual variables (Elstein et al., 1993). At the individual level, progressive reasoning requires strategic knowledge about how to know the situation well enough, make inferences and accurate diagnoses, while regressive reasoning requires relational knowledge about conditions or symptoms associated with various problems (Clancy, 1988).

According each situation, the progressive reasoning is significantly influenced by the design of the display formations and the means used to acquire specific knowledge of the situation, while regressive reasoning is relatively insensitive to these factors (Langley et al., 1987).

The European Union Directive VIII mentions the statutory audit, which is the only type of audit regulated at European level and required, usually by company law and by the acts of incorporation. There are two major organizations that issue auditing standards, the International Auditing and Assurance Standards Board - IAASB and FAASB in the US. Audit practitioners should know very well these standards in order to correct professional judgments in their work.

ISA 200 emphasizes the importance of exercising professional judgment in the planning phase and in the auditor’s audit work. Judgment is exercised by an auditor whose training, knowledge and experience have assisted in developing the skills needed to achieve reasonable judgments.

3. PROFESSIONAL JUDGEMENT’S IMPORTANCE IN AN EFFICIENT AUDIT ENGAGEMENT

Professional judgment is essential to the proper conduct of an audit. Interpretation of relevant ethical requirements, auditing standards and decisions, during the audit, cannot be achieved without the application of auditor’s professional judgement and experience. Professional judgment is necessary, particularly with regard to decisions on:

- Materiality and audit risk
  Audit risk is the risk that the auditor expresses an inappropriate audit opinion, while the financial statements are materially misstated. Audit risk is a function of inherent risk, control risk and detection risk and requires a high degree of judgment from auditors.

Materiality is the magnitude of omissions, errors or misstatements of accounting information, which could change or influence the economic decisions of users of financial statements. In determining materiality, the auditor should consider the ISAs, the specific of each business entity, and the experience of previous years, where applicable.

- Nature, timing and extent of audit procedures used to meet international standards of audit and gather audit evidence
  Audit evidence is the information used by the auditor, to reach conclusions on the audit opinion’s report. Audit evidence includes information contained in the accounting records, the underlying financial statements, and other information obtained from management explanations. To assess if sufficient appropriate audit evidence was obtained and whether more needs to be done to achieve the objectives of international auditing standards and, therefore, the overall objectives, the auditor must use his professional judgment.

The extent of procedures performed in an audit of financial statements depends on several factors, including the auditor’s knowledge of the nature and volume of entity’s business, and the significant changes in accounting practices. If the auditor has reason to believe that the financial statements may be materially misstated, should carry out additional or more extensive procedures, as necessary, to be able to express negative assurance or to confirm the need for a modified report.

- Measuring the quality, relevance and credibility of audit evidence, to form conclusions for the audit opinion
  The quantity of audit evidence is affected by the auditor’s assessment of risk of material misstatement and the quality of audit evidence.

- Evaluation of management’ judgments in applying the entity’s financial reporting framework
  The financial reporting framework is adopted by management and by those charged with governance, in the preparation and presentation of financial statements, given the nature of the entity and the objective of financial statements, laws and regulations.

The term “correct reporting framework” is used to refer to a reporting framework that:
(i) acknowledges explicitly or implicitly that in order to achieve fair presentation of the financial statements, it may be necessary for management to provide information other than those specifically requested by the framework; or (ii) acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such deviations are necessary only in extremely rare cases.

- Drawing wrong conclusions based on the audit evidence obtained

Exercise of professional judgment in any particular case is based on the facts and circumstances known to the auditor. Consultation on difficult or controversial issues during the audit, both within the audit team and between the engagement team and other professionals at the appropriate level within or outside the company, helps the auditor to draw sufficient and appropriate judgments and conclusions.

A significant aspect is a problem or finding, important for the procedures performed, evidence obtained and conclusions reached. Significant aspects are, or could be important for the audit opinion or to support auditor’s opinion. These issues need more attention from managers, whom review the audit team’s work, and often require appropriate consultation. Important issues discovered need proper documentation and resolution and their timely review by the engagement manager. Significant issues identified during the audit mission requires the use of judgment, these issues are most often part of the audit opinion, drawing the attention of users of accounting information on issues identified.

4. CONCLUSIONS

Professional judgement is the key to a successful audit engagement. It can be evaluated based on the conclusions reached. These should reflect a competent application of auditing standards, accounting principles and is appropriate in the light and in accordance with the facts and circumstances that were known to the auditor to date of the auditor's report.

Before giving their consent to provide a service to a new or existing client, the auditors must make an assessment of occupational risks involved, so from the beginning the auditor should use his professional judgment. This involves assessing the acceptability of the audit client and professional risks associated with the service.

Professional judgment should be exercised during the audit. It also needs to be properly documented. In this regard, the auditor should prepare audit documentation sufficient to enable an experienced auditor, who is not related to the audit engagement, to understand the significant professional decisions taken to reach conclusions on significant matters, arising during the audit. According to ISA 200, judgment should not be used as justification for decisions that are not otherwise supported by the facts and circumstances or sufficient appropriate audit evidence.

The auditor should plan and perform the audit with professional scepticism, recognizing that, circumstances may exist, that cause the financial statements to be materially misstated. Professional scepticism is, in our opinion, another dimension of judgment. An auditor must exercise professional judgment carefully, sceptically.

Accounting and audit rules and regulations are becoming more and more numerous, while the pressures inside and outside entities can influence how audits are conducted. For auditors, professional judgment becomes mandatory.

There are situations where companies have received a favourable audit opinion prior to collapse or fraud. There are many examples such as the S & L in the US, and the UK BCCI, Polly Peck, and Mirror Group. Issuing a wrong opinion on the financial statements could result in loss of reputation, litigation and financial losses for audit firms.

It becomes mandatory the use of professional judgment, in order to mitigate risk of an inappropriate opinion.

Our future research will focus on auditor’s opinion about professional judgement and the key elements of an efficient engagement. We will also study the impact of professional judgement on the sampling method used in audit.

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REFERENCES


