

THE AUDITOR'S PROFESSIONAL JUDGMENT PROCESS

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ABSTRACT

Due to the application of principle-based approach in constitution of International Financial Reporting Standards (IFRSs) led to the use of general principles in development of accounting standards and the elimination of rules, Independent auditors required to use more professional judgments in applying these standards. Therefore, the recognition of the concept of professional judgment, the factors influencing and the process that must be conducted to achieve a rational, thoughtful and precise judgment is requisite. The present study's aim is to provide a framework for the professional judgment of auditors in Iran. For this propose, through the study of related Studies and interview with audit experts using the interpretive analysis method, a framework was developed for the professional judgment of auditors. Also, the factors affecting this framework were identified through a questionnaire. This framework includes 9 following steps: 1) Problem definition, 2) Exploring possible solutions, 3) Memory retrieval and applying accounting and auditing guidelines, 4) Collecting and evaluating information, 5) Reviewing judgment issue, 6) Hypothesis generation, 7) Hypothesis evaluation and challenging the judgment of the client, 8) Discussion and conclusion, 9) Documentation.

Keywords: Auditor Judgment, Judgment Framework, Principle-Based Approach, Rule-Based Approach.

INTRODUCTION

Professional judgment in accounting is used while predicting conditions and events and evaluating current situations in conditions of uncertainty (Dawes & Hastie, 2001). Professional judgment is the core of the audit. there is much evidence that auditors do not necessarily make high-quality judgments, Judgments that do not have sufficient quality can have serious consequences for those who make judgements and the users of the judgement results (Bonner, 2008). The emphasis on auditors “*professional judgment in many audit standards (ISA 200, 310, 315, 320, 500) indicates the essential role of auditors*” professional judgment in the audit process.

Since a large part of the auditor's judgments is regarding about the matching of information preparers practices with accounting standards, accounting standards and the standard-setting has a significant impact on professional judgment of auditors. Due to the change in the approach of accounting standard setting from a rule-based approach to a principle-based approach and the use of the general principles in the later approach, the choice of appropriate accounting methods requires a consideration of effective conditions. The scope of procedures and accounting methods that result from principled-based approach, lead to a proper presentation of corporates financial position which is a fruit of the professional judgment.

Although the increased professional judgment in the principle-based approach will increase the risk of auditing, applying more judgments by auditors will prevent the opportunistic behaviors of financial statements preparers through using thresholds (Grenier et al., 2015). Increasing audit risk is due to the fact that professional judgments will not lead to the same results in choosing accounting methods and procedures. The advisory committee on improvements to financial reporting required the Public Company Accounting Oversight Board (PCAOB) to provide guidance for appraising the rationality of professional judgment of auditors. Although PCAOB has not yet responded to the request of the advisory committee on improvements to financial reporting, the world's largest audit companies like the KPMG, Deloitte and Institute of Chartered Accountants of Scotland (ICAS) have set up a framework for their judgments.

Due to the global acceptance of international standards and the use of the principled approach in accounting standard setting, auditors should make more professional judgments in evaluating financial reports (Backof et al., 2013). This requires training and experience in accounting and auditing, considering the environmental, legal, economic and professional conditions.

For the auditor's judgments to be carried out properly, the ability to make judgments should not be taken as full or unlimited authority in the process of auditing. Instead, it is essential to imbibe this concept and identify the factors affecting a professional judgement and the process of making a rational, thoughtful and precise judgment.

In this paper for the first time, after reviewing the relevant literature about judgment and decision making in the field of psychological, the process of making professional judgment was identified through interviews with auditing experts and using the exploratory analysis method. The practical application of this process is also measured by collecting questionnaires.

The remainder of the paper is structured as follows: The next section presents theoretical foundations and literature review. The third section outlines the research methodology and research sample. The last section analyzes interviews and discusses study's conclusions.

THEORETICAL FOUNDATIONS AND LITERATURE REVIEW

As explained in the introduction section, the International Accounting Standards Board found that the use of principles-based standards compared to rule-based standards are more attentive to the economic content of transactions and economic events. Based on Securities and Exchange Commission (SEC, 2008) application of principled-based standards is along with some executional difficulties due to inadequate guidelines and lack of appropriate structure for the judgment of auditors and financial statement provider's professional judgment. In other hand, the use of a rule-based approach to standard setting provides a tool for (SEC, 2003).

Eventually, SEC concluded that principles-based standards provide the best opportunity for accountants to take into account economic realities (SEC, 2010). However, the critics had warned that the "*lack of rule*" is a double-edged sword. on one hand, managers can choose accounting methods that reflect the economic reality of transactions and on the other hand, this freedom of action allows managers to report aggressively (Hail et al., 2010; Maines et al., 2003)

Many studies have been conducted regarding the principled and rule-based standards, their impact on aggressive reporting and the role of auditors in each of these standards. Previous studies investigating rule-based standards indicate that when the standards are highly accurate and prescribe many mandatory rules, they provide for the managers the opportunity to use their intended accounting method through re-structuring the financial transactions. (Maines et al., 2003; Schipper, 2003; SEC, 2008). Other studies show that highly rule-based standards motivate

managers to manage earnings through re-structuring the transactions without violating those rules, while auditors are reluctant to prevent what managers are doing.

Concerning the principled-based standards Ng and Tan concluded that when there is an ambiguity in a standard, auditors use this ambiguity as a license to aggressive reporting. Rule-based standards reduce the power of auditors in negotiations with the client and on the other hand, they give them a lot of freedom to accept aggressive reporting of their clients. Also, Kadous et al. (2003) find that when accounting standards are ambiguous, auditors tend to allow managers to use methods that lead to aggressive reporting. On the other hand, Agoglia et al. (2011) found that when the imprecise standards were implemented, managers were less likely to report aggressively due to concerns about legal claims. The operational freedom resulting from the use of principle-based accounting standards in the selection of accounting practices and procedures will lead to a fair representation of the performance of the financial situation of the companies, which results from the use of professional judgment (Ionela, 2016).also any elevated litigation exposure associated with imprecise standards is manageable if audit firms can provide credible evidence of the quality of their judgments (Casey & Grenier, 2014).

In summary, past research shows that highly accurate or precise standards encourage managers to report aggressively with the help of precise rules present in the standard. (Cohen et al., 2013), Also, Previous studies show that auditor allow more aggressive reporting when implementing an standard with low precision (principled-based) compared to an standard with high precision (ruled-based) (Hackenbrack & Nelson, 1996; Salterio & Koonce, 1997; Nelson et al., 2002, Kadous et al., 2003; Blay, 2005). Therefore, it seems that the presentation of the professional judgment framework is more requisite when principles-based standards are applied compared to when the rule-based standards are applied.

METHOD

Sample and Data Collection

The research population is all the partners and managers of the highest rank listed on Iranian Association of Certified Public Accountants (IACPA). For the purpose of conducting interviews the statistical sample is selected based on snowball method. Because of the special knowledge of the auditors and not enough information about the knowledge of research sample, the snow ball method was used. In this method, the researcher continues interviewing until a theoretical consensus is achieved; the interviewees are selected based on the suggestions of other interviewees (Strauss & Corbin, 1990). In this research the theoretical consensus was achieved by interviewing 13 audit experts. Also, factors impacting the process of auditor's professional judgment was identified through analyzing the questionnaires collected from professional auditors with supervisor rank or higher. 147 questionnaires had been distributed and eventually 82 of them collected.

Instrument and Measure

In order to conduct this research, the following steps have been taken: 1) First, previous studies related to the subject of this study were analyzed and explored, 2) An exploratory interview was conducted from a limited number of audit professionals, 3) By combining the information gained from the analyzing the previous studies and the information from exploratory interviews, the main interview's questions were designed and then the interviews were conducted. Interviews continued until the interviewees didn't mentioned new subjects or points.

After completing interviews the interview transcripts were analyzed and the data interpretations were done. Finally, using the interpretive analysis methodology, the auditor's professional judgment process was developed. After the steps mentioned above, the data obtained from the questionnaires was analyzed by using independent t-test method and then the factors influencing the auditor's professional judgment was identified.

Descriptive Statistics

In Table 1 demographic information about the respondents is summarized. Based on results, sample includes as follows: most respondents (90 percent) were men, and members of in scientific and professional Associations Membership in scientific and professional Associations indicate that the respondents had enough professional knowledge certificate to answer the questions. as well as 86% respondents were less than 40 years old and 82% of respondents had a degree upper than Bachelor's these indicate that sample members had enough theoretical knowledge also the respondents had more than 5 years' experience in auditing therefore, it is obvious that the respondents had enough knowledge and experience to answer the questions.

Question	Options	Option 1	Option 2	Option 3	Option 4	Option 5	Option 6
Membership in scientific and professional Associations		Iranian Institute of Certified Accountants	Iranian Association of Certified Public Accountants	Iranian Management Accounting Associations	Iranian Association of Internal Auditors	University faculty member	None of them
		46%	41%	11%	25%	3%	33%
Professional experience in auditing		Less than 5 years	5 to 10 years	10 to 15 years	15 to 20 years	More than 20 years	
		14%	47%	19%	11%	8%	
age		Less than 30 years	30 to 40 years	40 to 50 years	50 to 60 years	More than 60 years	
		23%	63%	10%	4%	0%	
Degree		BS	MSc	Ph.D. student	P.H.D		
		18%	78%	1%	3%		
Grade in the Audit Institute		Supervisor	Senior Supervisor	manager	partner		
		53%	14%	24%	9%		
Field of Study		Accounting	Management	Economics	Other Fields		
		96%	3%	0%	1%		
Gender		Man	Female				
		90%	10%				

RESULTS

In Table 2 Based on interviews from the audit professionals we found that auditors go through 9-step process for professional judgment. Also, the results of questionnaires analysis indicated the factors affecting each of the steps for a professional judgment. In the following, we refer to the process of auditor's professional judgment and the factors affecting each stage.

Table 2		
AUDITORS PROFESSIONAL JUDGMENT PROCESS AND AFFECTIVE FACTORS		
Stage	Description	Affective factors
Problem definition	Correct determination of the judgment issue has great importance, which can affect the whole process of professional judgment. Research findings indicate that in order to determine the subject of judgment correctly, there should be an adequate familiarity with	<p style="text-align: center;">Factors Affecting the Determination of the Judgment issue:</p> <ol style="list-style-type: none"> 1. The effect of the auditor's judgment on an account. 2. The effect of the Judgment issue on information user's decision. 3. Economic, legal, professional consequences. 4. The magnitude of Judgment issue and its changes over the same period. 5. Familiarity with industry which audit client is engaged. 6. Shareholder structure of audit client. 7. Organizations and bodies supervising the audit client. 8. Honesty and good reputation of the audit client. 9. Financial reporting Users and their feedback. 10. Audit client risk considerations. 11. Professional independency of those who make judgments.
Exploring possible solutions	In order to obtain the correct judgment, all relevant information must be collected through " <i>data retrieval from memory</i> " or " <i>information search</i> ".	<p style="text-align: center;">Effective factors in determining possible solutions:</p> <ol style="list-style-type: none"> 1. The amount of judging experience and the extent of using these experiences. 2. Accounting and auditing standards expertise. 3. Awareness of the laws and regulations related to the industry. 4. Having specific relationships to obtain relevant information. 5. The existence of regulatory and control processes by legal or professional authorities. 6. Accountability to regulatory bodies. <p style="text-align: center;">Solutions for the appropriate professional judgment:</p> <ol style="list-style-type: none"> 7. Having a mental judgment plan. 8. Obtaining information from all relevant sources. 9. Understanding inherent risks and internal control over them. 10. Understanding the social, political, cultural and economic environment of the audit client. 11. Investigating the conditions of raw material suppliers and customers in the competitive market. 12. Studying the past periods audit reports of audit client.
Memory retrieval & Applying accounting and auditing guidelines	Memory information acquired in the past through training or professional experience leads to effective judgment.	<ol style="list-style-type: none"> 1. Using checklists to ensure compliance with all provisions of the standards and rules. 2. Revision of accounting and auditing standards and relevant laws and circulars. 3. The proper documentation of previous judgments in order to refer to them in similar cases. 4. The ability to retrieve memory is one of the most important limitations at this stage.
Collection and evaluation of information	Information search is conducted in two directed and sequential search methods.	<ol style="list-style-type: none"> 1. The mere use of the guided method does not necessarily lead to proper judgment. 2. All accounts must be audited by the audit team. 3. Identifying Risky areas facilitates the search for information.

Table 2		
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Stage	Description	Affective factors
Review the subject of judgment	Problem Representation is a mental process by which the judge modifies his knowledge of problem definition by using retrieved information and information gathered through the search.	<ol style="list-style-type: none"> 1. Re-examining the problem definition and Problem Representation after retrieving information from memory and collecting information. 2. Integrated survey of collected data and perform analytical reviews. 3. Assessing the status of future events in connection with audit client's going concern.
Hypothesis generation	Judgments in auditing, due to their diagnostic nature, require hypothesis. In general, hypothesis is made in two ways: hypothesis based on memory information and hypothesis based on information gathered.	Audit managers and partners use a hypothesis based on memory information.
Hypothesis evaluation and challenging the judgment of the client	At this stage, more evidence and documentation are gathered; the evidence and documents reject or confirm the hypotheses.	<ol style="list-style-type: none"> 1. In auditing, memory information leads to a judgment modification based on information collected. 2. Audit managers and partners provide their audit team with their expertise and knowledge about the judgment issue. 3. Investigating audit client judgment process can provide useful information for judgment purposes.
Discussion and conclusion	After the above steps, Audit managers and partners must make final judgment and report the results.	Receiving the interactive opinion of the audit team will improve the auditor's judgment quality.
Documentation	The auditor's judgment will have many consequences for them, so judgments must be made on the basis of adequate and appropriate documentation.	In conjunction with the judgments performed, whatever is the basis for the judgments must be documented in a separate section.

DISCUSSION AND CONCLUSION

We expanded previous research in the field of psychology and auditing, we tested the process of auditor's professional judgment based on psychological concepts and its practical application. Based on interviews from the audit professionals, in this research auditors' professional judgment process and the factors affecting it were identified. Also, factors affecting the auditor's professional judgment process were identified by collecting questionnaires from professional auditors with a supervisor or higher. The results show that in this process, first, the problem should be defined, then the best solution to the problem of effective judgment is

identified; in order to judge effectively the information must be collected through "memory retrieval" or "Collection and evaluation of information". In the next stage, the subject of judgment is reviewed again, then judgment's hypothesis are identified and evaluated, and the judgment of the client is challenged. Finally, according to the above steps, the discussion and conclusion are made; Professional judgment should also be documented appropriately. Recognition of mentioned process causes auditors to consider all the important and relevant dimensions when making a professional judgment. Also, this framework can be a basis for the documentation of professional judgment process, performance evaluation of audit personnel and audit firms evaluation by authoritative and legal bodies.

This research implications are important for auditors, accountants, legal and professional authorities. It is useful for auditors because this research identifies the stages of an effective and efficient judgment and also, it provides a basis for the documentation, assessing the performance of audit staff and defending professional performance against competent legal and professional bodies. Also the mentioned process provides guidance to accountants in conducting professional judgments that are used to prepare financial statements based on accounting standards. Eventually, identification of the process of the auditor's professional judgment helps legal authorities and professional bodies to better assess the performance of accountants and auditors.

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