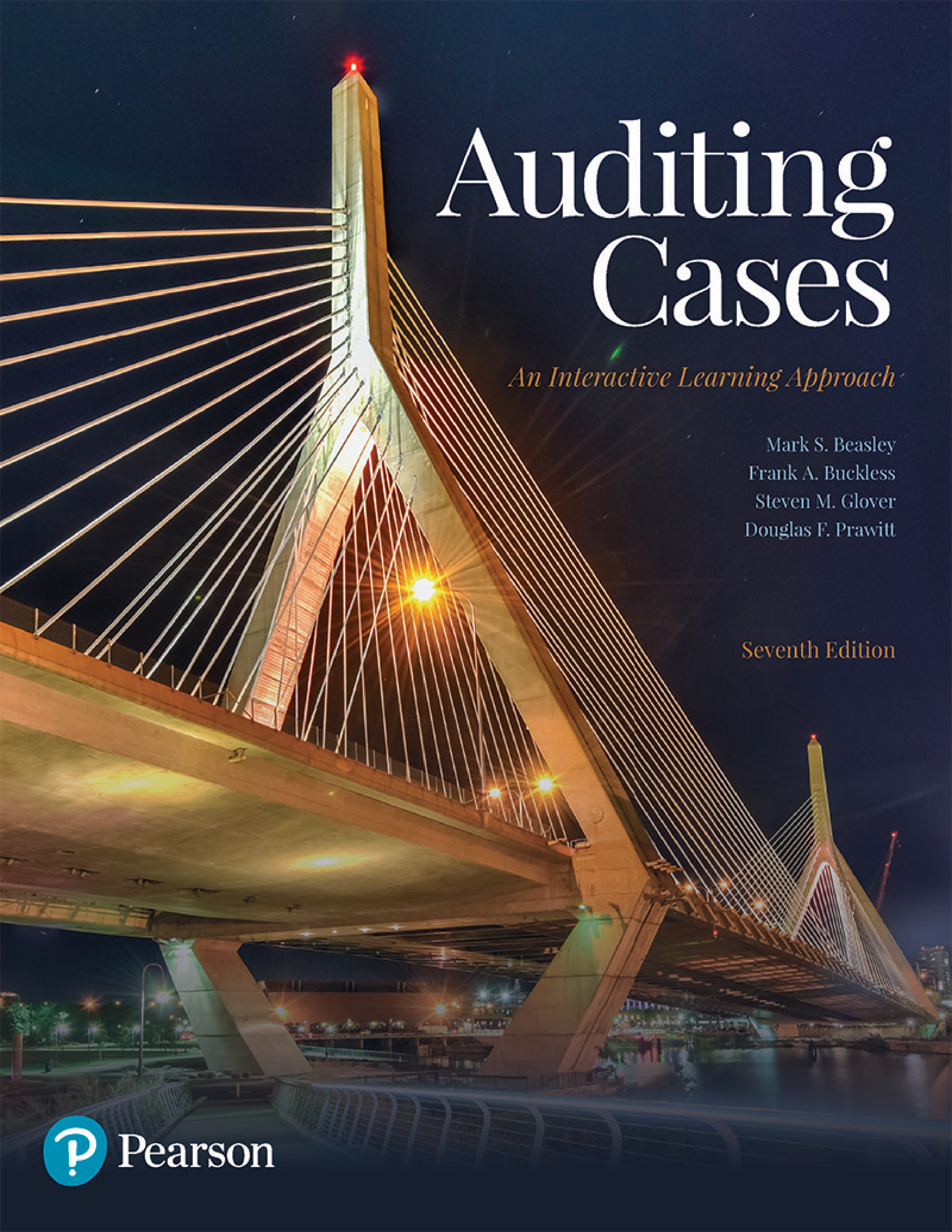

Auditing Cases

An Interactive Learning Approach

Mark S. Beasley
Frank A. Buckless
Steven M. Glover
Douglas F. Prawitt

Seventh Edition

Pearson

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SEVENTH EDITION

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New York, NY

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PREFACE

Auditing Cases: An Interactive Learning Approach provides exposure to real-world audit techniques and hands-on learning for students in both undergraduate and graduate auditing courses. This Seventh Edition continues our tradition of providing a rich learning experience for students that challenges them to apply knowledge learned in the classroom and from traditional auditing textbooks so they can develop skills to complete tasks they will be asked to do once they enter the accounting and auditing profession.

NEW CASES TO THE SEVENTH EDITION

The Seventh Edition continues to feature a variety of cases that address different aspects of the audit. Some are based on real companies, while others are disguised as "hypothetical companies" in order to provide a "surprise element" once they are completed. Additional cases include examples of client system documentation and audit workpapers that students prepare and evaluate as if they are on a current audit team.

CASE 3.6 Wells Fargo

Assessing the Impact of Ethical Culture

This case features the alleged inappropriate sales culture at Wells Fargo Bank that ultimately led to the CEO's 2016 testimony in front of the U.S. Senate Banking Committee and his subsequent resignation. The bank's audit firm was challenged to defend its work by four U.S. Senators, one of whom included Bernie Sanders, a recent candidate for U.S. President.

CASE 4.8 Koss, Inc.

The Sounds of a High-Fidelity Fraud

This case gives students a "bird's-eye" view of the 9th-largest embezzlement fraud in U.S. history, which took place at the Koss Corporation, headquartered in Wisconsin. The case vividly illustrates what can happen when internal control over financial reporting (ICFR) is lax at a public company. The case will be particularly interesting for students because much of the story of this massive defalcation fraud is introduced through the words of the company's CEO and the individual who stole $34 million from the company, adapted from deposition statements. The case brings to life the importance of effective ICFR, with an emphasis on the Control Environment, and introduces students to the role that accountants can play as expert witnesses in court cases.

CASE 5.8 Oilfields-R-Us, Inc.

Evaluation of Management Review Controls

This case introduces students to management review controls (MRCs), an increasingly important topic in practice for both management and auditors. In a MRC, members of management review key information and evaluate reasonableness by comparing it to expected value, such as budget-to-actual comparisons and review of accounting estimates. This case helps students appreciate the importance of the effective design and execution of MRCs, and it highlights some of the challenges of evaluating their effectiveness in audits of internal control over financial reporting.

Town and Country Hardware

Evaluation of Tests of Controls with Automated Component for the Expenditure Cycle (Purchases)

6.1 CASE

This case introduces students to internal controls with an automated component that are an increasingly important topic in the practice for both management and auditors. This case helps students appreciate the challenges of evaluating the effectiveness of internal controls over financial reporting with an automated component.

ADDITIONAL NEW FEATURES OF THE SEVENTH EDITION

Reflects Recent Auditing Standards

This edition includes updates that reflect new auditing standards issued by the AICPA's Auditing Standards Board (up through SAS No. 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*) and the PCAOB's Auditing Standards (up through AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). When relevant, questions expose students to new guidance contained in recently issued auditing standards.

Updated and Re-ordered Materials and Questions

Many of the case questions have been restructured to change the nature of the topics addressed and to expose students to different issues from those examined in prior editions. Many cases also have reordered questions. Dates in hypothetical cases have been set in calendar year 2018 with audit procedures performed on the 2017 fiscal year information and/or interim procedures performed on the 2018 fiscal year information. When appropriate, we have changed underlying data in some of the hypothetical cases so that the cases differ from prior editions. All of these changes reduce the potential benefit of students seeking our solutions from prior editions of the casebook. Further, students who inappropriately access and use solutions to prior editions are more likely to be detected by the instructor.

SOLVING TEACHING AND LEARNING CHALLENGES

Auditing educators continue to look for opportunities to increase their emphasis on the development of students' professional judgment, critical thinking, communication, and interpersonal relationships skills. Development of these skills requires a shift from passive instruction to active involvement of students in the learning process. Unfortunately, current course materials provided by many publishers are not readily adaptable to this kind of active learning environment, or they do not provide materials that address each major part of the audit process. The purpose of this casebook is to give students hands-on exposure to realistic auditing situations focusing specifically on each aspect of the audit process.

Over 50 Cases Spanning the Audit Processes

This casebook contains a collection of 50 auditing cases plus a separate learning module about professional judgment that allows the instructor to focus and deepen students' understanding in each of the major activities performed during the conduct of an audit. These cases expose students to aspects of the audit spanning from client acceptance to issuance of an audit report, with a particular focus on how professional judgment is applied throughout the audit. Each case is primarily assigned to one of 12 identified aspects of an audit; however, a number of cases address more than one topic. As a result, cases are cross-referenced in the Table of Contents so that instructors can easily pinpoint how a particular case might be useful to address different audit topics. The following Table of Contents Overview provides the number of cases for each of the 12 topics.

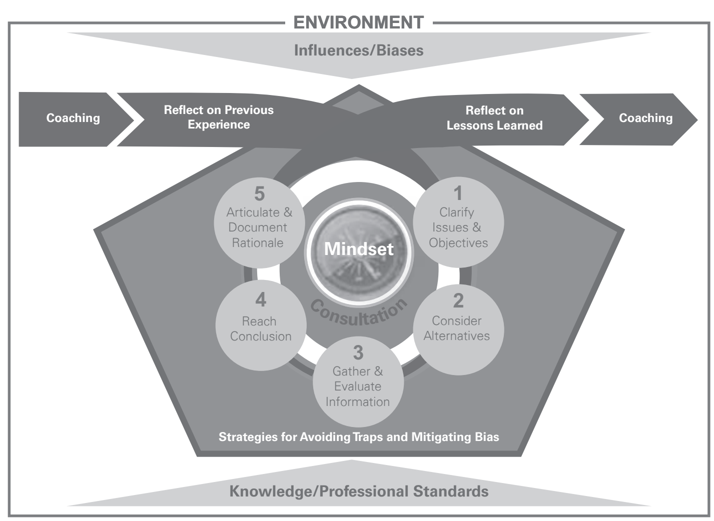
Table of Contents Overview

	Section / Audit Topic	Primary Cases	Cross-referenced Cases	Bonus Online Cases*
1	Client Acceptance	1		
2	Understanding the Client's Business and Assessing Risks	3		1
3	Professional and Ethical Issues	6		
4	Accounting Fraud and Auditor Legal Liability	8	1	
5	Internal Control Over Financial Reporting	8	2	
6	The Impact of Information Technology	1	5	2
7	Planning Materiality	1	4	
8	Analytical Procedures	3	1	
9	Auditing Cash, Fair Value, and Revenues	7	3	
10	Planning and Performing Audit Procedures in the Revenue and Expenditure Cycles	5		
11	Developing and Evaluating Audit Documentation	1	2	
12	Completing the Audit, Reporting to Management, and External Reporting	6		
	Total Cases	**50**	**18**	**3**

*In addition to the 50 cases included in the book, three additional cases from prior editions can be accessed via the casebook website (www.pearsonhighered.com/Beasley). Thus, there are 53 different case options available for use!

Module on Professional Judgment

The casebook includes a Learning Module on Professional Judgment that exposes students to a professional judgment framework and outlines a framework of good judgment as well as a number of judgment tendencies and traps that can introduce bias into the judgment process. Because professional judgments are required throughout the entire audit process, from client acceptance to report issuance, we include an Introduction to Professional Judgment as an upfront learning module rather than as an individual case. We encourage students to complete this learning module early in their auditing course to expose them to the fundamentals of professional judgment, which they can use as they complete the required professional judgment questions in many of the cases to this edition. The professional judgment questions are separately highlighted in gray-shaded sections of the Requirements section.



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In-Class and Out-of-Class Assignments

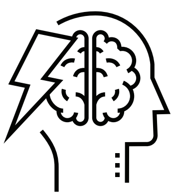
While all of the cases can be assigned for completion as an **outside-of-class assignment**, several of the cases are designed so that they can be easily used as an **in-class learning opportunity**. The Instructor's Resource Manual provides several ideas of how many of the cases can be easily incorporated as an in-class activity, which should be especially helpful for instructors who have "flipped" their classes.

Real-World Application

Each case presents a number of audit related issues and decisions that help students apply their audit knowledge and skills to **real-world scenarios**. A number of the cases are based on actual situations involving real companies. Others are hypothetical cases that disguise the innocent.

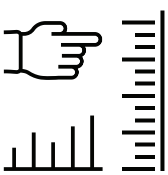
DEVELOPING SKILLS FOR THE PROFESSION

For students to succeed in a rapidly changing accounting and auditing profession, they need to be skilled at thinking critically and analytically, while remaining open and flexible to life-long learning and development. *Auditing Cases: An Interactive Learning Approach* provides an effective platform to help students build a strong toolkit of skills that will increase their career success. Here are some of the ways this casebook helps strengthen their abilities for careers in the accounting and auditing profession.



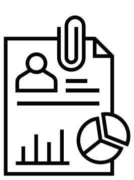
Critical Thinking

All of the cases present realistic issues and challenges that auditors face every day in the engagements they perform. Because of that, each case presents scenarios that require students to ***think critically*** about identifying the issue at hand and then determining how to respond in a way that would be appropriate in an audit engagement setting. Many of the cases present dilemmas that highlight the realities of the complexities students will face when in their professional careers. Completion of these cases will help students develop and mature their ***critical thinking and analytical skills***.



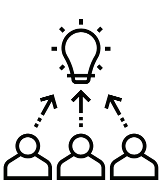
Hands-on Application

All cases engage students in applying their knowledge and skills in a hands-on learning environment. For some cases, students review ***client generated documentation***, complete ***actual audit program procedures***, and prepare and evaluate ***audit working papers***. Other cases require students to conduct Internet based research similar to what might be required in an audit to locate guidance in professional standards or to access relevant financial statement filings with the U.S. Securities and Exchange Commission.



Communication Skills

A number of the cases require students to prepare written responses in ***memorandum*** or ***report format***. The Instructor's Resource Manual contains a number of different ideas for structuring assignments to have students develop their written communication skills.



Team-Based and Individual Assignments

All of the cases are designed so that students can complete them either in ***teams or individually***. The Instructor's Resource Manual contains a number of different suggestions for assigning the cases as group or individual assignments.

Photo Credit: Creative Stall/Shutterstock

INSTRUCTOR TEACHING RESOURCES

The accompanying Instructor Resource Manual clearly illustrates the different instructional approaches available for each case (e.g., examples of cooperative/active learning activities and/or out-of-class individual or group assignments) and efficiently prepares the instructor for leading interactive discussions. The Instructor Resource Manual contains rich solutions to help instructors pinpoint the relevant issues that are the focus of each of the cases. To access this manual, log on to:

www.pearsonhighered.com/Beasley

We are pleased to provide this updated Seventh Edition and hope that the professional skills of your students will be enhanced through completion of cases contained within this edition.

ACKNOWLEDGEMENTS

The authors appreciate the assistance of Brant Christensen and Jacob Smith in assembling materials for some of the cases. We also want to express our sincere gratitude to Jonathan Liljegren for his incredible work in the design and assembly of the entire casebook and instructor resources. We are grateful for his professionalism and eye for detail. Finally, we thank our families who are always supportive of our efforts and who allow us to pursue these kinds of creative opportunities.

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Professional Judgment

Understanding and Developing Professional Judgment in Auditing and Accounting

Mark S. Beasley • Frank A. Buckless • Steven M. Glover • Douglas F. Prawitt

THE IMPORTANCE OF PROFESSIONAL JUDGMENT IN AUDITING AND ACCOUNTING[1]

As you prepare for a professional career, have you ever wondered what characteristics distinguish an exceptional professional from one who is just average? One key distinguishing feature is the ability to consistently make high-quality professional judgments. Professional judgment, which is the bedrock of the accounting and auditing professions, is referenced throughout the professional literature. In some of your accounting or auditing classes, you may have had an instructor respond to a question with the classic answer, "That depends; it is a matter of professional judgment." This is often true in auditing, but it is not overly satisfying to a student who wonders exactly what good professional judgment looks like, or how he or she can develop the ability to make good professional judgments. The purpose of this module is to provide a very brief overview and introduction to help you understand what a good professional judgment process looks like, make you aware of common threats to exercising good judgment, and give you a head start in developing and improving your own professional judgment abilities.

A common question people have is, "Can you really teach good judgment?" Many believe that it is a gift; either you have it or you do not. Others would say you cannot teach good judgment; rather, it must be developed through the "school of hard knocks" after many years of experience. There is no question that talent and experience are important components of effective professional judgment, but it is possible to enhance your professional judgment skills through learning and applying some key concepts. As with other important skills, the sooner you start learning how to make good professional judgments, the better—which is why KPMG made a very significant investment of time and resources to produce the monograph from which this module is adapted to help the next generation of professionals get a head start on developing professional judgment.

Research in the areas of judgment and decision making over the last few decades indicates that additional knowledge about common threats to good judgment, together with tools and processes for making good judgments, can improve the professional judgment abilities of both new and seasoned professionals. With the movement in financial reporting toward more principles-based standards and more fair value measurements, exercising good professional judgment is increasingly important for auditors. While this module contains a brief overview of some of the most important topics, KPMG's full monograph contains considerably more in-depth information about professional judgment in auditing, including additional coverage of judgment traps and biases, judgment in groups, and other topics. That monograph is titled *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*; it is available without charge at *http://www.kpmguniversityconnection.com*.

1 This Professional Judgment Introduction is adapted from *The KPMG Professional Judgment Framework: Elevating Professional Judgment in Auditing* and is included with this casebook with permission from KPMG, LLP.

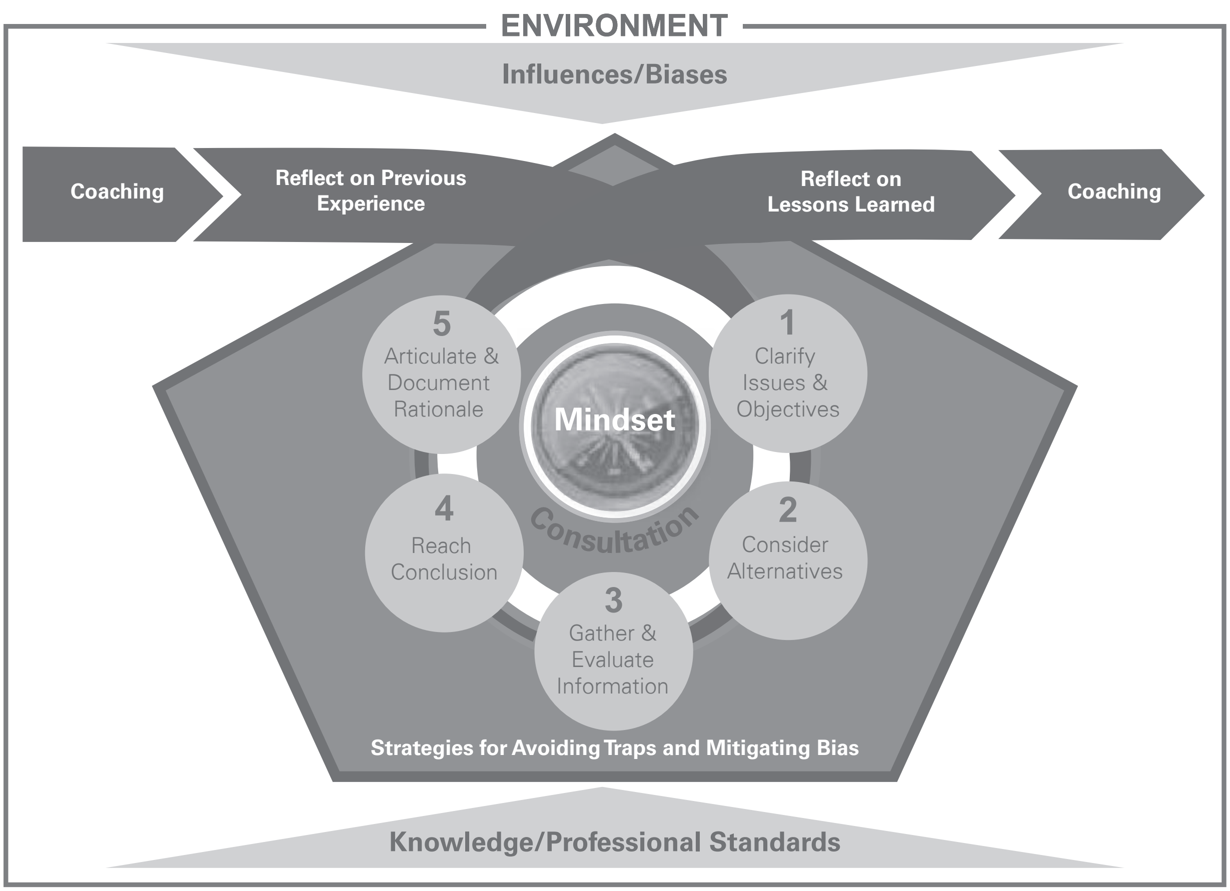
A MODEL OF A GOOD JUDGMENT PROCESS

Let's start with a common definition of judgment: *Judgment is the process of reaching a decision or drawing a conclusion where there are a number of possible alternative solutions.*[2] Judgment occurs in a setting of uncertainty and risk. In the areas of auditing and accounting, judgment is typically exercised in three broad areas:

- ***Evaluation of evidence*** (e.g., does the evidence obtained from confirmations, combined with other audit evidence, provide sufficient appropriate audit evidence to determine whether accounts receivable is fairly stated)
- ***Estimating probabilities*** (e.g., determining whether the probability-weighted cash flows used by a company to determine the recoverability of long-lived assets are reasonable)
- ***Deciding between options*** (e.g., audit procedure choices, such as inquiry of management, inspection, or confirmation)

Of course, we do not need to invest significant time or effort when making easy or trivial judgments. However, as the judgments become more important and more difficult, it is helpful to have a reliable, tested framework to help guide our judgment process. KPMG's Professional Judgment Framework is an example of such a framework. Following a good process will not make hard judgments easy or always guarantee a good outcome, but a well-grounded process can improve the quality of judgments and help auditing professionals more effectively navigate through complexity and uncertainty.

In the figure below, you will see the KPMG Professional Judgment Framework. The Framework includes a number of components, such as mindset, consultation, knowledge and professional standards, influences and biases, reflection, and coaching. At the core of the Framework, you will see a five-step judgment process.



2 Making judgments can be distinguished from making decisions. Decision making involves the act of choosing among options or alternatives, while judgment, according to Webster's 11th, involves "the process of forming an opinion or evaluation by discerning and comparing." Thus, judgment is a subset of the process of decision making—many judgments are typically made in coming to a decision. However, for simplicity in this module, we often refer to the combined processes of judgment and decision making as "judgment," "professional judgment," or "making judgments."

Take a moment to examine the steps in the process at the center of the framework. These steps are rather simple and intuitive. However, while the KPMG Professional Judgment Framework provides a good representation of the process we should follow when applying professional judgment, but it is not necessarily an accurate representation of the processes people follow consistently. The reality is that in a world of pressure, time constraints, and limited capacity, there are a number of judgment traps we can fall into. In addition, we can be subject to biases caused by self-interest or by unknowingly applying mental shortcuts.

The Professional Judgment Framework depicts constraints, influences, and biases that threaten good judgment with the box on the outer rim of the Framework labeled “Environment” and the triangle at the top labeled “Influences/Biases.” At the bottom of the Professional Judgment Framework, you will see Knowledge and Professional Standards, as these factors are foundational to quality judgments. These are environmental influences that can affect professional judgment. The “ribbon” of coaching and reflection running through the Framework is of great importance to the development of professional judgment in young professionals. In the next section of this module, we will highlight common judgment tendencies and the associated biases that can influence auditor judgment.

At the very center of the KPMG framework is “mindset.” It is important that auditors approach matters objectively and independently, with inquiring and incisive minds. Professional skepticism, which is required by professional auditing standards, is an objective attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism is not synonymous with professional judgment, but rather, it is an important component or subset of professional judgment. Professional skepticism helps to frame our “mindset.”

Finally, wrapping around “mindset” in the Framework is “consultation.” At professional services firms like KPMG, consultation with others, including engagement team members, specialists, or other professionals, is a vital part of maintaining consistently high judgment quality and enhancing the exercise of appropriate professional skepticism.

TRAPS THAT CATCH US IN THE EARLY STEPS OF THE JUDGMENT PROCESS

As we mentioned earlier, in reality people often do not follow a good process due to common judgment traps and tendencies that can lead to bias. These traps and tendencies are systematic—in other words, they are common to most people, and they are predictable. Some of these tendencies are judgment “shortcuts” that help simplify a complex world and facilitate more efficient judgments. These shortcuts are usually quite effective, but because they are shortcuts, they can lead to systematically biased judgments. As a simple illustration of how our mental processes that normally serve us very well can sometimes lead to bias, consider “optical illusions” you may have seen on the internet.[3] Our eyes and related perceptual skills ordinarily are quite good at perceiving and helping us to accurately judge shape similarity. However, optical illusions can predictably and systematically fool our eyes. Just as with perceptual biases, there are times when our intuitive judgment falls prey to systematic traps and biases. Research provides convincing evidence that even the smartest and most experienced people similarly fall into predictable judgment traps and biases.

The “Rush to Solve.” One of the most common judgment traps is the tendency to want to immediately solve a problem by making a quick judgment. As a result, we under-invest in the important early steps in the judgment process and often go with the first workable alternative that comes to mind or that is presented. As a result of the rush-to-solve trap, we sometimes end up solving the wrong problem, or we settle for a suboptimal outcome because we did not consider a full set of alternatives.

Judgment Triggers: Solving the Wrong Problem. Consider the following example. Two snack food companies are competing for market share—let’s call them Ax Snack Company and Bobb Goodies Inc. Bobb’s executives were convinced that Ax’s competitive advantage was attributable to the company’s distinctive, highly recognizable individual snack packaging design. The individual snack packages seemed to draw customers to the products. So, Bobb’s executives determined that to gain market share, they would need to develop individual

3 KPMG’s Professional Judgment student monograph contains illustrations, audio files, and links to internet files that vividly illustrate many of the concepts introduced in this module.

package designs that were equally distinctive. They spent millions on improved packaging appearance for their snack foods to compete against Ax's distinctive packaging. When increased market share did not follow, Bobb's executive team realized that they knew relatively little about what customers really wanted and what drove the consumption of their snack foods. Bobb's executives decided to conduct market research, and along the way, they discovered an important and somewhat unexpected aspect of consumer behavior: regardless of the quantity of product they placed in a home, it would be consumed in relatively short order. Thus, Bobb's executives clarified the decision problem as "how to get larger quantities of snack products into consumers' homes." Accordingly, they focused less on the appearance of individual snack packages and instead introduced bulk packaging that made it easier and more convenient to get more snacks into consumers' homes. The resulting gain in market share was dramatic.

This example illustrates one of the biggest traps we run into during the first couple of steps of the judgment process, which is under-investing in defining the fundamental issue. In the example above, Ax Snack Company's distinctive packaging functioned as what could be called a judgment trigger, or an assumed or inherited issue that can lead the decision maker to skip the crucial early steps in the judgment process. It caused Bobb Goodies' executives to focus, at first, on the wrong issue or problem. Judgment triggers can often be recognized when a particular alternative is used to define the problem in place of a well thought-out problem definition. Often, the trigger comes from the way others have defined the issue, which is often formulated in terms of one potential solution. Alternatively, we may create triggers ourselves because we are in such a hurry to "solve" or to be decisive. Judgment triggers often lead to judgments made on incomplete facts or understandings.

How might you overcome the very common trap of skipping the first couple of elements in the judgment process that comes about through the rush to solve or through judgment triggers? The answer is to ask "what" and "why" questions. For example, you might initially answer a "what" question regarding retirement goals with, "I want to have a certain amount of money in a retirement fund." That certainly is a worthy objective, but as with many initial objectives, it is only a means to an end. Following up by asking why you want a certain amount of money can help you uncover the more fundamental objective, which might be something like, "to maintain a high quality of life in retirement." Note that by clarifying the objective in this way, a number of additional approaches to achieving a high quality of life come to mind (such as good health, no debt, cost of living, location, availability of outdoor recreation, etc.). Carefully clarifying underlying objectives by asking "why" is a key step in making important judgments.

It often does not take a lot of time to consider the first step in the judgment process, but the more important the judgment, the more important it is to invest in clarifying the fundamental issues and objectives. A little extra investment in clarifying the issue and objectives will almost always pay off, sometimes in a big way. One very powerful way to improve your professional judgment is to make sure you are not accepting a judgment trigger in place of a solid problem definition, but rather that you are taking time to ensure your problem definition is complete and correct.

PROFESSIONAL SKEPTICISM AND "JUDGMENT FRAMING"

As noted previously, at the center of the Framework is "mindset." Professional skepticism helps to appropriately frame an auditor's mindset. Essential to an auditor's ability to effectively question a client's accounting choices is a fundamental but powerful concept called "judgment framing." This concept relates to the early steps in the judgment process. The definition of framing follows: *Frames are mental structures that we use, usually subconsciously, to simplify, organize, and guide our understanding of a situation. They shape our perspectives and determine the information that we will see as relevant or irrelevant, important or unimportant.* Frames are a necessary aspect of judgment, but it is important to realize that our judgment frames provide only one particular perspective. This is similar to looking out one window of your home—it provides one view that might be quite different from the view through another window facing a different direction.

Frames are necessary and helpful, but the problem is that we often are not aware of the perspective or frame we are using. Also, our frame can blind us to the fact that there are other valid perspectives. In other words, frames help us make sense of things but they also make it difficult for us to see other views. By being proactive in our use of judgment frames, we can improve how well we do with the initial steps in the judgment process: clarifying issues and objectives and considering alternatives. This is important because a distinguishing characteristic of professionals who consistently exercise sound judgment is that they recognize the judgment frame they are using, and they are able to consider the situation through different frames, or what KPMG professionals refer to as a "fresh lens." Sounds simple enough, but it is not always easy to do! The concept of judgment framing is important because appropriately questioning management's perspective by viewing the situation through other frames is fundamental to professional skepticism.

For example, suppose the results of a substantive analytical procedure suggest that a client's allowance for doubtful accounts is understated. The auditor's approach to gathering further audit evidence will be different if the results are framed in the context of a change in business condition or a change in the client's credit policy as compared to an indicator of a likely error. This is not to say one frame is necessarily better than the other, but the auditor can boost his or her professional skepticism by considering both frames.

A key characteristic of those who make high-quality judgments is that they are frame-aware. They know how to seek and consider different frames to get a fuller picture of the situation. Seasoned, experienced auditors develop this ability and apply it in situations where they need to help client management see an alternative viewpoint on an important accounting issue. For example, an alternative frame that auditors might use could be an investor or analyst perspective, or a regulator perspective. Or it might be a "hindsight" perspective—in other words, how will management's judgment look if a regulator later questions it, or if it is reported in the press in six months? While experienced auditors are typically quite skilled at challenging frames and considering issues from different perspectives, this is an area where auditors entering the profession typically need improvement.

JUDGMENT TENDENCIES THAT CAN RESULT IN BIAS

Peoples' judgments can be unintentionally biased due to underlying self-interest or because they unknowingly use mental shortcuts. For the most part, the shortcuts we use are efficient and often effective, but in certain situations, they can result in systematic, predictable bias. Keep in mind that the tendencies or shortcuts we will discuss are simplifying judgment strategies or rules of thumb that we have unknowingly developed over time to help us cope with the complex environments in which we operate. They are efficient and often effective, but because they are shortcuts, they can lead to lower quality judgment in some situations. Here's a quick example of a simplifying shortcut. When crossing a city street, say in New York City, some people don't wait until they get a "walk" sign; rather, they move through intersections by quickly looking to the left for oncoming traffic. If the coast is clear, they will take a step out into the street and then look to the right for traffic coming the other way. This is a very efficient and often effective shortcut strategy. Over time, it can become an unconscious, automatic part of how people cross the street in a busy city. However, if we were to use this shortcut strategy in London, where they drive on the other side of the street, it could result in a very bad outcome. Even in New York City, the shortcut can lead to a bad outcome if applied to all streets, since there are one-way streets that come from the other direction.

Similarly, the judgment shortcuts we commonly use are efficient and generally effective. However, there are situations where the use of a shortcut can predictably result in a lower quality or biased judgment. The good news is that once we understand the implications of a shortcut, we can devise ways to mitigate potential bias resulting from the shortcut. When it comes to crossing the street in London, transportation officials have devised rather ingenious ways to reduce the potentially serious consequences of using the "American" shortcut to start across the street looking first only to the left. They have placed signs on the sidewalk, on signposts, and even on the street, reminding visiting pedestrians of the direction of traffic flow. The signs are an attempt to get visitors out of the subconscious shortcut mode and apply more formal thinking, which is pretty important for the well-being of American tourists in London.

We will briefly introduce four common judgment tendencies that are most applicable and important for audit professionals: the availability tendency, the confirmation tendency, the overconfidence tendency, and the anchoring tendency.

The ***availability tendency*** is defined as: *The tendency for decision makers to consider information that is easily retrievable from memory as being more likely, more relevant, and more important for a judgment.*

In other words, the information that is most "available" to our memory may unduly influence estimates, probability assessments, and other professional judgments. Like other mental shortcuts, the availability tendency often serves us well, but it has been shown to introduce bias into business and audit judgments. For example, an auditor may be inclined to follow the approach used in a prior period or on a recent engagement even if the approach is not the best for the current engagement. This tendency is especially powerful if the approach worked well on the prior engagement.

The ***confirmation tendency*** is defined as: *The tendency for decision makers to seek for and put more weight on information that is consistent with their initial beliefs or preferences.*

You may have heard the old joke, "My mind is made up; don't confuse me with the facts!" Hundreds of years ago, leading philosophers recognized that once people have adopted a preference or an opinion, they tend to consider and gather information that supports and agrees with their preference. Research in psychology backs this up: people tend to seek confirmatory evidence, rather than looking for something inconsistent with their opinions or preferences. After receiving this confirmatory evidence, decision makers often are confident that they have adequate evidence to support their belief. The more confirmatory evidence they are able to accumulate, the more confident they become. However, in many instances, we cannot know something to be true unless we explicitly consider how and why it may be false. As an example of the confirmation bias in auditing, research and reviews of working papers find that auditors may be prone to overrely on management's explanation for a significant difference between the auditor's expectation and management's recorded value, even when the client's explanation is inadequate.

The ***overconfidence tendency*** is defined as: *The tendency for decision makers to overestimate their own abilities to perform tasks or to make accurate diagnoses or other judgments and decisions.*

When groups of people are asked to assess their own abilities, whether in auditing or in driving a car, a majority of the participants assess themselves as above average relative to the group being surveyed. But, of course, it is not possible for all participants to be above average. This is a simple illustration of the fact that many of us are overconfident in our abilities and, as a result, we often tend not to acknowledge the actual uncertainty that exists. Overconfidence is a subconscious tendency that results from personal motivations or self-interest. Importantly, this tendency to be more confident than is justified is likely to affect us even when we are doing our best to be objective. Research indicates that many people, including very experienced professionals, are consistently overconfident when attempting to estimate outcomes or likelihoods. Studies involving practicing auditors demonstrate that auditors may be overconfident in their technical knowledge and their competence in auditing risky areas. In addition, partners and managers may be overly confident in the ability of less experienced people in completing complex tasks. Conversely, associates and senior associates may be overconfident in the competency of more experienced auditors to complete lower-level tasks that they aren't accustomed to performing on a regular basis. Such overconfidence can lead to a variety of suboptimal outcomes in auditing, including neglecting to ask for needed help or guidance, failing to acquire needed knowledge, poor task performance, budget overruns, assignment of audit tasks to underqualified subordinates, and underreview of subordinates' working papers.

The ***anchoring tendency*** is defined as: *The tendency of decision makers to make assessments by starting from an initial numerical value and then to adjust insufficiently away from that initial value in forming a final judgment.*

To illustrate the anchoring tendency, managers often make salary decisions by adjusting from the starting point of an employee's previous salary. A prospective employer might quickly realize the unreasonableness of the anchor (e.g., her previous employer only paid her $48,000 before she earned an MBA degree), but proposes a starting salary irrationally close to the starting point, or anchor. So, in this example, the job applicant is likely to receive a lower salary offer if the prospective employer knows her salary before she earned her MBA. There are two components of anchoring and adjustment—the tendency to anchor on an initial value and the tendency to make adjustments away from that initial value that are smaller than what is actually justified by the situation. The anchoring tendency clearly has direct relevance to auditing in many settings. For example, management's estimate or unaudited account balance can serve as an anchor. The auditor is charged with objectively assessing the fairness of an account balance. But if his or her judgments are influenced by the amount asserted by management in an unaudited account balance, that objectivity might be compromised. In other words, the auditor might become anchored to management's estimate.

MITIGATING THE EFFECTS OF JUDGMENT BIASES

The most important step in avoiding judgment traps and reducing bias caused by subconscious mental shortcuts or self-interest is "awareness." By better understanding traps and biases, and recognizing common situations where they are likely to present themselves, we can identify potential problems and often formulate logical steps to improve our judgment. If we don't have any idea where the common judgment traps are, or where we are likely to be systematically biased, we do not even have a starting point. As we said earlier, some of the most serious judgment traps have to do with the failure to follow a judgment process. In other words, we might be influenced by a judgment trigger, solve the wrong problem, fail to clarify our objectives, or push too quickly through the initial steps in the judgment process because we want to quickly arrive at a solution or conclusion. In terms of mitigating bias, the first step is to recognize situations where we might be vulnerable. Awareness, coupled with the terminology to identify and label the potential traps and biases, is key to improving judgment. In fact, research exploring mitigation techniques suggests that simply providing instructions to decision makers about the seriousness of a bias can reduce the effect of these biases.

While a thorough discussion of potential ways to mitigate biases is beyond the scope of this professional judgment introduction, here are a few examples. Actively questioning our assumptions, which might include considering potentially disconfirming evidence or seeking more complete information, is a key approach in mitigating all of the judgment biases. Consulting with others can go a long way toward mitigating the effects of the availability tendency. Getting an outside view on a going-concern uncertainty assessment can help keep the auditor's judgment from being too optimistic, or pessimistic, given recent, salient experiences. In other judgment and decision tasks, a helpful approach is to ask others to gather and evaluate information without revealing our preference. We would not want to reveal our preference to others before getting their perspectives because our preference may affect their judgment just like it may affect our own. We can also take steps to objectively evaluate the pros and cons for each alternative. In mitigating bias related to the anchoring tendency, it can be helpful to seek out and explicitly consider alternative anchors.

The bottom line is that we need to realize where and how we may be biased in order to develop simple approaches for mitigating the effects of those biases. And the good news is that once you are aware of traps and biases, the mitigation approach often is a matter of applying logic and common sense. Bias-mitigation techniques are important, but just as important in avoiding traps and mitigating bias is to bake the steps of good judgment, such as those provided in the KPMG Professional Judgment Framework, into your judgment-making process. Thoughtfully applying the steps of a judgment process can in itself mitigate bias. And, finally, in auditing, the requirement to conclude and document provides the auditor the opportunity to carefully reconsider the preceding steps of good judgment and the possibility that judgment traps or biases may have influenced the final conclusion.

CONCLUSION

Professional judgment is an increasingly important subject in accounting and auditing. As accounting standards become more subjective and fair value measurement increasingly takes center stage, professionals will be required to apply more and better professional judgment on a consistent basis. In reality, none of us will ever make perfect judgments or be completely free from bias or from judgment traps. But by becoming aware of where we can fall prey to such influences and by practicing common sense mitigation techniques, including the steps in a judgment process, we can improve the quality of our professional judgment. And this, more than just about anything else you can do, will set you apart as an outstanding professional.

For more in-depth information about professional judgment in auditing, including additional coverage of judgment traps and biases, judgment in groups, and other topics, see the award-winning monograph, *Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework*, available without charge at *http://www.kpmguniversityconnection.com*.

REQUIRED

[1] Identify and describe two common judgment traps.

[2] How can considering multiple judgment frames enhance an auditor's professional skepticism? Explain and give an example.

[3] What is the first step in avoiding traps or reducing bias? Briefly explain why this first step is so important.

[4] Identify and briefly describe three potential ways to mitigate the effects of biases.

DISCUSSION CASES

The following discussion cases provide opportunity to apply the principles presented in this Professional Judgment Introduction.

[5] An audit engagement team is planning for the upcoming audit of a client who recently underwent a significant restructuring of its debt. The restructuring was necessary as economic conditions hampered the client's ability to make scheduled re-payments of its debt obligations. The restructured debt agreements included new debt covenants. In auditing the debt obligation in the prior year (before the restructuring), the team established materiality specific to the financial statement debt account (account level materiality) at a lower amount than overall financial statement materiality. In planning the audit for the current year, the team plans to use a similar materiality level. While such a conclusion might be appropriate, what judgment trap(s) might the team fall into and which step(s) in the judgment process are most likely affected?

[6] A client is determining its accounting treatment for new types of long-term contracts. Consider the differences in outcome for the two scenarios that follow regarding the approach the client and auditor took. How does framing relate to the two different scenarios?

- **Scenario A:** The client entered into a large number of long-term sales contracts and recorded revenue using an approach they determined was the preferred approach, with no consultation or discussion with the audit engagement team. The engagement team conducted revenue recognition testing to ensure that the client correctly followed the chosen approach. The engagement team noted that the client consistently and accurately applied the approach and determined that the audit testing supported the amount of revenue reported by the client.
- **Scenario B:** Before entering into long-term contracts with customers, the client reached out to the audit engagement team to discuss the client's preferred approach for recognizing revenue. The team researched authoritative accounting standards and considered the client's preferred alternative. The team also considered other possible approaches and consulted with other engagement teams with experience in accounting for long-term contracts. Based on this process, the engagement team determined that although the client's preferred approach had merit, another alternative was more consistent with accounting principles for revenue recognition. The client carefully reconsidered the situation and ultimately decided to use the alternative suggested by the engagement team to recognize revenue associated with the long-term contracts they entered into.

[7] For each of the two audit situations below, determine which judgment shortcut or tendency is most prevalent and briefly describe the likely consequences of using the shortcut.

[a] A staff auditor is testing accounts payable balances. The auditor observes an unexpected fluctuation in the account balance compared to the prior year. The client happens to be walking by, so the auditor asks the client about the fluctuation. The client provides a plausible and reasonable explanation. In considering other possible causes for the fluctuation, the client's explanation seems to be the most likely, so the staff auditor documents it as evidence supporting the fluctuation. Later, it is determined that other facts encountered during the audit do not support the client's explanation.

[b] A client has provided the audit engagement team an estimate of the inventory valuation reserve. The client used a method for calculating the reserve that had been used in prior years. To audit the reserve, the engagement team obtained and reviewed the client's calculation. However, the team noted that the client's calculation did not reflect a significant decline in customer demand for an older product line that was losing popularity relative to the newer products. The engagement team suggested that the client adjust the reserve upward. The client argued that the current reserve amount was adequate but indicated that a small increase in the reserve would be acceptable. The engagement team reviewed the client's proposal, and ultimately accepted the inventory account as fairly stated in view of the increase to the reserve. However, within a few months after the financial statements and audit report were issued, it became apparent that the reserve was insufficient as significant inventory write-downs were recorded for obsolete inventory that was discarded at scrap value.

[8] For each of the two audit situations that follow, determine which judgment tendency (or tendencies) is (or are) most prevalent and what the auditor could do to reduce bias.

[a] A client contacts the audit partner regarding the likely fee for the upcoming audit. The engagement team is in the early stages of planning interim and final fieldwork including making personnel assignments and estimating required audit hours. In the prior year the total hours for the audit were 900 hours. The engagement partner tells the client's CFO that, because the engagement team is returning and is very familiar with the client, the level of audit effort should be only slightly greater than that of the prior year, even though the client has acquired a new subsidiary and has begun manufacturing a new product line.

[b] An audit manager is tasked with approaching the client to discuss the possible need for write-downs on assets recorded at fair value (they are "level 2" in the FASB hierarchy). To her surprise, the client has already prepared a detailed schedule examining the assets in question and has modeled fair value using three different valuation approaches. Based on these analyses, the client has proposed a relatively small write-down. The analysis appears to be well thought-out and carefully performed. The audit manager checks the numbers in each valuation model and finds that there are no mathematical errors. The manager concludes that the client's proposed write-down is adequate.