



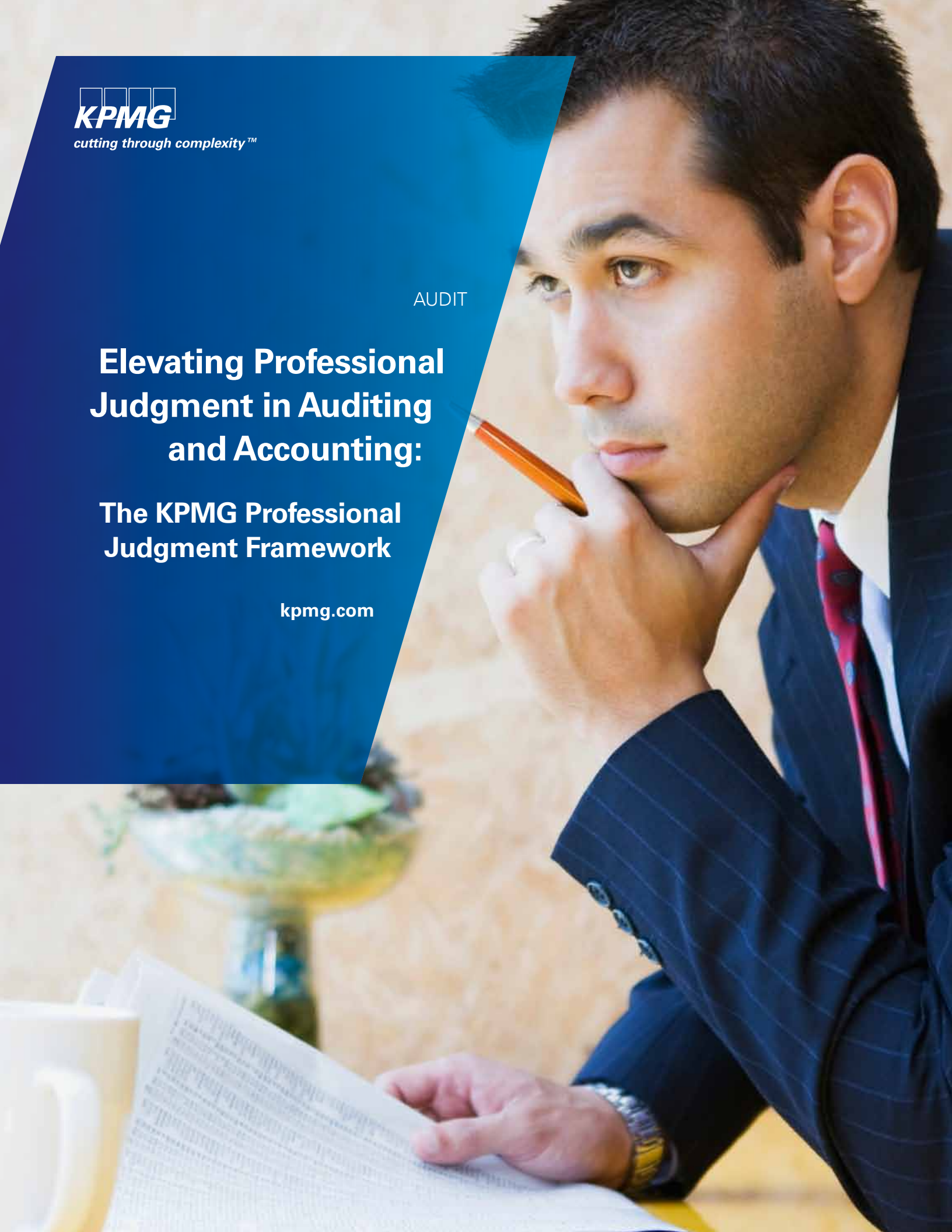
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AUDIT

Elevating Professional Judgment in Auditing and Accounting:

The KPMG Professional Judgment Framework

kpmg.com





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Preface



Unlike the professional judgments that made the difference between tragedy and success—the tragedy of the Challenger space shuttle and the heroics of Apollo 13, judgments that auditors make do not affect life and death outcomes.

They, nevertheless, can be consequential to the continued viability of organizations, the livelihoods of the people employed by them, and the investors who rely on them—not to mention the effectiveness and efficiency of our capital markets. Audit judgments—both big and small—matter. It matters, then, how well or poorly such judgments are made.

Those individuals, teams and organizations known for making good judgments will distinguish themselves in the professional services marketplace. At the same time, the effects of challenging economic times, increased use of fair value measurements, and ever-expanding regulations, among other things, have raised the threshold for what is considered effective judgment and decision-making skills. Because the demand for these skills is increasing, auditors must adapt to the changing environment.

To help keep pace with this change, KPMG launched an initiative two years ago to enhance the professional judgment and professional skepticism of its people and teams. KPMG collaborated with two professors at Brigham Young University to emphasize these skills in its training. The result of this effort is refreshed professional judgment content throughout KPMG's audit training curriculum for all levels of audit professionals.

KPMG has committed itself to keep this training content current—a necessary step to keeping its professionals engaged and aware of the need to continuously improve their own skills and those of their audit engagement teams. KPMG will continue to monitor this ongoing program to understand the impact this training is having on its professionals and how their professional judgment skills are impacting their audit activities.

KPMG is now taking the important step of sharing and leveraging the content we have created with the key stakeholder groups that are essential to KPMG's success as a public accounting firm, including the academic community.

We believe that the mindset, skills, and techniques behind good judgment begin to form at a young age—and can be taught and improved with experience and practice. We think it is critical that accounting and auditing students receive a strong foundation in the fundamentals of professional judgment. This is why KPMG has made this investment to develop and share this monograph with business and accounting schools, the primary suppliers of audit talent to the public accounting profession.

We start the monograph by introducing the KPMG Professional Judgment Framework, which includes a process for what auditors should do when making important professional judgments.

The monograph also:

- Presents simple, but powerful, principles that help overcome common threats to good judgment and that enhance your professional skepticism.
- Covers several common judgment tendencies and how they can lead to biased judgments, and offers techniques to overcome or reduce the potential impact of these biases.

After laying a foundation for individual judgments, we consider common threats to good judgment in groups, and the techniques that can improve the quality of group judgments. We close with a brief conclusion and a review of important “take-aways” from the monograph.

KPMG is committed to sustaining an ongoing dialogue about professional judgment—with its own people and with major stakeholders. KPMG believes that engaging with the academic community is a key way to do this—and hopes the monograph proves an effective vehicle to accomplish that goal.

We gratefully acknowledge the valuable input and feedback we received in the course of completing this monograph from numerous individuals, including Lisanne Biolos, Matt DeWald, Marty Finegan, Mike Reavis, Heather Ziegler and many others in Audit Learning and Development. We also want to recognize the many KPMG professionals who shared their insights and stories with us over the past few years as we developed our professional judgment initiative at KPMG. It is their enthusiastic response that convinced us that the KPMG Professional Judgment Framework and the commitment to continuous improvement makes a difference in the quality of the services we provide.

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Chapter One

Can you really teach professional judgment?



Introduction

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. For example, auditing standards require “the auditor to exercise professional judgment in applying them” (AU 150.04). 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 monograph is 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.

Ironically, even though we all constantly make judgments and decisions, most of us receive very little formal training in how to make good judgments. While many of the judgments we make on a daily basis are relatively easy and not terribly important, we also make difficult and important judgments. Many people have a hard time making judgments at all—some prefer to put off judgments until they are absolutely necessary. But such an approach can reduce the alternatives that are available and limit the quality of the ultimate judgment.

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 we at KPMG LLP (KPMG) are convinced 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 is pleased to produce this monograph for the next generation of professionals.

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. To elevate the professional judgment and professional skepticism of its auditors, KPMG developed a Professional Judgment Framework, which is discussed in Chapter 2. The KPMG Professional Judgment Framework provides auditors with a judgment process and a common vocabulary for understanding the components of good judgment and recognizing the threats to good judgment. KPMG recognizes that people who consistently and confidently make high-quality judgments will distinguish themselves as audit professionals.¹

¹ The KPMG Professional Judgment Framework, related training materials, and this monograph were developed with the help of two professors from Brigham Young University, Steven Glover and Douglas Prawitt. Professors Glover’s and Prawitt’s research focuses on the judgment and decision making of accounting and auditing professionals, and they have taught graduate (MBA) courses on effective judgment and decision making for many years.

Mental shortcuts

In Chapter 2, we will discuss what good judgment looks like, or what it should look like. 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 the two tabletops pictured below.² At first glance, do the tops of the tables appear to be the same shape?



If you are like most people, your intuitive judgment tells you the shapes are quite different. The table on the left appears elongated, less square than the table on the right. Our eyes and related perceptual skills ordinarily are quite good at perceiving and helping us to accurately judge shape similarity. However, despite appearances, the tabletops above are, in fact, identical in shape. In order to supplement your perceptual intuition, you can introduce rational or analytical tools (such as measuring or tracing), thereby convincing your rational mind that the tabletop shapes are identical.

Just as with this illustration of a perceptual bias, there are times when our intuitive judgment falls prey to systematic traps and biases. While the tabletop example illustrates a perceptual bias, research provides convincing evidence that even the smartest and most experienced people similarly fall into predictable judgment traps and biases.

Unfortunately, when it comes to these traps and biases, experience is not always the best teacher. However, the good news is that once we are aware of traps and biases, we can deploy logical steps to reduce their impact and improve judgment.

Does practice make perfect or permanent?

As with other skills, such as painting, snowboarding, golfing, or delivering effective speeches, our judgment can be improved by learning new knowledge and skills. Often, when learning a difficult activity, our natural tendencies can lead to bad form and bad habits. For example, if you have never golfed before, simply buying a set of clubs and then playing golf using your natural swing and intuition is unlikely to deliver the desired results, no matter how much repetition and experience. Practice makes permanent—not necessarily perfect! However, a person interested in improving his or her golf swing can get training, which might involve lessons on swing fundamentals and an analysis of the person’s current swing compared to that of a professional golfer. With an understanding of common swing flaws and proper swing fundamentals and “swing thoughts,” together with some practice, it is possible to retrain the body and mind to achieve an improved golf swing.

Similar to any ability that we want to improve, enhancing our ability to consistently make high-quality judgments takes effort. At first, a revised golf swing, or a revised judgment process, may seem awkward and cumbersome.



² See Shepard 1990. Picture adapted from “Turning the tables” www.michaelbach.de/ot/sze_shepardTables/index.html. To find similar examples, search the Internet for “Shepard tables.”

But with practice, the newly learned fundamentals become a natural part of what we do. It is important to note that in golf, a new, improved swing does not take any more time than the old swing. In fact, the new swing should ultimately save the golfer time during a round of golf, as he or she does not spend as much time tracking down errant shots. Similarly, an improved judgment process will not take much more time than your old process, and it can actually be much more efficient because you will be less likely to invest effort in trying to solve the wrong problem, gathering unnecessary information, or cleaning up a judgment mess that might result from falling prey to the common traps and biases you will be learning about in later chapters.

The materials in this monograph including the end of chapter questions, illustrative vignettes, and the Professional Judgment Framework are based on materials KPMG uses in its professional training.

Snapshot of what is in this monograph

In Chapter 2, you will learn about the KPMG Professional Judgment Framework, which includes a process for what we *should* do when making important professional judgments. The bulk of the monograph, however, will help you understand what we *typically do* when making judgments. This contrast will help you understand how our typical approaches and processes are often different from what they should be. We will also discuss some simple, but powerful, principles regarding how to overcome common threats to good judgment. Chapter 2 will introduce you to some common traps that can lead to suboptimal judgments. In Chapter 3, you will learn about how to boost your professional skepticism by overcoming a common tendency to only consider one perspective or “judgment frame.” Chapter 4 will cover several common judgment tendencies and how they can lead to biased judgments. Chapter 5 will address techniques to overcome or reduce the potential impact of these biases. The first five chapters largely focus on individual judgments. In Chapter 6, we consider common threats to judgment in groups and techniques that can improve the quality of group judgments. Chapter 7 provides a brief conclusion and a review of important “take-aways” from the monograph.

We believe that you will find this journey through the essential elements of sound professional judgment, including common traps and biases, interesting and insightful. In Appendix 1 at the end of the monograph,

we provide a summary of the steps to a judgment process and important considerations and threats common to each step. In Appendix 2, we provide a list of additional resources if you are interested in learning more in the area of judgment and decision making.

End of chapter questions

- 1. What is the primary purpose of this monograph?**
- 2. How do perceptual biases relate to judgment biases?**
- 3. True or False: You just cannot teach judgment; either you have it or you do not.**

Chapter Two

Judgment: What it looks like and common threats



Judgment defined

Before we get to what makes a judgment process good or bad, 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.³

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)

Components of judgment

When you think of someone who seems to consistently exercise good judgment, what characteristics or components of judgment does this person demonstrate?

In considering this, you may come up with a list something like the following:

- Logical
- Flexible

- Unbiased
- Consistent and reliable
- Appropriately balances experience with knowledge, intuition, and emotion
- Uses the right amount of relevant information, including professional literature and evidence

A judgment process that includes the components noted above could be used for small, less important judgments, as well as difficult, very important judgments. 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 framework to help guide our judgment process. The elements of good judgment noted above are built into KPMG's Professional Judgment Framework. Unfortunately, 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.

³ 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 monograph, we often refer to the combined processes of judgment and decision making as "judgment," "professional judgment," or "making judgments."

KPMG Professional Judgment Framework

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.

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.”

The steps in the process may not appear overly surprising to you; they may even seem 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, it is not necessarily an accurate representation of the processes people follow consistently. The reason that formal steps in the judgment process do not capture how we always make judgments is that the model assumes that we always properly define the important issues and objectives, consider all appropriate alternatives, gather the right amount (quantity) and type (quality) of information, and then properly weight the consequences of each alternative so that we can arrive at the optimal judgment. 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.

KPMG recognizes that with the move toward a more principles-based financial reporting framework and increased emphasis on fair value measurement, consistently making quality professional judgments is increasingly important. Auditors face a number of challenges in making those professional judgments. For these reasons, KPMG developed the Professional Judgment Framework. The Framework and related training are designed to provide three primary benefits:

1. To enhance the professional judgment and professional skepticism abilities of our auditors.
2. To provide our auditors a tool to follow to facilitate good judgments in a more consistent manner. A shared understanding of the steps in a judgment process, as well as an awareness of traps and biases that threaten judgment, provide a common vocabulary for auditors and facilitates coaching around good judgment skills.
3. To enhance audit documentation associated with exercising professional judgments. The Professional Judgment Framework assists in the development of audit documentation that provides evidence of professional skepticism in our judgments.

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. In this chapter, we will discuss the Environment and some of the influences that can affect professional judgment. In subsequent chapters, we will highlight common judgment tendencies and the associated biases that can influence auditor judgment. In Chapter 7, we will discuss the “ribbon” of coaching and reflection running through the Framework.

Where is professional skepticism in the Professional Judgment Framework?

The terms professional judgment and professional skepticism often go together in discussions about obtaining audit evidence or evaluating support for management’s accounting estimates. Professional skepticism is not separately noted

in KPMG’s Professional Judgment Framework, so you might wonder where this essential concept comes into play. Consider the following question:

Which of the following best describes the relationship between professional skepticism and professional judgment?

- a. Professional skepticism is an objective attitude that includes a questioning mind and a critical assessment of audit evidence. It is synonymous with professional judgment.*
- b. Professional skepticism is an objective attitude that includes a questioning mind and a critical assessment of audit evidence that is an important part of the professional judgment process.*

Professional skepticism 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.⁴ Thus, the correct answer to the question above is “b.” Professional skepticism helps to frame our “mindset,” which is at the center of the KPMG Professional Judgment Framework. It is essential, for example, that the auditor applies professional skepticism in evaluating management projections to be used in a goodwill impairment analysis. However, the overall determination of whether or not, in the auditor’s view, goodwill has been impaired is a matter of professional judgment.

Wrapping around “mindset” in the Framework is “consultation.” At KPMG, we make sure our professionals understand that one way to boost their professional skepticism is to consult with others, including engagement team members, specialists, or other professionals. In Chapter 3, we revisit professional skepticism and talk about other ways you can enhance your ability to effectively apply professional skepticism in your judgments.

Environment and judgment traps

The outer rim of the KPMG Professional Judgment Framework is “Environment.” Partners, managers, and others on the audit engagement team influence the environment in which audit judgments are made. It is important to create an atmosphere that facilitates good judgment. For example, at KPMG, we work hard to foster an environment characterized by open communication so that team members at all levels are comfortable speaking up when they have information that is

⁴ AU 230.07, *Due Professional Care in the Performance of Work.*

relevant to a particular judgment. Our environment fosters input and involvement from all team members, even the newest staff, to encourage openly sharing information and perspectives crucial to exercising good professional judgment.

For example, KPMG utilizes a Risk and Audit Quality Assessment (RAQA) process in conjunction with the execution of its audit engagements. RAQA is an overall risk and quality assessment process whereby the audit engagement team discusses and reassesses, based on audit procedures performed and evidence obtained, whether all risks of material misstatement have been identified and assessed, and whether the audit engagement team has designed and performed audit procedures whose nature, timing, and extent are responsive to the assessed risks. RAQA meetings are held at various times throughout the audit process and are predicated on the insights, observations, and assessments of the members of the audit engagement team.

The chart below lists other internal and external factors that influence the judgment context. Some elements of the judgment environment are within our control and some are not. For example, significant time pressure poses the risk of lowering the quality of judgments. We may not always be able to completely control the degree of time pressure we face, but often we can reduce the impact of time pressure on a work project, including audit engagements, through effective planning.

Environmental Factors Affecting Judgment	
<p>External Factors:</p> <ul style="list-style-type: none"> • Time pressure • Limited resources • Client, regulatory, industry 	<p>Internal Factors:</p> <ul style="list-style-type: none"> • Judgment traps <ul style="list-style-type: none"> – Rush to solve – Judgment triggers • Judgment shortcuts • Self-interest

In terms of internal factors, we want to highlight the first of the judgment traps, **which is 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.

For an illustration of solving the wrong problem, follow this [link](#) or go to YouTube™ and search for the “Car Ice Scraping Gone Wrong.”⁵ This video provides a humorous illustration of solving the wrong problem and highlights the need to properly clarify the issue or problem addressed. We’ve all likely experienced situations where we’ve invested time working on the “wrong” problem, and we know it can be a real time waster.

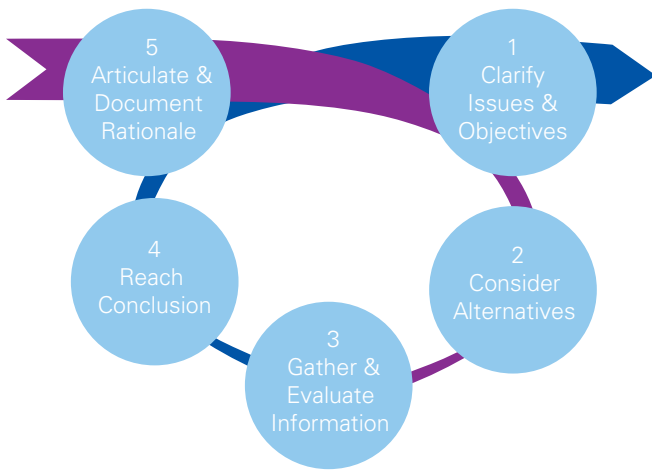
Most of the time, we do not even realize when we fall into the trap of “rushing to solve” because the trap involves not “seeing” the issues clearly. As a result, we have a limited view of the issues that are involved and the alternatives that are available to us. The fact that we frequently but unknowingly fall into this trap explains, in part, why experience in making judgments is not always the best teacher.

Research in cognitive psychology has demonstrated that our judgments tend to be influenced subconsciously by biases related to self-interest and by the use of mental shortcuts. In this chapter, we walk through the KPMG Professional Judgment Framework and highlight the most common judgment traps. In later chapters, we focus our attention on some of the most basic, common biases that can affect professional judgment. We will also offer some techniques that can help you to avoid the traps and eliminate or reduce these predictable, systematic biases.

⁵The video is a Statoil advertisement.

Steps in the judgment process

At the center of the KPMG Professional Judgment Framework are the steps to follow in making effective professional judgments. We will discuss each of the steps together with some of the common threats to good judgment. One of the most significant benefits of the KPMG Professional Judgment Framework is that it provides our audit teams with a common vocabulary that they can use to discuss how to improve judgment and how to avoid common judgment traps and biases. Active and repeated application of a judgment process like the one below also will help you to make higher-quality judgments and will help you integrate the components of good judgment into your everyday judgment approach.⁶



Step 1 Clarify Issues:

At the beginning of a judgment process, we clarify the issue, or in other words, we clearly define “what” is being solved. If we fail to appropriately consider or define the issue or problem, we might solve the wrong problem, as was illustrated in the video of the poor guy who scraped snow and ice off the wrong car (linked above). The reason that clarifying the issue is so critical is that a good solution to the right problem is almost always better than a great solution to the wrong problem.⁷



An example of initially solving the wrong problem, as illustrated here, involves two snack food companies competing for market share—let’s call them Ax Snack Company and Bobb Goodies Inc.

⁶ For other more general models of judgment and decision making, see Hammond, Keeney, and Raiffa, 1999; Bazerman and Moore, 2009.

⁷ See Hammond, Keeney, and Raiffa, 1999.

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 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 at the front end 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 on the wrong issue or problem.⁸



Judgment triggers can often be recognized when a particular alternative is used to define the problem. This is a crucial point to understand. Click on the link below to hear

a conversation between a partner and a staff auditor discussing a job offer the staff auditor has received. See if you can identify what the fundamental issue is as well as what might be serving as a judgment trigger.



⁸ Hammond, Keeney, and Raiffa, 1999, suggest that every judgment problem has a “trigger” or “initiating force.”

In the dialogue, you should have noted that the problem is actually defined in terms of the alternative being considered. Often, the trigger comes from the way others have defined the issue. 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. In the vignette between the staff auditor and the partner, the staff auditor seems to have defined the problem as *“should I stay or should I accept the SG job offer?”*

But stop and think about this for a second: if he is considering changing jobs, why should he limit the alternative to just the firm that contacted him? A change in jobs clearly should involve careful consideration of a broader set of alternatives, which would result from thinking more carefully about the first couple of elements in a judgment process.

How might you overcome this very common trap of skipping the first couple of elements in the judgment process? The answer is to ask “what” and “why” questions. You can hear the remainder of the conversation between the staff auditor and partner a little later. But first, the exhibit below provides another example of a judgment trigger that auditors frequently encounter in practice.

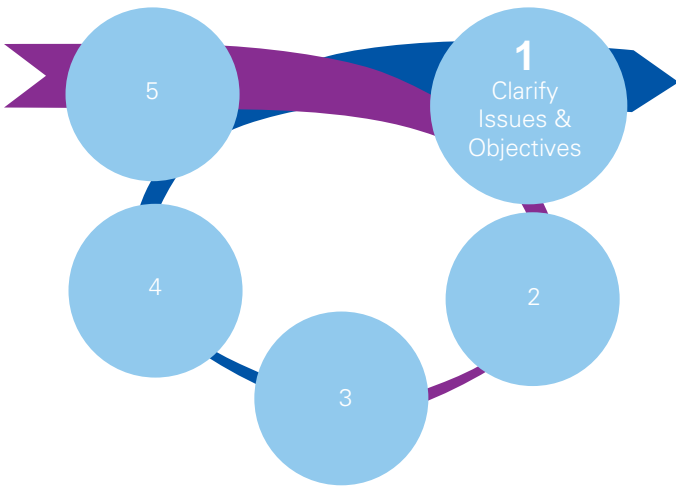


Practice insight

For each of the five previous years of a public company’s audit, the targeted deadline for the client to publicly release its year-end earnings has been moved closer to year-end. In the current year, the CFO is intent on meeting an even more accelerated reporting deadline and has consistently pushed the engagement team to reach its conclusions more quickly upon being provided with the company’s analysis and conclusion. A question arises relatively late in the engagement regarding the company’s accounting treatment for certain hedge transactions. The CFO feels very strongly and emphasizes to the engagement team that the company’s documented accounting position considers all applicable professional literature and is the correct accounting treatment. She indicates that all of the “legwork” has been completed and asks for the engagement team’s concurrence with the position as soon as possible.

Pressure placed on engagement teams in the form of aggressive timetables can be excessive especially during the height of the financial reporting season. It is therefore important for an engagement team to recognize the potential

pitfalls of failing to afford significant judgments the proper consideration, for example, by skipping the first couple of steps in the judgment process and proceeding directly to documenting reasons for why the client’s treatment is justified. In developing the KPMG Professional Judgment Framework and teaching the judgment process to our Audit professionals, we emphasize the importance of giving adequate attention to each of the components of the five-step judgment process and allowing the execution of the process to dictate our capabilities with respect to accommodating unrealistic client expectations. Taking the time to clarify the issues and objectives and independently consider other available alternatives is invaluable. Furthermore, sometimes another alternative is the correct answer. When the engagement team fails to consider all of the steps, it is more likely to accept a client position without thinking through the issues and alternatives. Another way of saying this is that the team may fail to apply a sufficient degree of professional skepticism. It is pretty clear that we are more prone to weak and incomplete reasoning or rationalization if we do not invest sufficient time in the initial steps of the judgment process.



Step 1 Continued, Clarify Objectives:

Also included in Step 1 of the judgment process is “clarify objectives.” Objectives are what you really want or need. In other words, these are the judgment criteria. Objectives help determine needed information and the importance of the judgment or decision, and thus the effort that is necessary. Just like with defining the problem, we tend to spend too little time and effort explicitly identifying our true objectives because we are in a hurry to “solve.” As an example, if you are searching for a new apartment or house and you do not carefully identify all relevant objectives such as affordability, safety, distance from the office, etc., you will not be able to identify the criteria necessary to make the best selection.

Identifying and clarifying fundamental objectives is not as easy as it sounds—the truth is that we often do not know what we really want. To identify judgment objectives, you might ask questions such as:

- What would make an outcome or alternative particularly great or terrible?
- Are you comfortable at a “gut level” moving ahead with the judgment process? If not, you may not have properly defined the problem or the objectives.
- What assumptions (if changed) would have the greatest impact on the judgment?
- Why is this judgment critical to the financial statements?

Test your objectives by asking what is important and why is it important, to get down to the root objectives.⁹

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.

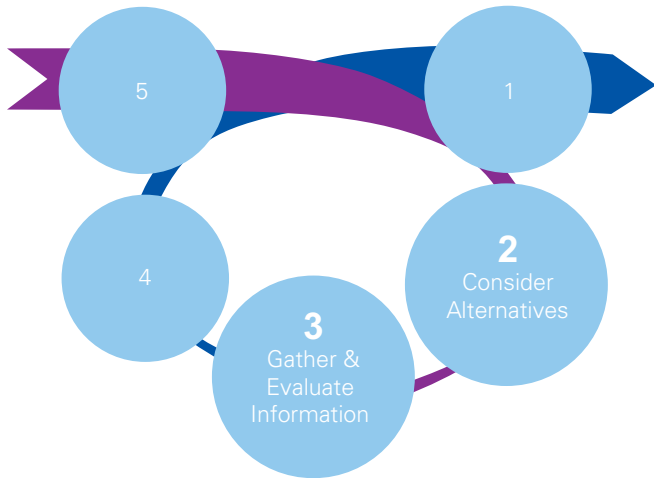
Let’s revisit the audio of the meeting between the staff auditor and partner discussing the job offer.

Notice how the partner helps clarify the issue and objectives by asking “what” and “why” questions. If we are going to consider an important decision like changing jobs, how wise is it to limit our choices to only two alternatives? One very important way we can improve our judgment is by being constantly on the lookout for judgment triggers, which as we said before can severely limit the set of alternatives we consider.



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. The practice insight below discusses how understanding objectives of planned audit procedures is important for staff auditors.

⁹ Hammond, Keeney, and Raiffa, 1999.



Step 2 Consider Alternatives:

If we have properly clarified the issue and objectives, we often can identify alternatives by asking “how” we can achieve our objectives. The most important point to remember when completing Step 2 is that your judgment can only be as good as the best alternative you consider. Our ability to consider alternatives (Step 2) is directly related to how well we clarify the issues and objectives (Step 1). The set of alternatives we consider is usually constrained both by how we define the problem and by the set of objectives we explicitly identify. This is a crucial point that bears reiterating: if we fall prey to the trap of accepting a judgment trigger, the pool of alternatives we consider will likely be seriously constrained. For example, we might consider one of the following:

- Only the alternative we *typically use* to solve problems.
- Only the *first* alternative that comes to mind.

To identify alternatives that will help us achieve our objectives, we often need to be creative in seeking input from others. As illustrated in an upcoming practice insight, the trap of considering only the first alternative that comes to mind can arise in an audit setting if an auditor only considers the alternatives represented by the prior year’s audit procedures.

Step 3 Gather and Evaluate Information:

Gathering and evaluating information is a central part of the audit process. In fact, auditing standards require the auditor to gather “sufficient appropriate audit evidence” to support an audit opinion.¹⁰ The relevance and reliability of the audit evidence is fundamental to an effective audit, but as you

will learn in Chapter 4, we all have certain tendencies that can bias our information search.

It is important for new auditors to realize that they cannot simply gather all necessary information and audit evidence by interacting solely with people within the client’s accounting function, such as an accounting manager or the controller. An important step in gathering information is finding the “right” person. That person may be outside the accounting function in operations, shipping, or human resources, or he or she could be a vendor or customer of the client.

Practice insight

If you decide to enter the auditing profession, as a new auditor you will find that most of your tasks will be laid out for you in “audit steps” describing procedures to be completed in gathering audit evidence. For many of these standard audit procedures, you may not need to spend much time to determine the problem and objectives that are being addressed or the possible alternatives that were considered in selecting the particular procedure(s) you have been asked to perform. Those factors have already been considered by more experienced auditors in determining the audit plan.

However, while these important considerations may have already been completed during the development of the audit steps, you will develop a deeper understanding and you will be a more effective auditor if you take a little time before you begin the procedure to clarify in your own mind what are the issues and objectives that the audit procedure is addressing.

For example, suppose you are observing the physical inventory count at a client that retails “smartphones.” You are asked to make sure that the inventory count does not include phones that do not belong to the client. You will be more effective in carrying out the procedure if you take time to understand the issue and the objectives of the audit procedure before you start—in other words, what are the specific risks the step is intended to address? If you understand the risk before you start, you will understand that the client’s warehouse or retail outlets might contain phones on consignment from other vendors, or phones that have been sold, but that the purchaser has asked your client to temporarily hold. With this understanding, you are much more likely to carry out the procedure in an efficient and effective way.

¹⁰ AICPA AU 326, *Audit Evidence*.

“The client’s fixed assets (net of accumulated depreciation) and related depreciation expense balances are material to the financial statements.”



Practice insight

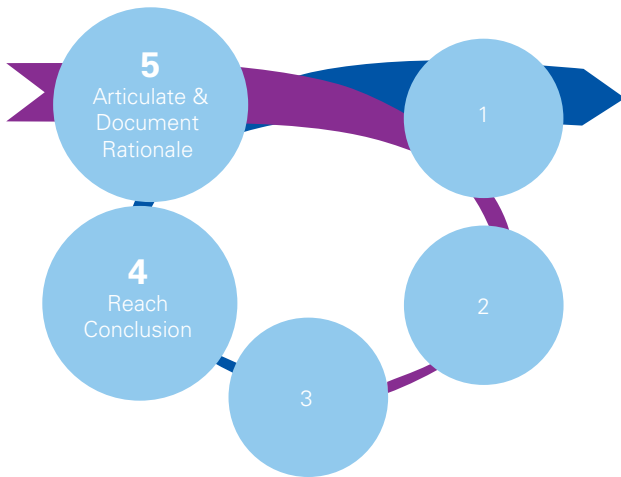
An audit manager and a senior are determining the audit approach for auditing fixed assets and the related depreciation expense. The audit manager (with eight years of audit experience) has not previously worked on this client. The audit senior (with four years of audit experience) has worked on this audit client for the past three years. Because of the audit senior’s prior experience with the client, the manager defers to the senior for purposes of determining the best audit approach for auditing fixed assets. The client operates in the retail industry, selling maternity clothing and accessories throughout the country from more than 1,000 distinct store locations. The client’s fixed assets (net of accumulated depreciation) and related depreciation expense balances are material to the financial statements. The client uses an off-the-shelf software product to calculate depreciation expense and to maintain its fixed asset subsidiary ledger, which consists of in excess of 30,000 individual fixed asset balances.

Consistent with prior year audits, the audit senior, with the concurrence of the audit manager, plans to audit management’s calculation of current period depreciation expense by manually recalculating depreciation expense for a sample of 50 individual fixed assets. Since there were no errors identified in the prior year recalculations and because the client’s internal controls over the calculation and recording of depreciation expense are operating effectively, the audit manager and the senior do not believe that this is a high-risk audit area that calls for more extensive sampling or additional audit procedures.

While the audit senior’s planned audit approach for testing depreciation expense may be acceptable, it may not be the most effective or efficient approach. For example, the audit senior and manager could have considered alternatives, including the use of substantive analytical procedures. Substantive analytical procedures, which would entail grouping fixed assets by similar depreciable category (e.g., machinery, buildings, equipment, etc.) and applying various depreciation rates, can be an effective approach to estimate depreciation expense over an entire population of individual fixed assets. Utilizing substantive analytical procedures is not only efficient because it minimizes the number of recalculations performed by the auditor, but it also is effective because it provides an overview of the reasonableness of the entire depreciation expense balance. In addition, the senior and manager could have considered using computer-assisted audit techniques to recalculate depreciation expense. Computer-assisted audit techniques might enable the automated recalculation of the entire 30,000 individual fixed asset balances with a little programming and the push of a button, providing a highly effective audit procedure with optimal efficiencies.

In the end, although the audit senior and manager properly identified the issue and objective (i.e., to plan the audit procedures to test depreciation expense), their failure to consider alternatives prevented them from identifying more effective and efficient audit techniques to address their objective.

Gathering information from different sources with different perspectives is an important step in being professionally skeptical.



Step 4 Reach a Conclusion:

After evaluating the information gathered and considering our objectives, we reach a conclusion. Important considerations in this step include:

- Step back and consider whether the judgment makes sense from a big-picture perspective
- Weigh the different points of view
- Evaluate whether sufficient appropriate audit evidence has been gathered
- Appropriately consider evidence and alternatives in light of relevant professional standards
- The more important the judgment, the more important it is for all team members to speak up and share what they know.

In later chapters when we discuss how to reduce or eliminate effects of common judgment biases, you will see that considering opposing points of view is a powerful technique in reaching a conclusion.

Step 5 Articulate and Document Rationale:

In developing the KPMG Professional Judgment Framework, we at KPMG debated whether Step 5 should be a separate step or whether it should be combined with Step 4. In a more general judgment context, it might be logical to combine these two steps. However, in the delivery of professional auditing services, we determined that appropriately articulating and documenting the rationale is so crucial to an effective and high-quality audit that it merits designation as a separate

step. Having a separate step highlights to engagement teams that while reaching a conclusion is certainly important, of equal importance is articulating and documenting the rationale supporting the conclusion. Recall at the top of this chapter that we indicated that one of the primary benefits associated with KPMG's professional judgment initiative is improved documentation. The KPMG Professional Judgment Framework helps to ensure engagement teams follow a judgment process. As the team documents the rationale for their conclusions, they can consider whether they avoided traps and biases and appropriately demonstrated professional skepticism. One way to demonstrate professional skepticism is to document the full set of information and alternatives the auditors considered in forming a conclusion, which might include information that is not supportive of the final conclusion.

KPMG encourages our auditors to consider the steps in the judgment process with the end in mind. In other words, if the goal is to clearly articulate and document the rationale for a conclusion, the other steps in the process can be seen as important steps toward achieving that goal. When engagement teams follow the process, judgments will be more defensible, even though in a world of uncertainty, outcomes will not always be what we expect.

Properly documenting and articulating the rationale is particularly important because it is not uncommon for an engagement team to reach a tentative conclusion only to find that the logic falls apart once they attempt to document the rationale. If the logic falls apart, the engagement team knows it needs to go back and identify where in the judgment process they need to invest more time.

At KPMG, we work hard to help our people understand how to document and articulate all the relevant evidence obtained, including evidence that may contradict the ultimate conclusion. While gathering evidence, auditors will often find both confirming and disconfirming evidence (i.e., evidence that is consistent and evidence that is inconsistent with the final conclusion). The description of how the confirming evidence overcomes disconfirming evidence is very important in the rationale and documentation, and helps to show that appropriate professional skepticism was exercised. Client management, audit committee members, peer reviewers, and regulators should be able to understand the rationale that was used to reach the conclusion by referring to the audit documentation.

Carefully carrying out the five steps in the judgment process in KPMG's Professional Judgment Framework assists our auditors to properly and thoroughly document the evidence gathered and conclusions reached.

Factors to consider in accounting judgments

The role of judgment in the accounting and auditing professions is finding increasing emphasis. For example, the *Final Report of the Advisory Committee on the Improvements to the Financial Reporting to the United States Securities and Exchange Commission* (SEC 2008) suggested 11 factors to consider in evaluating the reasonableness of a financial statement preparer's accounting judgments. Those 11 factors can be used within a judgment process. The 11 factors are:

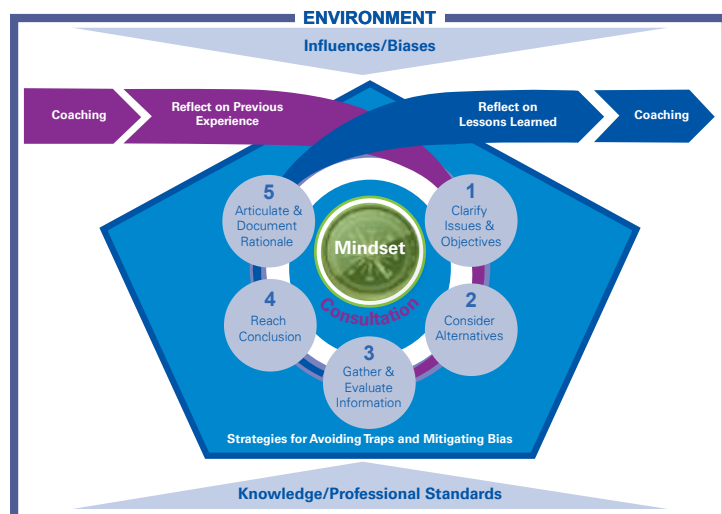
1. The preparer's analysis of the transaction, including the substance and business purpose of the transaction
2. The material facts reasonably available at the time that the financial statements are issued
3. The preparer's review and analysis of relevant literature, including the relevant underlying principles
4. The preparer's analysis of alternative views or estimates, including pros and cons for reasonable alternatives
5. The preparer's rationale for the choice selected, including reasons for the alternative or estimate selected and linkage of the rationale to investors' information needs and the judgments of competent external parties
6. Linkage of the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated
7. The level of input from people with an appropriate level of professional expertise
8. The preparer's consideration of known diversity in practice regarding the alternatives or estimates
9. The preparer's consistency of application of alternatives or estimates to similar transactions
10. The appropriateness and reliability of the assumptions and data used
11. The adequacy of the amount of time and effort spent to consider the judgment.

Summary

In this chapter, we covered many of the components of the KPMG Professional Judgment Framework, including the judgment environment and the steps in a judgment process. While the steps in the judgment process may seem quite simple and intuitive, you learned that people have a tendency not to follow such a process. One cause of ineffective judgments is that we fall into predictable judgment traps like judgment triggers and the rush to solve.

Remember that you don't need to formally use the Professional Judgment Framework for simple or easy decisions—such as what sort of jelly to put on your sandwich. Furthermore, for many “easy” judgments, the consideration of the judgment process can be applied quickly and some of the steps may not be important. Fortunately, for the vast majority of judgments, it does not take a lot of time to consider the Framework. The more important and difficult the judgment, the more likely it will be worth the investment in time and effort to more carefully apply the Framework, including the judgment process.

We will continue to discuss the KPMG Professional Judgment Framework in future chapters. In Chapters 3 and 4, we will discuss additional influences and biases depicted in the triangle at the top of the Framework as well as how to boost professional skepticism. In Chapter 5, we address the pentagon shape surrounding the judgment process, which encompasses strategies for avoiding judgment traps and mitigating bias. In Chapter 7, we discuss the coaching and reflection “ribbon” running through the judgment process.



End of chapter questions

(Select the best answer for the multiple choice questions)

1. What are the five steps in the judgment process?

2. What are two common judgment traps?

3. Within an auditing context, what is professional judgment?

- a. Professional judgment is the process of using relevant training, knowledge, and experience to reach a decision or draw a conclusion in evaluating evidence, estimating probabilities, or selecting between options.
- b. Professional judgment is professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- c. Professional judgment is the application of one's experience to make a judgment in the absence of supporting evidence, based on the facts and circumstances of the audit engagement.
- d. Professional judgment is the construction of a logical justification to support an outcome or conclusion that is otherwise not supported by the available evidence.

4. Which of the following best describes the relationship between professional skepticism and professional judgment?

- a. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence that is separate and apart from the process of exercising professional judgment.
- b. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence that is part of the process in forming professional judgments.
- c. Professional skepticism is synonymous with professional judgment.
- d. There is no relationship between professional skepticism and professional judgment.

5. Which of the following best describes a judgment trigger?

- a. An alternative stated in terms of a judgment objective
- b. A technique for making effective judgments quickly
- c. An issue/problem stated in terms of a particular alternative
- d. A technique for more effectively evaluating another's judgment

Chapter Three

Judgment framing: The stuff of professional skepticism

Professional skepticism refers to the ability of the auditor to approach issues in an objective, balanced way, with a questioning mind and an appropriate level of critical evaluation. Accordingly, it is important that you learn what professional skepticism is and how to develop and improve your own sense of professional skepticism. It is important to understand that professional skepticism does not mean that auditors should adopt a cynical attitude toward client management. To the contrary, professional standards indicate that auditors should neither assume that management is dishonest nor assume unquestioned honesty. Auditing standards define professional skepticism as “an attitude that includes a questioning mind and a critical assessment of audit evidence.”¹¹

Earlier in this monograph, we talked about how professional skepticism helps to frame the auditor’s mindset, which is at the center of the KPMG Professional Judgment Framework. If our mindset is aligned with the objectives of our profession and our duty to the public trust, our judgments are also likely to be appropriately aligned with those objectives.

Framing defined

At the core of 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.



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 we at KPMG refer to as a “fresh lens.” Sounds simple enough, but it is not always easy to do!

Mindset

Framing influences our **mindset**, which is at the center of the judgment process in the KPMG Professional Judgment Framework. The mindset of a professional auditor is one of objectivity and professional skepticism. But in terms of training or coaching staff auditors, simply telling them to “be professionally skeptical” is not as helpful as demonstrating what professional skepticism looks and sounds like. 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.

¹¹ AU 230.07–09, *Due Professional Care in the Performance of Work*.

The Center for Audit Quality (CAQ) indicates that “skepticism—a questioning mindset and an attitude that withholds judgment until evidence is adequate—promotes risk awareness and is inherently an enemy of fraud” in its 2010 report on Detering and Detecting Financial Reporting Fraud. The report lists the following characteristics of skepticism.

Six characteristics of skepticism

- Questioning Mind—A disposition to inquiry, with some sense of doubt
- Suspension of Judgment—Withholding judgment until appropriate evidence is obtained
- Search for Knowledge—A desire to investigate beyond the obvious, with a desire to corroborate
- Interpersonal Understanding—Recognition that people’s motivations and perceptions can lead them to provide biased or misleading information
- Autonomy—The self-direction, moral independence, and conviction to decide for oneself, rather than accepting the claims of others
- Self-Esteem—The self-confidence to resist persuasion and to challenge assumptions or conclusions

Summarized from Hurtt 2010.

Framing illustrated in nonaudit settings

Let’s provide a few quick illustrations of what we mean by judgment frames. The first is a video of a man in a store talking to a friend on his Bluetooth® ear bud about the cost of a construction bid. Click on the [link](#) to see the video. If the link doesn’t work, search on YouTube for “you are getting robbed.”¹² Come back to this point after you have watched the video.

What led to this outcome for the poor guy in the video? Different frames! The guy on the phone is reacting to a seemingly outrageous bid for a new deck. But the store owners’ frame is “there’s a man in our store who wants our money!” As this video illustrates, different frames can lead

to different understandings or interpretations of a situation, and these different understandings and interpretations will affect choices and behavior. Research shows that people’s willingness to take on risk depends on how a condition is framed. For example, doctors and patients tend to select riskier treatment options when a condition is framed in terms of the odds of dying than when the identical situation is framed in terms of the likelihood of surviving—same situation, but different frames.

Here’s another example—one study found that tax professionals tend to be more accepting of a client’s high-risk tax position when the underlying transaction is a “done deal” as compared to when the client has not yet completed the transaction. There was no difference in the transaction; however, the professionals either agreed or didn’t agree with the client’s position depending on the frame with which they viewed the transaction.¹³ This example can also apply to auditors—sometimes clients execute transactions and then inform the auditors of the accounting treatment rather than involving the audit team early in the process.

The point here is not to suggest that one frame is better than another, but rather that evaluating a situation from different perspectives usually results in better judgment. There often is no single “best frame.” But we can improve our judgment through the effective use of *multiple* frames. We need to be aware that we adopt a frame **any time** we make a judgment. To make effective use of multiple frames, we should work to identify and understand the frame that is being used either by us or by others. Our judgment improves as we consider alternative frames. Referring back to the medical treatment example, the best way to approach such a decision would be to think about the odds from *both* the survival *and* the mortality perspectives, and explicitly consider how our judgment is affected by the different frames.

Framing illustrated in audit settings

Framing and the evaluation of risk:

One area where auditors and their clients may have different perspectives is in the area of risk assessment. Client management will have perspectives on risk and risk management. It is important for auditors to understand management’s perspective, but auditors also need to be careful to consider alternative perspectives. In other words, if a particular client company is soundly outperforming the competition, or is trending up when others in the industry are

¹² The video is an Ameriquest advertisement.

¹³ See Spilker, Worsham, and Prawitt, 1999.

flat or trending down, it could be because the client really is stronger, faster, and smarter than the competition. However, there are alternative frames that should be considered. One is that it might just be “too good to be true.” For example, there was a time when the exceptional results of WorldCom and Enron, two companies that were engaged in massive accounting frauds, were explained in terms of the companies being better, smarter, faster, or part of a “new economy” trend. With hindsight, evidence to support an alternative perspective was available. The point is that when an auditor is evaluating management’s accounting treatment or estimates, he or she should *understand* management’s frame, but he or she should be careful not to adopt it too readily.

The role of framing in gathering and evaluating evidence:

Framing is also important in gathering and evaluating audit evidence. Research shows auditors’ information search and evaluation of evidence is significantly affected by the frame they adopt. If auditors initially frame an observed pattern as a potential error, their risk assessments and evidence accumulation approaches are substantially different from the approaches used by those who framed the pattern as simply reflecting a change in business conditions.¹⁴ 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. Again, 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.

Becoming and helping others become “frame-aware”:

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,

Practice insight

As an example of how frame blindness can affect judgments, suppose an audit firm was engaged to perform certain procedures as part of due diligence for an acquisition. The engagement team was asked to look at significant contracts and revenue recognition at the company being acquired. Revenues at the company being acquired, ABC Company, were recognized on a percentage of completion basis. ABC was being sold from a large multinational conglomerate. Client management had negotiated what they saw as a favorable purchase price and was excited about the revenue and diversification ABC Company would bring to the combined business.

The engagement team found no significant issues with controls over the contracting and percentage of completion processes, but the partner had the team analyze the history of contract performance for the prior three years. The analysis revealed that actual margins were, on average, over 25 percent *lower* than planned margins. This difference was significant enough that if the problem was pervasive, it could materially affect ABC Company’s revenue recognition and overall profitability, post-acquisition.

The engagement partner raised concerns regarding revenue recognition and margins on in-process projects with client management and recommended additional testing. However, management’s frame was that the acquisition was too important to pass by, and rather than approving additional testing, they closed the deal. Unfortunately, not long after the acquisition was final, management discovered that the acquired company had materially misstated revenue and margins. In fact, many of the projects actually experienced *negative* margins. The resulting liquidity problems at ABC Company ultimately contributed to the company that purchased ABC Company having to file for bankruptcy.

this is an area where auditors entering the profession typically need improvement.

¹⁴ For example, see Libby 1985, Kinney and Haynes 1990, Ayers and Kaplan 1993, Asare and Wright 2003.

Understanding the big picture

Framing can also help us understand the “big picture” of what we’re working on as auditors. Understanding and effectively managing frames can improve job satisfaction and result in better effort and better judgments. There’s an old story that illustrates this point. A traveler to a European city comes across a man carrying a load of bricks and asks him what he’s doing. The man replies, “I’m carrying bricks.” A little further, the traveler comes across another person carrying bricks. In response to the same question, this worker smiles and says, “I’m helping to build a cathedral.” Both people were doing the same task, but the perspective they took clearly made a big difference in how they viewed the task and the satisfaction they felt in doing their work. In performing audit tasks, we may not be building a cathedral, but when we understand how important our role is to the engagement, to the firm, and to the public, the tasks we are asked to perform are more meaningful and we are likely to do a better job.

Fresh lens

Finally, let’s think about framing and reframing as it relates to the selection of audit procedures and the nature of audit evidence. It is important to periodically evaluate the nature, timing, and extent of audit procedures so as to adequately address variations in the client’s business or industry and in the overall economy. Taking the time to look at how we approach our audits through a “fresh lens” provides opportunities to improve upon the effectiveness and efficiency of our work. This means considering issues for the next audit immediately after signing off on the current audit. It means getting on top of key issues early and eliminating unnecessary or redundant testing. It means gaining a deeper understanding of our clients’ businesses so that we can obtain better audit evidence more efficiently.

For important issues, it’s worth the effort to become aware of the frame we’re using, and then to consider alternative frames. Our natural tendency is to become increasingly “stuck” in an adopted frame. It takes effort and focus to become aware of the frame we are using and then to consider the issue from different perspectives.

Practice insight

An engagement manager challenged the audit team’s previous frame that testing revenue had to be done largely through detailed testing of a sample of individual sales. The manager determined that the team could replace much of the detail testing with a highly effective and efficient substantive analytical procedure. The substantive analytical procedure developed by the manager gave the audit team a “big picture” view of what was happening with the client’s revenues. In other words, the procedure allowed the team to view the “whole forest” as opposed to trying to see the forest based on a detailed examination of a sample of the individual trees in the forest. In the end, by shifting frames and using a substantive analytical approach to replace some of the detailed testing, the engagement team was able to obtain arguably more effective audit evidence in fewer hours, to the benefit of the overall engagement.

How do I learn to “reframe”?

This is an involved topic and there’s much that can be learned, but let’s discuss briefly some ways in which we can go about reframing a situation in order to enhance our professional skepticism and improve our judgment.

Understand your current frame and its sources:

First, we have to recognize and understand the frame we are currently using, and where it is coming from. This is not easy! One way to do this is to identify the analogies or metaphors you might be applying. You may have heard of the phrase “the war on drugs.” In an effort to change the nation’s approach to the drug problem, when General Barry McCaffrey became the nation’s “Drug Czar” a number of years ago, one of the first things he did was to change the metaphor from “the war on drugs” to “drugs are a cancer on our nation.” Think of the implications—if the drug problem is a “war,” we will send soldiers to the border; we will use force to attack and arrest. If it is a sickness, we will tend to treat addicts and look for preventative measures at the individual level. Again, the point is not that one frame is necessarily better than the other, but rather that the two metaphors point to very different perspectives *and actions*.

Challenge the current frame—Seek others’ opinions, welcome diversity:

This is one of the more difficult aspects of reframing. It refers to the need to *challenge* our current frame. To do this, you might ask yourself how you would *normally* approach a situation, ask *why*, and then see if you can look at the problem a different way. Another approach is to enlist the help of someone who tends to see things differently than you do. This is *not* our natural tendency—we all tend to seek confirming opinions. For example, consider a business manager who decided to obtain additional training by enrolling in a night MBA program that would allow him to continue to work in his current full-time job while going to school. As he approached the end of his MBA program, the business manager wanted to find a situation where he could more fully apply his newly acquired knowledge and skills, but at the same time, he appreciated his position at his current employer. In an effort to get an entirely different, fresh perspective on his decision to leave his employer and what kind of job to look for, he approached his 13-year-old daughter. After listening to what her father wanted to accomplish and his reasons for leaving his current employer, his daughter asked, “Why don’t you just figure out how to do what you want to do where you work now?” At first his daughter’s question seemed silly to him, but that simple question got him thinking about his situation differently; it gave him a new frame with which to consider the issue. In the end, he approached his boss with a proposal to create a new position that allowed him to apply his new skills in creative ways, resulting in a real win-win situation for both him and his employer.

Consider alternative metaphors:

We can also challenge our current frame by considering alternative analogies or metaphors. People often use sports metaphors like “this investment is a slam dunk.” You’ll notice that implicit in that statement is an analogy to basketball, and even a particular type of basketball shot. We can often challenge our frame by looking at the situation using a totally different metaphor, like we illustrated with the two drug analogies—where the drug problem can be seen as either a war on drugs or a cancer on the nation. In this situation, you might consider whether your perspective on the investment

you’re considering would change if you were to think of it as a three-point shot or as “swinging for the fences.” Analogies are often useful, but it’s important to recognize that they also often act as powerful judgment frames.

Generate alternative frames and consider how the judgment differs when viewed from different perspectives:

Finally, we need to identify and evaluate what issues might look like using *alternative* frames. As part of this, we should consider the *implications* of different frames. As we noted earlier, there is often no single “best” frame to use, but we almost always get a deeper, more complete understanding when we evaluate an issue through multiple frames. This can have very important practical implications. In the United States, for example, one has to “opt in” to become an organ donor, while in other countries, one has to “opt out.” Same decision, but framing donation as the default action results in much higher donor rates.

Challenging and proactively considering issues using different judgment frames is something that takes effort and practice, but it’s well worth it. The better you are at reframing judgments, the better you will be at identifying and understanding issues, objectives, and potential alternatives. In addition, you’ll be more effective at appropriately challenging management’s existing frames, *which is the essence of professional skepticism*. Learning to recognize, challenge, and use different judgment frames is a fundamental life skill and a key characteristic that can set you apart as a true professional.

“Another approach is to enlist the help of someone who tends to see things differently than you do.”

End of chapter questions

(Select the best answer for the multiple choice questions)

1. What is fundamental to exercising professional skepticism?

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

3. What role do metaphors and analogies play in judgment framing, and how can they be used to improve your ability to examine issues through multiple frames?

4. Which of the following statements about judgment frames is correct?

- a. A situation cannot have more than one appropriate frame.
- b. There is often no single best frame for a given situation.

c. Frames are not used by risk averse individuals.

d. Professionals should eliminate the use of frames from their judgment processes.

5. Which of the following is not a step in reframing a situation?

- a. Challenge the current frame
- b. Generate alternative frames
- c. Justify the current frame
- d. Understand the current frame



Chapter Four

It's a fact: Your typical judgment processes can lead to bias



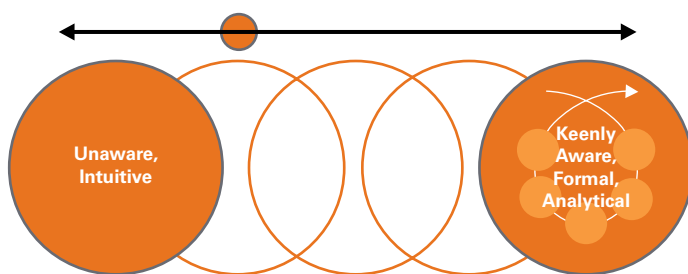
As we indicated in earlier chapters, we developed the KPMG Professional Judgment Framework and related training to enhance the professional judgment skills of our auditors. Earlier chapters addressed the steps involved in exercising judgment and how proactively managing judgment frames can boost professional skepticism. Auditors are regularly charged with making challenging judgments in an environment characterized by complexities and pressures. In such an environment, where both efficiency and effectiveness are at a premium, it is important that professionals understand not only what is involved in a judgment process but also where they are vulnerable to judgment pitfalls and biases. In previous chapters, we have discussed some of the common pitfalls that can derail a judgment process. In this chapter, we discuss judgment tendencies that can predictably and systematically affect the judgment of audit professionals. Research has identified a number of common tendencies that can lead to biased judgment. In this chapter, we focus on four such tendencies and the related biases that we have determined are of primary relevance to auditor judgment.

continuum. When we are operating on the right side of the continuum, we are keenly aware of the judgment we are making and we are consciously applying the steps of a judgment process. On the left side, we are less consciously aware of the detailed aspects of the judgment; we are using our subconscious or intuitive judgment processes. For most day-to-day judgments, people tend to operate between the extremes, but often toward the left side. Understanding where we tend to take judgment shortcuts and where our motives can subconsciously affect us can help us identify when the quality of our judgments can be affected by systematic bias, and when it is most important to engage in formal, conscious thought about the judgment process.

Judgment shortcuts that can lead to bias

Your judgment can be unintentionally biased due to underlying self-interest or because you 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.

Judgment Continuum



A judgment continuum: Intuitive to formal

A formal process like that depicted in KPMG's Professional Judgment Framework is an approach that provides a model of important steps we believe one should consider in making judgments. However, the tendencies or shortcuts we'll talk about are descriptions of tendencies we frequently, but unconsciously, use to simplify judgments. The exhibit above illustrates a judgment awareness

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.

In this chapter, rather than focusing on how we *should* make judgments and decisions, we will explore how we often *actually* make decisions. By doing so, we can identify limitations in our judgment processes as well as methods to mitigate bias and improve judgment. We will be covering four common tendencies that are most applicable and important for audit professionals. The four common tendencies are:

- The availability tendency
- The confirmation tendency
- The overconfidence tendency
- The anchoring tendency.

Our purpose is to illustrate that the tendencies are common and that the related biases affect all of us.

The availability tendency

The *availability* tendency¹⁵ 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.

As a quick illustration, briefly consider the following question: *Which of the following do you believe causes more deaths in the United States?*

- Shark attack*
- Being struck by an object falling from an airplane*

Most Americans believe shark attacks cause more deaths. However, falling airplane parts kill 30 times more people!¹⁶ Why the error in judgment? When a fatal shark attack occurs, it is covered extensively in the media and may also cause us to imagine the scene, thereby forming vivid, lasting, readily available memories. Some of us have vivid, lasting memories from the movie *Jaws*, for example. The point is that shark attacks are easier to imagine, and so people tend to attach a higher likelihood to them, even though in reality, they are not very common at all.

Is any news “good” news?

Here’s an example of how the availability tendency can influence a business decision. A purchasing agent selects a particular vendor because the company’s name is familiar. Without realizing it, the name recognition is associated with the belief that the vendor is bigger or better than the others on the list. Unfortunately, the name recognition may not be due to the company’s reputation, but rather due to a recent story in the news reporting on unethical and illegal practices by the vendor.

Availability and performance evaluation:

Let’s illustrate the availability tendency in the context of evaluating an auditor’s performance. Click on the link below to hear a vignette involving a conversation between a partner and a senior manager about the performance of a senior associate. In the first part of the dialogue, the senior manager is finalizing an engagement review for a senior associate when she receives some salient feedback from the engagement partner about the senior’s performance. In the second part of the vignette, you’ll hear the senior manager speaking with another KPMG manager about the performance evaluation of the senior associate. As you listen, see if you can identify how the availability tendency



¹⁵ See Tversky and Kahneman, 1974.

¹⁶ Adapted from Plous, 1993.

introduces bias into the performance evaluation process. As you heard in this vignette, the senior manager is completing an engagement review and gets some rather salient feedback from the partner. It appears that this highly “available” feedback skewed the senior manager’s evaluation of the senior associate’s performance upward. Of course, in a similar fashion, negative feedback or a mistake close to when the evaluation is being made can lead to a negative bias.

Selecting an audit approach:

The availability tendency can also affect the selection of audit procedures. 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. As an example, client management had to decide how to appropriately account for costs relating to the development of content to be provided on the Internet. Neither management nor the engagement team could find directly applicable authoritative guidance on the appropriate accounting treatment. Management, after consulting with the engagement team, ended up analogizing the situation to development costs for internal-use software. At first, management’s approach seemed reasonable to the engagement partner, who had recently seen this accounting treatment applied on another engagement in a different situation. However, after consulting with the engagement quality control review partner, who was able to provide a “fresh lens” perspective, the team determined that a better analogy in this situation was to account for the costs similar to the development of software to be sold or licensed to third parties. The engagement team initially may have been influenced by the approach that was most “available” since they had recently seen an appropriate application of the internal-use analogy at another client that faced different circumstances.

The confirmation tendency

The *confirmation* tendency¹⁷ 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.

Effects of the confirmation tendency in professional settings:

This tendency has been demonstrated in a number of professional settings. One study published in a leading accounting research journal demonstrated that experienced tax professionals could come to the wrong decision by searching for confirming information.¹⁸ The tax professionals in the study were provided with management’s preferred tax treatment. All of the professionals in the study had access to the same database of legal cases. The researchers found that in searching for legal precedents, tax professionals tended to seek out cases that were consistent with management’s preferred tax position over cases that went against that position. They also placed more weight on the confirming cases, even though these cases were no more relevant to the fact pattern than were the other cases. The confirmation bias also affected the tax professionals’ assessments of the likelihood that, if taken to court, the court would rule in the company’s favor. The bottom line is that management’s preference biased the tax professionals’ search and evaluation processes, leading to biased recommendations.

The confirmation tendency also can bias judgments made in conducting substantive analytical procedures. 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.¹⁹ Examination of audit files by regulators and research also shows that in certain circumstances, auditors may sometimes overrely on weak analytical procedures. This tends to happen when a weak analytic shows little or no difference from the prior year. In conducting analytical procedures, some staff auditors may have a natural preference to find no significant difference between the expectation and the client’s recorded value because it means no more audit work is necessary on

¹⁷ See Gilovich, 1991, and Wason, 1960.

¹⁸ See Cloyd and Spilker, 1999.

¹⁹ Glover, Jambalvo, and Kennedy, 2000.



that step. But of course weak evidence is weak, regardless of the outcome. Interestingly, if the very same weak analytical procedure produces a significant difference or in other words “disconfirmatory” evidence, auditors are able to point out the weaknesses in the expectation and procedures.²⁰

An audio vignette:

Click on the link to the right and listen to another vignette, this time between a client CFO and an audit senior manager. Listen carefully and try to identify where the confirmation tendency might come into play in such a situation.



It looks like the auditor will go with the client’s analysis in this scenario. Click on this next link to hear how this situation turns out:



This dialogue illustrates a number of potential judgment traps and biases that an engagement team might be vulnerable to in such a setting. First, consistent with the confirmation tendency, the senior manager appears to have relied too heavily on management’s analysis without adequately questioning the underlying assumptions. Although double-checking the numbers in management’s analysis is important, this step does not do anything to question whether management’s

analysis has left out any important considerations. Further, the fact that management came to the same conclusion using three different estimation approaches seemed to heavily influence the auditor. Second, the senior manager appears to have skipped the initial steps in the judgment process in the KPMG Professional Judgment Framework. Instead of carefully thinking through the nature of the issue and clarifying the objectives, he skipped ahead to evaluating the alternative provided by management.

KPMG engagement teams are mindful that they will sometimes encounter disconfirming evidence and that such evidence is to be considered within the context of the broad array of evidence collected. Audit documentation that describes how disconfirmatory evidence was considered and how it fits within the context of the broad array of evidence and judgments leading to a final conclusion demonstrates an objective mindset and the application of professional skepticism.

The overconfidence tendency

The *overconfidence* tendency²¹ 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

²⁰ Glover, Prawitt, and Wilks, 2005.

²¹ See Alpert and Raiffa 1982.

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.

Extreme overconfidence in history:

Consider the following quote: “Heavier than air flying machines are impossible.” This statement was made by Lord Kelvin, a highly respected British mathematician and physicist in the 1890s, just a few years before the Wright brothers showed the world such machines could fly at Kitty Hawk, NC. Here’s another historical example of overconfidence: “They couldn’t hit an elephant at this dist—.” These are the last words uttered by John B. Sedgwick, a Union Army General, before he was killed by a musket ball fired by the Confederate opposition during the Civil War.

Overconfidence in professional practice:

Research indicates that many people, including very experienced professionals, are consistently overconfident when attempting to estimate outcomes or likelihoods. For example, when Harvard MBAs, business managers, and physicians are asked to provide ranges around estimates that they are highly confident contain the true value of the item they are estimating, confidence in their estimates was misplaced. For example, in one study when doctors were asked to assess the likelihood of pneumonia, they were highly confident that they would be wrong only about 20 percent of the time. Instead, they were wrong over 80 percent of the time.²²

Similarly, 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.²³

Unchecked, overconfidence by auditors clearly can lead to suboptimal outcomes. Once we are aware that it is a human tendency to be overconfident about one’s abilities, including the ability to make estimates and to assess probabilities, we can take steps to mitigate the potentially negative effects of this tendency. We’ll discuss some of those steps in the next chapter.

The anchoring tendency

The last judgment tendency we address in this monograph is the *anchoring* tendency,²⁴ which 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 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.

Anchoring illustrated with real estate appraisers:

One interesting example of the power of the anchoring tendency involves research with professional real estate appraisers. Researchers investigated the effect of an anchor on appraisers’ property pricing judgments. For example, appraisers were asked to develop an independent appraisal on a property. They were told the seller’s asking price, but it was emphasized that their task was to develop an independent and objective appraisal. Researchers found that the asking price had a significant effect on the appraisers’ estimates. Appraisers provided with a higher asking price produced higher “independent” estimates than appraisers provided with a lower asking price... for the same house.²⁵

To further illustrate this tendency, consider the following questions.²⁶

²² See Russo and Schoemaker, 2002.

²³ For example, see Kennedy and Peecher, 1997.

²⁴ See Tversky and Kahneman, 1974.

²⁵ For example, see Northcraft and Neale, 1987; Black, 1997.

²⁶ Adapted from Joyce and Biddle, 1981.

What is your estimate of the prevalence of executive-level management fraud?

- A.** Is the incidence of significant executive-level management fraud more than 10 in each 1,000 firms audited by Big Four accounting firms (circle one)?
1. Yes, more than 10 in each 1,000 Big Four audit clients have significant executive-level management fraud.
 2. No, fewer than 10 in each 1,000 Big Four audit clients have significant executive-level management fraud.
- B.** What is your estimate of the number of Big Four audit clients per 1,000 that have significant executive-level management fraud (fill in the blank)?
_____ in each 1,000 Big Four audit clients have significant executive-level management fraud.

Now, if we change the question as noted below, do you think it will influence the estimate?

What is your estimate of the prevalence of executive-level management fraud?

- A.** Is the incidence of significant executive-level management fraud more than 200 in each 1,000 firms audited by Big Four accounting firms (circle one)?
1. Yes, more than 200 in each 1,000 Big Four audit clients have significant executive-level management fraud.
 2. No, fewer than 200 in each 1,000 Big Four audit clients have significant executive-level management fraud.
- B.** What is your estimate of the number of Big Four audit clients per 1,000 that have significant executive-level management fraud (fill in the blank)?
_____ in each 1,000 Big Four audit clients have significant executive-level management fraud.

You can see that the only difference between the two versions is the irrelevant threshold in the first part of the question— part A in the first version asks the reader to indicate above or below 10, whereas the second version asks the reader to indicate above or below 200. However, this 10/200 threshold has nothing to do with the ultimate judgment, which is the best estimate of the number of Big Four audit clients that have significant executive-level management fraud. In other words, should the best estimate in the second part depend on the arbitrary numerical thresholds in the first part?

When executives were asked to estimate the prevalence of management-level fraud, the following results were noted:

Influence of the Anchor

Executives' estimates of management fraud:

- Version with arbitrary anchor of 10, estimate 47
- Version with arbitrary anchor of 200, estimate 130

So, one may conclude that business executives are influenced by the arbitrary numbers used as thresholds in the first part of the question. What about professional auditors? Would they have this bias in an audit context? Industry expertise does influence the overall judgment, but it does not remove the bias associated with anchoring on the initial value. The auditor results are as follows:

Influence of the Anchor

Auditors' estimates of management fraud:

- Version with arbitrary anchor of 10, estimate 17
- Version with arbitrary anchor of 200, estimate 43

While the auditors' estimates are lower, it is clear their estimates were also influenced by the arbitrary anchor or initial value. The initial value, or starting point, may be suggested from historical precedent, from the way in which a problem is presented, or from random information.

Anchoring in auditing:

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.²⁷

Anchoring effects are pervasive:

You can imagine how pervasive anchoring effects are when you start thinking about the potential effect of this tendency on a fee or salary negotiation, when a low or high starting figure is thrown out. You can bet that expert negotiators know this source of bias very well, and often use it to their

²⁷ See Kinney and Uecker, 1982, and Wild and Biggs, 1990.



advantage. This tendency is powerful and pervasive. If you are unaware of it, you are not only very likely subject to bias but you are also vulnerable to possible manipulation by others.

The illustrations of the anchoring tendency point to a potentially important area to watch in auditing because one common analytical procedure is to compare last year's balances to this year's preaudited balances. The potential problem is that after seeing the preaudited numbers in comparison to prior years, the tendency is to consider the current-year trends and fluctuations as expected and explicable. In other words, the fluctuations between current year and prior year may not seem too unusual to the auditor. If, on the other hand, the auditor were to first develop an expectation for what the current year's preaudited balances should be, they would be more likely to identify unusual fluctuations.

Think back to the audio vignette on confirmation—anchoring was also present:

One last note on the anchoring tendency. Think back to the vignette you listened to, where management had an initial estimate of \$10 million for the contingent liability associated with the plant explosion. We used that example to demonstrate the confirmation bias as the engagement team primarily focused on the evidence supporting management's analysis. However, the engagement team may have been influenced by the anchor of management's initial \$10 million estimate. Recall that the auditors did propose that management increase the liability estimate to \$12 million, which represented an upward adjustment from the starting point. But ultimately in this situation the liability turned out to be \$24 million. That vignette illustrates the effect of the anchoring and adjustment tendency as the auditor's recommended adjustment away from

management's estimate was insufficient, a hallmark of the anchoring tendency.

Availability, confirmation, overconfidence, and anchoring and the KPMG Professional Judgment Framework

Let's summarize the four tendencies we have covered in this chapter in terms of how they relate to the KPMG Professional Judgment Framework and the process for judgment found in the Framework. It is helpful to know at what points in the judgment process we might be vulnerable to the biases brought on by these pervasive tendencies. Once we are aware of the tendencies and where we are vulnerable, we can take steps to mitigate their effects, which is the topic of the next chapter. **Appendix 1** provides a summary of where these tendencies affect the KPMG Professional Judgment Framework.

Availability:

Availability comes into play in several places in the KPMG Professional Judgment Framework. Note that it is included in the set of potential biasing influences in the inverted triangle at the top of the Framework. In terms of the steps in the judgment process, the availability tendency can have particular influence on Steps 2 and 3—consider alternatives and gather and evaluate evidence. The availability tendency limits alternatives considered or evidence gathered to those alternatives or that evidence that readily comes to mind. Similarly, the availability tendency can affect risk and likelihood assessments when evaluating evidence.

Confirmation:

The confirmation tendency primarily affects Steps 3 and 4 of the judgment process at the center of the KPMG Professional Judgment Framework. Our tendency is to seek

and overweight confirming information in the information gathering and evaluation steps, and to favor conclusions that are consistent with our initial beliefs or preferences.

Overconfidence:

So what’s so bad about overconfidence? Some suggest that a touch of overconfidence may be helpful in not getting bogged down or falling prey to “paralysis by analysis.” On the other hand, in some cases, overconfidence can detrimentally affect important judgments. It can lead to suboptimal behavior in every step of the judgment process. For example, overconfidence can lead to underinvesting in clarifying issues and objectives, considering too few alternatives, truncating the information search, or skipping evidence gathering altogether. It can also lead to taking on too many projects, overpromising on deadlines, and reaching ill-considered snap judgments. In sum, overconfidence can result in avoiding or poorly executing a sound judgment process at every step.

Anchoring:

The anchoring tendency primarily affects us in Step 3 of the judgment process, as we gather and evaluate information, and as we use that information to reach a conclusion in Step 4. In gathering and evaluating information, human nature is to anchor on an initial value and adjust insufficiently away from that value in making our final assessments of what the value should be. This tendency is particularly important for auditors to recognize when auditing amounts recorded by management.

Okay, what do we do about these tendencies and biases?

The judgment tendencies and associated biases we’ve talked about in this chapter are availability, confirmation, overconfidence, and anchoring. There are a number of other important and interesting judgment tendencies and biases, but these are four of the most researched tendencies that are particularly relevant to auditing and auditors. In the next chapter, we will discuss approaches for mitigating these tendencies and associated biases.



End of chapter questions

(Select the best answer for the multiple choice questions)

- 1. Describe the availability tendency in your own words, and give an example of how the tendency could result in auditor bias.**
- 2. Describe the confirmation tendency in your own words, and give an example of how the tendency could result in auditor bias.**
- 3. Which of the following is an example of the confirmation bias?**
 - a. An auditor improperly concludes on a complex revenue recognition matter without having the appropriate technical accounting background.
 - b. An auditor improperly concludes on the valuation of an investment security by looking at only the most recent sale of the security.
 - c. An auditor improperly concludes on the accounts receivable balance because negative confirmations were sent instead of positive confirmations.
 - d. An auditor improperly concludes a contingent liability is properly stated after examining only the evidence that supported the amount accrued in the financial statements.
- 4. What tendency is most likely manifest in the following situation? An engagement team performed a substantive analytical procedure over an expense account. When investigating a significant difference, the team was satisfied with limited evidence to support the client's plausible explanation (which was in fact incomplete) for the difference.**
 - a. Confirmation tendency
 - b. Limited resources
 - c. Overconfidence tendency
 - d. Time pressure
- 5. The confirmation bias is a subconscious tendency to do which of the following?**
 - a. Seek evidence that confirms a biased judgment
 - b. Seek evidence that confirms a previously held view
 - c. Underutilize confirmations in the testing of accounts receivable
 - d. Seek evidence that disconfirms a previously held view
- 6. Which of the following is true with respect to the overconfidence bias?**
 - a. Overconfidence is always a conscious bias.
 - b. Overconfidence could result in the consideration of too many alternatives.
 - c. Overconfidence usually decreases with experience.
 - d. Overconfidence could result in engagement team members performing audit procedures that are beyond their skill sets.
- 7. Which of the following describes how the availability tendency is most likely to affect auditors?**
 - a. Auditors may first consider different potential causes for an observed fluctuation before seeking the client's explanation with regard to analytical procedures.
 - b. Auditors may rely on information provided by client staff who is most knowledgeable about an audit area rather than the staff most easily accessible.
 - c. Auditors may seek evidence that supports their belief of how a transaction should be accounted for.
 - d. Auditors may weigh more heavily the information that was received most recently from a client relative to information received earlier during the audit.

Chapter Five

Give me hope: How to recognize and reduce judgment bias



Most people find it interesting to learn about judgment biases. Experienced auditors are often quick to acknowledge that the biases we discussed in Chapter 4 do in fact influence actual auditor judgments. Our audit professionals find it very helpful to have a shared framework and a common vocabulary for a judgment process, together with the ability to recognize and identify the traps and biases that threaten good judgment. This shared framework facilitates communication, training, coaching, and mentoring.

At the same time, it can be a bit disconcerting at first to know that the judgment tendencies and related biases are a common aspect of human nature. If the tendencies we've discussed are simply a part of the way people commonly make judgments, is there hope that we can actually reduce the effects of these biases in our own judgment and in the judgment of others?

This is clearly an important question to consider. The answer is, although we might never eliminate these tendencies from our judgment processes, by understanding the nature of the shortcuts and other natural tendencies related to self-interest, we can recognize situations where our judgments can be biased. This recognition in turn enables us to take logical, intuitive steps to avoid judgment traps and mitigate the effects of judgment biases. Of course, this takes practice and experience. But when they are armed with awareness and understanding of these traps and biases, auditors can improve the quality of their professional judgments. In this chapter, we will share some common sense approaches for mitigating judgment biases.

Mitigating Biases and Judgment Traps

AWARENESS!



Awareness

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. As with other areas in life we are trying to improve, we first need to become aware and to acknowledge that each of us is subject to bias in our judgments.

In Chapter 1, we showed you an optical illusion featuring two tabletops. Our visual processes incorrectly tell us that the tabletops are different shapes. Once we are made aware of the misperception, we can introduce logical tools to help determine whether the tabletops are different or whether they are in fact identically shaped. A logical mitigation strategy might be to measure the two tabletops or trace one tabletop and lay the traced area over the top of the other table.

As another quick example, visit this [link](#) (or search on the internet for "motion induced blindness"). This site illustrates how our visual processes can lead to bias, and how we can mitigate the bias with some logic and effort.

As the Web site explains, you'll see a rotating array of blue crosses and three yellow dots. The site asks you to fixate on the center (watching the flashing green spot). If you do this, the yellow dots disappear, sometimes singly, in pairs, or all three at once. But in reality, the three yellow dots are continuously present. If you want convincing evidence that each yellow dot is not disappearing, or if you wish to take a common sense approach to mitigating the perceptual bias, you can focus on each yellow dot one at a time. If you do, you'll find that they don't disappear at all.

As with these optical illusions, we each need to acknowledge our susceptibility to judgment traps and biases. Once we are aware of the pitfalls and biases we are vulnerable to, the strategies to mitigate the effects of these judgment traps and biases are fairly logical.

Mitigating bias due to the availability tendency

Let's talk about some techniques specific to mitigating biases associated with the availability tendency. Recall that the availability tendency causes us to consider information that is relatively easy to retrieve from memory as being more likely, more relevant, and more important for a judgment.

In the chart below, we have listed some practical ways to mitigate the biases that can result from the availability tendency.

Mitigating Bias Caused by the Availability Tendency

- Awareness
- Consider why something comes to mind:
 - Vividness
 - Recent events
- Make the opposing case
- Consult with others
- Obtain and consider objective data

Awareness:

As we indicated above, *awareness* is the first step. Once we understand what the availability tendency is, we can be on the lookout for where it is likely to impact our judgment and we can formulate logical, intuitive ways to protect against the resulting traps or biases.

Consider *why something comes to mind*:

Once we become aware, we can consider how our memory might be influencing judgment. Before acting on

memory, think about *why* your thoughts came to mind. Are you focusing too much on cases that are vivid or unusual or relatively recent, rather than on more common occurrences? This can help debias your assessments or likelihood judgments of risks.

Make the opposing case:

Actively questioning our assumptions, which might include considering potentially disconfirming evidence or seeking more complete information, is key in mitigating judgment biases. Consider the performance evaluation audio/video we discussed in Chapter 4 (see page 23). Carefully thinking through all aspects of the senior's performance could have helped the senior manager avoid placing too much weight on the partner's comment at the end of the engagement.

Consult with others:

Outside perspectives can go a long way toward mitigating the effects of the availability tendency. As an example, 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.

Obtain and consider objective data:

In particularly important cases, it might be worth bringing to bear some hard data on likelihoods or probabilities, rather than relying solely on memory, the fallibility of which is the source of the availability tendency.

Mitigating the other tendencies

To illustrate approaches for mitigating the other biases, we ask you to consider some "knowledge checks" that will allow you to practice linking judgment situations to the shortcuts or tendencies that may lead to bias.

Knowledge check question:

You have been asked to lead a team in considering new office space to lease. The preliminary search has revealed various suitable locations, including one in a building and location you have always liked. **In gathering information, what is the most prevalent bias or trap?**

A. Anchoring

B. Confirmation

C. Overconfidence

D. Seeking too much information

Please take a few moments to respond to the question above before reading ahead.

If you selected the confirmation tendency, you are correct.²⁸ When gathering information on office space to lease, even if we don't mean to, we tend to search for information that supports our early preference, and we will weight confirming information more heavily than similar positive information supporting the other locations.

When we fall into the confirmation trap, we seek confirming evidence and often discount, misinterpret, and even make up evidence via memory reconstruction. In view of the fact that the primary responsibility of an auditor is to render an opinion on the financial statements taken as a whole, which encompasses gathering sufficient appropriate audit evidence to support management's assertions, estimates, account balances, and disclosures, it is easy to imagine just how many audit judgments can be influenced by the confirmation tendency. In the vast majority of cases, management will produce information in support of their own accounting choices, estimates, or disclosures. Most of the time, management's supporting information as well as the accounting choice, estimate, or disclosure may very well be appropriate. However, if the auditor simply audits management's supporting materials without considering potentially disconfirming information that comes to his or her attention, he or she can quickly fall into the trap of not exhibiting adequate professional skepticism in his or her evaluation of management's positions.

How might we mitigate the effects of this tendency? In other words, what are some common sense debiasing techniques we might use?

The chart below highlights some practical ways to mitigate the biases that can result from the confirmation tendency.

Mitigating Bias Caused by the Confirmation Tendency

- Awareness
- Make the opposing case and consider alternative explanations
- Consider disconfirming or conflicting information

Awareness:

Awareness of judgment conditions when we are likely to be impacted by the confirmation tendency is key if we want to develop useful mitigation techniques. Such conditions are characterized by a situation when we have

an initial preference or belief, or when we are dealing with others who have a preference or belief that may influence our judgment. Of course awareness alone is not enough. We also need to explicitly recognize and consider our preferences and motives, and we need to acknowledge that our judgment is susceptible to the confirmation tendency.

Make the opposing case and consider alternative explanations:

As we noted above, making the opposing case is perhaps the most universal of the mitigation techniques. We can improve our professional skepticism and the quality of audit evidence by taking a few moments to consider whether there may be alternative explanations for observed relationships. For example, it is common for there to be more than one cause for an observed accounting fluctuation, possibly including offsetting factors.

Consider disconfirming or conflicting information:

In an effort to overcome the confirmation tendency, we can explicitly consider where we have encountered disconfirming or conflicting information that has come to our attention. The auditor's typical search for unrecorded liabilities is a good example of explicitly considering disconfirming evidence. Rather than simply verifying the validity of balances recorded in accounts payable at year-end (i.e., confirming evidence), the auditor considers a separate population—subsequent cash disbursements—that can potentially disconfirm that the payable balance is completely and accurately stated.

In other judgment and decision tasks, a helpful approach is to ask others to gather and evaluate information without revealing our preference. (We do not want to reveal our preference because it 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.

Two important steps to mitigate biases we have discussed so far are (1) an awareness of when and how our judgment can be biased and (2) making the opposing case or considering alternative explanations. You may have noticed that we suggested these mitigating steps for the availability bias as well. In fact, these two elements are in some form important to mitigating all the biases we discussed in Chapter 4.

²⁸ Following is why each of the other answers is not the best answer for the scenario above.

A. Anchoring: There are no numerical anchors in the scenario.

C. Overconfidence: While overconfidence may come into play, the question asks about gathering information and the tendency will be for the decision maker to seek information that supports his or her initial preference.

D. Seeking too much information: The decision maker's tendency will be to seek confirming information rather than too much information.



Consider another one of the common judgment tendencies by answering the following question:

Knowledge check question:

The building contractor that you hired to complete your kitchen remodel tells you that he is certain that your kitchen will be completed by the agreed-upon date.

What is the most prevalent bias or trap the builder is subject to?

A. Availability

B. Confirmation

C. Overconfidence

D. Judgment trigger

Please take a few moments to respond to the question above before reading ahead.

If you said the builder is likely to suffer from the overconfidence bias, you are correct.²⁹ How can we mitigate our tendency or the tendency in others to be overconfident in our assessment of a likelihood or decision? The chart below lists some common sense ideas.

Mitigating Bias Caused by the Overconfidence Tendency

- Awareness
- Challenge expert or advisor's estimates
 - Ask about potential causes of unexpected outcomes
 - Ask for estimates or likelihoods of unexpected outcomes
- Challenge extremely high or low estimates
- Challenge underlying assumptions behind the estimates

Awareness:

Again, awareness is a key factor. We cannot develop logical, intuitive ways to mitigate the effects of judgment biases if we are not aware of the biases and the situations in which we are vulnerable to them.

Challenge expert's or advisor's estimates and underlying assumptions, including extremely high or low estimates:

This technique is particularly applicable when auditing an accounting estimate. For example, assume that an audit client, which is involved in the magnesium mining industry, is responsible for the cleanup of an environmental contamination site. The company's management uses an independent expert to assist in formulating the cleanup plan and developing the estimated costs to remediate the site. In the prior year, operations at the mine were halted due to shaft cutting operations penetrating the underground aquifer resulting in the mine filling up with water. Water in the mine became contaminated as the exposed magnesium leached into the water. In the current year, contaminated water had risen to such a level that it began to seep from the mine resulting in the destruction of a surrounding wooded area. Given the potential for further damage and inquiries from the US Environmental Protection Agency, the company engaged an environmental expert to develop a short-term and long-term plan for decontaminating the water along with an estimate of the costs for each. In connection with the audit, the company's management provided the engagement team with a report prepared by the environmental expert outlining several scenarios of the decontamination plan, a range of implementation costs for each scenario, and an implementation time line. The cost estimates contained in the report were used as the basis for recording the estimated environmental remediation liability in the company's financial statements.

When auditing the completeness and accuracy of the environmental remediation liability recorded by the client, the engagement team might challenge the estimates and the underlying assumptions, by asking about unexpected outcomes. For example, the engagement team might

²⁹ Here is why each of the other answers is not the best answer for the scenario above.

A. The availability tendency is not prevalent in this case as it is not a judgment dependent on memory recall.

B. Confirmatory evidence is unlikely to be available in this scenario.

D. The judgment to remodel the kitchen has already been made; therefore, judgment triggers are not relevant in this scenario.

ask company management and the environmental expert about factors that might delay implementation of the decontamination plan, and to identify the most likely causes of such a delay. Furthermore, the engagement team might discuss the effect of a prolonged implementation on the estimated costs of the plan. As company management and the environmental expert work together to provide a list of the possible causes for a delay, the engagement team might ask them to estimate the likelihood of these potential causes. It is quite possible that they will provide likelihood estimates for potential delays in the decontamination plan that, when considered in the aggregate, will significantly reduce the likelihood of a timely implementation resulting in significant revisions to the estimated costs.

The responses to these questions can help the engagement team to better understand the assumptions that underlie management's and the environmental expert's conclusions. The information received can be used by the engagement team to calibrate a more realistic assessment of the ultimate cost of the decontamination plan. While it is more difficult, it is also important that we each practice these same techniques for challenging our own judgments.

Consider another scenario:

Knowledge check question:

You have been asked by client management to propose on a new agreed-upon procedures attestation engagement. You have not had a chance to fully scope the work or estimate a detailed budget. Management indicates that the company paid \$40,000 for a similar project about 18 months ago. **What is the most likely bias or trap in this scenario?**

A. Anchoring and adjustment

B. Confirmation

C. Overconfidence

D. Slow to solve

Please take a few moments to respond to the question above before reading ahead.

You likely recognized that the \$40,000 may serve as an anchor and we could be prone to biasing our judgment toward that anchor.³⁰ In other words, our tendency would be to adjust insufficiently away from the \$40,000 anchor.

It isn't that the \$40,000 figure is completely irrelevant. But in any such situation, there is a good chance that the \$40,000 figure is on the low side, given management's incentive to

keep costs down. As we saw earlier, we tend to anchor on this initial value and adjust insufficiently as we try to get to a more accurate or reasonable conclusion. How might we reduce the potential bias?

Mitigating Bias Caused by the Tendency to Anchor and then Adjust Insufficiently

- Awareness of the significance of anchors
- Make an independent judgment or estimate. Take steps to make judgments or formulate expectations prior to seeing preliminary outcomes (e.g., unaudited information).
- Consider alternative anchors based on relevant and supportable benchmarking information
- Solicit input from others, and be careful to not provide an anchor for their thinking

Awareness:

Again, awareness of the powerful tendency to anchor and then adjust insufficiently is important before we can do other things to mitigate the effects of the bias.

Consider alternative anchors including independent estimates:

Often, considering alternative anchors is helpful. If you did have a preliminary estimate for the agreed-upon procedures engagement, you could respond to the client with something like, "We haven't had a chance to formulate a detailed proposal, but my preliminary assessment would suggest a fee that is in excess of \$40,000. But I'll have to get back with you once I've had a chance to do a careful assessment." Then you would search objectively and independently for information or benchmarking data relating to other similar engagements the firm has performed.

In auditing, it is often important to look at corroborating financial and nonfinancial information (e.g., operating data, employee headcount, key performance indicators such as average number of days to collect receivables, number of days' sales in ending inventory, cost per square foot), as well as industry and competitor benchmarking information. These financial and nonfinancial measures can serve to provide alternative "anchors." In some cases, while client trends or estimates may seem reasonable when compared to the client's prior year financial information, the trends and estimates may not seem reasonable relative to nonfinancial or competitor/industry benchmarking information.

³⁰ Following is why each of the other answers is not the best answer for the scenario above.

B. The confirmation bias is not prevalent in this scenario because the auditor has not developed initial beliefs about the estimated fees.

C. The overconfidence bias is not prevalent because estimates of likelihoods or outcomes are not present in this scenario.

D. Slow to solve is not a judgment trap. We tend to fall into the trap of rush to solve.

Solicit input from others:

An example of a useful way to search for objective, independent information would be to ask another engagement team familiar with providing similar agreed-upon-procedures engagements to objectively scope and estimate the work. And, of course, you wouldn't want to mention management's \$40,000 figure to the team because the team would be likely to anchor on it! Just knowing that anchors affect our judgment and that we tend to adjust insufficiently can be useful in mitigating the effects of this bias in our own estimates.

One example of where the bias related to the anchoring tendency can influence auditor judgment is in formulating expectations associated with substantive analytical procedures. The problem is that the unaudited value—the value about which we are attempting to gather sufficient appropriate audit evidence to determine whether it is fairly stated—can serve as an anchor. If the unaudited number influences the auditor's expectation, the reasoning process quickly becomes circular and loses its objectivity. As we mentioned earlier, research with auditors suggests that this does happen in practice—even with experienced auditors. A mitigation strategy for engagement teams is to take time at the end of an audit or quarterly review to consider broad expectations for significant accounts and ratios for the *next* period. This allows the engagement team to utilize trends and other information known at the time to formulate an objective expectation before the client's next period values have been recorded. Even considering a simple expectation regarding the direction of the change (e.g., increase, decrease, or stable) will improve the engagement team's ability to apply appropriate professional skepticism without requiring a significant investment of time.

Applying professional skepticism and the KPMG Professional Judgment Framework to debias judgment

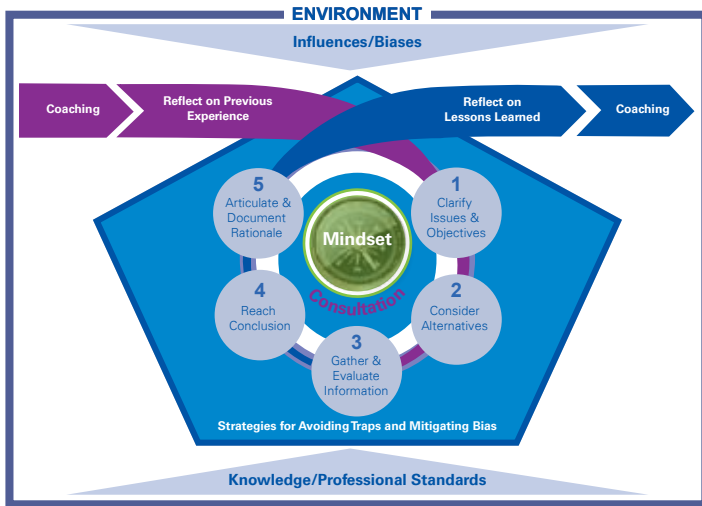
The good news is that one of the more important mitigating techniques for reducing all of the biases is baked into the auditing professional standards and accounting practices—the application of professional skepticism. In Chapter 3, you learned that considering alternative frames or perspectives boosts professional skepticism. Stakeholders such as investors, creditors, regulators, investment bankers, clients, and audit committees demand professional skepticism of auditors. Professional skepticism is the hallmark of a good auditor and, when auditors combine awareness of traps and biases with professional skepticism, it elevates the quality of their professional judgments.

As we discussed in Chapter 4, self-interest and the subconscious use of judgment shortcuts can lead to predictable, systematic bias. Awareness and knowledge of these common tendencies and situations where they are likely to influence judgment is the first and most important step in mitigating biases. We need to realize where and how we may be biased in order to develop simple approaches for mitigating the effects of those biases. You are taking a big step in terms of knowledge and awareness of judgment biases by studying this monograph. 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. Moving to a judgment approach that explicitly considers steps in the Framework is very important to debiasing judgments and avoiding traps. Thoughtfully applying the steps of a judgment process can in itself mitigate bias. 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.

We at KPMG take the development of our people very seriously. We want them to achieve their full potential as professionals. In fact, given the importance of the role we play in helping to ensure public confidence in the financial systems, we need them to. That's why we developed the KPMG Professional Judgment Framework and related trainings—to elevate the professional judgment and the professional skepticism of our people. And a key component to improving audit judgment is an awareness of where common judgment traps and biases can influence professional judgments that are required to be made by our auditors every day. With a recognition and awareness of traps and biases, our professionals are better equipped to use the steps of good judgment and other common sense strategies to avoid traps and reduce bias, thereby helping to elevate and maintain the consistently high quality of professional judgment we expect to be exercised by all professionals across our firm. Notice that the concepts covered in this chapter are depicted by the pentagon shape labeled "Strategies for Avoiding Traps and Mitigating Bias," surrounding the steps of the judgment process.

The KPMG Professional Judgment Framework



In reality, none of us will ever be completely free of bias or be invulnerable to 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. The sooner you start learning how to develop your professional judgment, the better. We at KPMG are pleased to produce this monograph to contribute to your efforts in developing your own professional judgment.

End of chapter questions

(Select the best answer for the multiple choice questions)

1. What is the most important factor in avoiding traps or reducing bias?

2. True or False: People are simply hardwired to use judgment shortcuts, and as such, there is no way to avoid the related biases.

3. Which of the following is NOT recommended when trying to mitigate the risk of bias attributable to the availability tendency?

- a. Consider the most unusual case
- b. Make the opposing case
- c. Consult with others
- d. Get objective data

4. Which of the following best describes a technique to mitigate the confirmation bias?

- a. Consider the most unusual case
- b. Make the opposing case
- c. Consult with others
- d. Get objective data

5. Which of the following is not a technique to help an auditor mitigate possible bias stemming from the use of a judgment shortcut?

- a. Be aware of the bias and when you might be vulnerable to it
- b. Consider disconfirming evidence
- c. Seek the advice of someone who agrees with your position
- d. Identify and acknowledge personal preferences

Chapter Six

What about judgment in groups?



Our discussion up to this point has focused on individual judgment. In this chapter, we will briefly touch on professional judgment in the context of teams or groups. This is a vitally important topic because many important audit judgments are made in groups. Judgment in groups is an immense area about which much research has been conducted and many volumes have been written. To be clear, in the next few pages, we will only touch on a handful of topics that relate to audit judgment in groups. **Much of what we would like to convey about group audit judgment is delivered through watching and discussing instructional videos that KPMG has produced. These videos are available in the instructor resource materials to be used at the option of your instructor.**

Group judgments are *usually* better than individual judgments

We have observed at KPMG that groups usually make better judgments than do individuals. But the word “usually” is important. While research confirms that groups generally do better, just as with individual judgment, judgment traps and biases can impact group judgment quality. And there are additional potential pitfalls involved in group judgment. Our objective in this chapter is to discuss and illustrate a few key take-aways on how to improve the quality of group judgments.

Let’s start with a quick illustration. Most of you are probably familiar with the TV show *Who Wants to Be a Millionaire*, where contestants answer trivia questions to earn prize money. In the show, contestants can get help in several ways. Two of those ways are to “poll the audience,” or “phone a friend.” It’s probably safe to say that the “friends” who are asked to be available for a phone call are likely well educated and well informed, while the average audience member might best be described as someone who has nothing better to do on a weekday afternoon.

Given that background, please answer the following question:

In the game show, which option do you think has provided the most accurate answers over time?

- a. Phone a friend
- b. Poll the audience

Many people respond “Phone a friend.” And “Phone a friend” does help—an analysis of past shows indicates phoning a friend has yielded correct answers about 67 percent of the time, which is really quite good; simply guessing would yield the right answer only 25 percent of the time. But the really surprising statistic is that “Poll the audience” results in correct answers *over 90 percent of the time!* And this higher accuracy by groups of people doesn’t happen only in game shows. Dozens of research studies bear out that groups are generally better at making judgments than are individuals, especially when there is a divergence of thought and experience among the members of the group. One study in an accounting setting showed that auditors working in groups in a fraud risk assessment task generated a larger number of high-quality fraud risks than did individual auditors working alone, and that there was less bias in the group setting.³¹

Other advantages of group judgments:

In addition to improved judgments, at KPMG, we see other important advantages of making judgments in groups, including that the more senior members of the engagement team can coach the less experienced members, and all team members have the opportunity to contribute to the judgment process. Further, group members participating in the judgment process can better understand the issues and the rationale for the conclusions reached.

³¹ See Carpenter, Reimers, and Fretwell, 2009.

Group judgments can be subject to traps and biases:

However, group judgments are also vulnerable to judgment traps and biases, and groups can actually produce *worse* judgments than individuals in some situations. You can see a summary of some of the biases and traps we covered in the first five chapters in the chart below. You might think these biases would be less of a problem in group judgment settings, but that's not necessarily the case. In fact, these biases can be *more pronounced* in judgment situations involving groups. In terms of traps, the first one noted below is the tendency to quickly reach a consensus, which is much like the judgment trap we discussed earlier—the “rush to solve.” Also, ineffective compromises are sometimes reached in order to avoid conflict, rather than fostering a healthy consideration of opposing ideas. In an engagement team setting, the tendency to reach consensus too quickly can easily happen without the engagement team even realizing it. Unfortunately, critical judgments can sometimes get pushed to the end of an engagement, and as the deadline pressure increases, teams may fall into the trap of coming to consensus too quickly without adequately considering alternative perspectives.

Group Judgment Biases and Traps

- Biases:
 - Overconfidence
 - Anchoring
 - Confirmation
 - Availability
- Traps:
 - Tendency for quick consensus
 - Conflict avoidance/suboptimal compromises
 - Limiting creativity and idea generation

The last point in the chart is that, unless they are structured properly, group settings can limit creativity and idea generation. This trap is contrary to what most people believe about group judgments. For example, a substantial body of research shows that open brainstorming in groups is often

not the best approach for generating creative ideas. We'll circle back to the implications of this later.

Three key themes:

In learning about group judgments and decisions, keep in mind three key themes. First, the same judgment process in the KPMG Professional Judgment Framework applies to both individual and group judgments. Second, we need to be aware of the judgment traps and biases we have talked about and take steps to mitigate them in group settings. Finally, successful group leaders manage group judgment processes by properly structuring the group's interaction and by effectively managing conflict.

Managing conflict doesn't mean *stifling* conflict—groups tend to produce good judgment when there is diversity of thought. Alfred Sloan, former chairman of the board of General Motors, stated the following at the end of a meeting with the board of directors:³²

“I take it we are all in complete agreement on the decision here... Then I propose we postpone further discussion of this matter until our next meeting to give ourselves time to develop disagreement and perhaps gain some understanding of what the decision is all about.”

Mr. Sloan saw the lack of conflicting views as a sign that the group did not fully appreciate the issue. Expression of different viewpoints should be encouraged and those viewpoints should be carefully considered. This kind of conflict—conflict in thoughts and views—is healthy because it promotes increased judgment quality.

Early consensus and the dangers of GroupThink:

You may have heard the term “GroupThink.”³³ GroupThink is a tendency for groups to strive toward cohesiveness and early consensus. Some very bad judgments with calamitous outcomes have been attributed to GroupThink, such as the ill-fated decision to launch the Challenger space shuttle in cold conditions in 1986, leading to the loss of the space shuttle and its crew. Members of a group who are subject to GroupThink suppress their own views with the assumption that agreement in the group equates to good judgment. Interestingly, overly cohesive groups begin to believe they have reached a fail-safe conclusion—in other words, they experience *extreme overconfidence*. Fostering healthy

³² See Drucker, 1967.

³³ See Janis, 1983.



debate and avoiding early consensus is key to overcoming GroupThink tendencies. A key take-away is to beware of early consensus for important group judgments—it is often the sign of a judgment trap. Instead, group interactions should be structured and conducted to stimulate and encourage the expression of different perspectives.

Fraud risk assessment and “brainstorming”

An example of a group judgment in auditing is a risk assessment and planning meeting. An important part of that meeting is “brainstorming” potential fraud risks. “Brainstorming” is a term that describes a freewheeling discussion where criticism of ideas is limited and seemingly “far out” ideas are welcomed. It involves a limited degree of structure, and maximum interaction among team members.³⁴ Surveys indicate that most audit firms’ fraud brainstorming meetings have this kind of open structure. Auditing standards in the United States provide the following guidance with respect to the auditors’ consideration of fraud:

*“The audit team should discuss the potential for material misstatement due to fraud. The discussion should include: An exchange of ideas or ‘**brainstorming**’ among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud...”³⁵ (emphasis added)*

We believe that this requirement for engagement teams to have a meeting to discuss fraud risks is a positive step toward improving the engagement team’s ability to address the risk of fraud. In fact, in recent studies examining the fraud risk

assessment meeting, the use of a brainstorming technique has been shown to improve the quality of the identified fraud risks as compared to an individual working alone.³⁶ However, scholars examining auditor group judgment have identified judgment traps and weaknesses associated with the traditional brainstorming approach.

A recent academic study examined 150 public company engagement teams as they conducted actual fraud risk assessment meetings.³⁷ The researchers found that the typical group “brainstorming” approach produced a lower quantity and *quality* of fraud risks as compared to other group judgment methods. This is because of the judgment traps and biases associated with typical brainstorming sessions. These traps are often intensified when senior members of the engagement team dominate the discussion.

Potential problems associated with typical brainstorming approach

As previously mentioned, your instructor has access to KPMG-produced videos that illustrate potential problems that can arise in a group fraud risk assessment meeting. If you watch the videos, you will recognize judgment traps in the situation illustrated in the video. Another KPMG video available to your instructor demonstrates a better approach to group judgment.

Some of the potential traps that can arise when groups use a typical brainstorming approach in audit engagement team judgments are as follows:

Free riding:

A problem that has been documented in both psychology and auditing research is that typical brainstorming sessions can

³⁴ See Maisel and Maisel, 2010.

³⁵ AU 316.14, *Consideration of Fraud in a Financial Statement Audit*.

³⁶ See Carpenter, Reimers, and Fretwell, 2009.

³⁷ See Hunton and Gold, 2010.

result in what is called “social loafing” or “free riding.” When individual group members anticipate that others will have lots to say, they may tend to invest less time preparing for the meeting.

Production blocking:

Another problem in group settings is referred to as “production blocking,” which means that ideas brought up by one team member can interfere with or “block” the thoughts of other group members. Research indicates that this can be a significant inhibitor of ideas in groups.

Evaluation apprehension:

Sometimes group members are reluctant to raise issues for fear of looking bad in front of others, especially more senior members of the group. This is known as “evaluation apprehension.” Because they are spending a lot of time on site at a client location, less experienced members of the engagement team will often have valuable, hands-on knowledge of potential risk factors such as system or operational changes, accounting policy issues, or personnel turnover. But staff can sometimes be intimidated by managers or partners, causing them to hold back their insights and ideas. This is a relatively simple concept, but research confirms that this is a key factor that makes brainstorming less effective than many believe it to be.

Narrowing of thought:

Brainstorming in group settings can actually limit or narrow the number of ideas generated. In unstructured, open sessions, individuals can become narrower in their thinking than they would if they used other group judgment methods. This often results when one or two individuals monopolize the early discussion. Obviously, this is the *opposite* result of what “brainstorming” is intended to accomplish.

Harnessing the power of group judgments

The combination of these traps can have a significant negative impact on the effectiveness of a typical group judgment process, whether it is brainstorming to identify fraud risks or any other judgment we typically make in group settings. At the same time, remember what we said earlier—groups are usually more effective at making judgments than are individuals. The key is to harness the power of groups while avoiding the traps that can impact the quality of group judgments. In this section, we will highlight some of the keys

to maximizing the effectiveness of judgment in groups. If you watch the KPMG video provided in the instructor material, you can observe these practices in action.

The best idea generation comes from asking individual team members to invest time generating ideas individually before coming to the meeting, with the understanding that they will be expected to share their thoughts with the group. This approach can better achieve the benefits associated with group judgment while at the same time avoiding some of the most serious threats. Such an approach has been shown to mitigate the narrowing and blockage of ideas as well as the tendency toward free riding. This is a fairly straightforward idea, but surprisingly, many times meetings are not carried out in this fashion. Another important element is that the group leader set an appropriate mindset for the judgment at hand—for example, the importance of being alert to conditions increasing the risk of fraud.

Maximizing the effectiveness of group judgment

- Preparation:
 - Individual members generate ideas before the meeting with an understanding that their ideas will be shared.
- During the discussion:
 - First round: Individuals share ideas with the group, without critique or debate
 - Second round: Individuals share ideas sparked by the first round of discussion.
 - Final round: Open discussion to rank ideas and formulate an appropriate response.

A combination of individual idea generation prior to the meeting and subsequent group discussion can improve group judgments. After the initial ideas are out on the table, group members can ask brief clarifying questions as well as share any additional ideas that come from listening to others’ thoughts. Finally, the engagement team can have an open discussion about the factors identified, assess their importance, and begin formulating an appropriate audit response.

Summary

Making judgments in groups is a broad topic—it easily could constitute an entire course of study. This chapter is a very brief introduction to some of the issues surrounding group judgments. While groups usually do better in making judgments than individuals, groups are also subject to judgment traps and biases. In addition to the traps and biases covered in Chapters 2–5, in this chapter we discussed some additional traps groups fall into, such as early consensus, free riding, idea narrowing, and evaluation apprehension. It is important to note that the steps of the judgment process in the KPMG Professional Judgment Framework also apply to group judgment. When a group

discussion is structured to encourage all group members to come prepared, participate, facilitate open communication, and take advantage of diversity of thought, groups can avoid judgment traps and biases and consistently make quality professional judgments.

End of chapter questions

(Select the best answer for the multiple choice questions)

- 1. Why is lack of expression of disagreement a sign of potential problems in group judgment?**
- 2. Summarize the key ways to enhance the effectiveness of groups in the context of a fraud risk assessment meeting.**
- 3. Which of the following statements is *false* regarding group judgment?**
 - a. Good judgment principles are similar for individuals and groups.
 - b. Groups can fall into judgment traps and biases.
 - c. Groups are prone to making quick decisions in order to avoid conflict.
 - d. Groups are not prone to judgment traps and biases.
- 4. What best describes the relationship between diversity of thought and group judgments?**
 - a. Differences in opinions indicate internal conflict, which team members should avoid.
 - b. Diversity in thought should be fostered in group judgment and typically improves judgment quality.
 - c. Team members should always work together to reach an early consensus.
 - d. GroupThink is a pitfall that teams may fall into as a result of encouraging expression of different ideas within the group.
- 5. Which of the following is one of the keys for effectively preparing for a brainstorming session?**
 - a. The engagement team should participate in a pre-meeting to assess the objectivity of the participants attending the meeting in order to avoid bias.
 - b. The individual team members should generate ideas before the meeting with an understanding their ideas will be shared.
 - c. The leader should send out an agenda of important topics and preliminary conclusions for the participants to consider before the meeting in order to expedite the process.
 - d. The purpose of the meeting should not be communicated prior to the meeting in order to avoid individual pitfalls and biases.

Chapter Seven

Coaching, reflection, and conclusion



In this final chapter, we will complete our discussion of the components of the KPMG Professional Judgment Framework by discussing the ribbon of “Coaching and Reflection” that runs through the judgment process. We will also summarize some of the key take-aways we have covered in this monograph on professional judgment.

The KPMG Professional Judgment Framework



The ribbon: Coaching and reflection

Up to this point, we have talked at least briefly about all of the elements in the KPMG Professional Judgment Framework, except for the ribbon that begins and ends with coaching. This ribbon, running from left to right through the Framework, represents the flow of decisions and experiences, and how the auditor improves and refines his or her professional judgment ability over time.

The importance of coaching in developing judgment skills in our people:

Coaching bookends this process because KPMG believes it is critical for more senior members of engagement teams to use judgment situations as coaching opportunities to help develop our people and to help them achieve their full potential as professionals. The most experienced auditors

can help increase the judgment maturity of less experienced auditors by involving them in some of the key judgments made on an audit so that they are able to understand and learn from the process. Similarly, when making professional judgments, or any important or difficult judgments for that matter, our engagement teams discuss key aspects with peers and mentors and invite input, particularly seeking alternative perspectives. These discussions in both directions help our engagement teams to make effective decisions and to improve their judgment skills. We believe it is important to invest in our people, both through formal training and on-the-job learning.

The importance of a common framework and vocabulary:

One of the benefits of developing the Professional Judgment Framework and training our people on its proper use is that it provides a common language and vocabulary that can be used when coaching our people and in helping them to develop their own ability to exercise good professional judgment.

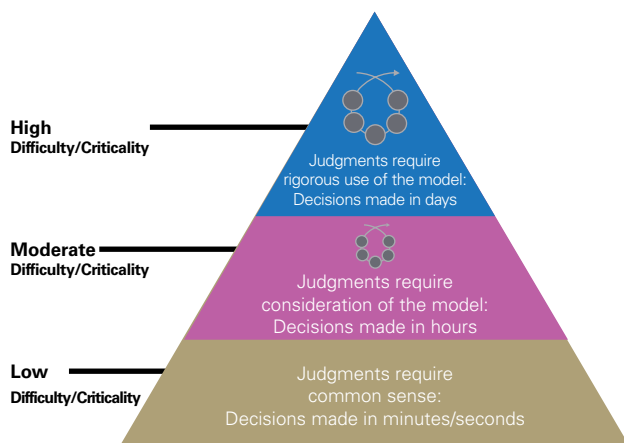
As you encounter situations where judgment is required, it is valuable to stop and reflect upon other situations you or others have faced in the past with similar facts and circumstances, to bring the experience from those judgments to the surface. Reflecting is often the best way, for example, to identify whether your judgment has been influenced by an implicit judgment trigger that has led you down the “garden path” toward a narrow set of alternatives.

After we have made judgments, there is value in reflecting on the experience, to consider what went well and what did not go so well, to help reinforce the positive lessons and learn from the negative experiences, rather than relying on our memories to automatically file away these elements without formal thought. Self-reflection provides an opportunity to step back and think about whether we have done a thorough job of working through a judgment process and whether pressure, self-interest, judgment traps, and biases might have unduly influenced our judgment.

Applying the KPMG Professional Judgment Framework: How critical is the judgment?

As we discussed in earlier chapters, the key to elevating your professional judgment is to integrate the judgment process into your thinking and to be aware of judgment traps and biases. Initially, applying the steps of the judgment process might seem awkward or cumbersome, but as you practice and get familiar with the steps, they become a natural part of your own judgment processes. It is also important to remember that the judgment process is flexible and can be adapted to work for very difficult judgments as well as only moderately complex judgments. As depicted in the exhibit below, the decision maker need not always invest much time in making the judgment; for easier judgments, common sense and perhaps one or two of the steps in the process might be most relevant. However, as the judgments become more difficult and critical, it is worth the time to apply carefully the steps in the judgment process and to consider potential threats to good judgment.

How Critical Is the Judgment?



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.

Let's review some of the key take-aways from this monograph:

- All of us, even seasoned professionals, can improve judgment by following the steps of a formal model like the KPMG Professional Judgment Framework. This

can help us overcome judgment traps, including falling prey to judgment triggers, solving the wrong problem, constraining the set of available alternatives, or hastily forming a conclusion when a few minutes of good thinking could improve our judgment and often save time in the long run.

- Understanding the components of good judgment provides a common framework and vocabulary to help us improve judgment and to facilitate coaching and mentoring. A judgment process starts with the end in mind, which is to arrive at sound judgments that can be articulated, documented, and withstand challenge.
- We all have a tendency to adopt certain judgment frames or perspectives. When we proactively consider multiple frames to generate additional perspectives on an issue, we usually make higher-quality judgments.
- A proactive approach to judgment framing is a critical component of consistently high-quality professional judgment, and it is an important way to boost professional skepticism. Proper use of frames also helps us effectively complete the initial steps in a judgment process.
- Judgment shortcuts are efficient and often effective, but they can lead to bias. Looking only to the left may be a great shortcut when crossing the street in Manhattan, but it is a potentially deadly approach in London. It pays to be aware of when and where we are vulnerable to judgment tendencies that can negatively impact our judgments.
- Some of the common tendencies that can lead to bias in an accounting/auditing setting are:
 - Availability tendency
 - Confirmation tendency
 - Overconfidence tendency
 - Anchoring tendency
- An awareness and understanding of where and how judgment traps and self-interest and shortcut-related biases can affect judgment can help us identify ways to avoid or mitigate the effects of traps or biases.
- One of the ways to reduce the impact of traps and biases in making good judgments is to use a judgment process like the one at the center of the KPMG Professional Judgment Framework. Use of such a process can be quick and informal for lesser judgments, while a more involved and methodical consideration of the process can pay off for more important judgments.

- Familiarity and experience with the Professional Judgment Framework and watching for traps and biases helps us to bake the processes into our natural judgment and decision-making processes.
- Group judgments are usually better than individual judgments, but the same traps and biases, plus some that are unique to groups, can threaten the quality of judgments made in groups. We discussed some ways to address the threats to judgment in order to improve the quality of group judgments, including structuring and conducting meetings to stimulate and encourage preparation and thought as well as the expression of differing viewpoints.

The KPMG Professional Judgment Framework is simple and intuitive, but it is a powerful vehicle for our professionals to improve their judgment processes and related outcomes. While incorporating the concepts you have learned will take time and practice, eventually the processes in the Framework can become a natural part of how you make judgments. Just like practicing any new skill, once the concepts you have learned become part of how you think, it does not have to take more time or effort to consistently make more effective judgments. Over time, improved judgment processes will result in more efficient and effective judgments, which will enable you to enjoy a more successful professional career.

We hope that you have enjoyed this monograph on professional judgment. We believe it provides a great start to learning some important ways to improve your professional judgment. The real benefit of learning these concepts will come as you apply the steps to good judgment, recognize potential traps and biases in everyday judgment settings, and identify approaches and techniques to avoid and mitigate the effects of these threats.

End of chapter questions

- 1. True or False: It is essential to carefully apply each step in the judgment process in the KPMG Professional Judgment Framework for all judgments.**
- 2. Describe how reflection applies to the KPMG Professional Judgment Framework.**
- 3. KPMG encourages experienced professionals to take time to coach less experienced professionals through the process of making critical judgments rather than just making those judgments themselves, even though it may take more time to do so. Why is this important?**

Appendix 1: Summary of key considerations in applying the steps of good judgment

1. IDENTIFY THE ISSUE AND OBJECTIVES

- Obtain a thorough understanding of fundamental aspects of the judgment or decision
- Develop specific objectives and relevant measurable criteria
- Consider different perspectives or frames: Challenge the current frame, seek input from those who see the matter differently
- Ask “what” and “why” questions to get to the root of the issue and the fundamental objectives
- Be aware of common threats to judgment that may affect this step, including accepting the client’s frame, and biases and traps such as the overconfidence tendency, the rush to solve, and judgment triggers

2. CONSIDER ALTERNATIVES

- Invest the appropriate time and effort to consider different alternatives: ask “how” questions
- Remember a judgment can be no better than the best alternative considered
- Seek input from others with different perspectives and apply a new frame
- Weight the alternatives in terms of how well they meet objectives
- Be aware of common threats to judgment that may affect this step, including judgment biases and traps including the tendency to fall back to the familiar, the availability tendency, and judgment triggers

3. GATHER AND EVALUATE INFORMATION

- Gather the appropriate amount of relevant information
- Consider the reliability, validity, certainty, and accuracy of the information
- Determine whether sufficient appropriate audit evidence has been obtained
- Identify and consider relevant technical literature, professional standards, and industry information
- Make the opposing case and consider “disconfirming” information
- Assess the consequences associated with alternative approaches or options considered
- Identify the alternative that best meets relevant objectives
- Be aware of common threats to good judgment that may affect this step, including deadline pressure or biased information search introduced by the anchoring, confirmation, availability, or overconfidence tendencies



4. REACH A CONCLUSION

- Before reaching a conclusion, ask whether a supportable process has been followed (i.e., consider steps 1–3) and if not, return to the appropriate previous step(s)
- Beware of common threats to judgment that may affect this step, including engagement pressures and conflict avoidance tendencies

5. ARTICULATE AND DOCUMENT RATIONALE

- Consider the judgment with the end in mind of articulating and documenting the rationale; reflect on the steps of good judgment, and consider whether a good process was followed and whether judgment traps and biases influenced the conclusion
- Document the conclusion and significant factors involved in reaching the conclusion, including confirming and disconfirming information considered



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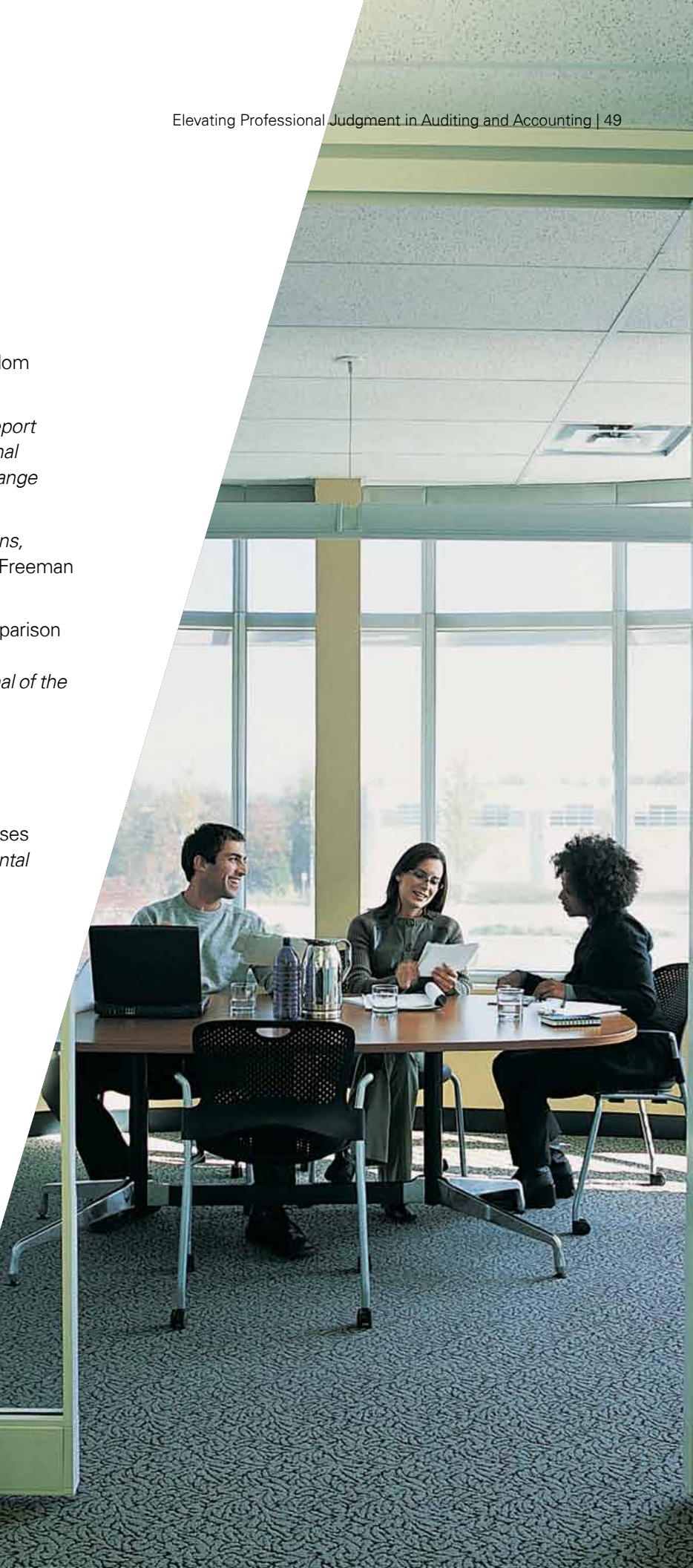
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Suggested solutions to end of chapter questions

Chapter 1

1. What is the primary purpose of this monograph?

Answer: To help readers understand the nature of professional judgment and to give them a head start in developing and improving their own professional judgment abilities.

2. How do perceptual biases relate to judgment biases?

Answer: Similar to how our minds can be deceived by optical illusions or perceptual biases, there are times when our judgment can fall prey to systematic traps and biases.

3. True or False: You just cannot teach judgment; either you have it or you do not.

Answer: False. While both innate ability and experience are important, gaining knowledge and skill relating to exercising good judgment can help elevate and improve students' and professionals' judgment maturity.

Chapter 2

1. What are the five steps in the judgment process?

Answer: 1-Clarify Issues and Objectives, 2-Consider Alternatives, 3-Gather and Evaluate Information, 4-Reach a Conclusion, 5-Articulate and Document Rationale.

2. What are two common judgment traps?

Answer: Rush to Solve and Judgment Triggers.

3. Within an auditing context, what is professional judgment?

a. Professional judgment is the process of using relevant training, knowledge, and experience to reach a decision or draw a conclusion in evaluating evidence, estimating probabilities, or selecting between options.

b. Professional judgment is professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence.

c. Professional judgment is the application of one's experience to make a judgment in the absence supporting evidence, based on the facts and circumstances of the audit engagement.

d. Professional judgment is the construction of a logical justification to support an outcome or conclusion that is otherwise not supported by the available evidence.

Answer: a

4. Which of the following best describes the relationship between professional skepticism and professional judgment?

a. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence that is separate and apart from the process of exercising professional judgment.

b. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence that is part of the process in forming professional judgments.

c. Professional skepticism is synonymous with professional judgment.

d. There is no relationship between professional skepticism and professional judgment.

Answer: b

5. Which of the following best describes a judgment trigger?

a. An alternative stated in terms of a judgment objective

b. A technique for making effective judgments quickly

c. An issue/problem stated in terms of a particular alternative

d. A technique for more effectively evaluating another's judgment

Answer: c

Chapter 3

1. What is fundamental to exercising professional skepticism?

Answer: The concept of judgment framing or appropriately questioning a client's perspective by viewing the situation through other frames is fundamental to exercising professional skepticism.

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

Answer: Evaluating issues and objectives from different frames, or what we at KPMG would call looking at an issue through a "fresh lens," can help auditors to understand a variety of different perspectives. Considering multiple frames can bring additional insights or ways to understand a situation. It can also open up a variety of additional alternatives that might not have been considered otherwise. For example, suppose that a client's revenues have increased more than any other company in the industry and that the client attributes its success to a new marketing strategy. The auditor should understand the client's explanation and then apply professional skepticism by considering other possibilities, such as an error in revenue recognition or even financial statement fraud. Considering financial results from that perspective will help the engagement team identify evidence that could help to either identify or rule out the possibility of error or fraud.

3. What role do metaphors and analogies play in judgment framing, and how can they be used to improve your ability to examine issues through multiple frames?

Answer: We often adopt metaphors or analogies as part of our judgment frames to help us make sense of complex situations. An example mentioned in the monograph relates to the alternative frames "the war on drugs" versus "a cancer on the nation." Identifying the metaphors or analogies that we use can help us recognize the frames through which we are processing our perspectives and judgments. Once we fully understand our current judgment frame, we can then consider alternative frames by thinking about the issue at hand using alternative analogies or metaphors. Practicing this skill can bring a variety of different insights and alternatives to mind.

4. Which of the following statements about judgment frames is correct?
- A situation cannot have more than one appropriate frame.
 - There is often no single best frame for a given situation.
 - Frames are not used by risk averse individuals.
 - Professionals should eliminate the use of frames from their judgment processes.

Answer: b

5. Which of the following is not a step in reframing a situation?
- Challenge the current frame
 - Generate alternative frames
 - Justify the current frame
 - Understand the current frame

Answer: c

Chapter 4

1. Describe the availability tendency in your own words, and give an example of how the tendency could result in auditor bias.

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

Student examples will vary. An illustrative example would be: An auditor who identified a significant amount of unrecorded liabilities on a prior audit is likely to overestimate the likelihood of the presence of unrecorded liabilities on a subsequent audit.

2. Describe the confirmation tendency in your own words, and give an example of how the tendency could result in auditor bias.

Answer: The tendency for people making judgments to seek and to put more weight on information that is consistent with their initial beliefs or preferences.

Student examples will vary. An illustrative example would be: If management has taken a particular stance in accounting for a complex transaction and the authoritative standards are not clear on the subject, the auditor may be likely to seek and to place inordinate weight on evidence that supports or “confirms” management’s treatment of the transaction.

3. Which of the following is an example of the confirmation bias?
- An auditor improperly concludes on a complex revenue recognition matter without having the appropriate technical accounting background.
 - An auditor improperly concludes on the valuation of an investment security by looking at only the most recent sale of the security.
 - An auditor improperly concludes on the accounts receivable balance because negative confirmations were sent instead of positive confirmations.
 - An auditor improperly concludes a contingent liability is properly stated after examining only the evidence that supported the amount accrued in the financial statements.

Answer: d

4. What tendency is most likely manifest in the following situation? An engagement team performed a substantive analytical procedure over an expense account. When investigating a significant difference, the team was satisfied with limited evidence to support the client’s plausible explanation (which was in fact incomplete) for the difference.
- Confirmation tendency
 - Limited resources
 - Overconfidence tendency
 - Time pressure

Answer: a

5. The confirmation bias is a subconscious tendency to do which of the following?
- Seek evidence that confirms a biased judgment
 - Seek evidence that confirms a previously held view
 - Underutilize confirmations in the testing of accounts receivable
 - Seek evidence that disconfirms a previously held view

Answer: b

6. Which of the following is true with respect to the overconfidence bias?
- Overconfidence is always a conscious bias.
 - Overconfidence could result in the consideration of too many alternatives.
 - Overconfidence usually decreases with experience.
 - Overconfidence could result in engagement team members performing audit procedures that are beyond their skill sets.

Answer: d

7. Which of the following describes how the availability tendency is most likely to affect auditors?
- Auditors may first consider different potential causes for an observed fluctuation before seeking the client’s explanation with regard to analytical procedures.
 - Auditors may rely on information provided by client staff who is most knowledgeable about an audit area rather than the staff most easily accessible.
 - Auditors may seek evidence that supports their belief of how a transaction should be accounted for.
 - Auditors may weigh more heavily the information that was received most recently from a client relative to information received earlier during the audit.

Answer: d

Chapter 5

1. What is the most important factor in avoiding traps or reducing bias?

Answer: Awareness of potential traps and conditions that lead to bias is the most important factor – it is a necessary first step before any other efforts to mitigate bias can be implemented.

2. True or False: People are simply hardwired to use judgment shortcuts, and as such, there is no way to avoid the related biases.

Answer: False. While reliance on judgment shortcuts does come naturally, awareness of conditions that can lead to bias provides decision makers the ability to identify logical methods to reduce the bias.

3. Which of the following is NOT recommended when trying to mitigate the risk of bias attributable to the availability tendency?
- Consider the most unusual case
 - Make the opposing case
 - Consult with others
 - Get objective data

Answer: a

4. Which of the following best describes a technique to mitigate the confirmation bias?

- Consider the most unusual case
- Make the opposing case
- Consult with others
- Get objective data

Answer: b

5. Which of the following is not a technique to help an auditor mitigate possible bias stemming from use of a judgment shortcut?

- Be aware of the bias and when you might be vulnerable to it
- Consider disconfirming evidence
- Seek the advice of someone who agrees with your position
- Identify and acknowledge personal preferences

Answer: c

Chapter 6

1. Why is lack of expression of disagreement a sign of potential problems in group judgment?

Answer: Groups tend to do better than individuals because of the different perspectives and insights that are brought up and considered by the group. If expression of disagreement is stifled, one of the key benefits of group judgments is eliminated. The tendency to reach quick consensus is more likely to come into play, bringing with it the dangers of GroupThink.

2. Summarize the key ways to enhance the effectiveness of groups in the context of a fraud risk assessment meeting.

Answer: Participants should be asked to prepare ahead of the meeting by generating their own ideas, with the expectation that they will be asked to share their ideas at the meeting. To enhance participation and a sharing of ideas, group members should present the ideas they have prepared prior to the meeting with little or no discussion. There should be little or no criticism or evaluation of ideas at this point. Once the ideas are on the table, an open discussion should be facilitated, encouraging those with different or opposing viewpoints to speak up.

3. Which of the following statements is *false* regarding group judgment?

- Good judgment principles are similar for individuals and groups.
- Groups can fall into judgment traps and biases.
- Groups are prone to making quick decisions in order to avoid conflict.
- Groups are not prone to judgment traps and biases.

Answer: d

4. What best describes the relationship between diversity of thought and group judgments?

- Differences in opinions indicate internal conflict, which team members should avoid.
- Diversity in thought should be fostered in group judgment and typically improves judgment quality.
- Team members should always work together to reach an early consensus.

d. GroupThink is a pitfall that teams may fall into as a result of encouraging expression of different ideas within the group.

Answer: b

5. Which of the following is one of the keys for effectively preparing for a brainstorming session?
- a. The engagement team should participate in a pre-meeting to assess the objectivity of the participants attending the meeting in order to avoid bias.
 - b. The individual team members should generate ideas before the meeting with an understanding their ideas will be shared.
 - c. The leader should send out an agenda of important topics and preliminary conclusions for the participants to consider before the meeting in order to expedite the process.
 - d. The purpose of the meeting should not be communicated prior to the meeting in order to avoid individual pitfalls and biases.

Answer: b

3. KPMG encourages experienced professionals to take time to coach less experienced professionals through the process of making critical judgments rather than just making those judgments themselves, even though it may take more time to do so. Why is this important?

Answer: KPMG takes seriously the development of our people, and on-the-job coaching and mentoring is an essential part of developing the professional judgment of less experienced people. Walking through critical judgments with less experienced professionals enables the less experienced professionals to better understand the elements of a judgment process and how they are applied in difficult accounting and auditing contexts. The KPMG Professional Judgment Framework provides a shared conceptual understanding of good judgment and it facilitates coaching, mentoring, and training by providing a common understanding and vocabulary relating to the elements of good judgment as well as the traps and biases that can threaten good judgment.

Chapter 7

1. True or False: It is essential to carefully apply each step in the judgment process in the KPMG Professional Judgment Framework for all judgments.

Answer: False. For easy, low-stakes judgments, common sense and quick consideration of one or two steps in the judgment process may be enough to make a good judgment.

2. Describe how reflection applies to the KPMG Professional Judgment Framework.

Answer: Reflection is often the best way to identify whether a judgment has been influenced by a judgment trap or bias, like a judgment trigger that could have led the decision maker down a "garden path" toward a narrow set of alternatives.

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Sam is the national managing partner, Audit Quality and Professional Practice. Prior to this role, Sam was the partner in charge of Professional Practice in KPMG's national office. Prior to joining the national office, Sam was the area risk management partner for KPMG's Southwest area, a partner in KPMG's U.S. Capital Markets Group in Hong Kong, and a partner in the Houston office. Sam is a member of the PCAOB Standing Advisory Group and the Professional Practice Executive Committee of the Center for Audit Quality.

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Rob is an Audit partner in KPMG's Department of Professional Practice (DPP). He has more than 25 years of experience providing financial statement audit services to public and private clients in a wide range of industries. In connection with his current assignment in DPP, he assists engagement teams with the resolution of accounting and auditing issues. In addition, Rob is a member of the core team of professionals responsible for the development of the KPMG Professional Judgment Framework and the integration of its core concepts into the firmwide Audit professional training curriculum. Rob currently serves as the firm's representative on the Auditing Standards Board, which is the senior technical committee of the AICPA designated to issue auditing standards and guidance relating to private entities in the United States. Rob has assisted in the development of several KPMG publications, and he has served as an instructor at various firm-sponsored trainings for professional staff, managers, and partners. Rob graduated with a BS degree in accounting, with high honors, from the University of Florida.

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George is an Audit partner in KPMG's Audit Quality and Process Monitoring group. Prior to his current role, George served as the partner in charge of professional practice for the Seattle office including four additional offices in the Pacific Northwest region. Since joining KPMG, George has accepted assignments in five separate offices including KPMG's national office and the U.S. Capital Markets Group in Tokyo, Japan



where he provided services to many of the firm's Asia Pacific-based global clients. George frequently serves as an instructor on auditing and technical-related topics at firm-sponsored training events. He is also a member of the core team of professionals responsible for the development of the KPMG Professional Judgment Framework and integration of its core concepts into the firmwide Audit professional training curriculum. George received his BS degree from Albright College and his MBA degree from Saint Joseph's University. George is also a graduate of the KPMG Chairman's 25 program, an internationally integrated executive development program sponsored by the chairman of KPMG, focusing on building leadership skills.

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Steve is the Mary & Ellis Professor in the School of Accountancy (SOA) at Brigham Young University (BYU). He received his PhD degree at the University of Washington. Steve teaches undergraduate and graduate auditing courses in the SOA and a judgment and decision-making course in the Executive MBA program. Steve is a CPA, and prior to his graduate studies, he worked as a senior accountant for KPMG in Seattle. From 2000 to 2002, Steve took a leave of absence from BYU to work as a director in the U.S. National Office of PwC where he worked on a team revising audit policies. Steve continues to consult with public accounting firms and has also served as an expert witness. Steve served on the AICPA's Task Force for Sampling/Materiality Issues in a Single Audit Environment, and as a reviewer for the AICPA's 2008 *Audit Sampling Guide*. Steve has served the American Accounting Association in various capacities including president of the Auditing Section (2010–11), Auditing Section Distinguished Service Award Committee, AAA/AICPA Notable Contributions to the Literature Committee, chair of the Auditing Section Outstanding Dissertation Award Selection Committee, AAA/AICPA Joint Literature Award Recommendation Committee, Auditing Section Nominating Committee, vice chair of the American Accounting Association Annual Meeting, and cochair of the Auditing Section Meeting. Steve has received BYU Marriott School's Teaching Excellence and Outstanding Researcher awards. Steve's primary research interests involve the application of behavioral decision theory to professional judgment of auditors and financial analysts. He has had articles published in *The Accounting Review*, *Contemporary Accounting Research*, *Auditing: A Journal of Practice and Theory*, *The Journal of Accounting Research*,

Behavioral Research in Accounting, *Organizational Behavior and Human Decision Processes*, *Current Issues in Auditing*, *Issues in Accounting Education*, *The Journal of Accountancy*, *Internal Auditor*, and *CPA Journal*. Steve has coauthored several books including *Auditing: A Systematic Approach (6e)*, *Auditing Cases: An Interactive Learning Approach (4e)*, and *An Introduction to Corporate Governance and the SEC*.

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Doug is the Glen Ardis Professor of Accountancy at Brigham Young University. He received his BS and MAcc degrees at BYU and his PhD degree at the University of Arizona. He teaches financial statement auditing in BYU's undergraduate and graduate accounting programs, and effective managerial decision-making courses in BYU's Executive MBA program. He founded and leads BYU's Accounting PhD Prep program, which has placed over 75 students in top-quality PhD programs over the past decade. Doug's scholarly research has been published in *The Accounting Review*, *Contemporary Accounting Research*, *Organizational Behavior and Human Decision Processes*, *Auditing: A Journal of Practice and Theory*, *Journal of the American Taxation Association*, *Accounting Horizons*, *Behavioral Research in Accounting*, and others. Doug has also published articles in *Internal Auditor*, *Journal of Accountancy*, and *CPA Journal*, and has coauthored eight books and monographs, including two leading college auditing textbooks: *Auditing: A Systematic Approach (6e)*, and *Auditing Cases: An Interactive Learning Approach (4e)*. Doug is active in the profession, having served on several professional committees and task forces, including two years on the IAAs Independence & Objectivity and Advanced Technology Committees, and five years on COSO's Enterprise Risk Management and Small Business Guidance task forces. He recently completed a three-year appointment as a member of the AICPA's Auditing Standards Board, where he was heavily involved with projects focusing on internal control, auditor reporting, analytical procedures, and audit sampling. Doug has recently been appointed to serve a three-year term on the COSO board. He also has served in the academic community, cochairing the American Accounting Association's 2004 Auditing Section Mid-Year Conference Committee and chairing the AAA's 2004 Annual Meeting Committee. Finally, Doug has won several "best paper" awards for his research and writing, and has earned several awards at BYU, including the BYU Marriott School's Outstanding Researcher award in 1998, the Marriott School's Teaching Excellence award in 2000, the BYU Young Scholar Fellowship in 2001, the Merrill J. Bateman Student Choice Teaching Award in 2002, and BYU's Wesley P. Lloyd Award for Distinction in Graduate Education in 2006.



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