



Financial Reporting Council

Professional Judgement Guidance

Illustrative Examples



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Contents

Professional Judgment Framework	3
Illustrative Examples	4
Illustrative example 1	5
Illustrative example 2	10
Illustrative example 3	14

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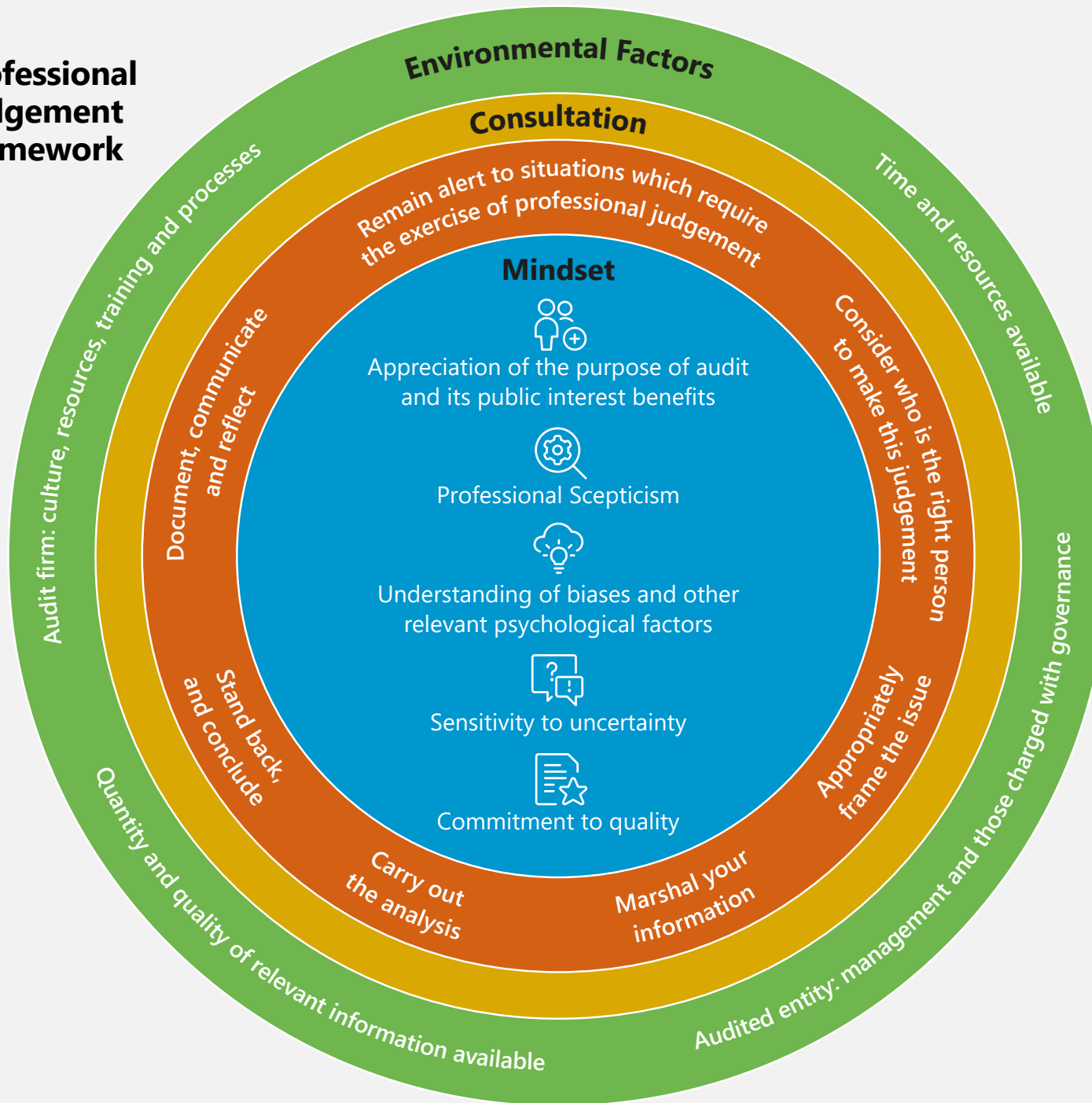
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Professional Judgement Framework



This framework consists of four main components:

- **Mindset** – An appropriate mindset for auditors exercising professional judgement;
- **Professional Judgement Trigger and Process** – A suggested professional judgement process, together with a reminder to remain alert to situations which may require professional judgement;
- **Consultation** – Effective communication with a range of relevant parties; and,
- **Environmental Factors** – Factors that may be present in the environment of those making a judgement, that can impact on how challenging it is to exercise professional judgement in an appropriate manner.

Illustrative Examples

These examples show professional judgement being exercised in illustrative scenarios, highlighting some important aspects of professional judgement. The characters in the examples are not portrayed as demonstrating perfect judgement, nor do they always employ the professional judgement framework described above.

These examples are simplified and abbreviated as compared to equivalent real life situations and the characters do not always take the most appropriate course of action. Therefore, they should not be taken as purporting to show a complete list of considerations that should or would be considered in a real life judgement process on a similar topic and should not be seen as guidance on the accounting and auditing scenarios covered. The illustrations provided are entirely fictional, and should not be taken to relate to actual scenarios or ongoing FRC inspections or enforcement cases.



Illustrative example 1

F plc (or the company) is a listed manufacturing company, audited by J LLP. Materiality was set at £3 million for the audit under consideration.

At year end, F plc's cash balance was £25 million, and their loans and other borrowings balance was £33 million, giving them a net debt figure of £8 million. For most of the rest of the year, however, their net debt was significantly higher, fluctuating around £24 million. The primary reason for this change is a significant increase in the cash account balance in the run up to year end, from around £9 million to £25 million. This was caused by a shift in working capital management policies prior to year end. For example, F plc delayed payments to suppliers and offered one-off discounts to customers to pay early.

During the year end audit, each individual relevant account balance was tested and no issues were noted. However, in the notes to the financial statements, F plc calculates and presents the company's net debt figure as part of their note on capital management. One of the engagement team noticed that the sharp increase in cash just prior to year end would mean that the net debt position disclosed in the notes is different from the level it would have been at for the rest of the year. The engagement team member is aware that this could potentially mislead users of the financial statements, and escalates the issue to the engagement partner, as the judgement as to whether anything should be done is complex, requiring experience and knowledge of the needs and expectations of the intended users.

Here, the engagement team member is demonstrating perceptiveness and professional scepticism in noticing the potential issue, and good awareness of their own skillset as compared to that required for making this judgement.



The engagement partner is aware that professional judgement is called for in assessing what course of action should be taken here. She understands the issue at a high level as being a decision about whether or not to require F plc to change or remove the relevant disclosure, but takes the time to better define the issue and articulate her objectives in making this judgement.

The engagement partner defines the judgement being made as being whether the company's presentation of the capital management disclosure showing net debt constitutes a material misstatement and, if so, how the disclosure could be modified so that it is no longer materially misstated.

The engagement partner articulates their objectives for this judgement as follows:

- To be able to express the appropriate opinion as to whether the financial statements are prepared, in all material respects, in accordance with UK adopted international accounting standards and are true and fair

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- That the intended users' understanding of the financial position and performance of F plc is enhanced

The engagement partner shows good awareness of the purpose of audit in articulating her objectives.



Next, the engagement partner considers the alternatives available to choose between. The engagement partner sees her four options as being:

- The disclosure is not materially misstated
- The disclosure is materially misstated and the information relating to net debt should be deleted
- The disclosure is materially misstated and the information relating to net debt should be modified
- The disclosure is materially misstated and the information relating to net debt should be supported by further clarifying information

The engagement partner knows that IFRS is a fair presentation framework, and that it requires that the financial statements must fairly present the financial position and performance of the entity. IFRS defines the objective of the financial statements as being to provide information about the financial position, financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions.

Her concern, then, is that the capital management disclosure referencing net debt obscures useful information, or is actively misleading, regarding the level of net debt that the company carried for most of the year.

If it does so, it is arguably not fairly presented and thus not in accordance with UK adopted international accounting standards. This would be a misstatement, which could be material if it could reasonably be expected to influence the economic decisions of users of the financial statements.

The engagement partner understands that any assessment of whether the disclosure might be misleading requires consideration of the perspectives of the intended users; in order to determine whether they might be misled, she must develop an understanding of how they might take in and use the information.

The engagement partner knows from experience that many investors and potential investors look at net debt levels and the capital structure of companies when making investment decisions, but does not have extensive experience with listed companies in this specific industry, so undertakes to research the matter further.

Here, the engagement partner understands the need to consider the relevance of her knowledge in the specific context of the judgement at hand.



The engagement partner enquires with F plc's management about their reasoning in presenting the information in the way that they did, and whether they considered adding further disclosures to clarify that the year end position was unusual and transient.

Management offer the following argument for their approach:


We made the relevant transactions that led to this figure for normal commercial reasons, and this is the correct net debt balance based on the year end cash and debt balances, which you have audited and found no issues with. Furthermore, the impacts of our actions prior to year end are visible in other account balances such as revenue, trade receivables and trade payables, and in the cash flow statement, so nothing is being hidden from the intended users.

In considering this argument, the engagement partner realises there are (at least) two different ways the net debt disclosure could potentially mislead users. Firstly, it could imply the company is less reliant on debt and has a stronger balance sheet than has actually been the case for the majority of the reporting period. Secondly, the context in which the net debt figures are presented could mislead users about the company's capital management policies, if it is taken as implying the company's policy is to maintain net debt at roughly the year end level.

Here, the engagement partner realises her framing of the issue was incomplete, and shows good willingness to return to earlier parts of her judgement process when appropriate.



The engagement partner does not think that any of management's points address the second of these issues. Regarding the first issue, the engagement partner splits the argument into three claims:

Management claim 	The engagement partner's response 
We made the relevant transactions that led to this figure for normal commercial reasons	<p>The engagement partner has some doubt about the claim that the transactions were made for commercial reasons and not to portray financial statement items in a more favourable light; this makes her question the integrity and trustworthiness of management, which could have wider implications for the audit.</p> <p>Furthermore, whatever the motivation for the actions that led to the lower year end net debt figure, they are only temporary in their effects, i.e. there is no reason to assume net debt will not swiftly return to its higher level. The current disclosure does not make this clear (though see the third claim below for further discussion on this).</p>
...this is the correct net debt balance based on the year end cash and debt balances, which you have audited substantively and found no issues with.	<p>The engagement partner notes that the net debt figure can be "correct" but nevertheless misleading.</p> <p>She understands that the point around having performed other audit procedures over the relevant account balances is irrelevant to the issue at hand, as different assertions were being covered by those procedures.</p>

Continued

Management claim



Furthermore, the impacts of our actions prior to year end are visible in other account balances such as revenue, trade receivables and trade payables, and in the cash flow statement, so nothing is being hidden from the intended users.

The engagement partner's response



The engagement partner accepts that this is a relevant consideration to how intended users might evaluate the net debt figure. In particular, it may be possible for a user to "connect the dots" and understand that net debt may increase significantly soon after year end. However, there are many and varied other factors that influence the levels of these various balances, so it may be highly difficult to actually trace the connection.

Furthermore, it may be the case that the users pay more attention to net debt figures than some other balance sheet metrics.

The engagement partner demonstrates professional scepticism by critically assessing management's arguments.



The engagement partner also asks her engagement team to look at the capital management disclosures of similar companies, in an effort to understand whether any peer companies provide information on how net debt had moved throughout the period; this is important in understanding what needs and expectations the intended users might have regarding this disclosure. The team find that some companies do provide such information, for example disclosing the average net debt for the year.

She consults with an internal technical panel of partners who have greater experience in how the intended users of F plc's financial statements might interpret and use the relevant disclosure. They advise that net debt levels and capital structure ratios do indeed commonly influence investment decisions in this sector, and that there is diversity regarding the extent to which investors take the time to look at other balance sheet metrics with similar interest.

The engagement partner should be careful here, as there is a risk of both groupthink and confirmation bias affecting her judgement. Groupthink is possible whenever a group convenes to make a decision. Confirmation bias is a threat here as the engagement partner's prior experience from other sectors suggested that the intended users would be interested in net debt and capital structure issues, so she could inadvertently place undue weight on the panel's corroborative evidence.



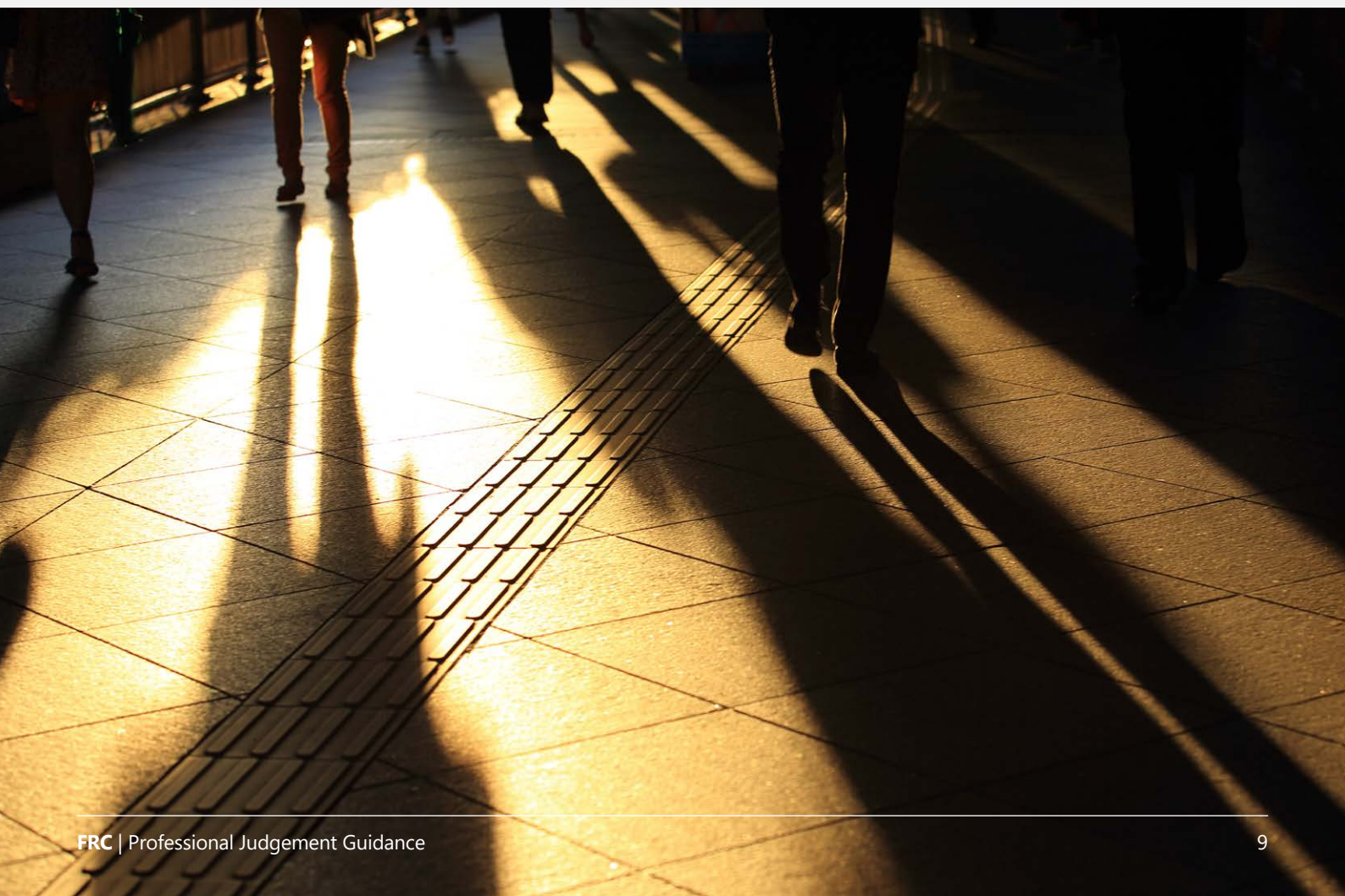
The engagement partner notes that the change in net debt at year end is many times materiality, so if she decides that the disclosure is misstated, it is likely materially misstated.

The engagement partner weighs the various alternative conclusions against how well they allow her to meet her objectives for the judgement. Having gathered and analysed a range of information, the engagement partner sees the judgement as coming down to two main considerations, reflecting the two ways she identified that the disclosure could be potentially misleading. Firstly, whether the intended users would understand from what is disclosed that the low level of net debt is likely transient and, secondly, whether the context that the net debt figure is shown in makes it appear as though the company's capital management policy includes keeping net debt at broadly the year end level.

This illustrative example does not contain sufficient detail for the engagement partner's conclusion to be clear. Irrespective of how she concludes, the engagement partner will ensure that the issue is soundly documented on the audit file.

Reflecting on the judgement, the engagement partner notes that issues have arisen during the judgement process that may trigger further professional judgement processes. These include the need to consider whether other parts of the financial statements could be materially misstated as a result of the unusual working capital policies prior to year end, and to assess how the company's net debt and capital management policy are discussed in the front half of the annual report.

Furthermore, if she ends up concluding that the disclosure is materially misstated, she will likely wish to consider the possibility that the original disclosure was intentionally deceptive, and the implications of that. This would raise issues around the integrity and values of F plc's management, which could significantly alter the risk assessment for many areas of the audit, mandate greater professional scepticism and affect the decision as to whether to continue the audit engagement in future years.



Illustrative example 2

XYZ LLP has a long-standing audit engagement to carry out the audit of the ABC Group Limited. The group is financed through a combination of long-term debt and facilities with a reputable bank, equity investment and capital contribution from two individual shareholders and cash from its ongoing trading income. The business is involved in corporate events and other entertainment activities and experienced significant difficulties during the Covid-19 pandemic.

For the year ended 31 March 2021, both management and the auditor concluded that the going concern basis of accounting was appropriate, and that no material uncertainties were identified and reported; ABC's shareholders had committed to providing additional cash to meet the expected need to June 2022 and the bank had renewed facilities to December 2022.

Emerging from the pandemic, the directors believe that the company can finance its day-to-day operations through its ongoing trade but is not in a position to be able to repay the loan when it falls due and would need to either refinance the borrowing or would need a contribution from the shareholders to meet this liability should refinancing be impossible.

In the current financial year to 31 March 2022, XYZ LLP has assigned a new engagement partner to the engagement. The new partner identifies that there is a close-call scenario with respect to considerations around going concern.

In identifying the close-call nature of the scenario, when no material uncertainties were identified in the prior year, the new partner resists falling prey to anchoring bias or groupthink.



As such, she decides to make a start on going concern work earlier in the process than she would normally. Further, she has identified that this part of the audit requires significant professional judgement. She recognises that there are two main judgements to be made: whether the going concern basis of accounting is appropriate and whether there is a material uncertainty relating to going concern.

As a starting point, the engagement partner requests the directors' initial going concern assessment, including cash flow forecasts, initial discussions with the bank about potential for refinancing and an initial view from the existing shareholders about ongoing support and their willingness or otherwise regarding entering legally binding agreements in this respect.

The partner exercises enhanced professional scepticism when considering the information provided by management here as she recognises the potential for management bias is pronounced.

These information gathering activities yield the following results:

- Management and those charged with governance have concluded that the going concern basis of accounting is appropriate, and that they have not identified any material uncertainties in respect of going concern.

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- Cash flow forecasts show a cash need in month October 2022 in a number of plausible scenarios. The forecasts are complex with a significant number of assumptions (particularly about expected growth and timing of cash flows).
 - The bank is willing to hold further discussions about ongoing lending and renewal of facilities and is planning to agree a position on this in advance of audit sign off.
 - The shareholders write a letter to those charged with governance expressing their willingness to support as they have in the past but will not enter into a binding agreement, preferring to make live decisions on when and whether to provide cash to the business.

The engagement partner considers that it is appropriate to involve a cash flow modelling expert to interrogate the adequacy and appropriateness of the information used and assumptions made in the cash flow forecasts.

Further, she engages an expert specialising in debt financing to offer insight around the likelihood of the bank renewing the facilities.

Shortly after this, management provide their final going concern assessment, deeming the going concern basis to be appropriate, with no identified material uncertainties, and note that the bank have informally agreed to renew the facilities and are drawing up formal agreements to extend for two years from December 2022.

Those charged with governance concur with management's opinions; the key piece of evidence that satisfied them is the letter of support from the shareholders indicating their willingness to provide support if necessary.

The auditor's experts involved in the process come back to the engagement partner with their findings. The cash flow modelling expert has produced a report which concludes positively on the mechanical accuracy of the forecasting model, and on the appropriateness of the assumptions based on previous trading, known facts about the business, known facts about the sector and expected economic conditions. The debt financing expert, however, informs the engagement partner that there are indications that appetite for lending in this sector is decreasing and that there has been a slight but noticeable deterioration in the bank's own financial position.

The partner is in agreement with management and those charged with governance that the going concern basis is appropriate, as they have no intention of ceasing trading and she does not think the evidence supports a view that they have no realistic alternative but to do so. However, she is much less convinced that there is no material uncertainty around this judgement.

She acknowledges that the shareholders have provided cash if required in the past and have expressed willingness to do so in the future, but the fact that they are unwilling to commit formally here means uncertainty remains around whether they would do so if a need arose for a significant sum. She is satisfied, following investigations, that the shareholders have the wherewithal to provide the funds if they choose to do so.

Similarly, she is aware that the bank have informally agreed to renew the facilities but, in the absence of a formal agreement, together with the insight from the auditor's expert providing some reason to think the bank's appetite for lending may be decreasing, leaves her with uncertainty around whether the bank will ultimately sign an agreement.

The partner considers the likelihood of occurrence and potential impact of these negative outcomes, namely there being a cash need and the group not being able to obtain financing from either the shareholders or the bank. If such an outcome were to occur, she thinks the impact would be severe, and so frames the main judgment that now needs to be made as being an assessment of how likely such a scenario is to occur.

Here, the engagement partner recognises the need to return to the framing step, to refocus the judgement.



She is aware that the team are nearing the end of the audit timetable and that she has not yet made a judgement. She communicates her position to management.

Discussions with management are tense. Management are pressuring the partner to conclude on this area, saying any further delay could result in the planned deadlines not being met. In particular, they are pressuring her to conclude that there is no material uncertainty, saying that is what the partner in prior years concluded and pointing out that both the shareholders and the bank had expressed willingness to provide support and renew arrangements respectively. Those charged with governance are exerting pressure on the partner as well, claiming her doubts are unfounded and that she is being unreasonable.

Management have agreed to a draft representation letter which confirms their previous view on going concern and will provide an email from the bank explaining their intentions as alternative evidence. The engagement partner recognises quality risks associated with obtaining information late in the process under time pressure. Furthermore, she recognises that significant pressure is now being asserted on her by management and that she must not unduly rush or take short cuts over her judgement process.

The management of the audited entity are acting in a way that could hinder the partner's attempts to carry out an effective judgement process, but she is alive to this threat and resolves to continue taking the appropriate actions.



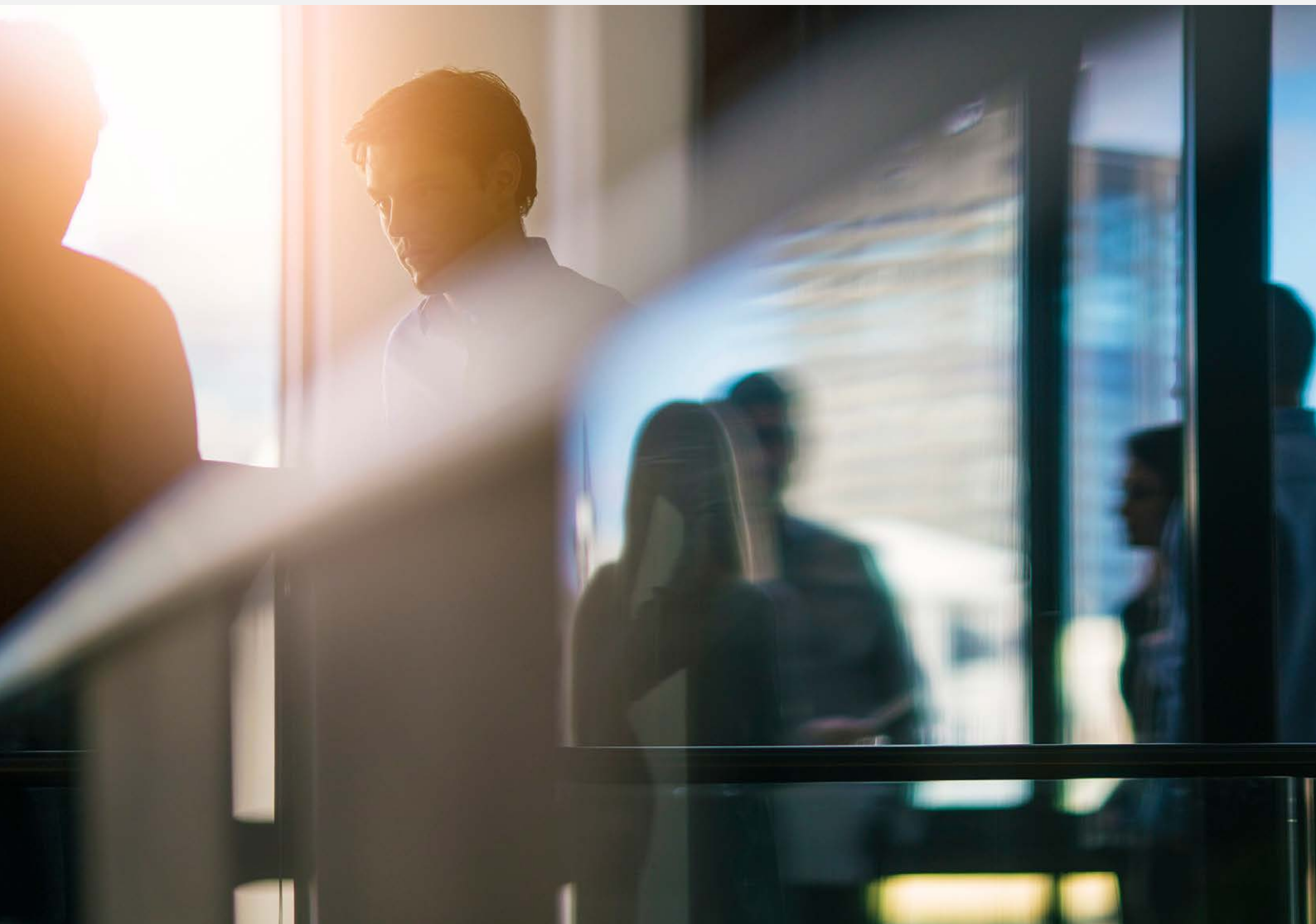
The partner considers whether the level of pressure being exerted remains acceptable and consults with her firm's ethics team. The ethics team advise that she should put a safeguard in place, namely discussing this significant judgement with the firm's central technical team and seeing if they concur with whatever judgement she reaches.

Consultation, with both the ethics function and the central technical team, assists the partner's professional judgement process here, mitigating the threat of management pressure compromising the judgement.



The partner considers whether the lack of disclosure in the financial statements in respect of the uncertainty surrounding the future financing of the business would influence the decisions of users and whether or not the financial statements would give a true and fair view without additional disclosures being made in the financial statements, either to disclose a material uncertainty in respect of going concern or to disclose significant judgments made by management as part of its going concern assessment.

Whether or not the partner concludes that there is a need for additional disclosure, she should ensure the documentation on file is appropriate in light of the significance of the judgement, and should reflect on whether the behaviour of both management and those charged with governance raise any issues around continuance for the following year.



Illustrative example 3

The auditor has just completed the group audit of C PLC for the year ended 31 December 202X, a UK listed entity with operations in the UK and overseas. This was the fourth year that the auditor had been performing the audit and, as in previous years, the audit had been going smoothly and the work performed by the component auditors was completed on time. The group audit team enjoyed working on the audit as they had good relationships with management and the central finance team. In addition, the end of March group accounts signing date meant that there was not significant time pressure on the audit. The audit fee had also been agreed at a reasonable level that meant that the team could undertake the work required and still deliver a good recovery rate.

However, the following issue arose late in the audit:

- Management's paper on impairment of goodwill, that was provided to the auditor 10 days before the agreed signing date, did not cover some key sensitivities that the auditor felt were required and did not sufficiently support a key assumption. The auditor requested the paper to be updated and more disclosure to be made in the financial statements. This caused delays in the preparation of the annual report and identified new information that showed that the key assumption was optimistic and that a small movement in the assumption could result in an impairment. As a result of this, the auditor needed to perform more work and the time required to complete this work resulted in the company delaying the announcement of their results by a week.
- The audit committee felt that the level of the auditor's challenge of management on impairment was not justified and complained that the auditor should have completed their work on time. This involved some heated exchanges with the engagement partner, and it was mentioned that the board were considering whether the audit should be put out to tender. In addition, they felt that the completion process that the auditor needed to undertake to complete their audit was too extensive and should have been completed quicker.
- In the end it was decided that the audit would not be put out to tender at this time.

As a result of the above, the audit firm convened an internal panel to decide whether these events would affect the annual decision that the firm was required to make on whether to continue with the audit engagement.

The issues that the panel considered were:

- The reason for the lateness and incompleteness of management's paper. The panel discern three broad possible categories of explanation for this, noting that they need not be mutually exclusive:
 - There were legitimate business reasons, such as unforeseen exceptional circumstances that affected management's work. This explanation is made less credible, however, by the apparent lack of communication and warning from the audited entity about the issue.
 - Lack of competence on the part of relevant management personnel led to work of insufficient quality that didn't meet required deadlines.
 - Lack of integrity or ethical values on the part of management; for example, it is possible that management were attempting to obscure an overly aggressive accounting treatment by limiting the time that the auditors had to look at it.

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- The reason for the reaction of the audit committee, namely not supporting the level of challenge of management that the audit team displayed, and going so far as to threaten putting the audit out to tender as a result. The panel again sees three possible non-mutually exclusive explanations here, mirroring the previous point:
 - The actions of the audit team were inappropriate in the circumstances. While it is correct to delay providing the audit opinion until the required work is done, it is possible that the work effort went significantly beyond what was reasonable. The panel are conscious of the paramount importance of audit quality, and of the fact that the lateness of the paper could have rightfully increased professional scepticism on the part of the audit team, which may have led them to increase the work effort for appropriate reasons. Therefore, the panel would require a significant body of persuasive evidence to support this explanation before judging it to be a viable conclusion, but it is a possibility and so merits consideration.
 - The audit committee may not understand their role or lack the capability to effectively carry it out. This could compromise their ability to support the auditor and challenge management.
 - The integrity or ethical values of the audit committee may be lacking. This would compromise the ability of the audit committee to fulfil their role effectively.
 - Whether the results of the debate of the first two points have implications for an assessment of whether such a scenario is likely to occur again.
 - Whether this raised wider concerns over the governance of the company. Had a heightened risk been created that meant that the auditor did not want to continue to be associated with the entity?
 - The fact that this audit was profitable for the business unit. What impact could resigning have on staff resourcing and the business unit?
 - The fact that the audit committee chair is on the audit committee of an entity that the firm is tendering for. Could the decision to resign from this audit impact that audit tender?

It appears that the panel has not articulated a clear set of objectives that they hope are achieved by their chosen course of action.



This could cause issues, as it could lead to the panel judging each of the issues discussed to be of equal or similar importance. If the conclusions on each point of discussion do not all point to a consistent course of action being appropriate, the panel may struggle to determine what the best conclusion is, or may reach an inappropriate or unreasonable conclusion.

For example, the panel discussed the possible financial and operational impacts of not continuing with the engagement. These are not irrelevant, but ISQM (UK) 1 is clear that the decision as to whether or not to continue should be based on “information obtained about the nature and circumstances of the engagement and the integrity and ethical values of the client (including management, and, when appropriate, those charged with governance) that is sufficient to support such judgements; and the firm’s ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements”, and that “the financial and operational priorities of the firm do not lead to inappropriate judgements about whether to accept or continue a client relationship or specific engagement”.

If the panel had articulated a set of objectives, they may have a better chance of reaching an appropriate judgement. An example of such an objective would be: that the continuance decision is based on the nature and circumstances of the engagement, the integrity and ethical values of the client and the firm's ability to perform the engagement in accordance with professional standards and applicable legal and regulatory requirements, such that the firms would not agree to continue if they could not deliver an audit of appropriate quality or if relevant personnel at the audited entity lack integrity or ethical values.

The panel decided that the following information would be important for their continuance decision:

- An independent assessment of the appropriateness of the audit work performed on this issue by the audit team. The panel are conscious of the risks of bias here – in particular, motivated reasoning, confirmation bias, anchoring bias and overconfidence would appear to be especially threatening here – so deem it important for this assessment to be performed by an independent audit partner.

The panel are staying aware of the potential for biases to affect the judgement process, and planning actions to mitigate this risk.



- An assessment of the track record of management and the audit committee at the entity. For management, this will focus on how aggressive their accounting choices have been and whether they have been consistently open and honest with the auditor in the past. In respect of the audit committee, the panel are interested in the level of challenge they have offered management and conversely the amount of support they have provided to the auditor on previous issues of contention.

Despite recognising the threat of bias for the assessment of the audit work, the panel fail to consider the similar risk that could arise around an assessment of the track record of personnel at the audited entity, since those who worked on the audit may be incentivised to find these parties unreasonable, in order to make their level of challenge appear more appropriate.



- Information concerning the integrity and ethical values of the audit committee and management. The firm is required to consider such information in any continuance decision, but a stronger body of evidence is likely to be needed in this case due to the actions of the relevant parties around the goodwill issue.
- Any evidence that investors and analysts are concerned about the Board or the governance of the company; this may serve as useful evidence on the business reputation of the leadership of the entity, which could be relevant to assessing why management and the audit committee acted in the manner described above.

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- Information on the market reaction to the delay in the results announcement; e.g. whether there was there any short selling of the shares of the listed entity.
 - Information around what financial and operational impacts not continuing the engagement would have on the business unit and the firm as a whole, including consideration of a scenario where the tender involving the audit committee chair is unsuccessful.

Based on the results of these information gathering activities, the panel will decide whether to continue the engagement, not continue, or continue conditionally on some mitigating actions being taken at the audited entity. If the panel judges the audit committee or management to have behaved inappropriately, they will consider whether there is a wider cultural issue at the entity, or if the problem is confined to a limited number of people. This may affect an assessment of whether similar behaviour is likely to happen again.

The panel's plan for how to conclude does not appear very structured and may run into issues if there is conflicting evidence coming out of the information gathering activities. For example, if it is judged that management lack integrity, but that not continuing the engagement would significantly impact the profitability of the business unit, it is unclear if the panel's framing of the issue would lead them to judge that they should not continue the engagement.



This may be due to a lack of clear objectives set by those making the judgement, which would act as a set of criteria to judge possible conclusions against.

If the firm does decide to continue the engagement, many of the issues considered in making judgement will be relevant for planning and performing the audit itself. Likewise, if the audit goes ahead, the firm determines that an independent audit partner should have debrief conversations with the Audit Committee Chair, the Chairman and the CFO to ascertain whether they fully understand the firm's concern with how the issue was dealt with.



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