

Case 2-2

Is the Level of Professional Judgment Expected for Auditors Unreasonably High?

Auditors today are subject to increased expectations from regulators and the investing public. At the same time, corporations are expanding, transactions have become more complex and there are requirements on auditors to provide much greater levels of assurance related to financial fraud. A paper by the Institute of Chartered Accountants in Australia titled, Professional Judgment: Are Auditors Being Held to a Higher Standard than Other Professionals¹ contends that auditors are being held to higher standards for judgment than other professions such as law and medicine where the difficulty of making judgments is recognized. The paper suggests that even a well-conducted audit, following all appropriate audit standards, can fail to detect a material fraud in the financial statements, particularly where management has gone to great lengths to cover up the fraud. These considerations are important in an environment where audit standards have the force of law as is the case with public companies whose audits are overseen by the PCAOB, an entity that reports to the SEC.

The paper notes that judgment is the cornerstone of auditing. The auditor is expected to use professional judgment in light of the given circumstances. Even though auditors should exercise professional skepticism in an attempt to mitigate risk of being deceived, there will always be some residual risk of material misstatement due to fraud. With the increased complexity of accounting standards, these judgments for auditors are becoming even more difficult. This is due in part to the growing number and complexity of standards in areas such as fair value accounting and financial derivatives.

Questions

- 1. Do you think auditors should be held to higher standards than those in other professions? Why or why not? How do expectations for professional judgment in the case of external auditors differ from those for internal accountants?**

All professions are held to higher standards than the general public. If this was not so, then it would not be a profession. Many professions, i.e., medical professions, have a major responsibility to the individual and only a minor responsibility to the public.

Auditors have a major responsibility to the public. The fiduciary duty of financial matters also carries an additional burden of being prudent and cautious with other people's money. The duty to the public is primary for external auditors, while internal accountants have a primary duty to their employer.

- 2. To what extent do you think the possession of certain virtues can help to mitigate the risk that the audit might fail to detect a material fraud in the financial statements, particularly where management has gone to great lengths to cover up the fraud?**

Auditors need the virtues of honesty, objectivity, and skepticism to evaluate all evidence in auditing financial statements. The auditors should not be willing to accept glib answers or subordinate their judgment in the audit. The auditor will need perseverance to keep asking questions until satisfied with the answers.

3. To what extent do you think the stage of moral development might influence an auditor's ability to take the necessary steps to identify and correct for fraud?

The auditor will need to reason at the conventional and post conventional stages to take the necessary step to identify and correct for fraud. In looking for fraud the auditor becomes an external whistleblower. Whistleblowers cannot be concerned with just one's own need, but be concerned with the greater good and wanted justice to prevail. Whistleblowers can be mocked, ridiculed, fired, and threatened. The need for justice, rules to be followed, the greater good or social contract drives a whistleblower to determine and report fraud.