

## Professional Skepticism—Issues and IESBA WG Proposals

### Background

1. At their September 2016 meetings, the International Auditing and Assurance Standards Board (IAASB) and IESBA Consultative Advisory Groups (the CAGs), IAASB and IESBA exchanged views about the Professional Skepticism Working Group's (PSWG) preliminary recommendations about how the restructured Code might further emphasize professional skepticism (PS).<sup>1</sup> From those discussions, two principal messages emerged:
  - (a) The majority of the CAG representatives agreed that all professional accountants (PAs) need to apply a degree of "professional skepticism" when discharging their professional responsibilities, and expressed support for the IESBA to examine how to develop that idea in the IESBA Code. The CAGs emphasized the importance of ensuring that any proposals developed by the IESBA should be scrutinized to avoid any potential unintended consequences for the IAASB's standards.
  - (b) During its meeting, many IAASB members expressed concern that the concept of PS as defined in the International Standards on Auditing (ISAs) for use in audit and assurance engagements might be diluted if the IESBA were to undertake an initiative to extend the applicability of "professional skepticism" to all PAs. IAASB members also raised concerns that extending the concept of PS beyond audits, reviews and other assurance engagements might lead to an expansion of the work effort for engagements that are not audit and assurance engagements.
2. Taking into the account the feedback from the CAGs and the IAASB, the IESBA asked its newly established IESBA PS Working Group (IESBA WG) to explore the feasibility of developing short-term PS enhancements for possible inclusion in the restructured Code, provided that those enhancements do not:
  - (a) Compromise or dilute the concept of PS as it is currently used in ISAs;
  - (b) Give rise to any unintended consequences; and
  - (c) Pre-judge any longer-term initiative that the PSWG might undertake.

### *Activities Post-September 2016 IESBA Meeting*

3. Since the September 2016 IESBA meeting, the IFAC Professional Accountants in Business (PAIB) Committee has discussed the topic of PS and the activities of the PSWG, including whether the concept of PS should be extended to all PAs. The PAIB Committee expressed various views on the topic, including, in particular:
  - When promoting the value of the accounting profession in roles beyond audit and assurance, it is critical that the profession is not undermined by the use of terminology that implies that PAIBs do not uphold the same professional standards and competence as auditors and

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<sup>1</sup> The term PS is dealt with in the extant IESBA Code as part of the description of independence. See Part B, *Independence – Audit and Review Engagements* of the extant Code, Section 290, *A Conceptual Framework Approach to Independence*, paragraph 290.6 and Section 291, *Independence – Other Assurance Engagements*, paragraph 291.5.

assurance practitioners.

- The need for, and use of, a specific description of PS in the IAASB's standards that is applicable to audit and assurance engagements does not mean that the concept of PS is not applicable to PAIBs. In other words, all PAIB roles require a degree of PS.
  - As the current definition of PS in the IAASB's standards focusses on audit and assurance engagements, different concepts or terms might be needed. For example, the ISAs might continue to require a more specific and limited application of PS in the context of the audit engagement – "assurance skepticism" as compared to PS in a broader sense.
  - It might be useful to develop additional guidance to explain what is meant by PS more broadly – for instance, how the concept of PS might be applied in different roles and activities, such as how PS might apply to PAs involved in financial statements preparation or in performing financial reviews, planning, forecasting and budgeting. However, the PAIB Committee cautioned against regulating the exercise of PS for PAIBs.
4. The International Accounting Education Standards Board (IAESB) also discussed the topic of PS at its November 2016 meeting, including possible short-term and longer-term actions that might be taken with respect to PS. IAESA members exchanged views about:
- How the definition of PS might be harmonized in the Standard Setting Boards' (SSBs') standards.
  - How best to inventory and promote best practices about promoting learning outcomes related to PS in the International Education Standards (IESs).
  - Whether further action should be taken to expand on the distinction between PS and professional judgment in the IESs.
  - Whether to commission an academic to undertake research about specific aspects of PS and its application.
  - The outreach activities that might be needed in progressing the project. For example, it was suggested that the PSWG liaise with the International Public Sector Accounting Standards Board.

### **Issues and IESBA WG Proposals**

5. In forming a view about a way forward, the IESBA WG reflected on the views expressed by the CAGs, the IAASB, the IESBA and the PAIB Committee during their September 2016 meetings. It also considered the views of stakeholders who questioned whether the relevant "information" or "evidence" underpinning ethical decisions (usually relating to relationships between individuals within a firm and the entity being audited or other matters relating to compliance with the IESBA Code) is being assessed with adequate PS.
6. The IESBA WG noted the support for:
- Considering an initiative to emphasize PS in the restructured Code; and
  - Having the concept of PS apply to all PAs, provided that it remains clear that the expectation

of those performing audits, reviews and other assurance engagements is different;<sup>2</sup>  
provided that there are no potential unintended consequences for the IAASB's standards.

7. The IESBA WG reviewed the proposed restructured Code to determine whether and, if so, where it would be beneficial to emphasize PS in the Code. It concluded that in the short-term there is merit in:
  - (a) Explaining the interaction between PS, independence and certain fundamental principles in the context of audit and assurance engagements in the Code. This explanation is based on the current definition of PS in the ISAs.<sup>3</sup>
  - (b) Establishing a new requirement in the Code to better enable all PAs to comply with the fundamental principles. Thus, when applying the conceptual framework, professional accountants would be required to apply a critical mindset in order to understand facts and circumstances being considered and their implications with respect to compliance with the fundamental principles.<sup>4</sup>
8. The IESBA WG agrees with those, including some CAG Representatives, who pointed out that the expectation with respect to PS for PAs who do not perform audit and assurance engagements is different from the expectation relative to auditors and assurance practitioners. The IESBA WG also agrees that in the short-term, the ISA definition of PS has an established and well understood meaning in the context of audit and assurance engagements. However, the IESBA WG noted the view that it is important for all PAs to exhibit a certain degree of “skepticism” in fulfilling their responsibilities.

#### **Matter for CAG Consideration**

1. Representatives are asked for views on the short-term IESBA project proposal set out in **Agenda Item A-3?**

#### *Applying a Critical Mindset – A Short-term Approach for All PAs*

9. Taking into account discussions with the PSWG, the IESBA WG has explored a suggestion made at the September 2016 meetings of the CAGs and the IESBA, and has proposed a new requirement to address the expectation of PAs who do not perform audits, reviews and other assurance engagements. In doing so, the IESBA WG believes it is being responsive, while avoiding the potential for unintended consequences that would arise if it extended the concept of PS to all PAs.
10. Complementing the other requirements set out in R120.5 namely to: (i) exercise professional judgment, (ii) remain alert for new information and changes in facts and circumstances, and (iii) apply the reasonable and informed third party test, IESBA WG members believe that *applying a critical mindset* is required when applying the conceptual framework to better enable PAs to comply with the fundamental principles.

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<sup>2</sup> Some CAG Representatives were of the view that PS should also apply to those with responsibilities for overseeing PAs' work, for example, those charged with governance.

<sup>3</sup> See paragraphs 120.13 A1 – 120.13 A3.

<sup>4</sup> See paragraphs R120.5 (a), 120.5 A1 and 120.5 A2.

11. **The IESBA WG is of the view that its proposal in paragraphs R120.5 (a), 120.5 A1–120.5 A2 is an important requirement to add to the restructured Code to improve the PA’s application of the conceptual framework, thereby enhancing the process by which the PA identifies, evaluates and addresses threats to compliance with the fundamental principles.** New application material has been developed to explain that a critical mindset might involve considering whether:
- Information is inconsistent with other relevant information and whether additional information is needed to draw an informed conclusion.
  - Other conclusions could be drawn from the information being considered.
  - The accountant’s own preconception or bias might be affecting the judgment being made.
  - The accountant’s own expertise and experience is sufficient, or whether others with a particular expertise or experience might need to be consulted.
12. The proposal does not repeat the definition of the fundamental principles set out in Section 110<sup>5</sup> of the restructured Code, but provides examples to illustrate how a PA might apply a critical mindset in order to properly understand the facts and circumstances being considered, and their implications in relation to compliance with each of the fundamental principles. Section 120 of the restructured Code<sup>6</sup> explains that those facts and circumstances include the various professional activities,<sup>7</sup> interests and relationships that create threats to compliance with the fundamental principles.
13. In developing its proposals, the IESBA WG considered, but decided against, the use of:
- “Critically consider” because the verb “consider” was not thought to be sufficiently robust or enforceable.
  - “Critically assess” because the word “assess”<sup>8</sup> has a specific meaning in the IAASB’s standards that in the IESBA WG’s view should not be extended to all PAs.
  - “Critically reflect” because the concept of “reflection” is generally understood as being an aspect of the fundamental principles of objectivity or professional competence and due care.

#### Critical Mindset Versus PS

14. The IESBA WG believes that, when asserting compliance with the fundamental principles and ultimately compliance with the Code, PAs cannot simply take information at face value, but rather need to apply a critical mindset to form judgments and conclusions about such information.

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<sup>5</sup> Section 110, *The Fundamental Principles*

<sup>6</sup> See paragraph 120.1.

<sup>7</sup> Consistent with the extant Code, the proposed restructured Code defines professional activity as “an activity requiring accountancy or related skills undertaken by a PA, including accounting, auditing, taxation, management consulting and financial management.” The term professional activity includes professional services, which is defined as “professional activities performed by clients”.

<sup>8</sup> The ISAs define word “assess” as “analyze identified risks of material misstatement to conclude on their significance.” The ISAs further note that conventionally, the word assess is used only in relation to risk.

15. The IESBA WG is of the view the concept of critical mindset is not the same as PS – “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.”<sup>9</sup> Reference to a key component of the definition of PS, “a questioning mind”, is intentionally avoided. Nevertheless, the IESBA WG notes that any longer-term PS project, the scope of which is still being considered by the PSWG, might need to explore the relationship between the “critical mindset” and PS.

#### Critical Mindset Versus Further Explaining the Fundamental Principles

16. It was suggested that the same objective of establishing the requirement for “applying a critical mindset” could be achieved if an explanation for one or more of the fundamental principles, for example, objectivity or professional competence and due care was included in the Code instead.
17. The IESBA WG is of the view that the requirement to apply a critical mindset is relevant to compliance with *all, not just one of* the fundamental principles. Accordingly, the proposed text includes the proposed requirement as one of the elements of applying the conceptual framework, which in turn enables the professional accountant to comply with the fundamental principles.
18. The IESBA WG also regards its approach as important so as to avoid the notion that one fundamental principle is more important than others. This is important because the IESBA WG recognizes that the five fundamental principles are inter-related.

#### Critical Mindset Versus Professional Judgment

19. In developing its proposals, the IESBA WG also considered the merits and drawbacks of expanding on what is meant by professional judgment in the context of the Code, i.e., using the material in R120.5 (a) and 120.5 A1-120.5 A2 to explain what is meant by exercising professional judgment in paragraph R120.5 (b).
20. The term professional judgment is not defined in the Code, but is defined in the ISAs as “the application of relevant training, knowledge and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.”<sup>10</sup>
21. Questions have been asked about whether the term critical mindset is a necessary component of the application of the various matters referred to in the definition of professional judgment. The IESBA WG notes calls for the IESBA to consider whether the Code should further expand on what is meant by professional judgment in the context of the Code. However, the IESBA WG is of the view that a consideration of professional judgment in the context of the Code should be done in a more holistic manner (requiring an analysis of all references to professional judgment in the Code to ensure, for example, that the term is not used only in the context of a final conclusion). Such an undertaking will also require collaboration with the IAASB and possibly IAESB – for example, the IESBA WG notes that the PSWG is exploring suggestions from respondents to the IAASB’ December 2015 Invitation to Comment (ITC), *Enhancing Audit Quality in the Public Interest*, for the development of a

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<sup>9</sup> Paragraph 13(l) of ISA 200, *Overall Objectives of The Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>10</sup> Paragraph 13(k) of ISA 200

professional judgment framework as a response to issues related to PS. The development of such a framework would have implications for, and might require a more thorough analysis of, the Code with respect to the use of the term professional judgment.

22. The words “in reaching a conclusion on a reasoned basis” was added to paragraph R120.5 (b) for clarification.

**Matters for CAG Consideration**

1. With respect to the material set out in paragraphs R120.5–120.5 A2 in **Agenda Item A-2**, Representatives are asked for views about:
  - (a) The proposed approach that establishes a new requirement, with supporting application material, for PAs to apply a critical mindset when applying the conceptual framework; and
  - (b) The proposed text.

*Explaining the Linkage between PS and Certain Fundamental Principles/ Independence – For Audits and Assurance Engagements Only*

23. As noted above, the IESBA agreed to explore how to explain the linkage between PS and the fundamental principles/independence. The IESBA WG is of the view that the Board’s ongoing work to clarify the relationship between independence and the fundamental principles in Section 120 provides a basis for this further explanation.
24. The IESBA WG agrees with those, including the CAGs, who suggested that there is a perceived linkage between the concept of professional skepticism and four of the five fundamental principles in the Code – i.e., objectivity, integrity, professional competence and due care, and professional behavior.<sup>11</sup> It is of the view that there is merit in explaining this linkage in an explicit manner in the restructured Code. In developing its proposals in this regard, the IESBA WG further studied the following views expressed by respondents to the IAASB’s ITC:
- The fundamental principles support the exercise of PS.<sup>12</sup> One respondent suggested that the IESBA incorporate the concept of PS into the fundamental principles of integrity and professional behavior in the IESBA Code.<sup>13</sup>
  - Threats to independence might also be threats to auditors’ ability to exercise PS and that a skeptical mindset might safeguard against familiarity and self-interest threats to the fundamental principles, as well as independence.<sup>14</sup>
  - The drivers and impediments to the application of PS are likely to be the same as the drivers and impediments to compliance with the fundamental principles and independence.<sup>15</sup>

<sup>11</sup> This message was also received from some respondents to the December 2015 Exposure Drafts, *Proposed Revisions Pertaining to Safeguards in the Code—Phase 1* and *Improving the Structure of the Code of Ethics for Professional Accountants—Phase 1*.

<sup>12</sup> Investors: CalSTRS, IA; NSS: IDW; Public Sector Organizations: AGSA

<sup>13</sup> Accounting Firms: PwC

<sup>14</sup> Monitoring Group: IAIS; Regulators and Audit Oversight Authorities: EBA

<sup>15</sup> Member Bodies and Other Professional Organizations: KICPA

## Proposed Text

25. The proposed text to describe the linkage between PS and the fundamental principles/ independence in the context of audits, reviews and other assurance engagements is set out in paragraphs 120.13 A1–120.13 A3. It is intended to reinforce PS in the audit and assurance context by explaining how the fundamental principles underpin the effective application of PS. The proposed material has been considered and is unanimously supported by the PSWG. The proposed text:
- Builds on paragraph 120.12 A1 and explains that *independence of mind* (and compliance with the International Independence Standards) allows a PA in public practice to act with integrity, and exercise objectivity and PS when performing audits, reviews, or other assurance engagements. This statement is intended to expand on the definition of *independence of mind* set out in paragraph 120.12 A1 (a).<sup>16</sup>
  - Explains that complying with the fundamental principles, other than confidentiality, reinforces a PA's ability to apply appropriate PS when performing audits, reviews and other assurance engagements. The IESBA WG and the PSWG concluded that the short-term IESBA initiative should focus on the how the fundamental principles support PS. However, there is acknowledgement that an inverse relationship also exists, and should be further explored as part of a longer-term PS project.
  - Indicates that threats to compliance with the fundamental principles are also threats to the accountant's appropriate application of PS when performing audits, reviews and other assurance engagements. This statement is intended to be responsive to respondents to the IAASB's ITC.
  - Includes examples to illustrate how compliance with each of the fundamental principles, other than confidentiality, when performing audits, reviews and other assurance engagements, enhances the appropriate application of PS.
26. The IESBA WG attempted to develop an example relating to confidentiality, but ultimately concluded that such a linkage does not exist. This view is supported by the responses to the IAASB's ITC. The IESBA WG recommends that the EM to the ED include a specific question about this matter.

### Matter for CAG Consideration

2. Representatives are asked whether they support the proposed text in paragraphs 120.13 A1–120.13 A3 in **Agenda Item A-2**.

## Other Matters

27. Questions have been raised, in particular from some of the Structure and Safeguards Task Force members, about whether the material in paragraphs 120.5 A2 and 120.13 A3:
- Should be further streamlined.
  - Should be re-characterized so the proposed examples avoid an explicit reference to each of the fundamental principles. It was suggested that the general statement be considered.

<sup>16</sup> Independence of mind is "the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and PS."

- Would be better positioned elsewhere in the Code, for example as part of Section 110 because the level of detail in those paragraphs is inconsistent with the rest of the material in Section 120.
28. Discussions at the PSWG level indicate that the level of detail at paragraphs 120.5 A2 and 120.13 A3, with explicit references to the fundamental principles, is useful and responsive to the suggestions made by the CAGs and the respondents to the IAASB's ITC. The IESBA WG was also of the view that the clarification and rigor provided by the PS proposals might be diminished if they were presented in different Sections of the Code.

**Matters for CAG Consideration**

3. Representatives are asked whether they agree that the proposed text appropriately complements the material set out in Section 120 and the rest of the restructured Code.
4. Representatives are asked whether they believe the short-term PS proposals set out in **Agenda Item A-2** represent meaningful enhancements to the restructured Code and, if so, to approve them for exposure.