

# Agenda Item 5-6(J3-C)

## Professional Skepticism – Proposed Revisions to Section 120

### Section 120

#### The Conceptual Framework

##### Introduction

- 120.1 The circumstances in which professional accountants operate might create threats to compliance with the fundamental principles. Section 120 sets out requirements and application material, including a conceptual framework, to assist accountants in complying with the fundamental principles and meeting their responsibility to act in the public interest. Such requirements and application material accommodates the wide range of facts and circumstances, including the various professional activities, interests and relationships that create threats to compliance with the fundamental principles. In addition, it deters an accountant from concluding that a situation is permitted solely because that situation is not specifically prohibited by the Code.
- 120.2 The conceptual framework specifies an approach for the professional accountant to:
- (a) Identify threats to compliance with the fundamental principles;
  - (b) Evaluate the threats identified; and
  - (c) Address the threats by eliminating or reducing them to an acceptable level.

##### Requirements and Application Material

- R120.3** The professional accountant shall apply the conceptual framework to identify, evaluate and address threats to compliance with the fundamental principles set out in Section 110.
- 120.3 A1 Additional requirements and application material that are relevant to the application of the conceptual framework are set out in:
- (a) Part 2 – *Professional Accountants in Business*;
  - (b) Part 3 – *Professional Accountants in Public Practice*; and
  - (c) Part 4 – *International Independence Standards* as follows:
    - (i) Part 4A – *Independence for Audits and Reviews*; and
    - (ii) Part 4B – *Independence for Other Assurance Engagements*.

The proposed text below seeks to relate the need for a measure of review/reflection to achieve compliance with all aspects of the Code (not just in an audit and assurance context).

**R120.4** When determining whether a particular fact or circumstance would affect compliance with the fundamental principles, and therefore specific provisions in the Code; the professional accountant shall consider the information available without bias as to its relevance or credibility.

**120.4 A1** The application of the conceptual framework requires the consideration of information and compliance with the fundamental principles of:

- Integrity - by having the courage consistently to act in a manner that is honest, in

particular when new information that becomes available contradicts the professional accountant's initial judgments or conclusions about a situation.

- Objectivity - by considering information without preconception and thereby not subordinating his or her professional judgment to that of another person.
- Professional Competence and Due Care - by not engaging in professional activities the quality of which does not reflect the appropriate degree of rigor expected of the professional accountant's training and expertise for the particular activity; or
- Professional Behavior - by not being complacent and thereby, through the consequences of such complacency, bringing the profession into disrepute.

120.4 A2 When considering information, the professional accountant:

- Considers whether the information that has been provided is inconsistent with other relevant, available information and whether there is information that has not been provided but which could or should be available.
- Considers whether other conclusions could be drawn from the available information
- Takes into account the professional accountant's own experience of the subject matter and of the people involved in the transaction or subject matter.
- Considers whether the professional accountant's own experience and competence is sufficient, or if additional resources or expertise is needed.

**R120.5** When applying the conceptual framework, the professional accountant shall:

- (a) Exercise professional judgment in reaching **a conclusion on a reasoned basis**;
- (b) Remain alert for new information and to changes in facts and circumstances; and
- (c) Use the reasonable and informed third party test as described in paragraph 120.5 A1.

### **Reasonable and Informed Third Party**

120.5 A1 The reasonable and informed third party test is a consideration by the professional accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant, but would possess the relevant knowledge, experience and impartiality to understand and evaluate the appropriateness of the accountant's conclusions.

### **Identifying Threats**

**R120.6** The professional accountant shall identify threats to compliance with the fundamental principles.

120.6 A1 An understanding of the facts and circumstances, including professional activities, interests and relationships that might compromise compliance with the fundamental principles, is a prerequisite to the accountant's identification of threats to such compliance. Certain conditions, policies and procedures established by the profession,

legislation, regulation, the firm, or the employing organization that can enhance the professional accountant acting ethically, might also impact the identification of threats to compliance with the fundamental principles.

- 120.6 A2 Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. It is not possible to define every situation that creates threats. In addition, the nature of engagements and work assignments might differ and, consequently, different types of threats might be created.
- 120.6 A3 Threats to compliance with the fundamental principles fall into one or more of the following categories:
- (a) Self-interest threat – the threat that a financial or other interest will inappropriately influence a professional accountant’s judgment or behavior;
  - (b) Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made; or an activity performed by the professional accountant, or by another individual within the accountant’s firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity;
  - (c) Advocacy threat – the threat that a professional accountant will promote a client’s or employer’s position to the point that the accountant’s objectivity is compromised;
  - (d) Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
  - (e) Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.
- 120.6 A4 A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.

### **Evaluating Threats**

- R120.7** When the professional accountant identifies a threat to compliance with the fundamental principles, the accountant shall evaluate whether such a threat is at an acceptable level.
- 120.7 A1 The consideration of qualitative as well as quantitative factors is relevant to the professional accountant’s evaluation of threats, as is the combined effect of multiple threats, if applicable.
- 120.7 A2 The existence of conditions, policies and procedures described in paragraph 120.6 A1 might also impact the accountant’s evaluation of the level of threats to compliance with the fundamental principles. Examples of such conditions, policies and procedures include:
- Corporate governance requirements.
  - Educational, training and experience requirements for the profession.
  - Effective complaint systems which enable the professional accountant and the general public to draw attention to unethical behavior.

- An explicitly stated duty to report breaches of ethics requirements.
- Professional or regulatory monitoring and disciplinary procedures.

#### *Acceptable Level*

120.7 A3 An acceptable level is a level at which a professional accountant applying the reasonable and informed third party test would likely conclude that the accountant complies with the fundamental principles.

#### *Consideration of New Information or Changes in Facts and Circumstances*

**R120.8** If the professional accountant becomes aware of new information or changes in facts and circumstances that might impact whether a threat has been eliminated or reduced to an acceptable level, the accountant shall re-evaluate and address that threat accordingly.

120.8 A1 Remaining alert throughout the professional activity assists the professional accountant in determining whether new information has emerged or changes in facts and circumstances have occurred that:

- (a) Impact the level of a threat; or
- (b) Affect the accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.

#### **Addressing Threats**

**R120.9** If the professional accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating them or reducing them to an acceptable level. The accountant shall do so by:

- (a) Eliminating the circumstances, including interests or relationships, that are creating the threats;
- (b) Applying safeguards, where available and capable of being applied; or
- (c) Declining or ending the specific professional activity.

#### *Safeguards*

120.9 A1 Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to compliance with the fundamental principles to an acceptable level. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity. This is because the circumstances that created the threats cannot be eliminated or safeguards are not capable of being applied to reduce the level of the threat to an acceptable level.

#### *Consideration of Significant Judgments Made and Overall Conclusions Reached*

**R120.10** The professional accountant shall form an overall conclusion about whether the actions that the accountant takes, or intends to take, to address the threats created will eliminate those threats or reduce them to an acceptable level. In forming the overall conclusion, the accountant shall:

- (a) Review any significant judgments made or conclusions reached.

- (b) Use the reasonable and informed third party test.

### Considerations for Audits, Reviews and Other Assurance Engagements

120.11 A1 Professional accountants in public practice are required to be independent when performing audits, reviews, or other assurance engagements. Independence is linked to the fundamental principles of objectivity and integrity. It comprises:

- (a) Independence of mind – 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 professional skepticism.
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's or an audit or assurance team member's integrity, objectivity or professional skepticism has been compromised.

120.11 A2 Part 4 of the Code comprise the *International Independence Standards*. This part set out requirements and application material on how to apply the conceptual framework to maintain independence when performing audits, reviews or other assurance engagements, as the case may be. Professional accountants and firms are required to comply with these standards in order to be independent in relation to such engagements. The conceptual framework to identify, evaluate and address threats to compliance with the fundamental principles applies in the same way to compliance with independence requirements. The categories of threats to compliance with the fundamental principles described in paragraph 120.6 A3 are also the categories of threats to compliance with independence.

This proposed text below is intended to reinforce Professional Skepticism in the audit and assurance context by explaining how the fundamental principles underpin the effective application of professional skepticism.

#### Professional Skepticism

120.11 A3 While independence is essential in allowing an individual to act with professional skepticism, complying with the fundamental principles of integrity, objectivity, professional competence and due care, and professional behavior enhances a professional accountant's ability to apply appropriate professional skepticism when performing audits, reviews and other assurance engagements. Accordingly, threats to compliance with those fundamental principles are threats to the accountant's effective application of professional skepticism when performing such engagements.

120.11 A4 Complying with the fundamental principle of integrity places a professional accountant on alert to circumstances that might lead the accountant to be associated with materially false or misleading information. Being alert to the possibility that such circumstances might arise is an important factor in enabling the accountant to adopt a questioning mind and critically assess information in order to form conclusions.

120.11 A5 Complying with the fundamental principle of objectivity requires a professional accountant to exercise professional judgment without bias or undue influence when considering particular facts or circumstances in the engagement. Maintaining an impartial state of mind is important in enabling the accountant to critically assess the

facts and circumstances and to act on the accountant's professional judgment, including raising appropriate questions, on the basis of those facts and circumstances alone.

120.11 A6 Complying with the fundamental principle of professional competence and due care requires a professional accountant not to undertake an engagement without appropriate professional knowledge and skill and due diligence. Accordingly, performing the engagement with appropriate professional competence and due care is essential to enabling the accountant to assess information with the appropriate degree of critical analysis that the circumstances demand, and to raise questions that are relevant to the circumstances.

120.11 A7 Complying with the fundamental principle of professional behavior requires a professional accountant to avoid any conduct that the accountant knows or should know might discredit the profession. This principle therefore imposes a greater obligation on the accountant to have regard to the reputation of the wider profession when undertaking an engagement rather than merely the firm's success in rendering the service or the client's satisfaction with the service rendered. Such an obligation is an important factor in stimulating the accountant to take a stand in questioning or challenging information or assertions that seek to persuade but otherwise appear contradictory or inconsistent with the accountant's understanding or assessment of the particular situation.