

## IESBA PROJECT PROPOSAL—PROFESSIONAL SKEPTICISM

### I. Subject

1. Inclusion of application material in the proposed restructured Code<sup>1</sup> related to professional skepticism (PS) in the context of audits, reviews and other assurance engagements.

### II. Project Objective and Scope, and How the Project Serves the Public Interest

#### Project Objective

2. The purpose of this project is to enhance the professional accountant's (PA's) understanding of the connection between the ethical considerations set out in the Code's fundamental principles (FPs) and the application of PS when performing audits, reviews or other assurance engagements (see definition of key terms in the Appendix to this paper). Explicitly explaining this linkage is intended to illustrate how compliance with the FPs also contributes to the PA's ability to apply appropriate PS when performing such engagements.

#### Project Scope

3. The project involves the addition of application material in Section 120<sup>2</sup> related to audits, reviews and other assurance engagements.
4. As the proposed additional application material relates to audits, reviews and other assurance engagements only, it will be based on the existing definition of PS set out in the International Auditing and Assurance Standards Board's (IAASB's) standards (see Appendix).
5. Paragraphs 120.12 A1–120.12 A2 of the [proposed restructured Code](#) address independence and articulate the linkage between independence and PS. Therefore, no additional application material in regard to this linkage is included as part of this proposal.
6. Although not part of this project, the IESBA PS Working Group is separately proposing to clarify the requirement for a PA to exercise professional judgment when applying the conceptual framework (see **Agenda Items 2-A**, *Issues Paper* and **2-D**, *Proposed Clarification to the Enhanced Conceptual Framework*).
7. There have been suggestions from certain stakeholders for enhancements to the Code regarding the definition and application of PS among PAs more broadly.<sup>3</sup> These suggestions raise complex issues

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<sup>1</sup> In January 2017, the IESBA announced the completion of the major first phase of its strategic project to restructure its Code of Ethics for Professional Accountants™ (the Code). For information, IESBA Staff has prepared a compilation of the proposed restructured Code that combines the [agreed-in-principle texts](#) for Phase 1 of the Structure and Safeguards projects and the proposed texts relating to the January 2017 Exposure Drafts (i.e., [Structure ED-2](#), [Safeguards ED-2](#), and [Applicability ED](#)).

<sup>2</sup> Part 1 – Complying with the Code, Fundamental Principles and Conceptual Framework; Section 120, *The Conceptual Framework*

<sup>3</sup> For example, Some respondents to the IESBA Part C Phase 1 ED (including Monitoring Group member IOSCO) suggested that:

- The Code should emphasize the need for PAIBs to exercise an adequate level of professional skepticism throughout the process of preparing, presenting or filing information, because PAIBs' work typically involves accumulating, distilling, and interpreting information from others, namely colleagues who work at the source (e.g., in operating departments) of an entity's transactions.

that require consideration across and a coordinated approach by the three IFAC Standard Setting Boards. Accordingly, this project proposal does not address such suggestions.

### How the Project Serves the Public Interest

8. While it is widely agreed that PS is essential to the conduct of an audit, the term is used only a few times in the Code (and the proposed restructured Code). Furthermore, these limited references are without any descriptive guidance as to how PS might be applied. The public interest would be served by including explanatory guidance in the Code to highlight ways in which actions taken by the PA to comply with the FPs also contribute to the application of appropriate PS when performing audit and other assurance engagements.
9. The project would be responsive to the suggestions made by the respondents to the IAASB's December 2015 Invitation to Comment (ITC), [Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits](#). Respondents to the ITC suggested that an explanation of the linkage between PS and the FPs would reinforce the requirement for PAs to apply PS when performing audit or other assurance engagements.

### Impact Analysis Considerations

10. It is not envisioned that the proposed additional application material would result in significant implementation costs at the national or accounting firm levels for those who properly comply with the FPs in the Code.
11. Further consideration of the impact of the proposed additional application material will be an important part of the IESBA's evaluation of the responses received following exposure of the proposed addition.

### III. Background and Relevant Developments

12. Audit inspection reports have identified issues about the level and consistency of PS being applied in audits, in particular in areas that require high levels of professional judgment.<sup>4</sup>
13. To facilitate a holistic and coordinated response to those concerns, the PS Working Group (PSWG) was formed in June 2015. Since then, the IESBA working group members have been actively contributing to the activities of the PSWG with a view to determining whether there are areas within the Code where there would be benefit in elaborating on, emphasizing or clarifying ethical considerations relating to PS in ways that would support and complement the discussion of PS in the IAASB's International Standards and the International Education Standards (IESs).
14. In this regard, the IESBA has gained insights from IAASB-led initiatives aimed at enhancing PS in the context of audit engagements, including the June 2015 IAASB [panel discussion](#)<sup>5</sup> aimed at further

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- PAIBs should always maintain professional skepticism and that the concept of professional skepticism should not be limited to auditors.

<sup>4</sup> [IFIAR Report on 2014 Survey of Inspection Findings](#), March 3, 2015. This issue is not new. In their 2012 Report, 17 of the 22 IFIAR members that provided information regarding their inspections of listed audit engagements cited the auditor's lack of PS as a possible cause for audit deficiencies. Also in 2012, the most frequently cited significant challenge and audit quality issue among IFIAR members was a lack of PS by auditors.

<sup>5</sup> During its June 2015 meeting, the IAASB hosted a panel discussion on the topic of PS. IAASB member Prof. Annette Köhler, who chairs the PSWG, introduced the topic. The panel was comprised of: Jeremy Justin, Canadian Public Accountability Board's Representative on the International Forum of Independent Audit Regulators' Standards Coordination Working Group;

understanding the perspectives of certain stakeholders (in particular regulators); the December 2016 IAASB-commissioned summary of [academic research](#), and the ITC.

15. Based on its work to-date, the PSWG concluded that there is an important link between the application of PS and compliance with the FPs and recommended that a description of that linkage be developed.<sup>6</sup>
16. Taking into account advice from the IESBA and IAASB Consultative Advisory Groups (CAGs), the IESBA has agreed to explore the feasibility of developing enhancements for potential inclusion in the proposed restructured Code that is anticipated to be finalized in December 2017.

**IV. Implications for any Specific Persons or Groups**

17. The project is relevant to the PSWG, the IAASB, the IAESB, and the IFAC Small and Medium Practices (SMP) Committee. Therefore, they will be kept apprised of developments to ensure appropriate input is received at key stages of the project.
18. The project is also relevant to jurisdictions and IFAC member bodies that have adopted the Code, or use it as a basis or a benchmark for their own ethics standards. It is also relevant to firms that provide audit and other assurance services.

**V. Development Process, Project Timetable and Project Output**

**Development Process**

19. IESBA participation in the PSWG helped inform the scope and approach to the project, which will follow the normal due process of the IESBA.

**Project Timetable**

20. Subject to the IESBA’s approval of the project proposal, this project will commence immediately. The proposed timetable is intended to align with the finalization of the proposed restructured Code.

Indicative Timing	Milestone
<b>March 2017</b>	<ul style="list-style-type: none"> <li>• Discussion with IESBA CAG</li> </ul>
	<ul style="list-style-type: none"> <li>• Approve project proposal</li> <li>• Consider issues and proposed text</li> </ul>
	<ul style="list-style-type: none"> <li>• Obtain input from PSWG and IAASB on proposals</li> </ul>
<b>March/ April 2017</b>	<ul style="list-style-type: none"> <li>• Obtain input from PSWG and IAASB on proposals</li> </ul>

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Helen Munter, Division of Registration and Inspections, US Public Company Accounting Oversight Board; Doug Prawitt, Glen Ardis Professor of Accountancy, Brigham Young University; and Cindy Fornelli, Executive Director, Center for Audit Quality. The purpose of the panel discussion was to:

- Provide IAASB members with a further understanding of the issues related to auditors’ application of PS in the context of a financial statement audit and raise questions with experts in this area; and
- Consider how best to address concerns that have been raised about auditors’ application of PS in audits of financial statements and planned next steps.

An audio of the panel discussion is available at the [IAASB’s website](#).

<sup>6</sup> At its September 2016, the IESBA considered recommendations from the PSWG regarding actions that the IAASB, IESBA and IAESB could take, individually and in coordination, to enhance the application of PS in their respective standards.

Indicative Timing	Milestone
<b>April 2017</b>	<ul style="list-style-type: none"> <li>• IESBA approval of proposed text for exposure</li> </ul>
<b>April/May 2017</b>	<ul style="list-style-type: none"> <li>• Release of ED</li> </ul>
<b>August/ September 2017</b>	<ul style="list-style-type: none"> <li>• Task Force Consideration of issues raised by respondents to ED and revisions to proposed text</li> <li>• Liaison with PSWG and IAASB Staff on key issues</li> </ul>
<b>September 2017</b>	<ul style="list-style-type: none"> <li>• Discussion with IESBA CAG</li> <li>• IESBA consideration of issues raised by respondents to ED and revisions to proposed text</li> <li>• Obtain input from IAASB on revisions to proposed text</li> </ul>
<b>December 2017</b>	<ul style="list-style-type: none"> <li>• IESBA approval of proposed text</li> </ul>

**VI. Resources Required**

21. A project Task Force will be established, consisting of three individuals, including an IESBA member as Chair.
22. IESBA Staff will provide support to the project Task Force.

**VII. Relevant Sources of Information that Address the Matter Being Proposed**

23. Relevant sources of information include:
  - Ethics requirements for PAs established by IFAC member bodies and similar.
  - Professional standards for PAs who perform audits, reviews and other assurance engagements (e.g., the IAASB’s standards).
  - Educational standards for the profession, particularly the IAESB’s standards.

## Definition of Key Terms

### Professional Skepticism

#### IAASB

1. The International Standards on Auditing (ISAs) define PS as “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>7</sup> The ISAs note that PS is necessary to the critical assessment of audit evidence. A similar definition exists in the International Standard on Assurance Engagements (ISAE) 3000 (Revised)<sup>8</sup> for other assurance engagements.

#### IESBA

2. Consistent with the extant Code, the proposed restructured Code refers to PS in describing “independence” as follows:<sup>9</sup>

Independence is linked to the fundamental principles of objectivity and integrity. Independence 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 a member of the audit team’s, integrity, objectivity or professional skepticism has been compromised.

#### IAESB

3. PS is also addressed in the IAESB standards as follows:<sup>10</sup>

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<sup>7</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(l)

The IAASB Staff Publication, [Staff Questions and Answers – Professional Skepticism in an Audit of Financial Statements](#) issued in February 2012, further discusses considerations in the ISAs and International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audit and Reviews of Financial Statements, and Other Assurance and Related Services Engagement* that are relevant to the proper understanding and application of PS during an audit of financial statements.

<sup>8</sup> ISAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, paragraph 12(u)

<sup>9</sup> Part 1, Section 120, *The Conceptual Framework*, paragraph 120.14 A1; Part 4A, *Independence for Audits and Reviews*, Section 400, *Applying the Conceptual Framework to Independence for Audits and Reviews*, paragraph 400.5; and Part 4B, *Independence Other Assurance Engagements*, Section 900, *Applying the Conceptual Framework to Independence for Other Assurance Engagements*, paragraph 900.4 (See Extant Part B, *Professional Accountants in Public Practice*, Section 290, *Independence – Audits and Reviews*, paragraph 290.6 and Section 290, *Independence – Other Assurance Engagements*, paragraph, 291.5)

<sup>10</sup> IES 4, *Initial Professional Development – Professional Values, Ethics, and Attitudes* and IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*

- International Education Standards (IES) 3, establishes the professional skills that aspiring PAs are required to demonstrate by the end of Initial Professional Development (IPD) in order to perform a role as a PA.<sup>11</sup> IES 3 applies to all PAs.
- IES 4 establishes the professional values, ethics and attitudes that aspiring PAs need to develop and demonstrate by the end of IPD in order to perform a role a PA.<sup>12</sup> IES 4 applies to all PAs.
- IES 8 prescribe learning outcomes for PS and professional judgment that engagement partners are expected to develop and maintain through continuing professional development. Reference to PS in IES 8 are consistent with those in the IAASB's standards.<sup>13</sup>

IES 4 and IES 8 emphasize that effective development of PS need to include learning methods such as mentoring, reflective activity, and practical experience within the context of a work environment.

4. Separately, reference is made to the term “skepticism” in a July 2015 non-authoritative IAESB publication titled, [\*Framework for International Education Standards for Professional Accountants and Aspiring Professional Accountants\*](#) (the Framework).<sup>14</sup>

### Fundamental Principles

5. The proposed restructured Code requires all PAs to comply with the FPs set out in Section 110:<sup>15</sup>
  - (a) Integrity – to be straightforward and honest in all professional and business relationships.
  - (b) Objectivity – not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.
  - (c) Professional Competence and Due Care – to:
    - (i) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
    - (ii) Act diligently and in accordance with applicable technical and professional standards.

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<sup>11</sup> IES 3, *Initial Professional Development – Professional Skills (2015)*, paragraph 7 (c) (ii) includes as a learning outcome for professional skills “apply professional skepticism through questioning and critically assessing all information.”

<sup>12</sup> IES 4, *Initial Professional Development – Professional Values, Ethics and Attitudes*, paragraph 11 (a) (i) includes a competency area for professional values, ethics and attitudes “professional skepticism and professional judgment.” It also describes related learning outcome as:

- “Apply a questioning mindset critically to assess financial information and other relevant data; and
- Identify and evaluate reasonable alternatives to reach well-reasoned conclusions based on all relevant facts and circumstances.”

<sup>13</sup> IES 8, *Professional Competence for Engagement Partners Responsible for Audits of Financial Statements*

<sup>14</sup> Paragraph 28 of the IAESB Framework notes that “General education helps professional accountants and aspiring accountants integrate technical competence, professional skills, and professional values, ethics, and attitudes developed through professional accounting education. It supports the developments of decision making skills, judgment, and skepticism.”

<sup>15</sup> Part 1, Section 110, *The Fundamental Principles*, paragraph 110.1 (See also Subsection 111, *Integrity*; Subsection 112, *Objectivity*; Subsection 113, *Professional Competence and Due Care*; Subsection 114, *Confidentiality*; and Subsection 115, *Professional Behavior*.)

- (d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.
- (e) Professional Behavior – to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.