New Application Material Relating to:

(a) Professional Skepticism – Linkage with the Fundamental Principles; and

(b) Professional Judgment – Emphasis on Understanding Facts and Circumstances
This document was prepared by the Staff of the International Ethics Standards Board for Accountants® (IESBA®).

The IESBA is a global independent standard-setting board. Its objective is to serve the public interest by setting high-quality ethics standards for professional accountants worldwide and by facilitating the convergence of international and national ethics standards, including auditor independence requirements, through the development of a robust, *International Code of Ethics for Professional Accountants™ (including International Independence Standards™)* (the Code).
# BASIS FOR CONCLUSIONS:
# NEW APPLICATION MATERIAL RELATING TO PROFESSIONAL SKEPTICISM AND PROFESSIONAL JUDGMENT

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I. Introduction

1. The IESBA is committed to exploring a solution, in the public interest, to the underlying issues relating to professional skepticism, including clarifying the related behavior that is expected of professional accountants. As a short term measure, the IESBA approved in December 2017, with the affirmative votes of 16 out of 16 members present, new application material to:

   (a) Describe how compliance with the fundamental principles in the Code supports the exercise of professional skepticism in the context of audit and other assurance engagements; and

   (b) Emphasize the importance of professional accountants obtaining a sufficient understanding of the facts and circumstances known to them when exercising professional judgment in applying the conceptual framework to comply with the fundamental principles and where applicable, be independent.

2. The new application material has been drafted using the new structure and drafting conventions for the Code and form a part of the *International Code of Ethics for Professional Accountants (including International Independence Standards)* (the restructured Code, which the IESBA also approved in December 2017). The new application material clarifies what is already implicit in the provisions of the extant Code and will better support professional accountants (including auditors in the case of the application material relating to professional skepticism) in fulfilling their responsibility to act in the public interest and with respect to audits of financial statements, contribute to supporting audit quality.

3. This Basis for Conclusions summarizes and explains the IESBA’s rationale for the development of the new application material. It relates to, but does not form part of, the new application material relating to professional skepticism and professional judgment.

II. Background

Professional Skepticism Issues

4. Historically, professional skepticism is an important concept that is currently defined in auditing and assurance standards. Auditors are required to exercise professional skepticism throughout the audit, i.e., during engagement acceptance; as part of identifying and assessing risks of material misstatement; in designing the nature, timing and extent of audit procedures; and in forming an opinion on whether the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework. While the definition of professional skepticism in national auditing and assurance standards might differ slightly from how the term is defined in the International Standards of the International Auditing and Assurance Standards Board (IAASB), the general principles are the same.

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1 ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(l) states that professional skepticism is “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.”

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 Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* that are relevant to the proper understanding and application of professional skepticism during an audit of financial statements.
5. Although the concept of professional skepticism is most prominently dealt with in auditing and assurance standards, professional skepticism is also referred to in the extant Code as part of the description of independence (i.e., in the context of audit and other assurance engagements only). Also, there is a reference to professional skepticism in the International Accounting Education Standards Board’s (IAESB’s) International Education Standards (IESs).

6. The increasing complexity of business and financial reporting, changes in business model and rapidly advancing technologies are disrupting the roles of key players in financial reporting. For professional accountants, these changes are also affecting the public’s perceptions of whether and how their work contributes to reliable and credible financial reporting. For example, questions have been raised about whether auditors are appropriately exercising professional skepticism in their audits. Also, broader questions are being raised about whether professional accountants should accept information that they receive at face value, and whether the concept of professional skepticism should have greater prominence in the Code. Some stakeholders as well as the Public Interest Oversight Board (PIOB) have expressed the view that the concept of professional skepticism should apply to all professional accountants, and that the Code should reflect this.

7. In response to the questions that have been raised about whether auditors are appropriately exercising professional skepticism in their audits, a tripartite Professional Skepticism Working Group

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2 The Code in particular refers to professional skepticism in its definition of independence:

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, weighing all the specific facts and circumstances, that a firm’s, or a member of the audit team’s, integrity, objectivity or professional skepticism has been compromised. [Emphases added]

3 References to professional skepticism in the IAESB’s standards include the following:

- Applicable to all professional accountants, IES 3, Initial Professional Development – Professional Skills (2015), paragraph 7(c)(ii) includes as a learning outcome for professional skills the need to “apply professional skepticism through questioning and critically assessing all information.”

- Applicable to all professional accountants, IES 4, Initial Professional Development – Professional Values, Ethics and Attitudes, paragraph 11(a)(i) includes as a competency area for professional values, ethics and attitudes “professional skepticism and professional judgment.” It also describes related learning outcomes as follows:
  - 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.”

- Applicable to audit engagement partners only, IES 8, Professional Competence for Engagement Partners Responsible for Audits of Financial Statements prescribes learning outcomes for professional skepticism and professional judgment that engagement partners are expected to develop and maintain through continuing professional development.

Separately, reference is made to the term “skepticism” in paragraph 28 of a July 2015 non-authoritative IAESB publication titled Framework for International Education Standards for Professional Accountants and Aspiring Professional Accountants.

BASIS FOR CONCLUSIONS: PROFESSIONAL SKEPTICISM AND PROFESSIONAL JUDGMENT

(PSWG) comprising representatives of the IAASB, IESBA and IAESB was established in 2015. The PSWG’s views about issues relating to professional skepticism in the context of audit and assurance engagements are summarized in the IAASB’s December 2015 Invitation to Comment (ITC), \textit{Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits}.

8. Based on the feedback from respondents to the ITC, the PSWG recommended that the IESBA provide guidance in the Code to professional accountants undertaking audit, review and other assurance engagements to explain how compliance with the fundamental principles supports the exercise of professional skepticism in the context of such engagements. The PSWG’s recommendation was consistent with the advice from the Consultative Advisory Groups (CAGs) of the IESBA and IAASB, as well as with a December 2015 summary of academic research relating to professional skepticism that the IAASB had commissioned.

9. The PSWG’s subsequent work prompted focused and coordinated discussions at the plenary sessions of the IESBA, IAASB, IAESB and their respective CAGs about actions that the three Boards could take, individually and in coordination, to enhance the exercise of professional skepticism. As an immediate response to the PSWG’s recommendation, the IESBA launched a project to explore limited revisions to the extant Code which led to the new application material relating to professional skepticism. For a further discussion of the IESBA’s proposals relating to this project, including respondents’ feedback and the IESBA’s responses, see Section III of this document.

Professional Judgment Issues

10. Concurrently with its deliberation of the issues relating to professional skepticism and its work to restructure the Code and revisit the provisions in the Code relating to safeguards (the Structure and Safeguards projects, respectively), the IESBA considered the views of stakeholders who questioned whether the relevant information underpinning ethical decisions is being assessed with sufficient rigor. The IESBA determined that if a professional accountant were to accept information at “face value” without regard to whether it could lead the professional accountant to become associated with materially false or misleading information, this would constitute non-compliance with the fundamental principles, in particular, integrity and professional competence and due care.

11. On that basis, the IESBA explored establishing a new requirement in the Code for professional accountants to apply a critical mindset when applying the conceptual framework in order to emphasize the need for professional accountants to understand facts and circumstances being considered and their implications with respect to compliance with the fundamental principles. Subsequent discussions with the IAASB highlighted the potential for confusion between the concepts of “critical mindset” and professional skepticism, given the overlapping aspect of critical assessment common to both concepts. The IESBA also considered whether it was necessary to introduce a new requirement as part of the application of the conceptual framework, or whether the notion of obtaining a sufficient understanding of the facts and circumstances was not already an implicit part of the requirement to exercise professional judgment when applying the conceptual framework. Against this background, the IESBA determined to pursue an alternative approach of developing application material focused on emphasizing the importance of professional accountants obtaining a sufficient understanding of the facts and circumstances known to them when exercising professional judgment in applying the conceptual framework. For a further discussion about the proposed application material, including respondents’ feedback and the IESBA’s responses, see the Section IV of this document.
Exposure Draft (ED)

12. As a short-term measure to respond to the issues summarized above, the IESBA issued the Exposure Draft *Proposed Application Material Relating to Professional Skepticism and Professional Judgment* (ED) in May 2017 with proposed application material relating to professional skepticism and professional judgment. The comment deadline closed on July 25, 2017.

13. The IESBA received forty-two comment letters on the ED from a diverse group of stakeholders from many jurisdictions. Some respondents indicated in their letters that their response set out the collective views of a number of organizations they represent, or incorporate input from various stakeholders within their respective jurisdictions based on specific outreach. A discussion of respondents’ feedback and the resulting revisions made to the proposals in the ED is included in Sections III and IV.

14. In finalizing the revisions to the proposals in the ED, the IESBA also took into account comments and drafting suggestions from the members of the PSWG.

III. Application Material Relating to Professional Skepticism

15. In response to the PSWG’s recommendation and recognizing the public interest in promoting the application of professional skepticism in audits, reviews and other assurance engagements, the IESBA determined that it would be important to supplement the Code’s existing few references to professional skepticism with application material.

16. The proposed application material in paragraph 120.13 A1\(^\text{5}\) of the ED explains how compliance with the fundamental principles supports the exercise of professional skepticism by illustrating this linkage in the context of an audit of financial statements. The IESBA is of the view that further work is needed in the longer term to elaborate on the relevance of professional skepticism to compliance with the fundamental principles. Notwithstanding its plans for future work on the topic of professional skepticism, the IESBA determined that it should not withhold an immediate response to specific requests for clarification about how compliance with the fundamental principles supports the exercise of professional skepticism in the audit and assurance context.

Feedback from Respondents

17. A substantial body of respondents to the ED expressed support for the proposed professional skepticism application material, and some provided drafting suggestions to improve it. In particular, it was suggested that:

- The lead-in to the list of examples in paragraph 120.13 A1 of the proposed text should clarify the inter-related nature of professional skepticism and the fundamental principles.
- The examples illustrating how the fundamental principles support professional skepticism should be further clarified and streamlined.
- The proposed application material might be better positioned in either Section 110\(^\text{6}\) or Part 3\(^\text{7}\) of the Code, rather than in Section 120 as was proposed.

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\(^5\) Part 1 – Complying with the Code, Fundamental Principles and Conceptual Framework, Section 120, *The Conceptual Framework*

\(^6\) Part 1, Section 110, *The Fundamental Principles*

\(^7\) Part 3 – Professional Accountants in Public Practice
18. A few respondents were not supportive of the proposed application material relating to professional skepticism and commented that in their view:

- It is not necessary because it merely states what is already required in the Code. Within that context, questions were raised about:
  - Whether the proposed application material would be better dealt with in a staff publication rather than being placed in the Code.
  - Whether the level of detail was consistent with the new structure and drafting convention that the IESBA established in agreeing in principle Phase 1 of its Structure project.
- The relationship between the exercise of professional skepticism and compliance with the fundamental principles is a two-way one. In this regard, it was questioned whether the proposed application material appropriately described that relationship. Those respondents suggested that the IESBA should instead focus its efforts on the longer term professional skepticism initiative.

IESBA Decisions

19. Having duly considered all the respondents’ comments and drafting suggestions, the IESBA determined that the overriding public interest objective is to promote the application of professional skepticism in audits, reviews and other assurance engagements. Accordingly, the IESBA reaffirmed its decisions to (a) supplement the few references to professional skepticism in the extant Code with new application material to explain how compliance with the fundamental principles supports the exercise of professional skepticism, and (b) illustrate this linkage in the context of an audit of financial statements.

20. Taking into account respondents’ feedback, the revised application material in paragraphs 120.13 A1 to 120.13 A2 incorporates several refinements and clarifications. In particular:

- A new sentence has been added to paragraph 120.13 A1 to state that “Professional skepticism and the fundamental principles that are described in Section 110 are inter-related concepts.”
- The explicit reference to Section 110 emphasizing the location of the description of the fundamental principles is intended to minimize the risk of users of the Code misreading the material in paragraph 120.13 A2 to be a description of the fundamental principles.
- The lead-in sentence to paragraph 120.13 A2 further clarifies that the examples in the list are intended to explain the linkage in the context of an audit of financial statements only.
- Each of the specific examples demonstrating how the three fundamental principles of integrity, objectivity and professional competence and due care support the exercise of professional skepticism has been further streamlined and clarified (see paragraph 120.13 A2).

21. In conjunction with finalizing the Structure project, the IESBA also agreed to several drafting and structural refinements to the proposed application material relating to professional skepticism in order to achieve consistency with the approach used in the rest of the restructured Code.

22. With respect to the placement of the professional skepticism application material, the IESBA reaffirmed that the material should be prominently positioned in paragraphs 120.13 A1 to 120.13 A2 in Part 1, Section 120. As a practical matter, the IESBA determined that any elaboration of professional skepticism in the Code should be made in close proximity to the first mention of
professional skepticism, which is in paragraph 120.12 A1 as part of the description of independence under the heading titled “Considerations for Audits, Reviews and Other Assurance Engagements.”

IV. Application Material Relating to Professional Judgment

23. The restructured Code requires professional accountants to exercise professional judgment when applying the conceptual framework (see paragraph R120.5). Aligned to the discussion of professional judgment in the IAASB’s standards, the proposed application material in paragraph 120.5 A1 of the ED emphasized the importance of professional accountants obtaining a sufficient understanding of the facts and circumstances known to them when exercising professional judgment in applying the conceptual framework.

24. The IESBA intended the proposed application material to clarify and make more explicit an expectation that the IESBA believes is already implicit in the application of the conceptual framework.

Feedback from Respondents

25. While a few respondents suggested that the proposed application material relating to professional judgment should be elevated to a requirement, most respondents were supportive of the proposal and provided comments and drafting suggestions to improve it. In particular, it was suggested that:

- The reference to professional judgment in the first sentence of proposed paragraph 120.5 A1 should be aligned even more closely to the description of professional judgment in the IAASB’s standards.
- The word “sufficient” used in the second sentence of proposed paragraph 120.5 A1 should be avoided.
- The proposed application material should be drafted in a manner that more closely aligns to the new structure and drafting conventions for the Code.

26. A few respondents did not support the proposal, noting that in their view it was unhelpful or unnecessary.

IESBA Decisions

27. Having given due consideration to respondents’ comments and drafting suggestions, the IESBA reaffirmed that it is the public interest to include the new application material relating to professional judgment in the restructured Code. The IESBA determined that is was not necessary to elevate the application material to a requirement because the restructured Code already includes a requirement to exercise professional judgment in paragraph R120.5.

28. In addition to several drafting refinements and structural revisions that the IESBA agreed to as part of finalizing the Structure project, the IESBA determined to make the following revisions to the proposed application material in response to the feedback from respondents:

- Except for the use of the phrase, “….professional knowledge, skill and experience …..,” the first sentence in paragraph 120.5 A1 is now more closely aligned with the description of professional judgment in ISA 200. The words “professional” and “skill” are used in order to be

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8 See ISA 200, paragraphs 13(k), 16 and A23–A27. The IAASB’s standards define professional judgment 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.”
consistent with existing terminology that is already used in the Code (see description of professional competence and due care in paragraphs 110.1 A1 and R113.1).

- The word “sufficient” has been deleted as suggested.
- Proposed paragraph 120.5 A1 is now split into three distinct paragraphs.
  - The first paragraph describes what is involved in exercising professional judgment in the context of the provisions in the Code (see paragraph 120.5 A1).
  - The second paragraph explains that an understanding of known facts and circumstances is a prerequisite to the proper application of the conceptual framework and that professional judgment is required to determine the actions necessary to obtain this understanding and coming to a conclusion about whether the fundamental principles have been complied with (see paragraph 120.5 A2).
  - The third paragraph includes a list of examples of matters that professional accountants might consider in exercising professional judgment in the context of applying the provisions in the Code (see paragraph 120.5 A3).
- The examples of matters that professional accountants might consider in exercising professional judgment have been amended as follows:
  - A new example is added that states: “There is reason to be concerned that potentially relevant information might be missing from the facts and circumstances known to the accountant.”
  - The third bullet is further refined to incorporate respondents’ suggestions as follows: “There might be other reasonable conclusions that could be drawn from the available information being considered.”

V. **Other Matters**

29. Certain respondents, including some of those who did not support the proposals relating to professional skepticism in the ED, took the opportunity to provide input on the longer term initiative. Many of the respondents who commented emphasized the importance of IAASB, IESBA and IAESB coordination in determining a way forward.

30. Respondents’ expressed mixed views about whether the concept of professional skepticism should apply to all professional accountants. Some respondents with strong views in support of this position. A few respondents, however, expressed a contrary view and believed that professional skepticism should only apply when professional accountants perform audit and assurance engagements.9

31. Those who believed that the concept of professional skepticism should apply to all professional accountants also believed that:

- Professional skepticism is an “enabler of compliance with the fundamental principles.”

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9 Respondents who believed that professional skepticism should apply only to professional accountants who perform audit and assurance engagements cautioned against changes to the definition of professional skepticism, noting the potential risks of unintended consequences and confusion.
The exercise of professional skepticism is important for tax and consulting engagements and that the Code should explain the role of professional skepticism in performing those non-assurance services.

The approach taken by the IAESB is an appropriate basis for extending professional skepticism as a requirement for all professional accountants in the Code.

32. A few respondents suggested that different terms should be used to distinguish the skeptical behavior that is expected of auditors and assurance practitioners from that which is expected of all professional accountants more broadly.

33. The IESBA determined that the matters relating to the longer-term initiative were outside of the scope of this project and should be considered as part of the development of:

- The IESBA's future strategy and work plan (SWP). The IESBA anticipates finalizing its SWP 2019-2023 by the end of 2018.
- A future Consultation Paper (CP) on the topic of professional skepticism focused on issues relating to the application of the Code. The IESBA anticipates issuing this CP by June 2018.

VI. Effective Date

34. The effective date for the restructured Code, of which the new application material relating to professional skepticism and professional judgment is a part, is discussed in the Basis for Conclusions for the Structure project.