A PROFESSIONAL JUDGEMENT FRAMEWORK FOR FINANCIAL REPORTING
An international guide for preparers, auditors, regulators and standard setters
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ICAS has long advocated the benefits of principles-based accounting standards. The success of principles-based standards relies on the ability of accountants to make ‘good quality’ judgements, but to those new to the profession or new to principles-based standards, making judgements can be difficult. The need for some guidance to help those making judgements came to light in earlier ICAS projects on principles-based accounting standards and particularly while undertaking interviews for the report *Chinese accounting reform: Towards a principles-based global regime*.

Confidence in the profession and in principles-based standards requires us to demonstrate collectively that, as professionals, we are capable of making sound judgements. I believe that this professional judgement framework is vital for the future of the profession.

The aim of this project was to produce a short concise document which describes the benefits of a framework and provides guidance for preparers, auditors and regulators, and recommendations for standard setters.

The framework is a starting point for consideration and implementation across the globe and we therefore welcome any feedback on this project which would help to develop what we believe is a critical tool to assist those making and checking key judgements.

Sir David Tweedie
ICAS President
August 2012
The Institute’s Technical Policy & Services Board would like to thank the members of the Professional Judgement Framework Working Group who produced this report, the members of the ICAS Corporate Reporting Taskforce, under whose auspices and oversight this report was published, and the members of the ICAS Audit and Assurance Committee who reviewed and provided comments on the report.

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It should be noted that the members of the Professional Judgement Framework Working Group and the Corporate Reporting Taskforce were acting in their personal capacity and were not representing the organisations for which they work.
A PROFESSIONAL JUDGEMENT FRAMEWORK

INTRODUCTION
Professional judgement is a key skill for preparers, auditors and regulators of financial statements, especially under a principles-based accounting regime, but making a judgement can be difficult and there is not necessarily one correct answer. Being able to make good judgements is a cornerstone of being a professional accountant but to those new to the profession or those new to principles-based standards it can be a steep learning curve.

ICAS believes that a principles-based accounting system better serves the needs of business, the markets and the public interest1. Principles-based standards provide a framework within which the economic substance of transactions can be faithfully represented, especially in a complex and changing environment, but such an approach requires the use of ‘good’ judgement by preparers, auditors and regulators.

The purpose of this short document is to create a principles-based framework which can be used by preparers2 and auditors in making and auditing key judgements. Whilst to some the process may be intuitive, to others it may be new and we believe that this framework will help preparers and auditors make and document significant accounting judgements.

Guidance is also provided for regulators involved in assessing key judgements, and recommendations are made for standard setters in maintaining and producing principles-based standards which provide the scope for professional judgement.

The framework is intended to apply internationally to different sizes of companies, both listed and unlisted, or other entities, and within the context of different governance systems. Audit committees, where they exist, have a key role in challenging initial judgements, facilitating discussions with the auditors and recommending approval of key judgements to the board.

WHAT IS A PROFESSIONAL JUDGEMENT FRAMEWORK?
A professional judgement framework sets out a structured process by which preparers and auditors, with an appropriate level of knowledge, experience, and objectivity, can form an opinion on an accounting matter based on the relevant facts and circumstances within the context provided by applicable accounting standards3.

WHY DO WE NEED A FRAMEWORK?
The validity and usefulness of financial reporting relies upon good judgements being made, especially as business transactions become more complex. It is also fundamental that judgements can be demonstrated to be reasonable at the time they are made and in light of the facts and circumstances then present4. Preparers and auditors have also suggested that this would provide some protection from subsequent regulatory challenges with the benefit of hindsight.

The ICAS report, Principles not Rules: A Question of Judgement5, highlighted the importance of trust in a principles-based accounting framework5. Regulators and other users need to be able to trust preparers and auditors who, in turn, must be capable of exercising judgement. We believe that a professional judgement framework reinforces the quality and integrity of the judgements made and, therefore, also the trust in the operation of principles-based accounting standards.

The need for guidance on making judgements was identified in earlier work undertaken by ICAS on principles-based financial reporting, in particular Principles not Rules: A Question of Judgement5 and
Chinese accounting reform: Towards a principles-based global regime. Whilst the latter report identifies that such a framework would be particularly useful to those countries which are implementing International Financial Reporting Standards (IFRSs) for the first time, the working group believe that this framework will have wider international relevance.

This need for additional guidance was corroborated by the results of a recent survey of ICAS members on the future of financial reporting. Members were asked:

Would a professional judgement framework be useful if it outlined the procedures that preparers or auditors should consider in reaching a judgement and the matters to be documented?

The majority of respondents agreed that a professional judgement framework would be useful, with 52% of respondents stating that it would be very useful and 37% that it would be slightly useful.

THE CONTEXT OF THE FRAMEWORK
Judgements should be made within the context provided by existing applicable accounting standards, regulations and law.

This framework has been prepared to assist in determining the appropriate accounting treatment for a particular transaction or group of transactions, where:

- there is no specific standard covering the transaction; or
- there is a standard but no detailed provision of how to deal with its implementation in practice; or
- there are accounting principles in a standard but no detailed provision of how to deal with a specific principle in practice; or
- there is more than one set of accounting principles that may apply to the transaction.

IAS 8 (paragraphs 10-12) covers the situation where there is an absence of an IFRS that specifically deals with a transaction. The standard states that when making a judgement the aim should be that the resulting information is relevant and reliable. IAS 8 outlines the other sources which should be referred to in such an instance. IAS 1 (paragraph 122) requires that any judgements made which have a significant effect on the financial statements should be disclosed. Our professional judgement framework incorporates these requirements but takes them forward by incorporating them in a set of principles to be followed by preparers and auditors.

The framework has been prepared on the assumption that IFRSs are being followed; however, this could easily be adapted to other principles-based national GAAPs.

HOW CAN A FRAMEWORK WORK IN PRACTICE?
The success of a professional judgement framework is reliant upon the abilities of those using it. Making a judgement is rarely easy and much depends upon the ability and experience of individual accountants.

Accountants need to be questioning and capable of exercising professional judgement. Education, culture and experience of principles-based accounting and of making judgements varies from country to country and individual to individual, and therefore the extent to which a professional judgement framework process could be relied upon may vary. However, we believe that the framework will assist in the training process and also enable individuals to recognise situations where they need to seek assistance from others. Whilst the framework for preparers has been prepared with the decision maker in mind, ultimately the company board is responsible for the financial
Professional scepticism is a characteristic of a high quality audit.

ISAs define professional scepticism 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”10. Professional scepticism is a characteristic of a high quality audit and is closely related to professional judgement11. We believe that the ICAS professional judgement framework will assist auditors in applying professional scepticism.

Regulators are the second line of challenge for preparers’ judgement. We believe that having a professional judgement framework will assist regulators in understanding why key judgements have been made, and in assessing whether judgements were appropriate given the facts available at the time. However, it must be recognised that even if the framework is adhered to by both preparers and auditors, regulators still have a role to play in considering and, if appropriate, challenging the judgements made. The framework is intended to assist the judgement process and ensure that there is appropriate documentation to justify that judgement. We recognise that judgements made may fall within a range of possible outcomes. Due to the subjectivity involved in making a judgement, the framework cannot be relied upon to prevent judgements falling outside the range of acceptable outcomes or otherwise being perceived as ‘incorrect’.

We would urge regulators only to challenge judgements based on the facts available at the time of the decision rather than using hindsight, and believe that the professional judgement framework will assist regulators by ensuring proper documentation of the process followed in making a specific judgement. The role of regulators is essential to the success of principles-based standards and the professional judgement framework and we have therefore produced guidance for regulators to be used in their assessment of key judgements.

The role of standard setters is also crucial to the process, and as argued in earlier ICAS publications, they should create standards which allow judgement within a principles-based framework. The demands for any anti-avoidance provisions should be rejected, and standards should be written on the assumption that the majority of management are trustworthy and seek to provide the best quality information to their stakeholders. Our recommendations to standard setters are set out at the end of this document.
THE ICAS PROFESSIONAL JUDGEMENT FRAMEWORK

The focus of this framework is on making a judgement on an accounting treatment for a particular transaction, but it can be easily adapted for other judgements, for example, on materiality, disclosure in financial statements or narrative reports, or in relation to accounting estimates where there is a degree of uncertainty and therefore subjectivity.

The professional judgement framework has been prepared for guidance and is not intended to be a pure 'box ticking' exercise; judgement should be used to ensure that the procedures followed are appropriate to the individual circumstances. It is not expected that this framework would necessarily be used for every judgement made but we would recommend its use for significant judgements or those which would have a material effect on the financial statements.

The framework has been prepared on the assumption that the transactions entered into are genuine and substantive transactions permitted by law; if this appears not to be the case expert advice should be sought. The framework also assumes that the person making the judgement is appropriately qualified and trained and at a level appropriate to make the judgement.

We have set out on the following page a series of principles which should be followed as part of this framework. The subsequent illustrative lists of actions which you might undertake to apply the principles is not intended to be prescriptive or exhaustive. Some of the actions may be undertaken concurrently, or will not be relevant, depending on the specific situation.

ENDNOTES

2 'Preparers' represent all those parties in the company who are involved in judgements on accounting matters for the purpose of financial reporting, including financial accountants, financial controllers, CFOs, finance directors, audit committees and the full board.
7 The survey was issued to those members of ICAS with an interest in corporate reporting in July 2011. For further details contact accountingandauditing@icas.org.uk.
9 Professional Skepticism in an Audit of Financial Statements (IFAC, 2012) - pg 1 and 3.
10 ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing - paragraph 13(1).
THE PRINCIPLES OF A PROFESSIONAL JUDGEMENT FRAMEWORK

**FOR PREPARERS**

PRINCIPLE 1 - KNOWLEDGE GATHERING AND ANALYSIS
A professional accounting judgement can only be made once all relevant information has been collected and analysed.

PRINCIPLE 2 – ASSESSMENT OF ACCOUNTING GUIDANCE
A professional accounting judgement can only be made in the context of the applicable accounting framework, accounting standards and other literature where relevant.

PRINCIPLE 3 - PROCESS FOR MAKING A JUDGEMENT
A professional accounting judgement can only be made after undertaking appropriate due process.

PRINCIPLE 4 – DOCUMENTATION OF JUDGEMENT
A professional accounting judgement must be suitably documented.

**FOR AUDITORS**

PRINCIPLE 1 - KNOWLEDGE GATHERING AND ANALYSIS
A professional auditing judgement can only be made once all relevant information has been collected and analysed.

PRINCIPLE 2 – ASSESSMENT OF ACCOUNTING AND AUDITING GUIDANCE
A professional auditing judgement can only be made in the context of the applicable accounting framework, accounting standards and other literature where relevant, as well as the appropriate auditing standards and guidance.

PRINCIPLE 3 - PROCESS FOR ASSESSING AND CHALLENGING THE CLIENT’S JUDGEMENT
A professional auditing judgement can only be made after undertaking appropriate due process to assess and challenge the client’s judgement.

PRINCIPLE 4 – DOCUMENTATION OF JUDGEMENT
A professional auditing judgement and the assessment and challenge of the preparers’ judgement must be suitably documented.

**FOR REGULATORS**

PRINCIPLE 1 - REVIEW OF FINANCIAL STATEMENTS
The regulator should assess whether the professional accounting judgement has been appropriately disclosed in the financial statements or other document.

PRINCIPLE 2 - REVIEW OF PREPARER AND AUDITOR DOCUMENTATION
The regulator should assess whether the professional accounting judgement has been suitably documented.

PRINCIPLE 3 – DECISION
The regulator should assess the judgement based on the facts and circumstances available at the time the judgement was made.
A professional accounting judgement can only be made once all relevant information has been collected and analysed.

Understand the purpose, legal terms and economic substance of the transaction(s):
- Read all relevant documentation, including contracts, agreements, correspondence, etc.
- Consider the expected cash flows from the transaction and the impact on the entity’s cash position.
- Consider why each party is undertaking the transaction in order to understand its commercial reality.
- Identify if there are any related or linked transactions which need to be considered in determining the economic substance.
- Consider the uncertainties and range of possible outcomes of the transaction.
- Consider the effect of the transaction, once completed, on the entity’s assets, liabilities and operational capabilities.
- Prepare a risk and reward analysis. Consider who bears the risk and who receives the benefits under a range of scenarios governed by the transaction.
- Ask probing questions of those parties who set up the transaction – apply appropriate scepticism.

A professional accounting judgement can only be made in the context of the applicable accounting framework, accounting standards and other literature where relevant.

Consider what would be the expected/common sense approach of accounting for the transaction.

Consider if the transaction is covered by existing standards and the extent to which judgement is required.

In the absence of a relevant standard or specific guidance within a standard, or where there are conflicting standards or principles, refer to IAS 8 (paras 10-12), as appropriate, and proceed as follows:
- Consider the treatment of similar transactions under the relevant accounting framework.
- Refer to the conceptual framework for broad principles on definition, recognition and measurement of assets, liabilities, income and expenses.
- Refer to available authoritative accounting texts, for additional guidance.
- Consider if there is a generally accepted accounting practice in either the home or other countries.
PREPARERS - MAKING AND DOCUMENTING THE JUDGEMENT

- Consider if there is an accepted industry practice.
- Consider if there are other precedents for identical or similar transactions.
- Consider pronouncements of other standard-setting bodies with similar conceptual frameworks.
- Consider if the resulting financial information is both relevant and reliable and gives a fair presentation of the transaction.

PRINCIPLE 3 - PROCESS FOR MAKING A JUDGEMENT

A professional accounting judgement can only be made after undertaking appropriate due process.

After obtaining the above information:
- Consider and assess the range of alternative accounting treatments.
- Allow sufficient time to consult with experts and make your decision.
- Obtain appropriate advice from experts, where necessary.
- Identify any self interest and conflicts of interest to ensure the objectivity of the judgement.
- Ensure that you act ethically when making your decision and are not subject to undue pressures.
- Discuss with colleagues and professional advisers, where appropriate.
- Discuss your initial judgement with your auditors.
- Discuss with audit committee and other board members, where appropriate.
- Discuss with your professional institute, where appropriate.
- Discuss with the regulator and enforcer (pre-clearance), where appropriate and possible.
- Consider whether your proposal is one which you would be happy to defend against any possible reputational risk.
- Make your judgement.
- Consider the possibility of bias in the judgement process and reassess the judgement as appropriate.
- Identify the resultant accounting treatment and entries and ensure they make sense.
- Identify the appropriate note disclosures.
- Follow approval/escalation procedure for key judgements to ensure that material judgements have been endorsed, for example, by the audit committee or board.
- Identify points in time where reassessment of judgement will be required – for example period ends or trigger points in the initial contract.
PRINCIPLE 4 – DOCUMENTATION OF JUDGEMENT

A professional accounting judgement must be suitably documented.

The following should be documented in the entity’s paperwork:

- Overview of the transaction.
- Relevant accounting literature considered.
- The final judgement made/decision reached.
- Information known at that point in time.
- The timing of the decision.
- The alternative options considered and why the final solution was chosen and the reasons the other options were discounted.
- Any uncertainties in the decision.
- The sensitivity of the judgement to changes in the assumptions made or circumstances of the transaction.
- The process followed in making the decision:
  » sources used and relied upon
  » discussions held and with whom
  » the decision maker and date of the decision.
- The approval process for the decision – who approved it and when.
- Whether reassessment is required, and if so, the date of this review.
- Any shortcomings in the decision making process, for example, if the decision was subject to time pressures or specific expert advice could not be obtained.
- Make disclosure of key, material or significant judgements in the financial statements as required by IAS 1 (paras 122 and 125).
AUDITORS - CHALLENGING THE JUDGEMENT

PRINCIPLE 1 - KNOWLEDGE GATHERING AND ANALYSIS

A professional auditing judgement can only be made once all relevant information has been collected and analysed.

Read all relevant documentation, including contracts, agreements, correspondence, etc.
Obtain additional information from elsewhere, as appropriate or necessary.
Understand the client’s process for determining the judgement, including an assessment of competence and review/approval processes in place and whether such procedures have been followed.
Assess the risk of material misstatement in the financial statements.
Understand/analyse the purpose, legal terms and economic substance of the transaction(s):

• Review and challenge the expected cash flows from the transaction and the impact on the cash position of the client.
• Consider why each party is undertaking the transaction in order to understand its commercial reality.
• Identify the other parties to the transaction and consider if they are related parties.
• Identify if there are any related or linked transactions which need to be considered in determining the economic substance.
• Review and challenge the expected effect of the transaction, once completed, on the client’s assets, liabilities and operational capabilities.
• Assess the risk and reward analysis prepared by the client. Confirm who bears the risk and who receives the benefits under a range of scenarios governed by the transaction.

PRINCIPLE 2 – ASSESSMENT OF ACCOUNTING AND AUDITING GUIDANCE

A professional auditing judgement can only be made in the context of the applicable accounting framework, accounting standards and other literature where relevant, as well as the appropriate auditing standards and guidance.

Consider whether the transaction is covered by existing accounting standards, and the extent of judgement required.
Identify and review other relevant accounting literature.
Identify and review relevant auditing standards and guidance.
What would be the expected/common sense approach of accounting for the transaction?
Discuss with the client – apply appropriate professional scepticism and challenge.

If any conflicts of interest or bias are identified, relating to the transaction, reference should be made to the relevant ethical guidance and standards.
PRINCIPLE 3 - PROCESS FOR ASSESSING AND CHALLENGING THE CLIENT’S JUDGEMENT

A professional auditing judgement can only be made after undertaking appropriate due process to assess and challenge the client’s judgement.

Consider the uncertainties and range of possible outcomes of the transaction and compare with the client’s assessment of these.

Review the client’s assessment of alternative treatments and the reasons for rejection.

Evaluate whether significant assumptions made by the client are reasonable.

Assess the client’s proposed accounting treatment. If the transaction is covered by existing standards, is the proposed treatment in accordance with the appropriate standard? If there is an element of judgement, refer to IAS 8 (paras 10-12), as appropriate, and assess the client’s proposed treatment, as follows:

- Is the resulting financial information both relevant and reliable and does it give a fair presentation of the transaction?
- Is it consistent with the treatment of similar transactions under the relevant accounting framework?
- Is it consistent with the conceptual framework for broad principles on definition, recognition and measurement of assets, liabilities, income and expenses?
- Is it consistent with authoritative accounting texts?
- Is it consistent with generally accepted accounting practice in either the home or other countries?
- Is it consistent with accepted industry practice?
- Is it consistent with pronouncements of other standard-setting bodies with similar conceptual frameworks?
- Is there any evidence which would contradict the client’s proposed treatment?

Obtain appropriate advice from experts within the audit firm or externally, where necessary.

Identify any client conflicts of interest or bias to ensure the objectivity of judgements. If there are possible conflicts of interest or bias, reassess the above considerations with a greater degree of scepticism.

Be aware of any undue pressures from the client or audit firm and maintain your objectivity.

Make your own judgement on the appropriate accounting treatment.

Assess whether the client’s judgement on the accounting treatment is similar to your own or within acceptable limits. If not, discuss with your client and consider the implications for the audit and audit report (refer to appropriate ISAs).
Consider whether your decision is one which you would be happy to defend against any possible reputational risk.

Ensure approval/escalation procedure for key judgements have been followed to ensure that material judgements have been endorsed, where appropriate.

Check the resultant accounting treatment and entries and ensure they make sense.

Check the resultant note disclosures.

Identify points in time where reassessment of judgement will be required – for example period ends or trigger points in the initial contract.

PRINCIPLE 4 – DOCUMENTATION OF JUDGEMENT

A professional auditing judgement and the assessment and challenge of the preparers’ judgement must be suitably documented.

Documentation of significant matters arising during an audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions is required by ISA 230 (para 8(c)).

Record all key information reviewed, supporting evidence obtained and work performed.

Include copies of relevant client schedules relating to significant judgements in the audit file. Ensure that there is also evidence of the audit assessment and challenge of those judgements. This should include:

• How, and by whom, the audit judgement has been made.
• The rationale for the client and audit judgement.
• Any uncertainties regarding the audit judgement.
• Evidence of any consultation and endorsement of the audit judgement within the firm.
• Evidence of verification of facts and figures to underlying documents or external sources.
• Discussions held with the client to consider the accounting treatment.
• The impact of any disagreement about the accounting treatment on the audit report.
• Whether reassessment is required, and if so, the date of this review.
• Any shortcomings or difficulties in the assessment of the client’s judgement, and how these have been overcome.

Audit the disclosure of key, material or significant judgements in the financial statements as required by IAS 1 (paras 122 and 125).
The degree of regulatory assessment of accounting and auditing judgements varies between jurisdictions, therefore, these guidelines may not be relevant in all circumstances.

PRINCIPLE 1 - REVIEW OF FINANCIAL STATEMENTS

The regulator should assess whether the professional accounting judgement has been appropriately disclosed in the financial statements or other document.

Is there appropriate disclosure of key, material or significant judgements as required by IAS 1 (paras 122 and 125) included in the financial statements?

Is the treatment in line with extant standards or otherwise appears reasonable?

Are the corresponding disclosures in line with the extant standards or otherwise appear reasonable?

What is the preparer’s record of compliance with accounting standards?

Was there an earlier approach to the regulator to discuss the treatment - if so, assuming that the facts did not change, is the treatment in line with earlier guidance or pre-clearance provided?

Is it considered necessary to contact the preparers and auditors to seek clarification or obtain documentation in relation to the decision?

PRINCIPLE 2 - REVIEW OF PREPARER AND AUDITOR DOCUMENTATION

The regulator should assess whether the professional accounting judgement has been suitably documented.

Was an appropriate professional judgement framework followed?

Is there evidence:

- of the process undertaken to make or audit the decision?
- that the preparers/auditors understood the transaction?
- that all the facts and circumstances at the date the financial statements were prepared/signed were considered?

Have the reasons for the judgement been properly and fully set out?

If the treatment is not covered by existing standards, consider whether the procedure followed was appropriate:

- Was reference made to IAS 8 (paras 10-12) in order that the resulting information is both relevant and reliable and gives a fair presentation of the transaction?
- Was the treatment of similar transactions under the relevant accounting framework considered?
- Was reference made to the conceptual framework for broad principles on definition, recognition and measurement of assets, liabilities, income and expenses?
- Was reference made to available authoritative accounting texts?
• Is the treatment consistent with general accounting practice (GAAP) in either the home or other countries?

• Is the treatment consistent with accepted industry practice?

• If necessary, has there been consideration of pronouncements of other standard-setting bodies with similar conceptual frameworks?

Was there an earlier approach to the regulator to discuss the treatment - if so, assuming that the facts did not change, is the treatment in line with earlier guidance or pre-clearance provided?

Were the uncertainties at the time of the decision and range of possible outcomes and their probabilities fully considered?

Did subsequent events render the judgement made inappropriate? If so, to what extent should these post balance sheet events have been foreseen by the decision makers based on the facts available at the time of the decision?

Have the preparers and auditors properly considered all information available to them at the time of their decision and were their judgements reasonable in that context?

Is there evidence that people with the appropriate experience and seniority have made or approved the decisions?

Is there evidence that the auditors have exercised sufficient scepticism and challenge?

Are there local or cultural factors which may affect the quality of the judgement made?

**PRINCIPLE 3 – DECISION**

The regulator should assess the judgement based on the facts and circumstances available at the time the judgement was made.

After consideration of the above factors, assess the extent to which reliance may be placed on the judgement.

Reach a decision on the acceptability of the judgement, based on the facts and circumstances available at the time the judgement was made.
FINANCIAL REPORTING SHOULD BE BASED UPON PRINCIPLES-BASED STANDARDS WHICH PROVIDE THE SCOPE FOR PROFESSIONAL JUDGEMENT

- There should be a clear hierarchy of overarching concepts, principles which reflect the overarching concepts, with the minimum additional guidance necessary to make the standards operational.
- Standards should contain principles which are consistent with the conceptual framework and minimum additional guidance to apply those principles in practice.
- Principles should take precedence over any conflicting guidance/rules.
- Anti-abuse provisions and ‘bright-lines’ should be avoided if at all possible in accounting standards.
- Guidance should be restricted to what is necessary to make a standard operational.
- Guidance should not be so voluminous or prescriptive such that it is effectively a set of rules, which may on occasion therefore, conflict with the concepts or principles.
- Interpretations should focus on significant issues rather than detailed matters. Detailed matters should be left to the judgement of preparers and auditors with clear disclosure of how that judgement has been exercised.
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