

Professional Skepticism—Issues and IESBA Working Group Proposals

Background

Professional Skepticism Working Group's (PSWG) and Other Standard Setting Boards' (SSB) Activities

1. The tripartite PSWG, comprising representatives of the IESBA, the International Auditing and Assurance Standards Board (IAASB) and the International Accounting Education Standards Board (IAESB), was formed in June 2015 to consider how to improve application of professional skepticism (PS). The expectation and benefit of a coordinated response by the SSBs to the issue of professional accountants (PAs) applying appropriate PS was expressed by regulators and other respondents to the December 2015 Invitation to Comment (ITC), [*Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits*](#).¹
2. The work of the PSWG has prompted discussions among members of the IESBA, IAASB, IAESB and their respective Consultative Advisory Groups (CAGs) about actions that the SSBs could take, individually and in coordination, to enhance the application of PS in the short term and the longer term in their respective standards. The appendix to this paper includes a summary of the PSWG's preliminary recommendations, one of which being to recognize the existence of an important link between the fundamental principles (FPs) and PS.² Recognizing the limited reference to that linkage in the Code, the PSWG recommended that the IESBA consider how that linkage could be developed.
3. At their respective September November and 2016 meetings, the IESBA IAASB and IAESB exchanged views about the PSWG's preliminary recommendations and considered a "[PS strawman](#)" initially drafted by the IESBA representatives of the PSWG to consider how the proposed restructured Code might further emphasize PS.
4. From those discussions, two principal messages emerged:
 - (a) The majority of the representatives of the IESBA, IAASB and IAESB CAGs are of the view that all PAs need to apply a degree of "PS" when discharging their professional responsibilities. They expressed support for the IESBA to examine how to develop that idea in the Code. The CAGs emphasized the importance of ensuring that any proposals developed by the IESBA are scrutinized to avoid any potential unintended consequences for the IAASB's standards.
 - (b) Most IAASB members noted that the concept of PS as defined in the IAASB's International Standards is intended to be applied in the context of audit, review and other assurance engagements only. They cautioned that extending the applicability of PS to all PAs might result in unintended consequences of either:
 - (i) Diluting the meaning of PS in the context of audit, review and other assurance engagements, which would have negative implications for audit quality in particular; or
 - (ii) Expanding the work effort related to the provisions of other types of professional

¹ The IESBA was provided a summary and a full compilation of the PS related responses to the ITC during its September 2016 meeting. This material is available at the IESBA [September 2016 meeting webpage](#).

² The term PS is dealt with in the extant IESBA Code as part of the description of independence. See Part B, *Independence – Audit and Review Engagements* of the extant Code, Section 290, *A Conceptual Framework Approach to Independence*, paragraph 290.6; and Section 291, *Independence – Other Assurance Engagements*, paragraph 291.5.

services, for example financial statement compilations and tax return preparation.³

IESBA Deliberations

5. The IESBA's consideration of whether and, if so, how the proposed restructured Code should be developed to enhance references to PS started broadly at the March 2016 IESBA meeting and has continued in each subsequent meeting. Throughout these discussions, the IESBA acknowledged that, whilst PS (as defined in IAASB standards) applies to PAs undertaking audit, review and other assurance engagements, the FPs apply to all PAs. Several questions were raised, including whether (a) the IAASB definition of PS should be revisited and (b) whether PS should be a mind-set that all PAs should adopt and, if so, to what extent and in what circumstances.
6. The IESBA's deliberations on the topic of PS resulted in the establishment of the IESBA WG. Over the course of IESBA discussions, IESBA members have expressed varied views, which can be summarized as follows:
 - Some are of the view that the existing reference to PS in the Code is inadequate and should be developed.
 - Others have questioned whether a PS initiative is worthwhile given the IESBA's other priorities and the existing pressures on board and staff resources.
 - Some have expressed concerns about the risks associated with undertaking a “short term” project on PS whilst there remains a possibility (if not a probability) that unidentified, longer term developments may need to be pursued collectively or individually by the IESBA, IAASB and IAESB (e.g. to revise the definition of PS).

³ The WG notes that the term PS is used in a different manner in the IAESB's International Education Standards compared to the IAASB's standards:

- Applicable to all PAs, IES 3, *Initial Professional Development – Professional Skills (2015)*, paragraph 7 (c) (ii) includes as a learning outcome for professional skills the “application of professional skepticism through questioning and the critical assessment of all information.”
- Applicable to all PAs, 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 outcome 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 PS 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 a July 2015 non-authoritative IAESB publication titled, [Framework for International Education Standards for Professional Accountants and Aspiring Professional Accountants](#) (the Framework). Paragraph 28 of the 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.”

- Some thought that the suggestion that all PAs should apply PS (as defined by IAASB) should be a matter for a longer term project
 - Others took the view that the Code should not be silent (or rely on implied actions) as to the approach to be taken by PAs generally when considering information.
7. Taking into account the feedback from the IESBA's own discussions, the input of the PSWG, as well as a December 2016 IESBA CAG teleconference, the WG developed and presented to the IESBA at its December 2016 meeting a [PS project proposal](#) and [proposed text](#). The proposed text included:
- New application material to explain the linkage between FPs/independence and PS as defined in the IAASB's standards (required for audit, review and other assurance engagements); and
 - A new requirement for PAs to apply a critical mindset when applying the conceptual framework to assist in complying with the FPs.
8. After discussion at the December meeting, the IESBA asked that the WG revise its project proposal and bring it back for consideration at its March 2017 meeting.

IESBA WG Proposals

9. Reflecting on the feedback from the December 2016 IESBA, IESBA CAG, IAASB meetings, as well as feedback from PSWG members, the WG has amended its December proposal as follows:
- Drafted revised proposed application material to describe the linkage between the FPs and PS. The WG concluded that the description of the linkage between independence and PS in the proposed restructured Code is adequate and appropriate.
 - Withdrew its proposal for a requirement and supporting application material to apply a critical mindset. Proposed revisions to clarify the existing requirement to exercise professional judgment set out in Section 120⁴ are described in the "Clarification of the Requirement to Exercise Professional Judgment in Applying the Conceptual" section of the paper below.

Linkage between FPs and PS

10. As a basis for presenting the project proposal in **Agenda Item 2-B** and proposed text in **Agenda Item 2-C**, the WG carefully reviewed the draft minutes of previous discussions on the topic, in particular the December 2016 IESBA and IESBA CAG meetings; the transcript of December 2016 IAASB meeting; and the feedback on the topic of PS in the December 2016 comment letter from the IFAC SMP Committee. The WG is of the view that:
- Pursuing actions to respond to suggestions that have been made with respect to enhancing the definition of PS, or changing how PS is used in the Code (e.g., require all PAs to apply PS when applying the conceptual framework) raise complex issues that require consideration by the IESBA, IAASB and IAESB in a coordinated manner over a several year time horizon. Therefore, the proposals being put forward for the IESBA's consideration at its March 2017 meeting do not include a consideration of these suggestions.

⁴ Part 1 – Complying with the Code, Fundamental Principles and Conceptual Framework; Section 120, *The Conceptual Framework*

- In the short term, the public interest is best served if IESBA focuses its attention on emphasizing PS in the Code for the requirements that apply to audit, review and other assurance engagements only. In this regard, it is suggested that the existing references to PS in the Code, which are limited to the application of PS in audit, review and other assurance engagements, should be enhanced with additional application material explaining the linkage between the FPs and PS.
11. The proposed text in paragraph 120.13 A2 does not repeat the definitions of the FPs set out in Section 110⁵ of the proposed restructured Code, or PS as set out in the IAASB's standards. Rather, it provides examples to illustrate the interaction between the FPs and PS in the context of audit, review or other assurance engagements.
12. Subject to the IESBA's consideration and approval of the project proposal and the proposed text, the WG will explain the approach that it proposes for exposure in a manner that aligns the timing for the finalization of this PS project with that of the Structure of the Code project. Doing so will facilitate the inclusion of the proposed text that explains the linkage between the FPs and PS in the proposed restructured Code.

Matters for IESBA Consideration

1. IESBA members are asked whether they support:
- (a) The PS project proposal set out in **Agenda Item 2-B** and, if so, approve it; and
 - (b) Support the proposed text set out in **Agenda Item 2-C** related to the linkage of FPs to PS and, if so, approve it for exposure.

Clarification of the Requirement to Exercise Professional Judgment in Applying the Conceptual Framework

13. As part of its Phase 1 work, the Safeguards Task Force developed an enhanced conceptual framework set out in Section 120. The IESBA agreed in principle the text of Safeguards Phase 1 at its December 2016 meeting. Reflecting further on the feedback received from stakeholders on the role professional judgment plays in enabling PAs to comply with the provisions of the Code, including comments received on recent IESBA projects such as Safeguards, Part C, and Long Association, the WG is of the view that clarifying the exercise of professional judgment in the context of applying the conceptual framework is an appropriate and meaningful enhancement to Section 120 of the proposed restructured Code.
14. The proposed clarification would make explicit the expectation that when PAs exercise professional judgment as required in paragraph R120.5 (a), they should obtain a clear understanding of the facts and circumstances that are known to them. The WG believes that, although this expectation may already be implicit in the requirements and application material set out in Section 120 or elsewhere in the Code, it should be stated expressly. This approach of being explicit is in line with the approach taken by both the Safeguards and the Structure of the Code Task Forces throughout their respective projects.

⁵ Part 1, Section 110, *The Fundamental Principles*

15. The WG believes that the proposed clarifying language set out in revised paragraphs R120.5 (a) and 120.5 A1, complements but does not expand or introduce any new requirements to the existing requirements for PAs. The WG also believes that its proposed clarification set out in **Agenda Item 2-D**:
- Aligns to the definition of professional judgment in the IAASB's standards⁶ and is an important clarification to an already existing requirement in the Code; and
 - Will improve the PA's application of the conceptual framework, thereby enhancing the process by which the PA identifies, evaluates and addresses threats to compliance with the FPs.

Matters for IESBA Consideration

2. IESBA members are asked:
- (a) Whether they support the proposed clarification to the enhanced conceptual framework; and
 - (b) Whether the proposed text in **Agenda Item 2-D** is a meaningful addition to the proposed restructured Code and, if so, to approve it for exposure.

Interaction with Others and Forward Timeline

16. The WG has advised the PSWG of its plans to put forward for IESBA consideration the project proposal, the proposed text to explain the linkage between the FPs and PS, and the proposed clarification of the requirement to exercise professional judgment in the enhanced conceptual framework. Subject to IESBA support for the WG's proposals and the WG's finalization of the proposed texts, input of a "fatal flaw" nature will be requested from the PSWG, the IAASB, and the IAESB.
17. Following receipt of the views of the PSWG, the IAASB, and the IAESB, the WG will report back to the IESBA and if points have been raised that require the IESBA's input, a conference call will be arranged in April 2017 so that those points can be considered and an approach agreed.
18. The WG then envisages the release of the exposure draft(s) by the end of April 2017. The proposed timetable is set out in **Agenda Item 2-B** and is intended to align with the finalization of the proposed restructured Code.

Looking Ahead to Longer Term PS Initiatives

19. The WG welcomes IESBA members' views about other actions that the IESBA might take either alone or in coordination with the IAASB and IAESB to respond to the PS issues identified to-date, including the PSWG recommendations set out in the Appendix to this paper. Such a discussion will assist the WG's future work and will inform its discussions with the PSWG about how to respond to

⁶ 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" (see ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13(k)).

stakeholders' expectations with respect to PS. For example, questions have been raised about whether:

- The references to bias in the Code might be further developed (e.g., to better explain how a PA's own bias may affect how threats to compliance with the FPs are identified, evaluated and addressed).
- A non-authoritative publication might be developed to explain the attributes of a PA more broadly.
- The Code might include guidance about how PAs could overcome the impediments (e.g., time pressure, lack of confidence or "courage/fortitude", culture, and inadequate or inappropriate incentives) to compliance with the FPs. The WG notes a view that the impediments to compliance with the FPs and the application of PS are the same.
- Further consideration might be given to harmonizing how PS is addressed in the IESBA's and IAASB's standards in comparison to the IAESB's standards.

Matters for IESBA Consideration

3. IESBA members are asked how the IESBA should respond to concerns raised by its stakeholders with respect to PS in the context of:
 - (a) Applying the requirements set out in the Code; and
 - (b) Enhancing auditors' application of PS when conducting audits of financial statements.

Appendix

PSWG Preliminary Recommendations – As of September 2016

The following is an extract of [Agenda Item 7-A](#) to the September 2016 IESBA meeting materials and includes the PSWG's preliminary recommendations, the basis for which is discussed in detail in that paper.

Board	Relevant Action
All 3 SSBs	<ol style="list-style-type: none"> Using the PSWG as the mechanism to do so, jointly explore: <ol style="list-style-type: none"> In the longer term, whether it may be appropriate to extend the concept of PS beyond audit, review and assurance engagements (e.g., beyond how it is currently defined in the ISAs). In the longer term, whether a common description explaining the interrelationships among key concepts in the SSB's standards and the IESBA Code should be developed and, if so, how this description could be articulated. The potential standard-setting implications of (a) and (b), including providing views about whether this might result in changes to the SSBs' standards and the IESBA Code or whether a common description of PS could be promulgated in another way. In the longer term, whether a fundamental change to the concept of PS is needed. Continue to engage the PSWG to act as a central point for discussion of these and other issues as and when needed in relation to the discussions of the individual SSBs on matters that require coordination.
IESBA	<ol style="list-style-type: none"> Continue discussions on the relationship between PS and the FPs in the IESBA Code (as well as independence) and consider how this relationship should be addressed within the IESBA Code (e.g., in upcoming exposure drafts or with a longer term view). Explicitly address impediments to PS where possible in current and potential projects (e.g., safeguards, fees, etc.) Provide input to the PSWG's consideration of the applicability of the concept of PS beyond audit, review and assurance engagements and the common description of PS, and consider whether further changes are needed to the IESBA Code.
IAASB	<ol style="list-style-type: none"> Strengthen requirements and guidance in key standards currently under revision to emphasize the importance of the application of PS and set forth expectations about how PS is expected to be applied (e.g., accounting estimates / ISA 540,⁷

⁷ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

Board	Relevant Action
	<p>risk assessment / ISA 315 (Revised), quality control (firm level) / ISQC 1,⁸ quality control (engagement level) / ISA 220,⁹ group audits / ISA 600¹⁰).</p> <p>2. Explicitly address impediments to PS where possible in current projects (e.g., in relation to quality control using the quality management approach (QMA)).</p> <p>3. Commence information gathering and initial IAASB discussions on the topics of evidence and documentation, focusing on elaborating what the phrase “a critical assessment of evidence” in the definition of PS entails (e.g., by seeking to enhance ISA 500¹¹ and other ISAs) and reconsidering requirements related to the auditor’s documentation in accordance with ISA 230,¹² particularly in relation to significant professional judgments made in planning and performing the audit.</p> <p>4. Provide feedback on the potential implications of the IESBA’s efforts to articulate the relationship between PS and the FPs in the IESBA Code (as well as independence), in particular how this might affect both assurance engagements and other services.</p> <p>5. Provide input to the PSWG’s consideration of the applicability of the concept of PS beyond audit, review and assurance engagements and the common description of PS, and consider whether further changes are needed to ISA 200 or other IAASB International Standards.</p>
IAESB	<p>1. In view of the analysis of the drivers and impediments to PS determine what future actions might be most useful to further develop professional competence (e.g., an emphasis on training, education and mentoring).</p> <p>2. Provide feedback on the potential implications of the IESBA’s efforts to articulate the relationship between PS and the FPs in the IESBA Code (as well as independence).</p> <p>3. Provide input to the PSWG’s consideration of the applicability of the concept of PS beyond audit, review and assurance engagements and the common description of PS, and consider whether further changes are needed to the IESs.</p>

⁸ ISQC 1, *Quality Control for Firms That Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

⁹ ISA 220, *Quality Control for an Audit of Financial Statements*

¹⁰ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

¹¹ ISA 500, *Audit Evidence*

¹² ISA 230, *Audit Documentation*