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Exposure Draft

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Response Due Date  
23 June 2017

*Exposure Draft*

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**Proposed Application Material Relating to:**

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

**(b) Professional Judgment – Emphasis on  
Understanding Facts and Circumstances**



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

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Exposure Draft

IESBA Press Release

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## Exposure Draft

May 2017

*Comments due: July 25, 2017*

*International Ethics Standards Board  
for Accountants®*

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### Proposed Application Material Relating to:

- (a) Professional Skepticism –  
Linkage with the  
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- (b) Professional Judgment –  
Emphasis on Understanding  
Facts and Circumstances

**IESBA**

International  
Ethics Standards  
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Ethics Standards  
Board for Accountants®

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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, internationally appropriate *Code of Ethics for Professional Accountants™* (the Code).

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## REQUEST FOR COMMENTS

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. Comments are requested by **July 25, 2017**.

Respondents are asked to submit their comments electronically through the IESBA website, using the "[Submit a Comment](#)" link. Please submit comments in both PDF and Word files. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. Although the IESBA prefers that comments are submitted via its website, comments can also be sent to Ken Siong, IESBA Technical Director at [KenSiong@ethicsboard.org](mailto:KenSiong@ethicsboard.org)

This publication may be downloaded from the IESBA website: [www.ifac.org/ethics/restructured-code](http://www.ifac.org/ethics/restructured-code). The approved text is published in the English language.

# PROPOSED APPLICATION MATERIAL RELATING TO PROFESSIONAL SKEPTICISM AND PROFESSIONAL JUDGMENT

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# EXPLANATORY MEMORANDUM

## I. Introduction

1. This memorandum provides background to, and an explanation of, the IESBA's exposure draft which includes proposed 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.

The application material represents proposed additions to Section 120<sup>1</sup> of the restructured Code, the text of which was [agreed in principle](#) by IESBA in December 2016 as part of Phase 1 of its Safeguards project.<sup>2</sup>

2. The IESBA approved this exposure draft in April 2017.

## II. Significant Matters

### A. Proposed Application Material Relating to Professional Skepticism – Linkage with the Fundamental Principles

#### *Background*

3. Professional skepticism is an important concept that is currently defined in auditing and assurance standards. The International Auditing and Assurance Standards Board's (IAASB's) International Standard on Auditing (ISA) 200, for example, defines professional skepticism 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>3</sup> ISAs, in particular, explicitly require auditors 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. Although, the definition of professional skepticism in the auditing and assurance standards of national standard setters might differ slightly from how the term is defined in the International Standards of the IAASB, the general principles are the same.

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<sup>1</sup> Section 120, *The Conceptual Framework*

<sup>2</sup> In December 2016, the IESBA completed the first phase of its Safeguards project aimed at improving the clarity, appropriateness, and effectiveness of the safeguards in the Code. For further information about this project, including how the IESBA is coordinating it with its Structure project aimed at enhancing the understandability and usability of the Code, and anticipated timelines, see the January 2017 [IESBA Update](#).

<sup>3</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). 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 professional skepticism during an audit of financial statements.

EXPLANATORY MEMORANDUM

4. Although the concept of professional skepticism is most prominently dealt with in auditing and assurance standards, professional skepticism is also referred to in the Code<sup>4</sup> and in the International Education Standards (IESs).<sup>5</sup> Consistent with the International Standards of the IAASB, the extant Code refers to professional skepticism in the context of audit and other assurance engagements only.
5. In recent years, issues relating to professional skepticism have been cited by various stakeholders. For example, since 2012 International Forum of Independent Audit Regulators' (IFIAR's) has consistently identified professional skepticism as a finding in its global survey of audit inspection reports, in particular in relation to the audit of areas that require high levels of professional judgment.<sup>6</sup> At the national level, some jurisdictions have undertaken initiatives related to enhancing auditors' application of professional skepticism. 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\*](#), summarized issues related to professional skepticism and sought views about how those issues might be addressed.<sup>7</sup>

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<sup>4</sup> 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*]

<sup>5</sup> References to professional skepticism in the standards of the International Accounting Education Standards Board (IAESB) 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 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 professional accountants integrate technical competence, professional skills, and professional values, ethics, and attitudes developed through professional accounting education. It supports the development of decision making skills, judgment, and skepticism.”

<sup>6</sup> See the IFIAR Reports on Survey of Inspection Findings for 2012-2016. For example, in its 2016 Report dated March 2017, IFIAR highlights its continued focus on encouraging the development of standards that drive auditors to consistently exercise sufficient professional skepticism.

<sup>7</sup> The IAESB considered the significant matters raised by respondents to the ITC at its [September 2016 meeting](#).



6. Additionally, some stakeholders, in commenting on recent IESBA exposure drafts,<sup>8</sup> have suggested that the IESBA consider how the Code should address professional skepticism beyond audit and other assurance engagements. As further discussed in the Appendix to this explanatory memorandum, those stakeholders have expressed the view that the concept of professional skepticism should be relevant to all professional accountants – not just professional accountants who perform audit and other assurance engagements.
7. In response, the IESBA, IAASB and the IAESB jointly established a tripartite Professional Skepticism Working Group (PSWG) in June 2015. The PSWG's subsequent work prompted focused and coordinated discussions at the plenary sessions of the IESBA, IAASB, IAESB and their respective Consultative Advisory Groups (CAGs) about actions that the three Boards could take, individually and in coordination, to enhance the exercise of professional skepticism.
8. In September 2016, 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.
9. This recommendation is consistent with the advice from the joint CAGs of the IESBA and IAASB. It was also based on feedback from some respondents to the IAASB's ITC and a [December 2015 summary of academic research](#) relating to professional skepticism that the IAASB had commissioned, which suggested that proper application of, and compliance with, the provisions in the Code might also contribute to enhancing the exercise of professional skepticism. Consistent with the PSWG's observations, the academic research notes that :
  - (a) The drivers and impediments to compliance with the fundamental principles and to the exercise of professional skepticism are the same.
  - (b) Auditors who comply with the fundamental principles (in particular integrity, objectivity and professional competence and due care) are more resolute when making inquiries of and considering evidence received from management.
  - (c) Substantial time pressure, particularly at year end, which creates threats to compliance with the fundamental principles, also impairs an individual's ability to exercise professional skepticism.

#### *The IESBA's Response*

10. 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.
11. The proposed application material in paragraph 120.13 A1 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.

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<sup>8</sup> August 2014 Exposure Draft, [Proposed Changes to Certain Provisions of the Code Addressing the Long Association of Personnel with an Audit or Assurance Client](#); and November 2014 Exposure Draft, [Proposed Changes to Part C of the Code Addressing Presentation of Information and Pressure to Breach the Fundamental Principles](#)

12. 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. As further discussed in the Appendix to this explanatory memorandum, the IESBA has been considering whether and, if so, how the Code should address the applicability of the concept of professional skepticism to professional accountants other than professional accountants who perform audit and other assurance engagements.
13. 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.

**B. Proposed Application Material Relating to Professional Judgment – Emphasis on Understanding Facts and Circumstances**

*Background*

14. Concurrently with its deliberation of the issues relating to professional skepticism and its work on the Structure and Safeguards projects, 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, it would constitute non-compliance with the fundamental principles, in particular, integrity and professional competence and due care.
15. 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 the professional accountant when exercising professional judgment in applying the conceptual framework.

*Proposed Application Material Relating to the Requirement to Exercise Professional Judgment When Applying the Conceptual Framework*

16. In light of the above, the IESBA proposes application material in paragraph 120.5 A1 that emphasizes 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. Specifically, this proposed application material highlights the importance of the professional accountant considering whether:
  - There is an inconsistency between the known facts and circumstances and the professional accountant’s expectations.

- The information provides a reasonable basis on which to reach a conclusion.
  - Other reasonable conclusions could be drawn from the information being considered.
  - The professional accountant's own preconception or bias might be affecting the professional accountant's judgment.
  - The professional accountant's own expertise and experience are sufficient, or whether there is a need to consult with others with relevant expertise or experience.
17. The proposed application material is aligned to the discussion of professional judgment in the IAASB's standards.<sup>9</sup>
18. The IESBA believes that the proposed application material is a meaningful addition to the proposed restructured Code because it makes explicit an expectation that the IESBA believes is already implicit in the application of the conceptual framework. Therefore, the IESBA determined that it would be in the public interest to make this proposed application material available as part of the restructured Code when it is issued.

### III. Analysis of Overall Impact of the Proposed Changes

19. The IESBA believes that the proposed application material in paragraphs 120.5 A1 and 120.13 A1 relating to professional judgment and professional skepticism, respectively, will clarify what is already implicit in the provisions of the Code. Consequently, it is not expected that the proposals will introduce any significant additional costs for professional accountants already complying with the Code.
20. With respect to the proposed application material relating to professional skepticism, the proposed clarification will heighten auditors' focus on the provisions in the Code that are relevant to acting in a manner that supports the exercise of professional skepticism. Consequently, the IESBA believes that the proposed application material in 120.13 A1 will contribute to improving audit quality.

### IV. Project Timetable and Effective Date

21. The IESBA intends to finalize the proposed application material at the same time as its Structure project by December 2017. It also proposes to align the effective date of the proposed application material with the effective date of the restructured Code (see January 2017 [IESBA Update](#)).

### V. Guide for Respondents

22. The IESBA welcomes comments on all matters addressed in this exposure draft, but especially those identified in the Request for Specific Comments below. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this Exposure Draft, it will be helpful for the IESBA to be made aware of this view.

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<sup>9</sup> 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."

**Request for Specific Comments**

*Proposed Application Material Relating to Professional Skepticism (paragraph 120.13 A1)*

1. Do respondents agree that the proposed application material enhances the understandability of the conceptual framework in Section 120 of the proposed restructured Code?
2. Do the examples in the proposed application material clearly describe how compliance with the fundamental principles of integrity, objectivity, and professional competence and due care support the exercise of professional skepticism in the context of an audit of financial statements? If not, why not?

*Proposed Application Material Relating to Professional Judgment (paragraph 120.5 A1)*

3. Do respondents agree that the proposed application material enhances the understandability of the conceptual framework in Section 120 of the proposed restructured Code?
4. Do respondents agree that the proposed application material appropriately emphasizes 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? If not, why not?

**Request for General Comments**

23. In addition to the request for specific comments above, the IESBA is also seeking comments on the matters set out below:
  - (a) *Small and Medium Practices (SMPs)* – The IESBA invites comments regarding any aspect of the proposals from SMPs.
  - (b) *Regulators and Audit Oversight Bodies* – The IESBA invites comments on the proposals from an enforcement perspective from members of the regulatory and audit oversight communities.
  - (c) *Developing Nations* – Recognizing that many developing nations have adopted or are in the process of adopting the Code, the IESBA invites respondents from these nations to comment on the proposals, and in particular on any foreseeable difficulties in applying them in their environment.
  - (d) *Translations* – Recognizing that many respondents may intend to translate the final changes for adoption in their own environments, the IESBA welcomes comment on potential translation issues respondents may note in reviewing the proposals.

## **Matters Relating to the Applicability of Professional Skepticism Beyond the Audit and Assurance Context— Background and Future Considerations<sup>10</sup>**

### **Calls for Extending the Applicability of Professional Skepticism to All Professional Accountants**

1. As explained in paragraph 6, some stakeholders have suggested that the IESBA consider how the Code should address professional skepticism beyond audit and other assurance engagements. Those stakeholders have expressed the view that the concept of professional skepticism should be relevant to all professional accountants – not just professional accountants who perform audit and other assurance engagements. For example:
  - In its April 2015 [comment letter](#) to the IESBA, the International Organization of Securities Commissions (IOSCO) called on the IESBA to emphasize in the Code the need for professional accountants in business (PAIBs) to exercise an adequate level of professional skepticism throughout the process of preparing, presenting and/or filing information. IOSCO noted that:
    - 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.
    - Given the increased level of complexity of business transactions and financial reporting and the increasing use of estimates and management judgments, PAIBs should be required to demonstrate enhanced levels of attentiveness and sensitivity to the integrity of information with which they are associated.
  - Participants in a 2014 Public Interest Oversight Board (PIOB) Public Interest Workshop suggested that “professional skepticism as a state of the mind and attitude should govern the performance of auditors, and inspire the attitude of other accountants, e.g., accountants in business.” They further noted that “when accountants (practitioners, non-practitioners, accountants in business) do not display proper professional skepticism it is recognized as a barrier to effective performance.”<sup>11</sup>
  - Representatives of the PIOB at the March 2017 IESBA and IESBA CAG meetings expressed the view that the concept of professional skepticism is relevant to all professional accountants and that it is in the public interest that guidance on professional skepticism be made available to all professional accountants.

### **Issues, IESBA Deliberations and Decisions**

2. Concurrently with its deliberations on developing the proposed application material in paragraph 120.13 A1, the IESBA has been considering whether and, if so, how the Code should address the applicability of the concept of professional skepticism to professional accountants other than professional accountants who perform audit and other assurance engagements.

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<sup>10</sup> The IESBA is not seeking comments on the matters outlined in this Appendix at this time.

<sup>11</sup> See [Conclusions from the PIOB Public Interest Workshop](#).

3. The IESBA noted that:
- Professional skepticism is defined in the IAASB's International Standards and, as a concept, is long established in audit and assurance literature, with a very specific and clearly defined meaning in the context of audit and other assurance engagements.
  - The IAESB' standards already require professional skepticism to be a competency area for professional values, ethics and attitudes that all professional accountants should have. As stated in footnote 5, the IAESB's standards require all professional accountants to "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."
4. The IESBA's preliminary discussions with the IAASB and the joint CAGs of the IESBA and IAASB have identified a number of concerns about a potential for dilution of the meaning and importance of professional skepticism in the audit and assurance context if its applicability were to be extended beyond audit and assurance. Other concerns raised included, among others:
- A potential need to reconsider the definition of professional skepticism in the IAASB's International Standards and the implications that might have for the nature and extent of auditors' and assurance practitioners' work effort; and
  - Potential implications for the nature and extent of work effort related to the provision of other types of professional services by professional accountants in public practice, for example, financial statement compilations and tax return preparation.

Also, the IESBA recognizes that broadening the applicability of professional skepticism to all professional accountants could create implications for how the IAESB's standards address professional skepticism.

5. In regard to the above, the IESBA notes that:
- The IAASB's future considerations include analyzing potential fundamental changes to the concept and definition of professional skepticism in its International Standards.
  - The IAESB's extant standards use the IAASB's definition of professional skepticism and that the IAESB is planning to explore whether there is a need for clarification about professional skepticism in its standards.
6. Given the complexities described above and the desirability of a coordinated approach with ongoing initiatives by the IAASB and the IAESB, the IESBA intends to consider whether and, if so, how to extend the concept of professional skepticism to all professional accountants. This will involve consulting with stakeholders on relevant matters, including:
- The implications of extending the concept of professional skepticism to all professional accountants (including those matters identified above).
  - Whether the Code should include more guidance on how to overcome impediments to the exercise of professional skepticism. Development of such guidance might include, for example, a consideration of:
    - Whether the limited references to bias in the Code might need to be further developed, leveraging relevant academic research on the topic.
    - Whether more application material is needed to explain how professional accountants

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should respond to external factors such as pressure.

- Whether the Code should describe the attributes that have been identified as drivers to the application of professional skepticism (e.g., “courage/fortitude”, critical thinking).
- Whether there is, in the public interest, a need to develop material to describe the role and expectations of professional accountants and how their work contributes to enhancing the integrity and credibility of information with which they are associated.

# EXPOSURE DRAFT: PROPOSED APPLICATION MATERIAL RELATING TO (A) PROFESSIONAL SKEPTICISM – LINKAGE WITH THE FUNDAMENTAL PRINCIPLES; AND (B) PROFESSIONAL JUDGMENT – EMPHASIS ON UNDERSTANDING FACTS AND CIRCUMSTANCES

The IESBA's proposals include two sets of proposed application material presented in gray text below. The application material is a proposed addition to Section 120, *The Conceptual Framework* of the restructured Code.

## A. Proposed New Application Material to Explain How Compliance with the Fundamental Principles Supports the Exercise of Professional Skepticism

### Part 1 – COMPLYING WITH THE CODE, FUNDAMENTAL PRINCIPLES AND THE CONCEPTUAL FRAMEWORK

#### Section 120

#### The Conceptual Framework

...

#### Requirements and Application Material

...

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

##### *Independence*

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

- (a) Independence of mind – the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's or an audit or assurance team member's integrity, objectivity or professional skepticism has been compromised.

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



*Professional Skepticism*

120.13 A1 Auditing, review and other assurance standards, including those issued by the International Auditing and Assurance Standards Board (IAASB), require professional accountants in public practice to exercise professional skepticism when planning and performing audits, reviews and other assurance engagements. Compliance with the fundamental principles supports the exercise of such professional skepticism. For example, in an audit of financial statements, this is illustrated in the following examples:

- *Integrity* requires the professional accountant to be straightforward and honest. Therefore, integrity supports the exercise of professional skepticism when the accountant is aware of or suspects that a position advanced by a client could result in financial statements being materially false or misleading. Being straightforward when raising concerns, pursuing inquiries or seeking further evidence before reaching a conclusion about a matter of concern is consistent with a questioning mind and the critical assessment of audit evidence involved in exercising professional skepticism.
- *Objectivity* requires the professional accountant to recognize that previous involvement with a client, among other things, might give rise to a risk of bias by the accountant. Self-awareness of the accountant's own bias when considering evidence relating to a matter material to the audit of the client's financial statements and taking additional steps to evaluate relevant evidence to address such risks of bias are actions consistent with exercising professional skepticism.
- *Professional competence and due care* requires the professional accountant to have the appropriate level of professional knowledge and skill required for a particular engagement, and to act diligently in accordance with applicable standards, laws and regulations. These attributes enable the accountant to identify risks of misstatement that are relevant to a particular client's financial statements and to exercise professional skepticism by diligently pursuing and then critically assessing whether audit evidence is sufficient and appropriate in the circumstances.

**B. Proposed New Application Material to Emphasize the Importance of Understanding Facts and Circumstances in Relation to Exercising Professional Judgment**

**Part 1 – Complying with the Code, Fundamental Principles and the Conceptual Framework**

...

**Section 120**

**The Conceptual Framework**

...

**Requirements and Application Material**

...

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

- (a) Exercise professional judgment;
- (b) Remain alert for new information and to changes in facts and circumstances; and
- (c) Use the reasonable and informed third party test as described in paragraph 120.6 A1.

**Exercise of Professional Judgment**

120.5 A1 Professional judgment involves the application of training, knowledge and experience taking into account the nature and scope of the professional activity being undertaken. When exercising professional judgment it is important that the professional accountant obtains a sufficient understanding of the facts and circumstances known to the accountant to identify, evaluate and address threats to compliance with the fundamental principles. In obtaining this understanding, the accountant might consider, among other matters, whether:

- There is an inconsistency between the known facts and circumstances and the accountant's expectations.
- The information provides a reasonable basis on which to reach a conclusion.
- Other reasonable conclusions could be drawn from the information being considered.
- The accountant's own preconception or bias might be affecting the accountant's judgment.
- The accountant's own expertise and experience are sufficient, or whether there is a need to consult with others with relevant expertise or experience.

**Reasonable and Informed Third Party**

120.5 A2A1 The reasonable and informed third party test is a consideration by the professional accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable

EXPOSURE DRAFT

and informed third party, who weighs all the relevant facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant, but would possess the relevant knowledge and experience, to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

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