

Professional judgment: What it is and how to handle it

It may not be obvious, but we form judgment about almost everything: a friend or person, a property, a movie, etc. We usually form these views or judgments based on facts and complete information. The same applies in a professional environment.

Professional standards issued by the Institute – Hong Kong Financial Reporting Standards, Hong Kong Standards on Auditing and the Code of Ethics for Professional Accountants – are based on globally developed, principle-based frameworks. So naturally, this requires the use of judgment when applying principle-based standards.

Some stakeholders have asked: Is it necessary to set standards based on principles? The decision to base Hong Kong professional standards on globally developed principles is to enable accountants to apply the standards against any variation of circumstances, including diverse economies, legal structure and culture. Gary Kabureck, member of the International Accounting Standards Board, also explains in *The case for principle-based accounting*: “Principles written at too high a level result in issues with comparability and other challenges but excessive rules result in unnecessary complexity and invite structuring. Just like today’s modern technology, which is obsolete tomorrow, the same is true of detailed accounting rules as new transaction types, creative terms and conditions and complex structures emerge almost daily. Application of judgment, guided by and within standards-level or conceptual boundaries, is the only plausible solution.”

So, what is professional judgment to accountants?

Paragraph 13(k) of HKSA 200 explains 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.

Can everyone form the same professional judgment?

It depends. There are many influences in forming a professional judgment. The International Auditing and Assurance Standards Board believes that professional skepticism – an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence – influences professional judgment.

Other relevant concepts in ethical requirements, including independence of mind, objectivity, and competence, as well as entity or market-specific and environmental factors may impact a person’s attitude and mindset when applying judgment.

In its *Invitation to Comment, Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control, and Group Audits*, the IAASB notes that personal individual traits will impact the application of professional skepticism (and therefore professional judgment decisions). For example, this includes having the strength of mind that enables one to deal with confrontational matters with courage – the Institute thinks this may include being comfortable with challenging management in areas that are highly judgmental or subjective – and having the appropriate competence in the subject area, including knowledge, skills and experience. Behaviour is also influenced by inherent cognitive

biases such as long-term relationships between the preparer and auditor. Other factors that will influence how a professional skepticism is applied, includes tight financial reporting deadlines, heavy workloads, as well as time and resource constraints.

Believe it or not, cultural diversity around the globe can also impact professional judgment decisions. This is illustrated in a research report by the Korea Accounting Standards Board and the Australian Accounting Standards Board entitled *Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia*. The report investigated how accountants in Korea and Australia interpret 35 terms of likelihood in International Financial Reporting Standards, such as “probable” and “unlikely.” The research found that most of these terms tend to be interpreted inconsistently between jurisdictions and among professionals within the jurisdiction. For example, probable means a likelihood of 71 percent in Australia and 62 percent in Korea, while unlikely means 28 percent in Australia and 12 percent in Korea.

How to make a sound professional judgment?

The Institute’s Standard Setting Director, Christina Ng, and Compliance Director, Linda Biek, provide some advice on how to make a sound professional judgment.

How have you seen professional judgment misapplied?

Christina: When applying professional standards, I often see accountants cherry pick parts of a standard to read and do not really understand the spirit or principles of the standard. Not making the effort to dig deeper into

Useful resources

Sound professional judgment could be developed through years of experience, but the Institute's Standard Setting Department emphasizes the importance of ample education and training in the relevant standards and softer, non-technical skills.

The following electronic courses may be useful to strengthen your understanding of how to apply professional judgment and skepticism:

- HKICPA-CAANZ's Professional Skepticism e-Learning Programme for Audit Partners and Managers
- Elevating Professional Judgment in Auditing and Accounting: The KPMG Professional Judgment Framework

The following guidance may also be useful when applying professional judgment:

- *Will you be second guessed? Applying judgment in the financial reporting process*, PwC, January 2017
- *A professional judgment framework for financial reporting*, Institute of Chartered Accountants of Scotland, August 2016
- *The professional judgment framework*, Ernst & Young Foundation, 2014
- *Financial Statements: Framing your judgment calls*, Deloitte, 2014
- *Professional Judgment Resource*, Center for Audit Quality, August 2014

understanding the standards and the company's or client's transaction from a holistic point of view are also common mistakes. In these cases, they often miss the big picture and, as a result, make inappropriate judgments.

Linda: Our experience has shown that professional judgment is sometimes applied after a company decides they want a certain accounting outcome, which may deviate from the outcome prescribed by the standards. Auditors then work to find a way to justify the said outcome and claim they relied on "professional judgment" to take a position that is contrary to what would be reasonably expected under the applicable accounting standards.

What advice would you give a preparer or auditor in making sound judgments?

Christina: Just like in our personal lives, a sound professional judgment cannot be rushed – you need to invest time in understanding the requirements of the standards, the company or client background and the economic environment. Preparers and auditors should therefore make this a priority. Also, don't be afraid to probe into details of a transaction or a company or client's explanations and decisions.

They should also be mindful that professional judgment may change

based on facts and circumstances or as new information comes to light. It is therefore critical to have proper documentation of all information that was available at the time of forming a judgment – and, in circumstances where more than one way of accounting is available, the rationale for why a particular method is more appropriate than the other.

Linda: A paradigm shift may be needed for auditors to embrace their roles in the area of public interest. In order for financial information to remain robust and judgment to be properly applied, auditors should begin with a solid technical framework and clear understanding of their client's business and industry. They should strive to ensure the clients adhere to the relevant accounting standards. If clients apply alternatives because they consider the relevant accounting standards do not produce results that reflect the economic reality of a transaction, then auditors must assess the reasonableness and validity of management's rationale, obtain evidence that supports management's views, and ensure proper documentation. If there is insufficient evidence supporting management's rationale, then auditors must consider if issuance of a qualified audit report is needed. Sound judgment is best applied when auditors consider

the relevant facts and circumstances that may factor into a financial statement user's decision making before concluding on a challenging matter.

Watch this space

The IAASB, the International Ethics Standards Board for Accountants and the International Accounting Education Standards Board have a Joint Working Group that explores what actions may be appropriate within their collective standards and other potential outputs to enhance professional judgment and skepticism.

The Institute recognizes that forming professional judgments has its challenges, particularly in complex scenarios. The Standard Setting Department invites members to share, in what situations did members find challenging to apply professional judgment, and what forms of support would be helpful to develop your skill in exercising judgment. Contact us at outreachhk@hki CPA.hk.org.



This article is contributed by the Institute's Standard Setting Department.