

Guidance on Professional Judgment of Chinese CPAs

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I General Provisions

1. This Guidance aims at promoting CPAs' awareness of professional judgment, instructing them on how to exercise professional judgment, and increasing their capability and quality of professional judgment.

2. This Guidance applies to CPAs working in an accounting firm. However, professional accountants in business (non-practicing members) engaging in financial reporting, internal audit and other services can take this Guidance as a reference.

3. In this Guidance, the term "professional judgment" refers to the application of relevant training, knowledge and experience, based on auditing, accounting and ethical standards, in making informed decisions that are appropriate in the circumstances of the audit engagement¹.

4. Professional judgment is the essence of the CPA profession. Fundamentally, accounting and auditing practices are constituted by a series of judgment. The concept of professional judgment can be understood from the following aspects:

(1) Professional judgment shall be exercised by a professional who has necessary knowledge, experience and professional skills and can maintain due professionalism. Professional judgment shall be objective and fair, and shall not be subject to the will of others.

(2) Professional judgment shall be exercised within the framework of laws, regulations and professional standards, including both the auditing standards and the code of ethics that CPAs must abide by in practice, as well as financial reporting frameworks and some other professional regulations relevant to CPA engagements.

(3) Professional judgment is a decision-making process in the circumstance of uncertainties. Professional judgment is based on uncertainties of its target, and needs to be made following certain decision-making procedures. Such decisions are often made on complex and difficult issues, and the conclusion may have some impact on the related parties.

II Necessity of Professional Judgment

5. Professional judgment of financial report preparers and CPAs is the core of financial reporting. Without flexible use of knowledge and experience through professional judgment, mechanical implementation of accounting and auditing procedures will never operate effectively. In any case, professional judgment made by those with expertise and skills in specific circumstances are

¹ Please see Article 16 of China Standard on Auditing 1101- Overall Objectives of the Auditor and the Fundamental Requirements of an Audit.

indispensable in compiling and auditing financial reports.

6. A CPA is encouraged to exercise professional judgment in response to the uncertainties of the economic environment. The ongoing social and economic development has created an increasingly complex economic environment, exposing business entities to enhanced uncertainties. In such an economic context, every economic activity an entity engages in is more or less at risk. Therefore, the majority of accounting transactions are uncertain to some extent, such as the risk of bad debts in credit business and contingent liabilities arising from product warranties and after-sales service. In face of these uncertainties, compilers of financial reports must make estimates on basis of professional judgment. In order to express their opinions about financial information, CPAs need to analyze the judgment submitted by financial reporting preparers to make their own re-judgment.

7. A CPA is encouraged to exercise professional judgment in response to the information asymmetry between the entity and himself/herself. A CPA, not belonging to the entity, will find it impossible to observe the entity's operations in real time with limited access to the entity's information. Meanwhile, it is also necessary to consider the audit efficiency, the reporting timeliness and other factors. For this purpose, a CPA needs to exercise professional judgment when he/she conducts the audit deemed as necessary to obtain relevant information in support of his/her opinions.

8. A CPA is encouraged to exercise professional judgment when following the principle-based professional standards. Along with increasingly diversified and complex transactions in the real economy, audit workload grows rapidly, adding to the complexity of audit conducts. Qualified, competent and experienced persons are needed to support in the selection and application of relevant accounting policies, make use of audit sampling techniques, assess internal controls, and identify and assess risks of material misstatements - all these call for ever-rising demand for CPA's professional judgment.

9. Professional judgment is an inherent requirement of professional standards, and the relationship between them can be summarized as following:

(1) Professional standards are the judgment collectively made by the whole profession. Based on the practice of CPAs, professional standards summarize issues that can be standardized, pooling high-quality professional judgment on the problems often encountered in practice. In this sense, professional standards are guidelines on professional judgment for individual CPAs based on collective professional judgment of the whole accountancy profession.

(2) Professional standards can never play an effective role without CPA's professional judgment. With the extensive development and implementation of professional standards across a wide range of jurisdictions, the demand for CPA's professional judgment shows no sign of abating. Instead, the need thrives as the phrase "professional judgment" appears more frequently in professional standards. Professional judgment is critical for the effective implementation of professional standards. Without professional judgment, professional standards will be applied

mechanically without a clear purpose, and decision-making through such judgment can be misleading. To achieve the goals set forth in professional standards and give full play to the role of professional standards, professional judgment should be exercised in an appropriate and effective way.

(3) Professional judgment relevant to fair value measurement, such as how to determine the fair value of investment in real estates or financial assets;

(4) Professional judgment relevant to accounting items and disclosure in relation to related parties and related party transactions, such as whether the price is fair in such transactions, and whether parties related and related party transactions are adequately disclosed;

(5) Professional judgment relevant to contingencies, such as the estimate of the likelihood of contingencies, the recognition and measurement of contingent liabilities;

(6) Professional judgment relevant to subsequent events, such as the distinction between adjusting and non-adjusting events;

(7) Professional judgment relevant to consolidated financial statements, such as the determination of the consolidation scope;

(8) Other professional judgment relevant to accounting policies and accounting estimates, such as the identification of the depreciable life of fixed assets, and the selection of treatment to dispatched inventory.

14. In order to comply with the auditing standards and obtain audit evidence, CPAs need to exercise professional judgment in determining the nature, timing and scope of necessary audit procedures. Typical examples of professional judgment involving the audit process are as following (including but not limited to):

(1) Determining materiality, identifying and assessing risks of material misstatements;

(2) Determining the expected value when implementing substantive analytical procedures, and determining the amount of any difference of recorded amounts from the expected value;

(3) Evaluating the effectiveness of internal controls;

(4) Evaluating misstatements identified during the audit;

(5) Evaluating the entity's ability to continue as a going concern;

(6) Evaluating whether sufficient, appropriate audit evidence has been obtained and whether more efforts should be made to achieve the goals prescribed in the auditing standards and the overall objective of the CPA;

(7) Reaching a conclusion based on the evidence obtained and selecting appropriate type of the audit opinion;

(8) Determining whether and to what extent the work of internal auditors or experts shall be

used.

15. The CICPA Code of Ethics requires CPAs to comply with fundamental principles of professional ethics and apply a conceptual framework to identify, evaluate and address threats to the fundamental principles. While applying the conceptual framework, CPAs need to exercise professional judgment to evaluate the degree of the risks and determine safeguards to be applied. In respect of a specific engagement, typical examples of professional judgment involving compliance with ethical requirements are as following (including but not limited to):

(1) Professional judgment related to networks or network firms, such as whether a larger structure constitutes a network;

(2) Professional judgment related to public interest entities, such as whether an entity belongs to a public interest entity;

(3) Professional judgment related to financial interests, such as whether a financial interest is direct or indirect, and the significance of threats created by financial interests;

(4) Professional judgment related to familiarity, such as the nature of the familiarity and the significance of threats on independence;

(5) Professional judgment related to non-assurance services, such as whether a specific non-assurance service involves assumption of management responsibilities, whether a non-assurance service will affect the independence of an assurance engagement.

IV How Does a CPA Make a Professional Judgment?

Basic Requirements for CPAs' Professional Judgment

16. CPAs' professional judgment shall be made within the framework of relevant laws, regulations and professional standards, and shall be based on specific facts and circumstances. Professional judgment should not be used as the reason for inappropriate decisions that are not supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Decision-making Process of a CPA's Professional Judgment

17. The decision-making process of a CPA's professional judgment can be usually divided into the following five steps:

(1) Identifying the issue and objective of the professional judgment;

(2) Collecting and evaluating relevant information;

(3) Identifying possible solutions;

(4) Evaluating possible solutions; and

(5) Drawing a professional judgment conclusion and making written documentations.

18. Identifying the issue and objective is the starting point of professional judgment. When it comes to making a professional judgment, a CPA first needs to identify what to judge and what objective to achieve. An issue requiring professional judgment can be a CPA's audit event or conduct, or a different financial statement item or assertion. Identifying the issue and objective is crucial as it constitutes the basis of the entire professional judgment. Sometimes the issue or objective may not be obvious, so this is not always a simple task, and a CPA's capability in this area depends largely on his/her individual characteristics, especially the experience and professional skills. An inexperienced CPA may not be able to find a key issue accurately.

19. Collecting and evaluating relevant information is the basis of professional judgment. At the previous stage, the CPA may have collected some of the information. In general, information needed to be collected at least includes facts and circumstances of the entity and its industry. For example, the CPA needs to understand the factors that may affect objectivity and independence, identify the users of financial statements and other stakeholders, and take into account the applicability of relevant standards in the past similar circumstances or to another entity. In collecting and evaluating relevant information, communications with the entity will help CPAs identify key issues and possible biases.

20. In respect of a specific issue involving professional judgment, there could be more than one possible solution. In order to make a decision, a CPA needs to identify all possible solutions so that each can be evaluated to identify its strong points and weaknesses.

21. In evaluating possible solutions, the main task is to compare the target to be judged with the identified standards in order to determine the level of compliance. In addition, the CPAs shall consider the feasibility of the solutions.

22. On the basis of the evaluation of various possible solutions, a CPA needs to deliver a positive, negative or selective judgment. For instance, in terms of compliance, the CPA needs to decide whether it is compliant or non-compliant; for the audit opinion, the CPA needs to express an unqualified opinion, qualified opinion, adverse opinion or disclaimer of opinion.

23. CPAs need to exercise professional judgment in the whole audit process, and make appropriate documentation to the professional judgment exercised. The audit documentation prepared by a CPA shall be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant professional judgment made in reaching conclusions on significant matters. When recording professional judgment, the CPA needs to comply with relevant provisions of

² Please see item (c), Article 10 of China Standards on Auditing 1131- Audit Documentation, and paragraphs 8-11

24. The above decision-making process is not strictly sequential, and sometimes a CPA may need to return to previous steps. For example, in identifying or evaluating possible solutions, the CPA may find relevant information collected is inadequate and has to go back to collect and evaluate relevant information.

25. In some cases, a CPA may simplify some of the steps based on facts and circumstances. For example, if the internal technical manual of a firm has set clear guidelines on a professional judgment issue, and these guidelines provide a reasonable solution for the issue, the CPA may not need to identify and evaluate more possible solutions. For another example, in the circumstance of exercising a re-judgment on certain accounting matters, a CPA usually only needs to determine whether the solutions selected by the preparer meet the requirements of the financial reporting framework, instead of identifying all possible solutions and evaluating them.

26. The decision-making process of professional judgment is applicable to any event or conduct involving professional judgment. To demonstrate the decision-making process of CPA's professional judgment, we use the determination of materiality at the financial statement level as an example:

(1) Identifying the issue and objective of the professional judgment. Determining materiality at the financial statement level is a routine procedure in the development of the overall audit strategy, where a CPA usually needs to select a benchmark first, which will then be multiplied by a certain percentage to produce the materiality. Therefore, the key issue in professional judgment is to choose an appropriate benchmark and percentage, while the objective of professional judgment is to determine the materiality in the financial statement level.

(2) Collecting and evaluating relevant information. When choosing an appropriate benchmark and percentage, a CPA needs to consider the issue from the perspective of users of the financial statements, and may need to collect and evaluate the following information:

- i. The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- ii. Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets);
- iii. The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- iv. The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

v. The relative volatility of the benchmark.

(3) Identifying possible solutions. Any benchmark or percentage can be appropriate given that it meets the specific circumstances and falls in an acceptable range for the majority of people. For example, a CPA may select a certain percentage of the profit before tax from continuing operations, total assets or revenue as the materiality of the financial statement level. If one of the options is 5% of the profit before tax from continuing operations, the pros maybe that the entity is a listed company that is profit-oriented and 5% is within the acceptable range for most stakeholders, while the cons may be that the entity is at the breakeven point or a low-profit status.

(4) Evaluating possible solutions. At this step, a CPA needs to compare possible solutions identified in the previous step and consider their advantages and disadvantages to evaluate each solution. During this process, the CPA may need to consider relevant information collected and seek consultation where necessary.

(5) Drawing a professional judgment conclusion and making written documentations. After evaluating each possible solution, the CPA comes to a conclusion and selects one solution, and communicates with other members of the audit team to reach an in-house consensus. Finally, the CPA shall make a written documentation of the professional judgment.

V Quality of CPA's Professional Judgment

Standards for Measurement of Professional Judgment Quality

27. Standards for the measurement of professional judgment quality generally include the following:

(1) Accuracy and consensus;

(2) Consistency and stability; and

(3) Defensibility and written records.

28. Accuracy refers to the compliance of a professional judgment conclusion with specific standards or facts. Consensus refers to the extent of mutual agreement on the same professional judgment issue between different professional judgment makers. In many cases, specific standards or facts used to measure the quality of judgment do not exist. In such cases, the quality of professional judgment is measured by consensus. It should be noted that the internal audit manual of a firm generally represents a consistent in-house opinion on a specific professional judgment issue, and the mainstream opinion of the profession on a particular issue generally reflects the opinion of the majority of the profession. Different CPAs or firms may reach a high degree of consensus on the same professional judgment issue, but there may also be disparities

or even divergences. When disparities or divergences occur, the quality of professional judgment shall be measured in conjunction with other factors, such as whether the judgment is the profession's mainstream opinion or whether the CPA has sufficient experience and professional authority in that field.

29. Consistency is used to measure the relationship between judgments made by the same CPA

differentiate, is in relation with a CPA's professional competence. In general, knowledge and experience come from the education, training and practice of a CPA, which means a CPA with more knowledge and experience usually performs better in professional judgment than a CPA with relatively poor knowledge and experience. However, even with a certain amount of knowledge and experience, a CPA lacking of necessary professional skills will find it difficult to guarantee his own professional judgment quality where some professional knowledge and skills (such as the fair value of financial instruments) are required for professional judgment. Professional skill is a comprehensive concept, whose decisive factors include a CPA's mastery of relevant expertise and ability to solve practical problems, such as data analysis, logical reasoning and communication skills. These capabilities are largely cultivated through the problem-solving process.

33. Possessing good professional skills means a CPA can:

- (1) Use past experience to make decisions more or less automatically, quickly, clearly and emphatically;
- (2) Have a strong belief in the ability to make good decisions, and is calm and self-assured while making decisions;
- (3) Be able to make decisions under pressure and continues to be an effective problem solver, even as conditions progressively worsen because of high levels of pressure;
- (4) Can convince others of his or her specialized knowledge and can effectively communicate the ability to make decisions to others;
- (5) Can find novel or unique solutions to difficult problems;
- (6) Be capable of generating new approaches to established problems as necessary;
- (7) Exhibits a high degree of inquisitiveness in problem-solving situations.

34. A CPA can obtain necessary knowledge and experience through training and learning. However, obtaining the knowledge and experience alone cannot ensure the CPA of eligible professional skills. An experienced CPA also needs to pay attention to the flexible use of his established knowledge and experience to solve specific problems. A CPA is supposed to obtain relevant professional skills through studies of actual cases.

35. Independence, objectivity and impartiality are related to a CPA's professional ethics. In making professional judgment, a CPA shall maintain independence, avoid being impacted by others or self-interests, and shall evaluate and decide on the issues through objective observation and thinking and fair judgment, rather than deliberately distort the facts or hurt the objectiveness in addressing a problem due to stereotypes, prejudices or personal preferences.

36. A CPA has a responsibility to keep independent, objective and impartial in exercising high-quality professional judgment. Therefore, all firms need to develop necessary policies and procedures to ensure independence, objectiveness and impartiality. These policies and procedures constitute an integral part of the internal quality control system of a firm.

37. Professional skepticism is relevant to a CPA's thinking patterns. A CPA shall take an attitude that includes a question in mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. Professional skepticism is inherent in the CPA's professional judgment. When performing an audit or obtaining audit evidence, a CPA shall not take the statement or evidence provided by the entity as credible without a good reason.

38. Appropriateness is key to professional skepticism. A CPA shall maintain the appropriate level of professional skepticism, neither too little nor too much. Generally, a CPA shall appropriately strengthen professional skepticism in circumstances where:

- (1) Evidence obtained contradicts with each other;
- (2) Information that raises doubts over documentation as evidence and over reliability of replies to enquiry; or
- (3) There are indications that fraud may exist.

39. A CPA shall recognize the limitations of an individual. If a CPA does not acquire relevant knowledge, then he/she needs to consider consulting with others. Through consultation, the CPA can overcome the lack of knowledge or skills, and improve the capability of completing a specific task with the aid of others. In some cases, even when a CPA possesses relevant knowledge and capability, he/she can still seek advice from others on significant judgment issues. Such advice can help the CPA take advantage of the expertise and experience of others to avoid misunderstanding of the issue, and propose more solutions to choose from.

40. Group decision is often helpful in improving the quality of professional judgment. Group decision usually refers to discussions on professional judgment with other relevant personnel (possibly experienced CPAs or other experts in a certain field), and also involves studies of literature and other information to produce collective conclusions. Group decision often involves a group of people, so more options can be concluded and different views need to be considered when reaching a consensus. Therefore, a group decision judgment is often considered to be more defensible, and its quality is often higher than that of an individual judgment.

VI Recommendations Related to Improving the Quality of CPA's Professional Judgment

Recommendations for Accounting Firms

41. The quality of a CPA's professional judgment is closely related to the engagement quality and operational risks of a firm. A firm establishing and maintaining its quality control system in compliance with

can help its CPAs ensure and improve professional judgment quality.

42. The following measures may help improve the quality of a firm's professional judgment:

(1) Establishing a sound organizational structure, increasing the firm's publicizing and implementing efforts in its corporate culture and risk awareness, and improving the overall professional competence and risk awareness of CPAs;

(2) Establishing and enhancing a sound training system, improving the professional quality of CPAs, and taking professional judgment as a key training item to improve the CPAs' awareness and capability of professional judgment;

(3) Establishing and updating the knowledge database and case study database in a timely manner, filling them with expert and past professional judgment to enrich the knowledge and experience of CPAs;

(4) Creating a good organizational culture that encourages discussion among engagement team members to fully take advantage of group decisions;

(5) Establishing and improving a well-established mechanism for consultation, reasonably ensuring that a CPA can seek advice on difficult professional judgment issues or disputed issues;

(6) Developing relevant policies and procedures for handling and resolving different opinions that may arise among CPAs;

(7) Developing relevant policies and procedures to conduct quality control review on particular engagements to objectively assess the material judgment made by the engagement team and conclusions reached during preparing engagement reports;

(8) Personnel with more experience review work together with personnel with less experience;

(9) Developing and improving policies and procedures on independence to ensure independence, objectivity and impartiality of CPAs in practice;

Recommendations for CPAs

43. Risks arising from professional judgment usually results from time pressure, lack of knowledge and experience and the limited information obtained. As a result, a CPA cannot guarantee perfect professional judgment, as biases may occur to judgment and quality of professional judgment may be affected. A CPA usually needs to apply safeguards to reduce the

possibility of bias.

44. The following measures may help improve the quality of an individual CPA's professional judgment:

(1) Actively participating in relevant training, including training related to professional judgment, enhancing professional judgment awareness, confidence and capability;

(2) Participating in or observing the work performed by a CPA of higher level of professional judgment in the same audit team, or reading their documentations to understand their professional judgment process and techniques;

(3) Consulting with more experienced CPAs on difficult professional judgment issues and taking advantage of group decision when necessary;

(4) Collecting and evaluating relevant information more sufficiently before making professional judgment;

(5) Making professional judgment within the framework of relevant laws, regulations and professional standards, and on basis of facts and circumstances;

(6) Perform due procedures before exercising a professional judgment, and evaluating and questioning professional judgment by preparers of financial statements;

(7) Strictly complying with ethical requirements and maintaining independent, objective and impartial;

(8) Maintaining appropriate professional skepticism, stay alert against conditions that may arise doubts and critically assessing relevant evidence; and

(9) Recording significant matters arising during the engagement, the conclusions reached thereon, and significant professional judgment made in reaching those conclusions, including evaluation and questioning of the professional judgment made by preparers of financial statements.

Recommendations for Regulators

45. When implementing regulations, regulators may have to re-judge the professional judgment made by preparers of financial statements or by CPAs to assess whether such professional judgment is appropriate. The following recommendations may help regulators to make a judgment:

(1) Evaluating a professional judgment based on the information available at the time point where it is made rather than on the information available upon the implementation of regulation;

(2) Fully understanding the relationship between professional standards and professional judgment, especially the extent to which professional judgment is permitted in principle-based professional standards, and respecting professional judgment made by preparers of financial statements and CPAs;

(3) Evaluating whether related professional judgment has been adequately disclosed in the financial statements or other documents in accordance with relevant laws, regulations or professional standards; and

(4) Assessing whether relevant professional judgment has been properly recorded in accordance with relevant requirements.

Recommendations for Standard Setters

46. As previously described, professional standards and professional judgment is closely related to each other. Therefore, the role of a standard setter is also critical for professional judgment. The following recommendations may help standard setters appropriately exercise their duties:

(1) Developing principle-based professional standards, providing preparers of financial statements and CPAs with adequate space for professional judgment, and including the requirements for professional judgment into professional standards;

(2) Principle-based professional standards shall have a clear hierarchical structure, including all-inclusive concepts, principles reflecting these concepts and guidance making the standards practical;

(3) Endowing the guidance of professional standards with flexibility, focusing on important issues and leaving the details to preparers of financial statements and CPAs for judgment;

(4) Developing a guidance on professional judgment, instructing preparers of financial statements and CPAs to exercise professional judgment and improving their ability in this regard; and

(5) Instructing compliers of financial statements and CPAs to record important issues or conducts of professional judgment and disclose if necessary.

(CICPA organized translation of the Guidance into English. The Chinese text is the official version and this English text is for reference only.)