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Exercising Professional Judgment: A Case Study of EON Berhad Malaysia

Vicky Vendy[a]

[a] Faculty of Economy and Business, Universitas Pembangunan Nasional "Veteran" Jawa Timur, Indonesia.

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The objective of the interview is to understand how a preparer exercises his/her professional judgment on accounting treatment and describe the challenges faced by the preparer in exercising professional judgment. The data analyzed for the study were collected in a semi-structured interview with the Head of financial services and treasury at Edaran Otomobil Nasional (EON) Berhad Malaysia.
This study found that professional judgments are exercised in many things. Such as estimate of utility bills and rental payments, impairment of investment in a subsidiary, impairment of fixed assets, impairment of goodwill, asset revaluation, retirement benefits fund, contingent liability, and so on. In case of the absence of relevant accounting guidance, the preparer will have to look at the international accounting standard or seek advice from experts. Considering the implementation of the standards, the preparer also needs to look at the practicality of it.

* **Corresponding author**
E-mail address: vicky.vendy.ak@upnjatim.ac.id

INTRODUCTION

Professional judgment is defined as the use of knowledge and experience accumulated through appropriate accounting or auditing training to make decisions based on ethical standards in specific situations, such as an audit mission and/or the accounting of economic transactions while adhering to accounting principles (Ivan, 2016).

Professional judgment could be defined as an established opinion offered by a professional accountant in the face of uncertainty during the qualification, cost measurement, classification, and evaluation of economic events and transactions for accounting reporting based on readily available and impartial information (Kulikova et al., 2014).

According to PwC (2017), when utilizing accounting rules, several factors have enhanced the necessity for professional judgment. For instance, the accounting literature does not particularly cover the accounting for new financial products and certain transactions in the rapidly changing market. In addition, the adoption of new standards may not always be straightforward because they usually lay a greater focus on principles than on regulations. Finally, new standards rely more on estimations that can be arbitrary, such as fair value.

Principles-based standards offer a framework for accurately representing the economic substance of transactions, particularly in an evolving and complex environment, but such a strategy necessitates the exercise of competent judgment by auditors, preparers, and regulators. (ICAS, 2012). Guidance has always been appreciated when it comes to using professional judgment within the framework of the IFRS, which are principles-based accounting rules. This is a result of the complexity and variety of some situations, which could lead to challenges when selecting the proper accounting policies and methods (depreciation, inventory valuation, the recognition of revenues and expenses from a construction contract, accounting for lease contracts by the proper determination of the type of lease), and, respectively, the need to verify if the criteria set by the principles-based accounting standards are met. The freedom of choice and disclosure could lead to issues with the reliability of the accounting information. The ability to choose accounting techniques in accordance with the provisions of the standards is intended to produce a true and fair view of the company's financial performance and position (Ivan, 2016).

Company managers aim to adhere to all accounting principles as outlined in the accounting standards and provide the financial statements with a positive portrayal of the business's economic reality (Belkaoui, 2004). The involvement of people with sufficient expertise and experience in the process is a crucial component of this purpose since they are able to use the pertinent skills and knowledge to find all feasible possibilities (Ivan, 2016).

Professional judgment is therefore a topic that is getting more attention in accounting and auditing. As fair value measurement progressively dominates, accounting norms grow softer. Therefore, a preparer's ability to use sound professional judgment is becoming increasingly crucial. Professionals will need to consistently use more and better professional judgment. Several pre-conditions like technical knowledge and a critical mindset are required in making a reasoned judgment. Areas that required judgment include impairment of assets, revenue recognition, fair value measurement, contingencies, subsequent events, and others.

Some selected prior studies in professional judgment analyzed the judgment conducted by auditors (Gao & Zhang, 2015; Khoshtinat & Bostanian, 2007; Puthukulam et al., 2021; Shvyreva & Kruglyak, 2016; Şişmanoğlu et al., 2018; Song & Song, 2018), managers (Fuenzalida et al., 2021), and even mountain leaders (Collins et al., 2018). Only Long and Basoglu (2016) used accountants as the research subject. This study aims to investigate the role of accountants as the preparers of financial statements when exercising their professional judgment.

Research Questions and Research Objectives

The objective of the interview is to understand how a preparer exercises his/her professional judgment on accounting treatment and describe the challenges faced by the preparer in exercising professional judgment. Research questions used in the process of the interview consist of three parts. Those are related to knowledge gathering & analysis, evaluation of information, and the process of making a judgment. The questions are;

1. How does the preparer gather relevant information or knowledge with regard to accounting treatment? How is accounting guidance (standards) being used in making a judgment? In the absence of relevant accounting guidance, what would the preparer do?
2. How would the preparer consider the impact of an accounting treatment on the expected cash flows or the entity's cash position? How would the preparer consider the expected uncertainties and possible outcomes of an accounting treatment? Or the effect of the transaction on the entity's assets, liabilities, and operational capabilities (financial consequences or legal form)? How do acceptable industry practices and precedents or similar transactions influence the preparer's judgment?
3. What are examples of using professional judgment in preparing a financial report? How long do the judgment processes take place? Would the judgment process be done on an individual or group basis? How do you assess the possibility of bias in judgment? (i.e., self-interest or conflict of interest in ensuring the objectivity of the judgment). Would you seek advice from your auditors/audit committee or any board member? Would you consult and obtain advice from any experts? What factors would influence your judgment process most? Describe challenges that you faced in the judgment process.

This paper will consist of several parts. This part will continue giving a brief explanation of the framework of decision making in professional judgment and depict several prior works of literature that have studied the judgment of accounting professionals. Part two is related to the research method utilized in the paper. Part three contains the findings and discussion from the interview. Part four concludes the whole paper. And lastly, the research limitation will be presented.

LITERATURE REVIEW

The Institute of Chartered Accountants of Scotland (2012) have issued a professional judgment framework to guide accounting professionals, especially preparer to make a good professional judgment. The framework consists of four principles. First, a professional accounting judgment can only be made once all relevant information has been collected and analyzed. Second, a professional accounting judgment can only be made in the context of the applicable accounting framework, accounting standards, and other literature where relevant. Third, a professional accounting judgment can only be made after undertaking the appropriate due process. Lastly, a professional accounting judgment must be suitably documented.

Institute of Chartered Accountants of Scotland (ICAS) prepared the framework to help determine the proper accounting treatment for a particular transaction or group of transactions when there is no specific standard covering the transaction, when there is a standard but no detailed guidance on how to deal with its practical application, when there are accounting principles in a standard but no guidance on how to deal with a particular principle in a standard, or when there are accounting principles in a standard but no guidance on how to deal with them specifically (ICAS, 2012).

PricewaterhouseCoopers (2017) also issued a decision-making framework to apply judgment in the financial reporting process. The framework is just one approach that may help to make and support complex decisions. First, the preparer must be aware of the transaction's economics and the item's measurement. It is essential to developing an understanding of the facts to decide how to account for a complex transaction or measure an asset or obligation. Questions to be addressed while comprehending a transaction include why the business made the decision, what it gave up, what it will receive in return, and what might happen in various contingency scenarios. Understanding the rights and duties of the business, as well as what was given or received, is crucial when determining how to measure an item, whether it appears on the statement of financial position or the income statement.

Second, the preparer needs to be familiar with the literature. Sometimes there might not be any instruction at all, or there might be contradicting guidance. The conceptual framework, previous precedent, and advice for similar transactions may all need to be taken into account in such circumstances. The preparer must take the time to comprehend the pertinent accounting as well as the main decision-making processes.

Third, Form a conclusion. The proper accounting approach must be decided once the preparer is aware of the principles and regulations.

Before coming to an accounting decision, a few things should be taken into account. When there are multiple viable options, it is important to carefully analyze whether one of them would be preferable given that it would more accurately reflect the company's financial position. The preparer must also think about whether any further disclosures would be required. Next, documentation. Strong documentation could show that the conclusion adheres to the goals of the literature and that the right methods were taken to arrive at a result.

In order to document the decision-making process and provide evidence for the conclusions reached, the preparers should make sure that the necessary papers and other documents are created, saved, and maintained. These are frequently the documents that have been submitted to the audit committee or board (ICAS, 2012).

A thorough record of the techniques followed is necessary when professional judgment is questioned so that it can be demonstrated how the facts, circumstances, and available options were analyzed and used to support judgments. Therefore, it is much simpler to back up and defend the judgments when the professional judgment process is properly implemented and documented. The level of documentation required increases with the complexity of a given situation (Ivan, 2016). It goes without saying that decisions or conclusions that are not backed up by facts, proof, or other papers do not come from a trustworthy source. Professional judgments that are well-founded and well-documented are always upheld during internal practice reviews and defended during external inspections or other circumstances (Ivan, 2016).

Lastly, the preparer must consider disclosure. The disclosure provides users with the context to understand the relevant transactions and the basis for accounting conclusions. While good disclosure is always important, it may be especially significant when there is increased reliance on judgment, as it provides the users with the ability to understand the effect of an underlying transaction on the financial statements (PwC, 2017).

The use of options related to accounting policies and the freedom of choice when it comes to concepts are both related to the application of professional judgment. The principle supports the use of professional judgment, but the rule places restrictions on it. An important competency for preparers is professional judgment, particularly in a principles-based accounting environment. Making a decision, though, can be challenging, and there is not always a single right one (Ivan, 2016).

It is believed that IFRS calls for a significant amount of professional judgment. In fact, the IASB has emphasized the value of professional judgment in IFRS in its framework by using the phrase "substance over form." Following the principle that focus should be given to the substance of commercial transactions rather than their legal form, the substance-over-form approach calls for accountants to use their professional judgment. Standards that demand fair values for measurement and recognition further demonstrate the value of professional judgment. Since the accounting information that results from using the fair value approach is frequently reliant on judgmental estimations of fictitious prices and markets, using it entails making considerable judgments (Heidhues & Patel, 2011).

Ivan (2016) explained how professional judgment could be applied. For instance, while establishing the depreciation method and the useful life of long-term assets, professional judgment is advised to be used. Additionally, in the accounting treatment of building contracts, judgment is also used. The pertinent topic is whether results should be reported at the conclusion of the contract or at various points throughout the construction process. One of the two options has been used to formulate the solution: applying the matching principle or the prudence/conservatism principle (which states that the expected profit can be measured once the contract is concluded). By recognizing revenues and costs in proportion to the completion stage of contract activity, the percentage of completion method of accounting is used in conjunction with professional judgment to determine and account for the outcome of a construction contract, which should be reliably estimated.

Another instance of using professional judgment is lease accounting (applicable standard IAS 17 Leases), which raises moral dilemmas regarding the use of financial reporting alternatives. A lease must be categorized into either an operational lease or a finance lease in order to receive the proper accounting treatment. In the case of a finance lease, even though lessee is not the owner, the lessee controls the asset and is required to disclose it in the company's financial statements because lessee receives the majority of the economic advantages and bears the majority of the risks. However, in operating lease, payments made by the lessee are shown as a reduction in profits (expense) for each period.

Indicators used in financial analysis are impacted when a finance lease is incorrectly classified as an operational lease, understating the lessee's assets and liabilities. Additionally, misleading presentation of operating and financial expenses will occur. A similar incorrect classification has a less impact on the lessor's financial statements than it does on the lessee's (the structure of assets, operating result, and financial result).

However, Heidhues and Patel (2011) in their study of professional judgment using the German context. In Germany, historical cost accounting is heavily emphasized, which has an impact on and limits the use of professional judgment in some situations. One set of accounts is frequently provided for accounting and taxes purposes in single-entity financial statements, for instance, due to cost considerations. The German tax law restricts the use of professional judgment in these circumstances by mandating precise accounting methods, as is shown from the inclusion of depreciation tables.

METHOD

The data analyzed for the study were collected in a semi-structured interview with the Head of financial services and treasury, which has 12 years of work experience in the current position at Edaran Otomobil Nasional (EON) Berhad. EON Berhad is one of Malaysia's largest conglomerates which was established in 1984 to distribute Proton cars, Malaysia's first national car. The main shareholders of the company are DRB-HICOM Group Khazanah Nasional Berhad.

The interview was conducted on 16th May 2019. The length of the interview was one hour. The interview was recorded and transcribed to avoid inaccuracies because of poor recall (Yin, 2003). The interviewee/informant got a semi-structured interview guide that included broad open-ended questions on knowledge gathering & analysis, evaluation of information, and process of making a judgment. The data was enhanced and evaluated by reading several related literature in the field of accounting professional judgment. Then, the transcribed interviews were analyzed, reduced, and summarized to identify the key points.

RESULT AND DISCUSSION

Knowledge Gathering & Analysis (RQ1)

The preparer said that knowledge related to accounting treatment is gathered from accounting standards. Because standard becomes guidance. Inside the standards, there will be a stipulation of revenue recognition, how to recognize the cost of sale, inventories, and so on.

In case of the absence of relevant accounting guidance, the preparer will have to look at the international accounting standard. For instance, bringing a new business that previously does not exist in Malaysia, in this case, if no accounting standard regulates it, the preparer should look at the international standard. Another way to solve the problem is, for other auditors from another country will have to come to help. For example, when the company wants to impose Goods and Services Tax (GST) in Malaysia. The company needs to change the accounting system to be GST-compliant, so most GST and IT specialists come from other countries that already have implemented GST systems. They assist the company when a company does not have knowledge of it.

Another example is the case of the informant’s friend that works for one company that has a film studio. Even Ernst & Young (EY) audit firm in Malaysia does not know how to audit. So, the company must call an EY auditor from overseas to come and assist in the audit because they do not know how the revenue is recognized, and how to recognize the cost of sale of a film studio. Due to the unavailability of the experts, they need to have assistance from outside.

Evaluation of Information (RQ2)

Considering the implementation of the standards, the preparer cannot follow blindly what the standards said. The preparer also needs to look at the practicality of it. For instance, in the automotive industry, there is a term called unrealized profit in inventory. In the case of EON, they have a subsidiary and they also have a joint venture company. So, the subsidiary is under EON, and the joint venture is also under EON. As an illustration, the joint venture company sells 10 million worth of inventory to the subsidiary. Then, after closing the account, that 10 million worth of stock is not sold yet by the subsidiary. So, they need to eliminate this unrealized profit in inventory.

Because this inventory will generate profit if it is sold. However, it is still not realized yet. It is still in the form of inventory. If the profit margin is 5 percent, then this margin must be eliminated at the group level.

Moreover, the auditor will argue that the company not only sells the vehicle but also sell spare parts. The auditor questions why the company also does not eliminate unrealized profit in inventory on spare parts. The standards explain that a company must eradicate unrealized profit. However, the preparer will argue that it is not practical. Different from the vehicle, spare parts are more difficult to monitor. Spare parts are taken up when a company wants to do service and then sometimes, they also sell it over the counter. Then the auditor will agree on that. So, that is one case where the company does not really follow standards one hundred percent. They also look at practicality.

Related to the question of how acceptable industry practices and precedents or similar transactions influence the preparer's judgment. The preparer said when they encounter that issue, they will always pose the issue to the company group and let the group decides for them. Since they have a few companies, they need to come to the same conclusion between group companies. They need to report the same thing and adopt the same accounting policy. Another way is by asking for help from EY as their auditor to provide them with a sample of the practice of other companies. They believe the auditor has a lot of experience in auditing numerous numbers of companies.

The process of Making a Judgment (RQ3)

In this section, the preparer explained a lot about the application of professional judgment. Professional judgment is needed in certain things like estimates, providing provisions, and accruals. For example, utility bills. The company already knows that utility bills roughly every month are about RM 5,000, although the company has not received utility bills and has not paid yet, the company still must accrue in their accounts. The company will debit expenses and credit accrual accounts. It is also one sort of estimate, even though really close to the actual. Another thing is the rental expense. Rental expense is accrued based on the agreement. Because rental payment is quite fixed, so every month company already knows how much they are going to pay. They will accrue the rental expense although the landlord has not given them the invoice.

The example relating to the provision is the diminution in the value of the investment. EON Berhad has investments in subsidiaries. They have six subsidiaries. For instance, one of the subsidiaries of the automotive company is making a loss, which is an indication of impairment in investment. For instance, the cost of investment in that company is RM 60 million, but after the subsidiary closes its book at year-end, its equity or net tangible assets (NTA) is RM 50 million. Then, the company will compare the cost of investment in the parent's book, which is RM 60 million, with the net tangible asset in the subsidiary which is only RM 50 million. There is a difference of 10 million. It is an indication of impairment. However, to impair the investment in a subsidiary, the company cannot use net tangible assets, they must use value in use by calculating discounted cash flow (DCF).

DCF for five years must be calculated. The calculation is based on the forecast and budget approved by the board of directors. The company will calculate free cash flow first and then multiplied by the discount factor. The free cash flow can be calculated by adding back depreciation and amortization of goodwill and then deducted by capital expenditures, taxes, and changes in working capital. After that, the company will decide on the discount factor. For instance, in the automotive industry, the discount factor is 12%. Under DCF calculation, the company also must put the terminal value. Terminal value is the value of the business if they terminate after 5 years. Then, the company will get value in use. They will compare the value in use against the cost of investment. Normally, the value in use will be slightly higher than net tangible assets. If the value in use is RM 52 million, compared with net tangible assets which are RM 50 million. Then the company can reduce the impairment. They will impair RM 8 million of investment in the subsidiary instead of RM 10 million. Normally, the auditor will not accept if the company uses NTA unless the calculated value in use is unreasonable. This is how the judgment in accounting provision works.

The company nowadays must show its assets and liabilities at fair value. However, the auditor will question the preparer regarding the basis used in the calculation. The auditor will ask about the company's business plan, the expected sales unit, and so on. For example, the company forecasts to sell 5000 units per year in five years. But, when the auditor sees the actual sales of the company in the past years were only 2500 units per year, then the auditor will ask the company to revise the projected cash flow. An example of another challenge from the auditor is, for example, the company plans to sell cars with brand A for 3000 units. But, when the auditor sees that the planned model of a car with brand A is quite obsolete in the next three years, then the auditor will question the preparer and ask to revise the plan or projected cash flow. This is how professional judgment comes in.

Professional judgment is also based on trends, not merely thinking without a basis. There must be a basis, such as the last three to five years' trend, either in terms of sales or expenses. They also must consider the future economic condition, also other things such as the GST impact on expenses, and so on.

Another application of professional judgment is also on the impairment of fixed assets. To impair fixed assets, the company needs to look at the indication of impairment. For example, loss-making business as asset liquidation or whether the company has the intention to relocate. For instance, in the company's business plan, they plan to relocate from one place to another. So that is an indication of impairment of the existing place. The company will need to put in impairment figures. They also need to calculate DCF as the basis of impairment figures.

The same case is for impairment of goodwill. Every year company will assess impairment in goodwill. For instance, the company has RM 2 million in goodwill. Then, the company needs to look at and compare with the net tangible assets of the subsidiary. If the subsidiary is continuously loss-making, there might be an impairment. The same method is also used. They must use discounted cash flow to calculate the value in use, and then compare it against the goodwill. Currently, every impairment needs to use the concept of DCF. Previously, the company use net tangible assets which is more on a historical basis. Because now the company is moving to fair value accounting, the net tangible assets concept is not used anymore.

In case of asset revaluation, they have an investment property. The company will engage a professional valuer to revalue its assets. It is a professional judgment but they obtain it from an external party. The professional valuer will give them the latest market value based on their analysis. They will assess the company's land and building. As the result, they will come out with a letter of valuation. Then, the preparer will question them regarding the basis they use. Normally when they revalue upwards, the preparer will not question them. But if they revalue downwards, the preparer will question them. Because the company mostly wants to avoid any impairment.

The same thing goes for retirement benefits funds. The company will ask outside professionals from any other professional bodies to revaluate the retirement benefit fund. The professional valuer has expertise in calculating retirement benefits funds based on aging, demographic, life expectancy, and so on. After that, they will give the report to the company. The company will use the figure and compare it against their book. If the figure in the report is higher, then the company will follow its figure. But if the figure is lower, then the preparer will also lower their retirement benefit value.

Another thing that also needs professional judgment is a contingent liability. It is based on the contract. By understanding the contract, the company can identify whether there is a contingent liability or not. However, in fact, the company never put contingent liability in its book. The company ever tried to record a contingent liability, but the auditor argued that it was liability, not contingent. The contract is between the company and the principal. However, the preparer feels reluctant to elaborate further about the contract. The preparer only said that there is a liability to the company that they will have to pay the principal in the future. It is some sort of penalty. From the auditor's viewpoint, that penalty cannot be categorized as contingent. Because the company must pay when the time comes. It is not like there is a probability, because contingency requires a high probability that it will happen. Because once the company put it as contingent, it will not appear in their account, but they just report it as disclosure. Then, the company must put it as a liability in its account.

The judgment process can take one week to proceed. For instance, the company needs to do a forecast for five years. To come out with the forecast, the company needs to go and discuss with the operation to ask for five-year projected data for sales units, advertising cost, manpower planning (whether they will recruit or fire employees), asset planning (whether to purchase or sell assets), expansion plan (whether to add another branch or not). After getting all those information, the preparer can build up an income statement, balance sheet, and cash flow. So, one week is quite enough to gather the information, sit around the table discussion and make everybody agree. After getting their agreement, the preparer can put in the figures and then come out with discounted cash flow and show it to the auditor.

Normally, in the company group, they will refer to the group if there is a problem that they cannot solve or if they do not have expertise. Just like the case of GST, they have GST Management Office that will brief them about GST. Even not only GST, but they will also update the accounting people when there is a new accounting guideline and new companies act. Whatever standard the management office will update it to them.

Relating to the possibility of bias in judgment. It means whether there is self-interest or conflict of interest or not. The preparer said that bias is minimized. Because they will be challenged by the auditor. For example, when the preparer calculates the DCF, sometimes the preparer tries to make the DCF calculation looks good to minimize the impairment. However, the auditor will always question all their basis. Even, if the auditor thinks the DCF calculation is reasonable, the auditor will calculate the DCF for the company. Then, they must discuss it again. If they agree, that will be okay. But if they do not agree, they must defend by providing all evidence that becomes the basis. The auditor will ask whether the basis has been approved by the board or not and so on. So, being biased is quite difficult, because the auditor will question them back.

In case of seeking advice on professional matters, the company always goes to professional people such as auditors, tax agents, professional valuers, and investment bankers. But for the board, the preparer only goes to see them just for seeking approval. The preparer will brief the board about the company's plan, then the board will question them back before giving agreement or disagreement.

All the basis and assumptions will influence the preparer's judgment. Just like the case of calculating DCF. The preparer will need to have a proper forecast of the business in the future. Many things will influence the forecast such as the economic factor, past trends, future business plans, and group strategic direction. For instance, the group says that in the next five years company wants to expand, have no new branches, cut manpower, and so on. Those things will be impacting the calculation of discounted cash flow.

Another thing is professional judgment in terms of the useful life of assets. For instance, previously company depreciates its renovation cost for five years. The company justifies this because after five years company always relocates to another place, so that is why the assumption of the useful life of renovation cost is only five years. But to another company, they might be depreciated for 10 years. Because they will only relocate after 10 years. So that is why they have a lower depreciation rate. That is how people use judgment. Normally depreciation is the easiest way to play around. Because the preparer can use reasonable and acceptable ways. Maybe, last year the company depreciates for three years. Then the depreciation is very huge and hit their bottom line. Then they change the depreciation rate in order to make the profit look better. However, the preparer has to give reasonable justification to the auditor. For example, previously company wanted to relocate every five years. But due to the current economic condition, they want to save costs and plan to relocate after 10 years. If the auditor accepts the justification, then the company can change its depreciation rate.

CONCLUSION

The preparer obtained knowledge of accounting treatment from accounting standards. In case of the absence of relevant accounting guidance, the preparer will have to look at the international accounting standard or seek advice from experts, such as auditors and other specialists. Considering the implementation of the standards, the preparer cannot follow blindly what the standards said. The preparer also needs to look at the practicality of it. When encountering an issue, the preparer will always pose the issue to the company group and let the group decides for the company. Since they have a few companies, they need to come to the same conclusion between group companies. They need to report the same thing and adopt the same accounting policy.

Professional judgments are exercised in many things. Such as estimate of utility bills and rental payments, impairment of investment in a subsidiary, impairment of fixed assets, impairment of goodwill, asset revaluation, retirement benefits fund, contingent liability, and so on.

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