

INTERNATIONAL STANDARD ON AUDITING 310

KNOWLEDGE OF THE BUSINESS

(This Standard is effective, but will be withdrawn when ISA 315 and 330 become effective) *

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International Standard on Auditing (ISA) 310, “Knowledge of the Business” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.

* ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and ISA 330, “The Auditor’s Procedures in Response to Assessed Risks” are effective for audits of financial statements for periods beginning on or after December 15, 2004.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on what is meant by a knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.
2. **In performing an audit of financial statements, the auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report.** For example, such knowledge is used by the auditor in assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.
3. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. The level of knowledge required by the auditor would, however, ordinarily be less than that possessed by management. A list of matters to consider in a specific engagement is set out in the Appendix to this ISA.

Obtaining the Knowledge

4. Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry and of the ownership, management and operations of the entity to be audited, and would consider whether a level of knowledge of the business adequate to perform the audit can be obtained.
5. Following acceptance of the engagement, further and more detailed information would be obtained. To the extent practicable, the auditor would obtain the required knowledge at the start of the engagement. As the audit progresses, that information would be assessed and updated and more information would be obtained.
6. Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information and relating the resulting knowledge to audit evidence and information at all stages of the audit. For example, although information is gathered at the planning stage, it is ordinarily refined and added to in later stages of the audit as the auditor and assistants learn more about the business.
7. For continuing engagements, the auditor would update and reevaluate information gathered previously, including information in the prior year's working papers. The auditor would also perform procedures designed to identify significant changes that have taken place since the last audit.

8. The auditor can obtain a knowledge of the industry and the entity from a number of sources. For example:
- Previous experience with the entity and its industry.
 - Discussion with people with the entity (for example, directors and senior operating personnel).
 - Discussion with internal audit personnel and review of internal audit reports.
 - Discussion with other auditors and with legal and other advisors who have provided services to the entity or within the industry.
 - Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers, suppliers, competitors).
 - Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers, financial newspapers).
 - Legislation and regulations that significantly affect the entity.
 - Visits to the entity's premises and plant facilities.
 - Documents produced by the entity (for example, minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior years' annual and financial reports, budgets, internal management reports, interim financial reports, management policy manual, manuals of accounting and internal control systems, chart of accounts, job descriptions, marketing and sales plans).

Using the Knowledge

9. A knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:
- Assessing risks and identifying problems;
 - Planning and performing the audit effectively and efficiently;
 - Evaluating audit evidence; and
 - Providing better service to the client.
10. The auditor makes judgments about many matters throughout the course of the audit where knowledge of the business is important. For example:
- Assessing inherent risk and control risk.
 - Considering business risks and management's response thereto.

- Developing the overall audit plan and the audit program.
- Determining a materiality level and assessing whether the materiality level chosen remains appropriate.
- Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.
- Evaluating accounting estimates and management representations.
- Identifying areas where special audit consideration and skills may be necessary.
- Identifying related parties and related party transactions.
- Recognizing conflicting information (for example, contradictory representations).
- Recognizing unusual circumstances (for example, fraud and noncompliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results).
- Making informed inquiries and assessing the reasonableness of answers.
- Considering the appropriateness of accounting policies and financial statement disclosures.

11. **The auditor should ensure that assistants assigned to an audit engagement obtain sufficient knowledge of the business to enable them to carry out the audit work delegated to them.** The auditor would also ensure they understand the need to be alert for additional information and the need to share that information with the auditor and other assistants.
12. **To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.**

Appendix**Knowledge of the Business—Matters to Consider**

This list covers a broad range of matters applicable to many engagements; however, not all matters will be relevant to every engagement and the listing is not necessarily complete.

A. General Economic Factors

- General level of economic activity (for example, recession, growth)
- Interest rates and availability of financing
- Inflation, currency revaluation
- Government policies
 - Monetary
 - Fiscal
 - Taxation—corporate and other
 - Financial incentives (for example, government aid programs)
 - Tariffs, trade restrictions
- Foreign currency rates and controls

B. The Industry—Important Conditions Affecting the Client's Business

- The market and competition
- Cyclical or seasonal activity
- Changes in product technology
- Business risk (for example, high technology, high fashion, ease of entry for competition)
- Declining or expanding operations
- Adverse conditions (for example, declining demand, excess capacity, serious price competition)
- Key ratios and operating statistics
- Specific accounting practices and problems
- Environmental requirements and problems
- Regulatory framework

- Energy supply and cost
 - Specific or unique practices (for example, relating to labor contracts, financing methods, accounting methods)
- C. *The Entity*
1. Management and ownership—important characteristics
 - Corporate structure—private, public, government (including any recent or planned changes)
 - Beneficial owners and related parties (local, foreign, business reputation and experience)
 - Capital structure (including any recent or planned changes)
 - Organizational structure
 - Management objectives, philosophy, strategic plans
 - Acquisitions, mergers or disposals of business activities (planned or recently executed)
 - Sources and methods of financing (current, historical)
 - Board of directors
 - Composition
 - Business reputation and experience of individuals
 - Independence from and control over operating management
 - Frequency of meetings
 - Existence of audit committee and scope of its activities
 - Existence of policy on corporate conduct
 - Changes in professional advisors (for example, lawyers)
 - Operating Management
 - Experience and reputation
 - Turnover
 - Key financial personnel and their status in the organization
 - Staffing of accounting department
 - Incentive or bonus plans as part of remuneration (for example, based on profit)
 - Use of forecasts and budgets

- Pressures on management (for example, overextended, dominance by one individual, support for share price, unreasonable deadlines for announcing results)
 - Management information systems
 - Internal audit function (existence, quality)
 - Attitude to internal control environment
2. The entity’s business—products, markets, suppliers, expenses, operations
- Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export)
 - Location of production facilities, warehouses, offices
 - Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)
 - Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes)
 - Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as “just-in-time”)
 - Inventories (for example, locations, quantities)
 - Franchises, licenses, patents
 - Important expense categories
 - Research and development
 - Foreign currency assets, liabilities and transactions—by currency, hedging
 - Legislation and regulation that significantly affect the entity
 - Information systems—current, plans to change
 - Debt structure, including covenants and restrictions
3. Financial performance—factors concerning the entity’s financial condition and profitability
- Key ratios and operating statistics
 - Trends
4. Reporting environment—external influences which affect management in the preparation of the financial statements

5. Legislation
 - Regulatory environment and requirements
 - Taxation
 - Measurement and disclosure issues peculiar to the business
 - Audit reporting requirements
 - Users of the financial statements