STATEMENT OF AUDITING STANDARDS
210
KNOWLEDGE OF THE BUSINESS

(Issued January 1997; revised January 2004)

Contents *Paragraphs*

This SAS remains in effect for audits of financial statements for periods beginning before 15 December 2004. For audits of financial statements for periods beginning on or after 15 December 2004, the new SAS 315 and SAS 330 are applicable. Early application of the provisions of SAS 315 and SAS 330 is permissible.

STATEMENT OF AUDITING STANDARDS 210 KNOWLEDGE OF THE BUSINESS

Statements of Auditing Standards (SASs) are to be read in the light of SAS 010 "The scope and authority of auditing pronouncements". In particular, they contain basic principles and essential procedures, (auditing standards), indicated by paragraphs in ***bold italic type****, with which auditors are required to comply in the conduct of any audit including those of companies applying section 141D of the Companies Ordinance. SASs also include explanatory and other material which is designed to assist auditors in interpreting and applying auditing standards.*

Introduction

1. The purpose of this Statement of Auditing Standards (SAS) is to establish standards and provide guidance on what is meant by a knowledge of the business, why it is important to auditors, including members of the audit team working on an engagement, why it is relevant to all phases of an audit and how auditors obtain and use that knowledge.

2. In performing an audit of financial statements, auditors should have or obtain a knowledge of the business sufficient to enable them to identify and understand the events, transactions and practices that, in the auditors' judgement, may have a significant effect on the financial statements or on the audit or the auditors' report. (SAS 210.1)

3. Knowledge of the business is used by auditors in, for example, assessing inherent and control risks and in determining the nature, timing and extent of audit procedures.

4. The auditors' level of knowledge for an engagement normally includes 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 auditors is, however, ordinarily less than that possessed by management. An illustrative list of matters to consider in a specific engagement is set out in the Appendix.

Obtaining the knowledge

5. Prior to accepting an engagement, auditors would obtain a preliminary knowledge of the industry and of the ownership, directors, management and operations of the entity to be audited, sufficient to enable them to assess their ability to undertake the audit.

6. Following acceptance of the engagement, auditors obtain further and more detailed information. To the extent practicable, auditors obtain the required knowledge at the start of the engagement to enable them to plan the audit and develop an effective audit approach. As the audit progresses, that information is assessed and updated and more information obtained.

7. 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 later in the audit as the auditors learn more about the business.

8. For continuing engagements, auditors update and re-evaluate information gathered previously, including information from the previous year's working papers. Auditors also perform procedures designed to identify significant changes that have taken place since the last audit.

9. Auditors can obtain a knowledge of the industry and the entity from a number of sources, examples of which are set out below.

a. Previous experience with the entity and its industry.

b. Discussions with directors and management of the entity.

c. Discussions with internal audit personnel and review of internal audit reports.

d. Discussions with other auditors and with legal and other advisors who have provided services to the entity or within the industry.

e. Discussion with knowledgeable people outside the entity (for example, industry economists, industry regulators, customers, suppliers, competitors).

f. Publications related to the industry (for example, government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers, financial newspapers).

g. Legislation and regulations that significantly affect the entity.

h. Visits to the entity's premises and plant facilities.

i. 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

10. A knowledge of the business is a frame of reference within which auditors exercise professional judgement. Understanding the business and using this information appropriately assists the auditors in:

    a. assessing risks and identifying problems;

    b. planning and performing the audit effectively and efficiently;

    c. evaluating audit evidence; and

    d. providing better service to the client.

11. Auditors make judgements about many matters throughout the course of the audit where knowledge of the business is important, examples of which are set out below.

    a. Assessing inherent risk and control risk.

    b. Considering business risks and management's response thereto.

    c. Developing the overall audit plan and the audit programme.

    d. Determining a materiality level and assessing whether the materiality level chosen remains appropriate.

    e. Assessing audit evidence to establish its appropriateness and the validity of the related financial statement assertions.

    f. Evaluating accounting estimates and management representations.

    g. Identifying areas where special audit consideration and skills may be necessary.

h. Identifying related parties and related party transactions.

i. Recognising conflicting information (for example, contradictory representations).

j. Recognising unusual circumstances (for example, fraud and noncompliance with laws and regulations, unexpected relationships between statistical operating data and reported financial results).

k. Making informed enquiries and assessing the reasonableness of answers.

l. Considering the appropriateness of accounting policies and financial statement disclosures.

12. Auditors, including all personnel assigned to the audit engagement, should obtain sufficient knowledge of the business to enable them to carry out the audit work effectively. (SAS 210.2)

13. Auditors would also ensure they understand the need to be alert for additional information and the need to share that information with other members of the audit team.

14. To make effective use of knowledge about the business, auditors should consider how it applies to the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditors' knowledge of the business. (SAS 210.3)

Compliance with International Standards on Auditing

15. Compliance with the auditing standards contained in this SAS ensures compliance in all material respects with the basic principles and essential procedures in International Standard on Auditing 310 "Knowledge of the Business".

Effective date

16. Auditors are required to comply with the requirements of this SAS in respect of audits of financial statements for periods beginning before 15 December 2004.

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 list is not exhaustive.

1. General economic factors

a. General level of economic activity (for example, recession, growth)

b. Interest rates and availability of financing

c. Inflation

d. Government policies

   i. monetary

   ii. fiscal

   iii. taxation - corporate and other

   iv. financial incentives (for example, government aid programmes)

   v. tariffs, trade restrictions

e. Foreign currency rates and controls

f. Commodity prices

2. The industry - important conditions affecting the client's business

a. The market and competition

b. Cyclical or seasonal activity

c. Changes in product technology

d. Business risk (for example, high technology, high fashion, ease of entry for competition)

e. Declining or expanding operations

f. Adverse conditions (for example, declining demand, excess capacity, serious price competition)

g. Key ratios and operating statistics

h. Specific accounting practices and problems

i. Environmental requirements and problems

j. Consumer and social issues

k. Regulatory framework

l. Energy supply and cost

m. Specific or unique practices (for example, relating to labour contracts, financing methods, accounting methods)

3. The entity

a. Directors, management and ownership - important characteristics

   i. Corporate structure - private, public, government (including any recent or planned changes)

   ii. Beneficial owners and related parties (local, foreign, business reputation and experience)

   iii. Capital structure (including any recent or planned changes)

   iv. Organisational structure

   v. Management objectives, philosophy, strategic plans

   vi. Acquisitions, mergers or disposals of business activities (planned or recently executed)

   vii. Sources and methods of financing (current, historical)

   viii. Commitment to designing and maintaining reliable accounting systems and adequate internal control

   ix. 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)

   x. Operating management

   - experience and reputation
   - turnover
   - key financial personnel and their status in the organisation
   - 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

   xi. Internal audit function (existence, quality)

b. The entity's business - products, markets, suppliers, expenses, operations

i. Nature of business(es) (for example, manufacturer, wholesaler, financial services, import/export)

ii. Location of production facilities, warehouses, offices

iii. Employment (for example, by location, supply, wage levels, union contracts, pension commitments, government regulation)

iv. 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)

v. 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")

vi. Stocks (for example, locations, quantities)

vii. Franchises, licenses, patents

viii. Important expenses categories

ix. Research and development

x. Foreign currency assets, liabilities and transactions - by currency, hedging

xi. Legislation and regulations that significantly affect the entity

xii. Information systems - current, plans to change

xiii. Debt structure, including covenants and restrictions

c. Financial performance - factors concerning the entity's financial condition and profitability

i. Key ratios and operating statistics

ii. Trends

d. Reporting environment - external influences which affect management in the preparation of the financial statements

e. Legislation

i. Regulatory environment and requirements

ii. Taxation

iii. Measurement and disclosure issues peculiar to the business

iv. Audit reporting requirements

v. Users of the financial statements