STANDARD ON INTERNAL AUDIT (SIA) 15
KNOWLEDGE OF THE ENTITY AND ITS ENVIRONMENT*

Contents

Paragraph(s)

The following is the text of the Standard on Internal Audit (SIA) 15, *Knowledge of the Entity and its Environment*, issued by the Council of the Institute of Chartered Accountants of India. These Standards should be read in conjunction with the Preface to the Standards on Internal Audit, issued by the Institute.

In terms of the decision of the Council of the Institute of Chartered Accountants of India taken at its 260th meeting held in June 2006, the following Standard on Internal Audit shall be recommendatory in nature in the initial period. The Standards shall become mandatory from such date as notified by the Council.

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Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and provide guidance on what constitutes the knowledge of an entity's business, its importance to the various phases of an internal audit engagement and the techniques to be adopted by the internal auditor in acquiring such knowledge about the client entity and its environment, prior to commencing an internal audit engagement and subsequently thereafter, at all stages of the internal audit process. This Standard also sets out the guidelines regarding the application, usage and documentation of such knowledge by the internal auditor.

2. In performing an internal audit engagement, the internal auditor should obtain knowledge of the economy, the entity's business and its operating environment, including its regulatory environment and the industry in which it operates, sufficient to enable him to review the key risks and entity-wide processes, systems, procedures and controls. The internal auditor should identify sufficient, appropriate, reliable and useful information to achieve the objectives of the engagement. Such knowledge is used by the internal auditor in reviewing the key operational, strategic and control risks and in determining the nature, timing and extent of internal audit procedures.

Acquiring Knowledge of the Entity's Operations and Environment

3. Prior to accepting an engagement, the internal auditor should obtain a preliminary knowledge of the industry and of the nature of ownership, management, regulatory environment and operations of the entity subjected to internal audit, and should consider whether a level of knowledge of the entity's business adequate to perform the internal audit can be obtained.

4. Following the acceptance of the engagement, further and more detailed information should be obtained. To the extent practicable, the internal auditor should obtain the required knowledge at the commencement of the engagement. As the internal audit progresses, that information should be assessed, enhanced, updated, refined and validated as the internal auditor and the engagement team obtain more knowledge about the entity's business.

5. In case of continuing engagements, the internal auditor should update and re-evaluate information gathered previously, including information in the prior year's working papers. The internal auditor should also perform procedures designed to identify significant changes that have taken place in the operations, control environment, technology and strategic processes since the last internal audit.

6. The internal auditor should obtain sufficient, appropriate information about the entity, specifically the following aspects:

   (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment.

   (b) The nature of the entity to enable the internal auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

   (c) Business operations.

   (d) Investments and investment activities.

(e) Financing and financing activities.

(f) Financial reporting.

(g) The entity's selection and application of accounting policies, including the reasons for changes thereto. The internal auditor should evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(h) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

(i) Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognise the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in liabilities and reputational risk.

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement in the information subject to internal audit.

The Appendix to the Standard contains an illustrative list of sources from where the internal auditor may obtain information about the abovementioned aspects.

Sources of Information on Entity's Business

7. The internal auditor can obtain knowledge of the industry and the entity from a number of sources, inter alia:

   a) Previous engagement experience with the entity and its industry.

   b) The business plan of the entity.

   c) Incorporation documents like memorandum and articles of association in case of companies.

   d) The organisational structure and hierarchy of reporting system.

   e) Discussion with key management persons and operating personnel within the entity.

   f) Discussion with statutory audit personnel and review of statutory audit reports.

   g) Discussion with other auditors, legal and other advisors who have provided services to the entity or within the industry.

   h) Discussion with suppliers, customers and third party agencies.

   i) Discussion with knowledgeable experts outside the entity.

   j) Publications related to the industry, for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers.

   k) Legislations and regulations that significantly affect the entity and its business.

   l) Visits to the entity premises, plant facilities, depots, warehouses and other processing locations.

m) Internal documentation produced by the entity, for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature.

n) Prior years' annual and financial reports, budgets, internal management reports, interim financial reports.

o) Standard operating procedures (SOP), management policy manual, procedure manuals of accounting and internal control systems, chart of accounts, job descriptions, purchase policy, human resource policy, information technology manuals and procedures, credit policy, marketing and sales plans.

Using the Knowledge

8. Knowledge of the entity's business is a frame of reference within which the internal auditor exercises professional judgment in reviewing the processes, controls and risk management procedures of the entity. Understanding the business and using this information appropriately assists the internal auditor in:

   a) Assessing risks and identifying key focus areas.

   b) Planning and performing the internal audit effectively and efficiently.

   c) Evaluating audit evidence.

   d) Providing better quality of service to the client.

9. The internal auditor conducts review about several matters throughout the course of the internal audit engagement where knowledge of the business is important. For example:

   a) Assessing inherent risk and control risk.

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

   c) Developing the overall internal audit plan and programme.

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

e) Assessing audit evidence to establish its appropriateness.

f) Evaluating financial and non-financial 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) Recognizing conflicting information, for example, contradictory representations.

j) Recognizing unusual circumstances, for example, fraud and non-compliance with laws and regulations, unexpected relationships of statistical operating data with reported financial results.

10. The internal auditor should ensure that the internal audit engagement team assigned to an internal audit engagement obtains sufficient knowledge of the business to enable them to carry out the internal audit work delegated to them. The internal auditor should also ensure that the audit team appreciates and understands the need to be alert for additional information and the need to share that information with the internal auditor and other members of the internal audit team.

11. To make effective use of knowledge about the business, the internal auditor should consider how this knowledge acquired, affects his review of the internal controls and systems taken as a whole and whether his overall entity-wide assessment of systems, procedures, controls and risk management principles are consistent with his knowledge of the entity's business.

Documentation

12. The information and knowledge obtained by the internal auditor on the entity and its environment should be adequately documented in the engagement working papers.

Effective Date

13. This Standard on Internal Audit is applicable to all internal audits commencing on or after ______. Earlier application of the SIA is encouraged.

Appendix

Examples of Matters that the Auditor May Consider in Obtaining Knowledge About the Entity

(Refer paragraph 6)

Industry Factors

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

Regulatory Factors

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

External Factors

- General economic conditions.
- Interest rates.
- Availability of financing.
- Inflation or currency revaluation.

Nature of the Entity

- Operations.
- Ownership and governance structures.
- Types of investments that the entity is making and plans to make.
- The way that the entity is structured and how it is financed.

Business Operations

- Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.
- Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- Alliances, joint ventures, and outsourcing activities.
- Geographic dispersion and industry segmentation.
- Location of production facilities, warehouses, and offices, and location and quantities of inventories.
- Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, stock option or incentive

bonus arrangements, and government regulation related to employment matters).

- Research and development activities and expenditures.
- Transactions with related parties.

Investment and Investment Activities

- Planned or recently executed acquisitions or divestitures.
- Investments and dispositions of securities and loans.
- Capital investment activities.
- Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

Finance and Financing Activities

- Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

Financial Reporting

- Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).

- Revenue recognition practices.
- Accounting for fair values.
- Foreign currency assets, liabilities and transactions.
- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

Selection and Application of Accounting Policies

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt such requirements.

Entity's Objectives, Strategies and Related Business Risks

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).

- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).
- The measurement and review of the entity's financial performance.