

Auditing Standard

AUS 304
(July 2002)

Knowledge of the Business

Prepared by the **Auditing & Assurance Standards Board** of the
Australian Accounting Research Foundation



Issued by the
**Australian Accounting Research
Foundation** on behalf of
**CPA Australia and The Institute of
Chartered Accountants in Australia**

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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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ISSN 1324-4183

AUDITING STANDARD
AUS 304 “KNOWLEDGE OF THE BUSINESS”

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Introduction

- .01 The purpose of this Auditing Standard (AUS) 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 assistants working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge.
- .02 ***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 judgement, may have a significant effect on the financial report or on the audit 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.
- .03 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 is set out in the Appendix.

Obtaining the Knowledge

- .04 Prior to accepting an engagement, the auditor would obtain a preliminary knowledge of the industry within which the entity operates, 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.
- .05 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 additional information obtained.
- .06 Obtaining the required level of 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.

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- .07 For continuing engagements, the auditor would update and re-evaluate information gathered previously, including information in the prior period’s working papers. The auditor would also perform procedures designed to identify significant changes that have taken place since the last audit.
- .08 The auditor can obtain a knowledge of the industry and the entity from a number of sources. For example:
- (a) previous experience with the entity and its industry;
 - (b) discussion with people within the entity, such as directors and senior operating personnel;
 - (c) discussion with internal audit personnel and review of internal audit reports;
 - (d) discussion with other auditors and with legal and other advisers who have provided services to the entity or within the industry;
 - (e) discussion with knowledgeable people outside the entity, such as industry economists, industry regulators, customers, suppliers and competitors;
 - (f) publications related to the industry such as government statistics, surveys, texts, trade journals, reports prepared by banks and securities dealers and financial newspapers;
 - (g) legislation and regulations that significantly affect the entity;
 - (h) visits to the entity’s premises and plant facilities; and
 - (i) documents produced by the entity, such as minutes of meetings, material sent to shareholders or filed with regulatory authorities, promotional literature, prior periods’ annual and financial reports, budgets, internal management reports, interim financial reports, management policy manuals, accounting and control manuals, chart of accounts, job descriptions and marketing and sales plans.

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Using the Knowledge

- .09 A knowledge of the business is a frame of reference within which the auditor exercises professional judgement. Understanding the business and using this information appropriately assists the auditor 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.
- .10 The auditor makes judgements about many matters throughout the course of the audit where knowledge of the business is important. The judgements would include, for example:
- (a) assessing inherent risk and control risk;
 - (b) considering business risks and management’s response thereto;
 - (c) developing the audit plan and the audit program;
 - (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 report assertions;
 - (f) evaluating accounting estimates and management representations;
 - (g) assessing management integrity;
 - (h) identifying areas where special audit consideration and skills may be necessary;
 - (i) identifying related parties and related party transactions;
 - (j) recognising conflicting information, such as contradictory representations;

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- (k) evaluating unusual circumstances, such as fraud, error, or non-compliance with laws and regulations, and unexpected relationships of statistical operating data with reported financial results;
 - (l) making informed inquiries and assessing the reasonableness of answers; and
 - (m) considering the appropriateness of accounting policies and financial report 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 ***The auditor should consider whether the assertions in the financial report are consistent with the auditor’s knowledge of the business.***

Operative Date

- .13 This AUS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AUS 304 supersedes AUS 304 “Knowledge of the Business”, as issued in October 1995.

Compatibility with International Standards on Auditing

- .14 The basic principles and essential procedures of this AUS and of International Standard on Auditing ISA 310, Knowledge of the Business, are consistent in all material respects.

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APPENDIX

KNOWLEDGE OF THE ENTITY – 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.

General economic factors

- (a) general level of economic activity, for example recession and growth;
- (b) interest rates and availability of financing;
- (c) inflation, currency revaluation;
- (d) government policies:
 - (i) monetary;
 - (ii) fiscal;
 - (iii) taxation – corporate and other;
 - (iv) financial incentives, for example government aid programs; and
 - (v) tariffs, trade restrictions; and
- (e) foreign currency rates and controls.

The industry – important conditions affecting the entity

- (a) the market and competition;
- (b) cyclical or seasonal activity;
- (c) changes in product technology;
- (d) business risk, for example high technology, high fashion and ease of entry for competition;
- (e) declining or expanding operations;

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- (f) adverse conditions, for example declining demand, excess capacity and serious price competition;
- (g) key ratios and operating statistics;
- (h) specific accounting practices and problems;
- (i) environmental requirements and problems;
- (j) regulatory framework;
- (k) energy supply and cost; and
- (l) specific or unique practices, for example relating to labour contracts, financing methods and accounting methods.

The entity

Management and ownership – important characteristics

- (a) corporate structure – private, public, government (including any recent or planned changes);
- (b) beneficial owners and related parties, for example local, foreign, business reputation and experience;
- (c) dominance by one individual;
- (d) capital structure (including any recent or planned changes);
- (e) organisational structure;
- (f) management objectives, philosophy, strategic plans;
- (g) acquisitions, mergers or disposals of business activities (planned or recently executed);
- (h) sources and methods of financing (current, historical);
- (i) governing body:
 - (i) composition;
 - (ii) business reputation and experience of individuals;
 - (iii) independence from and control over operating management;

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- (iv) frequency of meetings;
- (v) existence of audit committee and scope of its activities;
- (vi) existence of policy on corporate conduct; and
- (vii) changes in professional advisers, for example outside legal counsel;
- (j) operating management:
 - (i) experience and reputation;
 - (ii) turnover;
 - (iii) key financial personnel and their status in the organisation;
 - (iv) staffing of accounting department;
 - (v) incentive or bonus plans as part of remuneration, for example based on profit;
 - (vi) use of forecasts and budgets;
 - (vii) pressures on management, for example overextended, dominance by one individual, support for share price and unreasonable deadlines for announcing results; and
 - (viii) quality of management information systems;
- (k) internal audit function (existence, quality); and
- (l) attitude to internal control structure.

The entity's business – products, markets, suppliers, expenses, operations

- (a) nature of business(es), for example manufacturer, wholesaler, financial services and import/export;
- (b) location of production facilities, warehouses, offices;
- (c) employment, for example by location, supply, wage levels, union contracts, superannuation commitments and government regulation;
- (d) 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,

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warranties, trends, marketing strategy and objectives and manufacturing processes;

- (e) important suppliers of goods and services, for example long-term contracts, stability of supply, terms of payment, imports and methods of delivery such as “just-in-time”;
- (f) inventories, for example locations and quantities;
- (g) franchises, licenses, patents;
- (h) important expense categories;
- (i) research and development;
- (j) foreign currency assets, liabilities and transactions – by currency, hedging;
- (k) legislation and regulation that significantly affect the entity, for example environmental;
- (l) use of information technology and plans to change; and
- (m) debt structure, including covenants and restrictions;

Financial performance – factors concerning the entity’s financial condition and profitability

- (a) key ratios and operating statistics; and
- (b) trends.

Reporting environment – external influences which affect management in the preparation of the financial report

- (a) legislation;
- (b) regulatory environment and requirements;
- (c) taxation;
- (d) measurement and disclosure issues peculiar to the entity;
- (e) audit reporting requirements; and
- (f) users of the financial report.