

EXPOSURE DRAFT

Standard on Internal Audit (SIA)

KNOWLEDGE OF THE ENTITY

AND ITS ENVIRONMENT

Invitation to Comments

The Internal Audit Standards Board (hitherto known as the Committee on Internal Audit), of the Institute of Chartered Accountants of India invites comments on the Exposure Draft of the Standard on Internal Audit (SIA), *Knowledge of the Entity and Its Environment*. Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to:

Secretary, Internal Audit Standards Board,
The Institute of Chartered Accountants of India,
ICAI Bhawan,
C-1, Sector-1, Noida – 201 301.

*The last date for receiving comments is **January 29, 2009**. Comments can also be emailed at cia@icai.in.*

The following is the text of the Standard on Internal Audit (SIA), “Knowledge of the Entity and Its Environment”, issued by the Council of the Institute of Chartered Accountants of India. This Standard should be read in conjunction with the “Preface to the Standards and Guidance Notes on Internal Audit”, issued by the Institute.

Introduction

1. The purpose of this Standard on Internal Audit is to establish standards and guidelines on the knowledge of an entity’s business 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 entity’s business and its operating environment 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.

3. The internal auditor's level of knowledge for an engagement should include a broad knowledge of the economy, regulatory environment and the industry within which the entity operates, and more specific knowledge of how the entity operates.

Acquiring Knowledge of the Entity’s Operations and Environment

4. 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.

5. 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 learning about the entity's business.

6. 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.

7. The internal auditor should obtain sufficient, appropriate, accurate and reliable macro and micro level information on the operations, control and regulatory environment of the entity, specifically on the following:

- a) Economic, reporting and regulatory environment and indicators affecting the client entity, for example interest rates, fiscal policy, disclosure issues relating to the particular industry.
- b) Industry factors and indicators affecting the client entity, for example market and competition forces, cyclical or seasonal activity, changes in product technology or service delivery mechanism, key 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 , specific internal audit reporting requirements policies and issues , environmental requirements and problems, legislation and regulatory framework, energy supply

and cost , specific or unique practices relating to Labour contracts, financing methods, industry ranking and market share enjoyed by the entity.

- c) **Entity-specific information , for example, management, ownership and board characteristics , organizational and capital structure, management objectives, philosophy, strategic plans , sources and methods of financing, composition of board of directors, audit committee, conduct of meetings, existence of audit committee and scope of its activities , existence of corporate ethics and conduct policy, internal control structure and its effectiveness, enterprise risk management (ERM) framework within the entity, operating management , attrition rates, compensation policy, pressures on management, soundness of MIS reporting, details of nature, location and manpower of entity's business - products, services, markets, suppliers, expenses, operations, employment details, inventory management procedures, details of information system—manual or computerised, the financial package or enterprise resource planning (ERP) system used, understanding of IT controls, financial performance and profitability, key performance indicators and ratios, trends and operating statistics, investments , R&D activities, financial reporting system and compliance with accounting standards, business expansion planned.**
- d) **Information on any unusual or non-recurring transactions or events including frauds.**
- e) **The entity's record of legal and statutory compliance including pending litigations.**
- f) **Transactions with related parties.**
- g) **Key business risks facing the entity.**

Sources of Information on Entity's Business

8. 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) The organisational structure and hierarchy of reporting system.

- d) Discussion with key management persons and operating personnel within the entity.
- e) Discussion with statutory audit personnel and review of statutory audit reports.
- f) Discussion with other auditors, legal and other advisors who have provided services to the entity or within the industry.
- g) Discussion with suppliers, customers and third party agencies.
- h) Discussion with knowledgeable experts outside the entity.
- i) Publications related to the industry , for example, government statistics, surveys, texts, trade journals, reports prepared by banks and institutions and financial newspapers.
- j) Legislations and regulations that significantly affect the entity and its business.
- k) Visits to the entity premises, plant facilities, depots, warehouses and other processing locations.
- l) Internal documentation produced by the entity for example, minutes of meetings, material sent to shareholders or furnished to regulatory authorities, promotional literature.
- m) Prior years' annual and financial reports, budgets, internal management reports, interim financial reports.
- n) 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

9. 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.

10. 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 a 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

11. The internal auditor should ensure that the internal audit engagement team assigned to an internal audit engagement obtain 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 appreciate and understand 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 .

12. 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

13. **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

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