



Exposure Draft
SCA -
Standard on Cost Auditing
“Cost Auditor’s Responsibility relating to Fraud
in an Audit of Cost Statement”

Contents

<u>Name of Clause</u>	<u>Paragraph</u>
Introduction	1
Objective	2
Scope	3
Definitions	4.1 - 4.14
Requirements	5
<i>Professional Skepticism</i>	5.1 – 5.3
<i>Discussion among the Audit Team</i>	5.4
<i>Risk Assessment Procedures and Related Activities</i>	5.5 – 5.12
<i>Identification & Assessment of the Risks of Material Misstatement Due to Fraud</i>	5.13 - 5.14
<i>Responses to the Assessed Risks of Material Misstatement Due to Fraud</i>	5.15 – 5.18
<i>Evaluation of Cost Audit Evidence</i>	5.19 – 5.22
<i>Cost Auditor Unable to Continue the Engagement</i>	5.23
<i>Written Representation</i>	5.24
<i>Communications to Management and with Those Charged with Governance</i>	5.25 – 5.27
<i>Communications to Regulatory and Enforcement Authorities</i>	5.28
<i>Documentation</i>	5.29 – 5.31
Application Guidance	6
<i>Characteristics of Fraud</i>	6.1 – 6.5
<i>Professional Skepticism</i>	6.6 – 6.9
<i>Discussion among the Audit Team</i>	6.10 – 6.11
<i>Risk Assessment Procedures and Related Activities</i>	6.12 – 6.25
<i>Identification & Assessment of the Risks of Material Misstatement Due to Fraud</i>	6.26 – 6.29
<i>Responses to the Assessed Risks of Material Misstatement Due to Fraud</i>	6.30 – 6.43



<i>Evaluation of Cost Audit Evidence</i>	6.44 – 6.47
<i>Cost Auditor Unable to Continue the Engagement</i>	6.48 – 6.50
<i>Written Representation</i>	6.51 – 6.52
<i>Communications to Management and with Those Charged with Governance</i>	6.53 – 6.57
<i>Communications to Regulatory and Enforcement Authorities</i>	6.58 – 6.59
Effective date	7
Statement of Modifications	8

The following is the **Standard on Cost Auditing, “Cost Auditor’s Responsibility relating to Fraud in an Audit of Cost Statement”**. In this Standard, the standard portions have been set in ***bold italic*** type. This standard should be read in the context of the background material, which has been set in normal type.

1. Introduction

The purpose of this Standard is to deal with the cost auditor’s responsibilities in understanding, differentiating misstatements with fraud, its detection, and reporting it to the concerned authorities in case any fraud is detected in the audit of cost statements.

Characteristics of Fraud

- (i) Misstatements in the cost statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement is intentional or unintentional.
- (ii) Although fraud is a broad legal concept, for the purposes of the Cost Auditing Standards, the cost auditor is concerned with fraud that causes a material misstatement in the cost statements. Two types of intentional misstatements are relevant to the cost auditor
 - misstatements resulting from fraudulent cost or revenue reporting; and
 - misstatements resulting from misappropriation of assets.

Although the cost auditor may suspect or, in rare cases, identify the occurrence of fraud, the cost auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. 6.1–6.5)

Responsibility for Prevention and Detection of Fraud

- (iii) The primary responsibility for the prevention and detection of fraud rests with both



those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the cost reporting process, such as efforts by the management to understate or overstate costs in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Cost Auditor

- (iv) A cost auditor conducting an audit in accordance with Cost Auditing Standards is responsible for obtaining reasonable assurance that the cost statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the cost statements may not be detected, even though the audit is properly planned and performed in accordance with the Cost Auditing Standards.
- (v) The potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the cost auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as cost estimates are caused by fraud or error.
- (vi) Furthermore, the risk of the cost auditor for not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate cost records,



present fraudulent cost information or override control procedures designed to prevent similar frauds by other employees.

- (vii) When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this Cost Auditing standard are designed to assist the cost auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

2. Objective

The objectives of the cost auditor are:

- (a) To identify and assess the risks of material misstatement in the cost statements due to fraud;*
- (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and*
- (c) To respond appropriately to fraud or suspected fraud identified during the audit.*

3. Scope

This cost auditing standard deals with the cost auditor's responsibilities relating to fraud in an audit of cost statements. Specifically, it expands on how risks of material misstatement and auditor's responses to assessed risks are to be applied in relation to risks of material misstatement due to fraud.

4. Definitions

The following terms are being used in this standard with the meaning specified.

4.1 Audit Risk: *Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.*

- (a) The risk of material misstatement has two components viz. Inherent Risk and Control risk.*

(1) Inherent risk: the susceptibility of an assertion about the measurement, assignment or disclosure of cost to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.



(2) Control risk: *the risk that a misstatement that could occur in an assertion about the measurement, assignment or disclosure of cost and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal, operational and management control.*

(b) Detection risk: *the risk that the procedures followed by the cost auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.*

4.2 Cost Audit: *Cost audit is an independent examination of cost statements, cost records and other related information of an entity including a non-profit entity, when such an examination is conducted with a view to expressing an opinion thereon.*

4.3 Cost Auditor: *"Cost Auditor" means an auditor appointed to conduct an audit of cost records and shall be a cost accountant within the meaning of The Cost and Works Accountants Act 1959. "Cost Accountant" is a cost accountant as defined in clause (b) of sub-section (1) of section 2 of The Cost and Works Accountants Act, 1959 (23 of 1959) and who holds a valid certificate of practice under subsection (1) of section 6 and who is deemed to be in practice under subsection (2) of section 2 of that Act and includes a firm of cost accountants.*

4.4 Cost Audit Report: *Cost Audit Report means the report duly audited and signed by the cost auditor on an independent examination of the cost statements, cost records and other related information of an entity including a non-profit entity, expressing his opinion thereon. It includes any statement, annexure, qualifications, observations, etc. attached to the cost audit report, or that is required by law or regulation.*

4.5 Cost Records: *"Cost Records" means books of accounts relating to utilization of materials, labour and other items of cost, to facilitate calculation of true and fair cost of production or cost of operations, cost of sales, and margin for each product or service or activity, produced or provided by an entity including a non-profit entity, for any period, in compliance with Cost Accounting Standards issued by the Institute.*

4.6 Cost Statements:-*Cost Statements, in relation to an entity, includes*



- (i) quantitative details of capacity, production and sales;*
- (ii) quantitative details of consumption of materials and other inputs;*
- (iii) cost sheet showing element-wise cost of production of goods or provision of services, cost of sales and margin for each product or service;*
- (iv) reconciliation of profits, or in case of an entity carrying on any activity not for profit, of surplus, as per cost accounts and as per financial accounts;*
- (v) statement of value addition and distribution of earnings; and*
- (vi) any explanatory note annexed to, or forming part of, any document referred to in (i) to (v) above.*

4.7 Audit Team: *Audit team means all personnel performing an engagement, including any experts engaged by the firm in connection with that engagement.*

4.8 Fraud: *An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.*

4.9 Fraud risk factors: *Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.*

4.10 Management: *The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance.*

4.11 Misstatement: *A difference between the amounts, classification, presentation or disclosure of a reported cost statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable cost reporting framework. Misstatement can arise from error or fraud.*

Where the cost auditor expresses an opinion on whether the cost statements give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the cost auditor's judgement, are necessary for the cost statements to be presented fairly, in all material respects, or to give a true and fair view.

4.12 Professional Judgement: *The application of relevant training, knowledge and experience, within the context provided by cost auditing standards, cost accounting standards and ethical requirements, in making informed decision about the courses of action that are appropriate in the circumstances of the audit engagement.*



- 4.13 Professional Skepticism:** *An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud, and a critical assessment of audit evidence.*
- 4.14 Risk Assessment:** *The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the overall cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof.*

5. Requirements

Professional Skepticism

- 5.1** *The cost auditor shall maintain professional skepticism throughout the cost audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the Cost auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. 6.6–6.8)*
- 5.2** *Unless the cost auditor has reason to believe the contrary, the cost auditor may accept records and documents as genuine. If conditions identified, during the audit cause the cost auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the cost auditor, the cost auditor shall investigate further. (Ref: Para. 6.9)*
- 5.3** *Where responses to inquiries from the management or from those charged with governance are inconsistent, the cost auditor shall investigate the inconsistencies.*

Discussion among the Audit Team

- 5.4** *Discussions among the audit team members shall place particular emphasis on how and where the entity's cost statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the audit team members' beliefs that management and those charged with governance are honest and have integrity. (Ref: Para. 6.10–6.11)*

Risk Assessment Procedures and Related Activities

- 5.5** *When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal controls, the cost auditor shall perform the procedures in paragraphs 5.6 - 5.12 to*



obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

5.6 *The cost auditor shall make inquiries from management regarding:*

- (a) Management's assessment of the risk that the cost statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. 6.12–6.13)***
- (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or material consumption, scrap sales, stock valuation, other items of cost or revenue, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. 6.14)***
- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and***
- (d) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.***

5.7 *The cost auditor shall make inquiries from management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. 6.15–6.17)*

5.8 *For those entities that have an internal audit function, the cost auditor shall make inquiries from appropriate individuals to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. 6.18)*

Those Charged with Governance (Ref: Para. 6.19–6.20)

5.9 *Unless all of those charged with governance are involved in managing the entity, the cost auditor shall:*

- (a) Obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.***
- (b) Make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries from management.***



Other Information

- 5.10** *While performing analytical procedures, the cost auditor shall evaluate risks of material misstatement due to fraud, if the cost auditor finds any unusual relationships in the cost statements*
- 5.11** *The cost auditor shall consider whether any other information obtained by the cost auditor indicates risks of material misstatement due to fraud. (Ref: Para. 6.21)*

Evaluation of Fraud Risk Factors

- 5.12** *The cost auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicate that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. 6.22–6.25)*

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

- 5.13** *The cost auditor shall identify and assess the risks of material misstatement due to fraud at the cost statement level; and at the assertion level including items and nature of cost, ascertainment, allocation and apportionment of cost to products or services and disclosures thereof. (Ref: Para. 6.26 - 6.27)*
- 5.14** *The cost auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. 6.28–6.29)*

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

- 5.15** *The cost auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the cost statement level. In determining overall responses, the cost auditor shall: (Ref: Para. 6.30)*
- (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals in the audit team to be given significant responsibilities and the cost auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. 6.31)*



- (b) Evaluate whether the selection and application of cost accounting policies by the entity, may be indicative of fraudulent reporting resulting from management's effort to manage earnings or costs; (Ref: Para. 6.32)**
- (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of cost audit procedures; and (Ref: Para. 6.33)**
- (d) Design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level. (Ref: Para. 6.34–6.35)**

Cost Audit Procedures Responsive to Risks Related to Management Override of Controls

5.16 Management is in a unique position to perpetrate fraud because of Management's ability to manipulate cost records and prepare fraudulent cost statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk. (Ref: Para. 6.36)

5.17 Irrespective of the cost auditor's assessment of the risks of management override of controls, the auditor shall design and perform cost audit procedures to:

- (a) Test the appropriateness of cost records, basis for measurement, allocation, apportionment and absorption of costs adopted in the preparation of the cost statements. In designing and performing audit procedures for such tests, the cost auditor shall make inquiries of individuals involved in the cost reporting framework about inappropriate or unusual activity relating to the measurement and presentation of costs; (Ref: Para. 6.37–6.39)**
- (b) Review costing estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In performing this review, the cost auditor shall:**
 - i) Evaluate whether the judgments and decisions made by management in making the costing estimates included in the cost statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the cost auditor shall reevaluate the costing estimates taken as a whole; and**
 - ii) Perform a retrospective review of management judgments and assumptions related to significant costing estimates reflected in the cost statements of the prior year. (Ref: Para. 6.40– 6.42)**



- (c) For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the cost auditor's understanding of the entity and its environment and other information obtained during cost audit, the cost auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent cost reporting or to conceal misappropriation of assets. (Ref: Para. 6.43)*

5.18 *The cost auditor shall determine whether, in order to respond to the identified risks of management override of controls, the cost auditor needs to perform other cost audit procedures in addition to those specifically referred to above (that is, where there are specific additional risks of management override that are not covered as part of the procedures performed to address the requirements in paragraph 5.17).*

Evaluation of Cost Audit Evidence (Ref: Para. 6.44)

5.19 *The cost auditor shall evaluate whether analytical procedures that are performed when forming an overall conclusion as to whether the cost statements are consistent with the cost auditor's understanding of the entity, indicate a previously unrecognized risk of material misstatement due to fraud.*

5.20 *When the cost auditor identifies a misstatement, the cost auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the cost auditor shall evaluate the implications of the misstatement in relation to other aspects of the cost audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. (Ref: Para. 6.45)*

5.21 *If the cost auditor identifies a misstatement, whether material or not, and the cost auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the cost auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of cost audit procedures to respond to the assessed risks. The cost auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. 6.46)*



5.22 *If the cost auditor confirms that, or is unable to conclude whether, the cost statements are materially misstated as a result of fraud the cost auditor shall evaluate the implications for the audit. (Ref: Para. 6.47)*

Cost Auditor Unable to Continue the Engagement

5.23 *If, as a result of a misstatement resulting from fraud or suspected fraud, the cost auditor encounters exceptional circumstances that bring into question the cost auditor's ability to continue performing the cost audit, the cost auditor shall:*

- (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the cost auditor to report to the person or persons who made the cost audit appointment or, in some cases, to regulatory authorities;*
- (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and*
- (c) If the cost auditor withdraws:*
 - (i) Discuss with the appropriate level of management and those charged with governance, the cost auditor's withdrawal from the engagement and the reasons for the withdrawal; and*
 - (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the cost auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. 6.48–6.50)*

Written Representations

5.24 *The cost auditor shall obtain written representations from management and, where applicable, those charged with governance that:*

- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;*
- (b) They have disclosed to the cost auditor the results of management's assessment of the risk that the cost statements may be materially misstated as a result of fraud;*
- (c) They have disclosed to the cost auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:*
 - (i) Management;*
 - (ii) Employees who have significant roles in internal control; or*
 - (iii) Others where the fraud could have a material effect on the cost statements;**and*
- (d) They have disclosed to the cost auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's cost statements communicated*



by employees, former employees, analysts, regulators or others. (Ref: Para. 6.51–6.52)

Communications to Management and with Those Charged with Governance (Ref: Para. 6.53–6.56)

- 5.25** *If the cost auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the cost auditor shall communicate these matters to the appropriate level of management, on a timely basis, or as prescribed under regulation.*
- 5.26** *Unless all of those charged with governance are involved in managing the entity, if the cost auditor has identified or suspects fraud involving:*
- (a) management;*
 - (b) employees who have significant roles in internal control; or*
 - (c) Others where the fraud results in a material misstatement in the cost statements, the cost auditor shall communicate these matters to those charged with governance on a timely basis or as prescribed under regulation. If the cost auditor suspects fraud involving management, the cost auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of cost audit procedures necessary to complete the cost audit.*
- 5.27** *The cost auditor shall communicate with those charged with governance any other matters related to fraud that are, in the cost auditor's judgment, relevant to their responsibilities. (Ref: Para. 6.57)*

Communications to Regulatory and Enforcement Authorities

- 5.28** *If the cost auditor has identified or suspects a fraud, the cost auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a regulatory or enforcement authority under prescribed regulation.. Although the cost auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the cost auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. 6.58–6.59)*

Documentation

- 5.29** *The cost auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement shall include:*



- (a) The significant decisions reached during the discussion among the audit team regarding the susceptibility of the entity's cost statements to material misstatement due to fraud; and*
- (b) The identified and assessed risks of material misstatement due to fraud at the cost statement level and at the assertion level.*

5.30 *The cost auditor's documentation of the responses to the assessed risks of material misstatement shall include:*

- (a) The overall responses to the assessed risks of material misstatement due to fraud at the cost statement level and the nature, timing and extent of cost audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and*
- (b) The results of the audit procedures, including those designed to address the risk of management override of controls.*

5.31 *The cost auditor shall include in the cost audit documentation communications about fraud made to management, those charged with governance, regulators and others.*

6. Application Guidance

Characteristics of Fraud (Ref: Para. 1)

6.1 Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent cost reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) outcome from the cost statements—particularly since the consequences to management for failing to meet goals can be significant. Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can also commit fraud in an environment that imposes sufficient pressure on them.

6.2 Fraudulent cost reporting involves intentional misstatements including omissions of amounts or disclosures in cost statements to deceive its users. It can be caused by the



efforts of management to manage cost records in order to deceive users by influencing their perceptions as to the entity's performance and profitability. Such act may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent cost reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent cost reporting by materially misstating the cost statements. In some entities, management may be motivated to manage earnings or cost by a material amount to minimize tax or to inflate costs to get benefits from the public authorities or does not want the regulatory authorities to understand their product margin.

6.3 Fraudulent cost reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of costing records or supporting documentation from which the cost statements are prepared.
- Misrepresentation in, or intentional omission from, the cost statements of events, transactions or other significant information.
- Intentional misapplication of costing principles relating to classification, allocation of cost, apportionment of cost, manner of presentation, or disclosure.

6.4 Fraudulent cost reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious entries or adjustments, particularly close to the end of an accounting period, to manipulate margin in cost statements, operating results, tax liabilities or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate cost statements.
- Omitting, advancing or delaying recognition in the cost statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the cost statements.
- Engaging in complex transactions that are structured to misrepresent margin in cost statements or performance of the entity.
- Altering records and terms related to significant and unusual transactions.

6.5 Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in

ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Inventory and operating assets
 - a. Theft of inventory.
 - b. False write offs and other debits to inventory.
 - c. False sales of inventory
 - d. Theft of operating assets
 - e. Receiving free, higher or below market value goods and services from suppliers.
 - f. Non disclosing or understating the generation of scraps and wastages
 - g. Unauthorised private use of company property.
- Recording additional depreciation on product cost by showing fictitious assets (Machinery)
- Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Professional Skepticism (Ref: Para. 5.1)

6.6 An attitude of professional skepticism means the cost auditor makes a critical assessment, with a questioning mind, of the validity of audit evidence obtained and be alert to audit evidence that contradicts or brings into question the reliability of documents and response to inquiries and other information obtained from management and those charged with governance. An attitude of professional skepticism is necessary throughout the cost audit process for the auditor to reduce the risk of overlooking unusual circumstances of over generalizing when drawing conclusions from cost audit observations, and of using faulty assumptions in determining the nature, timing and extent of the cost audit procedures and evaluating the results thereof. When making inquiries and performing other cost audit procedures, the cost auditor should not be satisfied with less-than-persuasive audit evidence based on the belief that management and those charged with governance are honest and have integrity. Accordingly, representations from management are not a substitute for obtaining sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the cost auditor's opinion.

6.7 Although the cost auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

6.8 A cost auditor conducting an audit in accordance with Cost Auditing Standards obtains assurance that the cost statements taken as a whole are free from material



misstatement, whether due to fraud or error. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the cost statements taken as a whole. Reasonable assurance relates to the whole audit process. (Ref: Para. 5.1)

6.9 The cost auditor conducting cost audit in accordance with Cost Auditing Standards rarely involves in the authentication of documents, nor is the cost auditor expected to be an expert in such authentication. However, when the cost auditor identifies conditions that cause the cost auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Comparison of key performance indicators and key ratios.
- Confirmation of the possible reasons given by the management for direct material cost increase or cost reduction from the third party directly.
- Using the work of an expert to assess the document's authenticity. (Ref: Para. 5.2)

Discussion among the Audit Team (Ref: Para. 5.4)

6.10 Discussing the susceptibility of the entity's cost statements to material misstatement due to fraud with the audit team:

- Provides an opportunity for more experienced audit team members to share their insights about how and where the cost statements may be susceptible to material misstatement due to fraud.
- Enables the cost auditor to consider an appropriate response to such susceptibility and to determine which member of the audit team will conduct which cost audit procedures.
- Permits the cost auditor to determine how the results of audit procedures will be shared among the audit team and how to deal with any allegations of fraud that may come to the cost auditor's attention.

6.11 The discussion may include such matters as:

- An exchange of ideas among audit team members about how and where they believe the entity's cost statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent cost reporting, and how assets of the entity could be misappropriated.
- A consideration on analysing the budgets, forecasts, variance analysis, key ratios etc.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent cost reporting.
- A consideration of the known external and internal factors affecting the entity that



may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.

- An emphasis on the importance of maintaining a proper state of mind throughout the cost audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the cost audit procedures to be performed.
- A consideration of the cost audit procedures that might be selected to respond to the susceptibility of the entity's cost statement to material misstatement due to fraud and whether certain types of cost audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the cost auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud [Ref: Para. 5.6(a)]

6.12 Management is responsible for the entity's internal control and for the preparation of the entity's cost statements. Accordingly, it is appropriate for the cost auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In some entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the cost auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

6.13 In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets. [Ref: Para. 5.6(a)]



6.14 In the case of entities with multiple locations, management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist. [Ref: Para. 5.6(b)]

Inquiry of Management and Others within the Entity (Ref: Para. 5.7)

6.15 The cost auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the cost statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the cost statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the cost auditor that may not otherwise be communicated.

6.16 Examples of others within the entity to whom the cost auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the cost reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

6.17 Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the cost auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 5.8)

6.18 The cost auditor may inquire about specific internal audit activities, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

Obtaining an understanding of Oversight Exercised by Those Charged with Governance (Ref: Para. 5.9)



6.19 Those charged with governance of an entity oversee the entity's systems for monitoring risk, cost reporting and compliance with the law. Those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since their responsibilities may vary from entity to entity, it is important that the cost auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.

6.20 An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The cost auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Consideration of Other Information (Ref: Para. 5.11)

6.21 In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim cost information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 5.12)

6.22 The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the cost auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to manage earnings or cost by a material amount to minimize tax
- The need to manage cost so that regulatory authorities do not understand their product margin for price fixation or ascertainment of subsidy levels.

6.23 Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of whether a fraud risk factor is present and whether it is to be considered in



assessing the risks of material misstatement of the cost statements due to fraud requires the exercise of professional judgment.

6.24 The risk factors may be classified based on the three conditions that are generally present when fraud exists:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- An ability to rationalize the fraudulent action.

Risk factors reflective of an attitude that permits rationalization of the fraudulent action may not be susceptible to observation by the cost auditor. Nevertheless, the cost auditor may become aware of the existence of such information.

6.25 The size, complexity, and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, in the case of a large entity, there may be factors that generally constrain improper conduct by management, such as:

- Effective oversight by those charged with governance.
- An effective internal audit function.
- The existence and enforcement of a written code of conduct.

Furthermore, fraud risk factors considered at a business segment operating level may provide different insights when compared with those obtained when considered at an entity-wide level.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

6.26 Material misstatement due to fraudulent reporting relating to revenue recognition often results from an overstatement of revenues through, for example, premature revenue or cost recognition or recording fictitious revenues or cost. It may result also from an understatement of revenues or costs through, for example, improperly shifting revenues or costs to a later period. (Ref: Para. 5.13)

6.27 The risks of fraud in revenue or cost recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent reporting through inappropriate revenue or cost recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales. (Ref: Para. 5.13)



6.27 The presumption that there are risks of fraud in revenue or cost recognition may be rebutted. For example, it may be concluded that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, annual sale of scrap or wastage. (Ref: Para. 5.13)

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 5.14)

6.28 Management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. In determining controls to implement to prevent and detect fraud, management considers the risks that the cost statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

6.29 It is therefore important for the cost auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the cost auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the cost auditor's assessment of the risks that the cost statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 5.15)

6.30 Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the cost audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters discussed below.

Assignment and Supervision of Personnel

6.31 The cost auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge,



such as forensic and IT knowledge, or by assigning more experienced individuals to the engagement. [Ref: Para. 5.15 (a)]

6.32 The extent of supervision reflects the cost auditor's assessment of risks of material misstatement due to fraud and the competencies of the engagement team members performing the work. [Ref: Para. 5.15 (b)]

Unpredictability in the Selection of Cost Audit Procedures [Ref: Para. 5.15 (c)]

6.33 Incorporating an element of unpredictability in the selection of the nature, timing and extent of cost audit procedures to be performed is important as individuals within the entity who are familiar with the cost audit procedures normally performed on engagements may be more able to conceal fraudulent cost reporting. This can be achieved by, for example:

- Performing substantive procedures on selected cost records and assertions not otherwise tested due to their materiality or risk.
- Adjusting the timing of cost audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing cost audit procedures at different locations or at locations on an unannounced basis.

Cost Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level [Ref: Para. 5.15 (d)]

6.34 The cost auditor's responses to address the assessed risks of material misstatement due to fraud at the assertion level may include changing the nature, timing and extent of cost audit procedures in the following ways:

- The nature of cost audit procedures to be performed may need to be changed to obtain cost audit evidence that is more reliable and relevant or to obtain additional corroborative information. This may affect both the type of cost audit procedures to be performed and their combination. For example Physical observation or inspection of certain assets may become more important or the cost auditor may choose to use computer assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files.
- The timing of substantive procedures may need to be modified. The cost auditor may conclude that performing substantive testing during the year better addresses an assessed risk of material misstatement due to fraud. The cost auditor may conclude that, given the assessed risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In contrast, because an intentional misstatement – for example, a misstatement involving improper revenue recognition – may have been



initiated in an interim period, the cost auditor may elect to apply substantive procedures to transactions occurring earlier in or throughout the reporting period.

- The extent of the procedures applied reflects the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level may be appropriate. Also, computer-assisted techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

6.35 The cost auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions. The risk may also relate to significant changes in assumptions relating to cost estimates. These may include the basis and methodology adopted for estimating the cost of finished product and services, valuation of semi-finished goods, finished goods, goods used for captive consumption, inter-unit transfers of goods and service and other related areas. Information gathered through obtaining an understanding of the entity and its environment may assist the cost auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

Cost Audit Procedures Responsive to Risks Related to Management Override of Controls

Costing Entries and Other Adjustments

6.36 Material misstatement of cost statements due to fraud often involve the manipulation of the cost reporting process by recording inappropriate or unauthorized cost accounting entries. This may occur throughout the year or at period end or by management making adjustments to amounts reported in the cost statements that are not reflected in Cost ledger, such as through consolidating adjustments, reclassifications, adopting inappropriate basis for determination of cost, sales and stock valuation. (Ref: Para. 5.16)

6.37 Further, the cost auditor's consideration of the risks of material misstatement associated with inappropriate override of controls over costing entries and adjustments is important since automated processes and controls may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the cost ledgers or change in the basis of determination of cost or to the cost reporting system. Furthermore, where IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems. (Ref: Para. 5.17)



6.38 When identifying and selecting cost ledger entries and other adjustments for testing and determining the appropriate method of examining the underlying support for the items selected, the following matters are of relevance: (Ref: Para. 5.17)

- Presence of fraud risk factors and other information obtained during the cost auditor's assessment of the risks of material misstatement due to fraud.
- Effective controls over the preparation and posting of costing entries and other adjustments which may reduce the extent of substantive testing necessary, provided that the cost auditor has tested the operating effectiveness of the controls
- *The entity's cost determination and reporting process may involve a combination of manual and automated steps and procedures and controls.*
- *The characteristics of fraudulent costing entries or other adjustments like entries or adjustments (a) made to unrelated, unusual, or seldom-used accounts, (b) made by individuals who typically do not make costing entries, (c) recorded at the end of the period or as post-closing entries that have little or no explanation or description, (d) made either before or during the preparation of the cost statements or (e) containing round numbers or consistent ending numbers.*
- *The nature and complexity of the accounts* - inappropriate entries or adjustments may be applied to accounts that (a) contain transactions that are complex or unusual in nature, (b) contain significant estimates and period-end adjustments, (C) have been prone to misstatements in the past, (d) have not been reconciled on a timely basis or contain reconciled differences, (e) contain inter-company transactions, or (f) are otherwise associated with an identified risk of material -misstatement due to fraud. In audits of entities that have several locations or components, consideration is given to the need to select entries and basis of adjustments from multiple locations.

6.39 The cost auditor uses professional judgment in determining the nature, timing and extent of testing of entries and other adjustments. However, because fraudulent entries and other adjustments are often made at the end of a reporting period, the cost auditor is required to select the entries and other adjustments made at that time. Further, because material misstatements in cost statements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished, the cost auditor is required to consider whether there is also a need to test entries and other adjustments throughout the period.

Cost Estimates (Ref: Para. 5.17(b))

6.40 The preparation of the cost statements requires management to make a number of judgments or assumptions that affect significant cost estimates and to monitor the



reasonableness of such estimates on an ongoing basis like variance analysis which help in identifying the reasons for variations and need to review the basis adopted for cost estimation. However, fraudulent cost reporting through intentional misstatement of cost estimates may often be accomplished, for example under-valuation or over-valuation of stock or inter-unit transfers or inappropriate adjustments designed to achieve a designated level of cost and profitability in order to deceive cost statements.

6.41 The purpose of performing a retrospective review of management judgments and assumptions related to significant estimates reflected in the Cost statements of the prior period is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the cost auditor's professional judgments made in the prior period that were based on information available at the time.

6.42 A retrospective review is also required as a risk assessment procedure to obtain information regarding the effectiveness of management's prior period estimation process that is pertinent to making current period cost estimates, and possible uncertainty or inconsistencies that may be required to be disclosed in the cost statements.

Business Rationale for Significant Transactions [Ref: Para. 5.17(c)]

6.43 The methods the company uses to account for significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature include:

- The form of such transactions appears overly complex (for example, when a new product needs to be manufactured with the existing ones it becomes very complex when a number of products are manufactured from a variety of materials with different types of labour using different types of machines or different processes).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular cost accounting treatment.
- Transactions that involve non-consolidated related parties or unidentified related parties, critically evaluating the business rationale of the transactions and arm's length nature of such transactions needs to be done.



Evaluation of Cost Audit Evidence (Ref: Para. 5.19)

6.44 The Cost auditor, based on the cost audit procedures performed and the audit evidence obtained, evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate. This evaluation is primarily a qualitative matter based on the cost auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures.

Analytical Procedures Performed Near the End of the Cost Audit in Forming an Overall Conclusion (Ref: Para.5.20)

6.45 Determining particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue are particularly relevant. These might include, for example: large amounts of income or items of cost being reported in the last few weeks of the reporting period or unusual transactions,

Consideration of Identified Misstatements (Ref: Para. 5.21)

6.46 Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, numerous misstatements by employees or management and denial of access to records, facilities, identified employees, customers, vendors, or others from whom cost audit evidence might be sought, may be indicative of a risk of material misstatement due to fraud.

6.47 The implications of identified fraud depend on the circumstances. For example, an insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained is questionable. There may also be a possibility of collusion involving employees, management or third parties. (Ref: Para. 5.22)

Cost Auditor Unable to Continue the Engagement (Ref: Para. 5.23)

6.48 Examples of exceptional circumstances that may arise and that may bring into question the cost auditor's ability to continue performing the cost audit include:

- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the cost statements;
- The cost auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or



- The cost auditor has significant concern about the competence or integrity of management or those charged with governance.

6.49 Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the cost auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the cost auditor of a continuing association with the entity.

6.50 The Cost auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary. For example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the cost auditor may consider it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.

Written Representations (Ref: Para. 5.24)

6.51 Appropriate written representations may be obtained from management and, where appropriate, those charged with governance in the cost audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the cost statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

6.52 Because of the nature of fraud and the difficulties encountered by cost auditors in detecting material misstatements in the cost statements resulting from fraud, it is important that the cost auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- (a) The results of management's assessment of the risk that the cost statements may be materially misstated as a result of fraud; and
- (b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance (Ref: Para. 5.25-5.26)



6.53 The cost auditor's communication with those charged with governance may be made orally or in writing in accordance with the importance of the matter. Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the cost auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

6.54 In some cases, the cost auditor may consider it appropriate to communicate with those charged with governance when the cost auditor becomes aware of fraud involving employees other than management that does not result in a material misstatement. Similarly, those charged with governance may wish to be informed of such circumstances. The communication process is assisted if the cost auditor and those charged with governance agree at an early stage in the cost audit about the nature and extent of the cost auditor's communications in this regard.

6.55 In the exceptional circumstances where the cost auditor has doubts about the integrity or honesty of management or those charged with governance, the cost auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

6.56 When the cost auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Other Matters Related to Fraud (Ref: Para. 5.27)

6.57 Other matters related to fraud to be discussed with those charged with governance of the entity may include, for example:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the cost statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- The cost auditor's evaluation of the entity's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent cost reporting, such as management's selection and application of cost accounting policies that may be



indicative of management's effort to manage profitability and performance in order to deceive cost statement users by influencing their perceptions as to the entity's performance and profitability.

- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Communications to Regulatory and Enforcement Authorities (Ref: Para. 5.28)

6.58 The cost auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the cost auditor's duty of confidentiality may be overridden by statute, the law or courts of law. In some cases, the cost auditor may have a statutory duty to report the occurrence of fraud to regulatory authorities or to report misstatements to authorities.

6.59 The cost auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud.

7. Effective Date

This Standard is effective for audits on or after _____.

8. Statement of Modifications: Modifications to ISA 240, "Cost Auditor's Responsibility relating to Fraud in an Audit of Financial Statements"

The ISAs have been developed with focus on Auditing of Financial Statements, while the focus of SCAs is on Auditing of Cost Statements. Hence, following changes are introduced across all the SCAs:

1. Change of 'terms' used in the ISAs that have corresponding meaning in cost audit vis-à-vis financial audit, such as Auditor with Cost Auditor, Audit with Cost Audit, Financial Statements with Cost Statements, Financial Reporting with Cost Reporting, Audit Procedures with Cost Audit Procedures, Auditor's Responsibility with Cost Auditor's Responsibility, etc.;
2. Corresponding modification in definitions of similar terms, examples used and in the Application Guidance;
3. Unlike the practice followed in ISAs, definitions of all 'terms' relevant to this SCA are reproduced.