



Exposure Draft
SCA -
Standard on Cost Auditing
“Materiality in Planning and Performing a Cost Audit”

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The following is the **Standard on Cost Auditing, “Materiality in Planning and Performing a Cost Audit”**. 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 establish requirement regarding the cost auditor’s consideration of materiality in planning and performing cost audit.

Materiality in the Context of Cost Audit

- i) Cost reporting frameworks are generally based on the concept of materiality in the preparation and presentation of cost statements. In this context, materiality generally explains that:
 - a) Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the decisions taken on the basis of the cost statements;
 - b) Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
 - c) Judgments about matters that are material to users of the cost statements are based on a consideration of the common cost information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.
- ii) Such a discussion provides a frame of reference to the cost auditor in determining materiality for the cost audit.
- iii) The cost auditor’s determination of materiality is a matter of professional judgment, and is affected by the cost auditor’s perception of the cost information needs of users of the cost statements. In this context, it is reasonable for the cost auditor to assume that users:
 - a) Have a reasonable knowledge of business and economic activities and cost accounting and a willingness to study the information in the cost statements with reasonable diligence;
 - b) Understand that cost statements are prepared, presented and audited to levels of materiality;
 - c) Recognize the uncertainties inherent in the measurement of costs based on the use of estimates, judgment and the consideration of event taken place during the audit period ; and



- d) Make reasonable decisions on the basis of the information in the cost statements.
- iv) The concept of materiality is applied by the cost auditor both in planning and performing the cost audit, and in evaluating the effect of identified misstatements on the cost statements and in forming the opinion in the cost auditor's report. (Ref: Para. 6.1 to 6.3)
- v) In planning the audit, the cost auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:
 - a) Determining the nature, timing and extent of risk assessment procedures;
 - b) Identifying and assessing the risks of material misstatement; and
 - c) Determining the nature, timing and extent of further cost audit procedures.

The materiality, determined when planning the audit, does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the cost auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the cost auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the cost statements.

2. Objective

The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the cost audit

3. Scope

This standard deals with the cost auditor's responsibility to apply the concept of materiality in planning and performing audit of cost statements, cost records and other related documents. This standard explains how materiality is applied in evaluating the effect of identified misstatement on the cost audit and of uncorrected misstatement, if any, on the cost statements, cost records and other related documents.

4. Definitions

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

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or



legal form, when such an examination is conducted with a view to expressing an opinion thereon.

- 4.2 Audit Documentation:** *Audit Documentation means the records, in physical or electronic form, including working papers prepared by and for, or obtained and retained by the Cost auditor, in connection with the performance of the audit*
- 4.3 Audit Partner:** *Audit partner means the partner in the firm who is a member of the Institute of Cost Accountants of India and is in full time practice and is responsible for the audit and its performance, and for the report that is issued on behalf of the firm, and who, where required, has appropriate authority from a professional, legal or regulatory body.*
- 4.4 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.*
- 4.5 Audit Team:** *Audit team means all personnel performing an engagement, including any experts engaged by the firm in connection with that engagement.*
- 4.6 Auditor:** *Auditor is used to refer to the person or persons conducting the audit, usually the audit partner or other member of the audit team, or, as applicable the firm. Auditor includes Cost Auditor.*



- 4.7 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.*
- 4.8 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.*
- 4.9 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.*
- 4.10 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.*
- 4.11 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 Performance Materiality:** means materiality level or levels set by the cost auditor for the cost statements as a whole or for particular items of cost, to reduce the audit risk.
- 4.13 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.
- 4.14 Overall Audit Strategy:** Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

5. Requirements

Determining Materiality and Performance Materiality when Planning the Cost Audit

- 5.1** While establishing the overall audit strategy, the cost auditor shall determine materiality level for the cost statements as a whole that is appropriate depending on the nature of industry, scale of operations and the regulatory requirements. (Refer 6.4)
- 5.2** The cost auditor shall evaluate whether for one or more items of cost, there is substantial likelihood that misstatements of lesser than the materiality level established for the cost statements as a whole may influence the decision of users, the cost auditor shall also establish separate materiality level or levels for those particular items of cost. (Refer 6.5 to 6.11)
- 5.3** The cost auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further cost audit procedures. (Refer 6.12)

Revision as the Cost Audit Progresses

- 5.4** The cost auditor shall revise the established materiality level or levels for the cost statements as a whole (and, if applicable, the materiality level or levels for particular items of cost in the event of becoming aware during the audit that would have caused the cost auditor to have determined different level or levels initially. (Refer 6.13)



- 5.5** *If the cost auditor concludes that a lower materiality for the cost statements as a whole (and, if applicable, materiality level or levels for items of cost) than initially determined is appropriate, the cost auditor shall determine:*
- (i) whether it is necessary to revise performance materiality, and;*
 - (ii) whether the nature, timing and extent of the further cost audit procedures remain appropriate. (Refer 6.13)*

Documentation

- 5.6** *The cost auditor shall include in the audit documentation the following factors considered in the cost auditor's determination of:*
- a) Overall materiality level or levels for cost statement as a whole;*
 - b) If applicable, the materiality level or levels specifically determined for the particulars item of cost;*
 - c) Performance materiality; and*
 - d) Any revisions to the above mentioned factors (a-c) as the cost audit progressed.*

6. Application Guidance

Materiality in the Context of Cost Audit

6.1 The overall objectives of the cost auditor are to obtain reasonable assurance about whether the cost statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the cost auditor to express an opinion on whether the cost statements are prepared, in all material respects, in accordance with an applicable cost reporting framework, and to report on the cost statements, and communicate in accordance with the cost auditor's findings. The cost auditor shall obtain reasonable assurance by obtaining sufficient appropriate audit evidence to reduce the audit risk to an acceptably low level. [Refer 1(iv)]

6.2 Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion when the cost statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. [Refer 1(iv)]

6.3 Materiality and audit risk are considered throughout the cost audit, in particular, when;

- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further cost audit procedures; and



- (c) Evaluating the effect of uncorrected misstatements, if any, on the cost statements, cost records and related documents and in forming the opinion in the cost auditor's report. [Refer 1(iv)]

Determining Materiality and Performance Materiality when Planning the Cost Audit

Consideration Specific to Regulated Entities

6.4 In the case of a regulated entity, the regulators are often the primary users of its cost statements. Furthermore, the cost statements may be used to make decisions other than costs related decisions. The determination of materiality for the cost statements as a whole (and, if applicable, materiality level or levels for particular items of cost) in an audit of the cost statements of a regulated entity is therefore influenced by law, regulation or other authority, and by the cost information needs of regulators, the government and other authority, in relation to its policies and programs. (Refer 5.1)

Use of Benchmark in Determining Materiality for the Cost Statement as a Whole

6.5 Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the cost statements as a whole. Factors that may affect the identification of an appropriate benchmark include:

- (a) The elements of the cost statement (for example, capacity, nature of products or services, cost of production or operation, cost of sales);
- (b) Whether there are items on which the attention of the users of the particular entity's cost statements tends to be focused (for example for the purpose of evaluating cost statements users may tend to focus on valuation of material cost, utilities cost, primary packing material cost, apportionment of overheads);
- (c) The nature of the entity, where the entity is in its life cycle, and the industry and regulatory or non-regulatory sector in which the entity operates;
- (d) The entity's Production or operational structure, production facilities, production units or locations of its operation (for example, an entity is a manufacturing a single product on multi locations or manufacturing multi products on a single location, number of shifts, number of cities or locations of rendering services);
- (e) The relative volatility of the benchmark (Refer 5.2)

6.6 Example of benchmarks that may be appropriate, depending on the circumstances of the entity, include types of cost such as materials cost, utilities cost, cost of production or operation, cost of goods sold. Materials cost or cost of production benchmark is often used by heavy industries. When benchmarks percentage from continuing operation is volatile, other benchmarks may be more appropriate, such as cost of goods sold. (Refer 5.2)



6.7 In relation to chosen benchmark, relevant data ordinarily include previous year's cost records, cost statement, cost reporting framework, the period –to- date cost information, and budgets or forecast for the current period, adjusted for significant changes in the circumstances of the entity (for example a significant change in production process or operating process) and the relevant changes of condition in the industry, market, economic environment in which entity operates. For example, when, as a starting point, materiality for the cost statements as a whole is determined for a particular entity based on percentage of cost of production from continuing operations, circumstances that gives rise to an exceptional changes in such percentage may lead the cost auditor to conclude that materiality for the cost statements as a whole is more appropriately determined using cost of goods sold after absorption of overheads from continuing operations based on past year's performance. (Refer 5.2)

6.8 Materiality relates to the cost statements on which the cost auditor is reporting. Where the cost statements are prepared for a cost reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the cost reporting period, materiality relates to the cost statements prepared for that cost reporting period. (Refer 5.2)

6.9 Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to cost of production from continuing operations will normally be higher than a percentage applied to cost of goods sold. For example, the cost auditor may consider fifty percent of mark up of cost of production from continuing operations to be appropriate for a manufacturing industry, while the auditor may consider seventy five percent of cost of goods sold or total expenses to be appropriate for a service industry. Higher or lower percentages, however, may be deemed appropriate in the circumstances. (Refer 5.2)

Materiality level or Levels for Items of Cost or Disclosures

6.10 Factors that may indicate the existence of one or more particular items of cost or disclosures for which misstatements of lesser amounts than materiality for the cost statements as a whole could reasonably be expected to influence the decisions of users taken on the basis of the cost statements include the following:

- a) Whether law, regulation or the applicable cost reporting framework affect users' expectations regarding the measurement of costs or disclosure of certain items of cost (for example, cost of production of goods captively consumed, related party transactions).



- b) The key disclosures in relation to the industry in which the entity operates (for example, power generation cost in power generation company, surveys and drilling costs in petroleum industry).
- c) Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the cost statements (for example, land acquisition cost in construction industry). (Refer 5.2)

6.11 In considering whether, in the specific circumstances of the entity, such items of cost exists, the cost auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management. (Refer 5.2)

Performance Materiality

6.12 Planning the cost audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the cost statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the cost statements exceeds materiality for the cost statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular item of cost is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular item of cost or disclosure exceeds the materiality level for that particular item of cost or disclosure. The determination of performance materiality is not a simple mathematical calculation and involves the exercise of professional judgment. It is affected by the cost auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous year's cost audits and thereby the cost auditor's expectations in relation to misstatements in the current period. (Refer 5.3)

Revision as the Cost Audit Progresses

6.13 Materiality for the cost statements as a whole (and, if applicable, the materiality level or levels for particular items of cost) may need to be revised as a result of a change in circumstances that occurred during the cost audit. For example, during the course of cost audit, if it appears that cost of goods sold is likely to be substantially different from as anticipated to determine materiality for the cost statements as a whole, the cost auditor revises that materiality. (Refer 5.4 – 5.6)

7. Effective Date

This Standard is effective for audits on or after _____.



8. Statement of Modifications: Modifications to ISA 320, “Materiality in Planning and Performing an Audit”

The ISAs have been developed with the focus on Auditing of Financial Statements, while the focus of SCAs is on Auditing of Cost Statements. Hence, certain changes are globally introduced in the SCAs. These are:

- 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.;
- Corresponding modification in definitions of certain similar terms; examples used; and in the Application Guidance;
- Unlike the practice followed in ISAs, definitions of all ‘terms’ relevant to this SCA are reproduced.

Addition:

- Paragraph on Considerations Specific to Regulated Entities (Paragraph 6.4) has been added to give effect to prevailing regulatory framework for audit of cost statements in Indian context.

Deletions:

- Paragraphs on considerations Specific to Small Entities and Public Sector Entities have been deleted as those are not relevant to the Audit of Cost Statements in Indian context.