



SCA-117
Standard on Cost Auditing
“Identifying and Assessing the Risks of Material Misstatement”
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The following is the **Standard on Cost Auditing (SCA-----)** on “**Identifying and Assessing the Risks of Material Misstatement**”. 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

- 1.1 An understanding of the entity and its control activities relevant to audit, including internal control, establishes a frame of reference within which the cost auditor plans the audit and exercises professional judgment throughout the audit, particularly when assessing risks of material misstatement, determining materiality, considering the appropriateness of the selection and application of cost accounting policies, identifying areas where special audit consideration may be necessary (for example related party transactions), responding to the assessed risks of material misstatement, obtain sufficient appropriate audit evidence, etc.
- 1.2 This standard describes the audit procedures to identify and assess the risk of material misstatements and control activities relevant to the cost audit so that information obtained by performing such risk assessment procedures and related activities may be used by the cost auditor to determine the appropriate audit evidence to support assessments of the risks of material misstatement.

2. Objective

The objective of this standard is to enable the cost auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the cost statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

3. Scope

This Standard deals with the cost auditor’s responsibility to identify and assess the risks of material misstatement in the cost statements, through risk assessment procedure and related activities, including the entity’s internal control.

4. Definitions

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

- 4.1. ***Analytical Procedures: means evaluation of cost information through analysis of possible relationship among both cost and non-cost data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.***
- 4.2. ***Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of***



potential misstatements that may occur.

- 4.3. 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.*
- 4.4. Audit Evidence:** *Information used by the cost auditor in arriving at the conclusions on which the cost auditor's opinion is based. Audit evidence includes both information contained in the cost accounting records underlying the cost statements and all other related information.*
- 4.5. Business risk –** *A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.*
- 4.6. 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.*
- 4.7. 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.*
- 4.8. Cost Reporting Framework** *means the framework adopted by the management and, where appropriate, by those charged with governance, in the preparation of the cost statements that is acceptable in view of the nature of the entity and the objective of the cost report, or that is required by law or regulation.*
- 4.9. Cost Statements:** *Cost Statements, in relation to an entity, includes plant-wise, factory wise or service Centre wise*
- (i) quantitative details of capacity, production, trade purchases, sales and stock;*
 - (ii) quantitative, rates and value details of consumption of materials, utilities, and other inputs;*
 - (iii) cost sheet showing element-wise, total as well as per unit, 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) reconciliation of indirect taxes showing details of total clearance of goods/services, assessable value, duties/ taxes paid, CENVAT or VAT or Service Tax credit utilized, duties/taxes recovered and interest / penalty paid;*
- (vi) statement of value addition and distribution of earnings;*
- (vii) details of purchases and sales of goods and services with related parties showing transfer price vis-à-vis normal price; and*
- (viii) any explanatory note annexed to, or forming part of, any document referred to in (i) to (vii) above.*

4.10. Internal control: *The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.*

4.11. 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 financial statement and assertion levels including items of cost, cost heads and disclosure thereof.*

4.12. Significant risk: *An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.*

5. Requirements

Risk Assessment Procedures and Related Activities

5.1. *The cost auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the cost statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. 6.1 – 6.5)*

5.2. *The risk assessment procedures shall include the following:-*

- (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the cost auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. 6.6 - 6.11)*
- (b) Analytical procedures. (Ref: Para. 6.12 - 6.14)*
- (c) Observation and inspection. (Ref: Para. 6.16)*



- 5.3. The cost auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.**
- 5.4. If the audit partner has performed other engagements for the entity, the audit partner shall consider whether information obtained is relevant to identifying risks of material misstatement.**
- 5.5. Where the cost auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. 6.17 - 6.18)**
- 5.6. The audit partner and other key audit team members shall discuss the susceptibility of the entity's cost statements to material misstatement, and the application of the applicable cost reporting framework to the entity's facts and circumstances. The audit partner shall determine which matters are to be communicated to audit team members not involved in the discussion. (Ref: Para. 6.19 – 6.21)**

The entity's risk assessment process

- 5.7. The cost auditor shall obtain an understanding of whether the entity has a process for:**
- (a) Identifying business risks relevant to cost reporting objectives;**
 - (b) Estimating the significance of the risks;**
 - (c) Assessing the likelihood of their occurrence; and**
 - (d) Deciding about actions to address those risks.**
- 5.8. If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the cost auditor shall obtain an understanding of it, and the results thereof. If the cost auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the cost auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.**
- 5.9. If the entity has not established such a process or has an ad hoc process, the cost auditor shall discuss with management whether business risks relevant to cost reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in**



the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. 6.37)

Control activities relevant to the audit (Ref: Appendix I)

- 5.10. The cost auditor shall obtain an understanding of control activities relevant to the cost audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, and disclosure in the cost statements or to every assertion relevant to them. (Ref: Para. 6.40 – 6.44)***
- 5.11. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. 6.45 – 6.47)***

Monitoring of controls

- 5.12. The cost auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to cost reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. 6.48 – 6.49)***
- 5.13. If the entity has an internal audit function, the cost auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. 6.51 – 6.53)***
- 5.14. The cost auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose.***

Identifying and Assessing the Risks of Material Misstatement

- 5.15. The cost auditor shall identify and assess the risks of material misstatement at:***
- (a) the cost statement level; and (Ref: Para. 6.54 – 6.55)***
 - (b) the assertion level for classes of transaction, cost head and disclosures, (Ref: Para. 6.56 – 6.59)***

To provide a basis for designing and performing further audit procedures.

- 5.16. For this purpose, the cost auditor shall:***
- (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, cost head and disclosures in the cost statements; (Ref: Para. 6.60 – 6.61)***



- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the cost statements as a whole and potentially affect many assertions;**
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the cost auditor intends to test; and (Ref: Para. 6.62 – 6.64)**
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.**

Risks that Require Special Audit Consideration

- 5.17. As part of the risk assessment, the cost auditor shall determine whether any of the risks identified are, in the cost auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.**
- 5.18. In exercising judgment as to which risks are significant risks, the cost auditor shall consider at least the following:**
- (a) Whether the risk is a risk of fraud;**
 - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;**
 - (c) The complexity of transactions;**
 - (d) Whether the risk involves significant transactions with related parties;**
 - (e) The degree of subjectivity in the measurement of cost information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and**
 - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. 6.65 - 6.67)**
- 5.19. If the cost auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. 6.68 – 6.69)**

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

- 5.20. In respect of some risks, the cost auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions and cost heads, the characteristics of which**



often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. 6.70)

Revision of Risk Assessment

5.21. The cost auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the cost auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the cost auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. 6.71)

Documentation

5.22. The cost auditor shall include in the audit documentation:

- (a) The discussion among the audit team, and the significant decisions reached;***
- (b) The identified and assessed risks of material misstatement at the cost statement level and at the assertion level; and***
- (c) The risks identified, and related controls about which the cost auditor has obtained an understanding. (Ref: Para. 6.72 – 6.75)***

6. Application Guidance

Risk Assessment Procedures and Related Activities (Ref: Para. 5.1)

- 6.1. Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when
- Assessing risks of material misstatement of the cost statements;
 - Determining materiality ;
 - Considering the appropriateness of the selection and application of cost accounting policies, and the adequacy of cost statement disclosures;
 - Identifying areas where special audit consideration may be necessary, for example, abnormal losses, lower yields, higher wastages, higher utilities consumption, related party transactions, etc.
 - Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and



- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- 6.2. Information obtained by performing risk assessment procedures and related activities may be used by the cost auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- 6.3. The cost auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this standard. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- 6.4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this standard. However, the significance of fraud is such that further requirements and guidance are included separately in another standard in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.
- 6.5. Although the cost auditor is required to perform all the risk assessment procedures described in paragraph 5.2, the auditor is not required to perform all of them for each aspect of that understanding.

Inquiries of Management, the Internal Audit Function and Others within the Entity (Ref: Para. 5.2(a))

- 6.6. Much of the information obtained by the cost auditor's inquiries is from management and those responsible for cost reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- 6.7. The cost auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the cost auditor to understand the environment in which the cost statements are prepared.



- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the cost auditor to evaluate the appropriateness of the selection and application of certain cost accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect cost reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

Inquiries of the Internal Audit Function

- 6.8. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the cost auditor in identifying and assessing risks of material misstatement at the cost statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the cost auditor's risk assessments or other aspects of the audit. The cost auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed. Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.
- 6.9. If, based on responses to the cost auditor's inquiries, it appears that there are findings that may be relevant to the entity's cost reporting and cost audit, the auditor may consider it appropriate to read related reports of the internal audit function.
- 6.10. In addition, if the internal audit function provides information to the cost auditor regarding any actual, suspected or alleged fraud, the cost auditor takes this into account in accordance to the SCA on the auditor's identification of risk of material misstatement due to fraud.
- 6.11. Appropriate individuals within the internal audit function with whom inquiries are



made are those who, in the cost auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Analytical Procedures (Ref: Para. 5.2(b))

- 6.12. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the cost auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both costing and non-costing information. For example the relationship between overheads absorption and capacity utilisation
- 6.13. Analytical procedures may help identify the existence of unusual or abnormal transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- 6.14. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of such analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the cost auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

- 6.15. Some smaller entities may not have interim or monthly costing information that can be used for purposes of analytical procedures. In these circumstances, although the cost auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's cost statements is available.

Observation and Inspection (Ref: Para. 5.2(c))

- 6.16. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:



- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim cost statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 5.5)

6.17. The cost auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the cost auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

6.18. The cost auditor is required to determine whether information obtained in prior periods remains relevant, if the cost auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information; the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Audit team (Ref: Para.5.6)

6.19. The discussion among the audit team about the susceptibility of the entity's cost statements to material misstatement:

- Provides an opportunity for more experienced audit team members, including the audit partner, to share their insights based on their knowledge of the entity.
- Allows the audit team members to exchange information about the business risks to which the entity is subject and about how and where the cost statements might be susceptible to material misstatement due to fraud or error.
- Assists the audit team members to gain a better understanding of the potential for material misstatement of the cost statements in the specific areas assigned to them,



and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

- Provides a basis upon which audit team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

6.20. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the audit team to be informed of all of the decisions reached in the discussion. The audit partner may discuss matters with key members of the audit team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the audit team. A communications plan, agreed by the audit partner, may be useful.

Considerations Specific to Smaller Entities

6.21. Many small cost audits are carried out entirely by the audit partner (who may be a sole practitioner). In such situations, it is the audit partner who, having personally conducted the planning of the cost audit, would be responsible for considering the susceptibility of the entity's cost statements to material misstatement due to fraud or error.

Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

6.22. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

6.23. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and



to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

- An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

6.24. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

6.25. However, IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

6.26. Manual elements in internal control may be more suitable where judgment and



discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

6.27. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

6.28. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

6.29. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

6.30. Factors relevant to the cost auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.



- The nature of the entity's business, including its organization and ownership characteristics.
 - The diversity and complexity of the entity's operations.
 - Applicable legal and regulatory requirements.
 - The circumstances and the applicable component of internal control.
 - The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
 - Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.
- 6.31. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the cost auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.
- 6.32. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Nature and Extent of the Understanding of Relevant Controls

- 6.33. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may.

Audit Evidence for Elements of the Control Environment

- 6.34. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behaviour.



The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

- 6.35. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.
- 6.36. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 5.9)

- 6.37. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the cost auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations Specific to Smaller Entities

- 6.38. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.
- 6.39. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities Relevant to the Audit (Ref: Para. 5.10)

- 6.40. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:
- Authorization.
 - Performance reviews.
 - Information processing.
 - Physical controls.



- Segregation of duties.

6.41. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 5.19 and 5.20, respectively; or
- Those that are considered to be relevant in the judgment of the cost auditor.

6.42. The cost auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

6.43. The cost auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

6.44. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising from IT (Ref: Para. 5.11)

6.45. The use of IT affects the way that control activities are implemented. From the cost auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

6.46. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mainframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.
- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.



They are generally implemented to deal with the risks.

- 6.47. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial and cost data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 5.12)

- 6.48. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- 6.49. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

- 6.50. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

The Entity's Internal Audit Function (Ref: Para. 5.13)

- 6.51. If the entity has an internal audit function, obtaining an understanding of that function contributes to the cost auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over cost reporting. This understanding, together with the information obtained from the auditor's inquiries may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.
- 6.52. The activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management



accounting information that are designed to contribute to how the entity prevents or detects misstatements.

- 6.53. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the cost auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. It help the cost auditor in planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the cost auditor's attention. The cost auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Cost Statement Level (Ref: Para. 5.15(a))

- 6.54. Risks of material misstatement at the cost statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, cost head or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Cost statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.
- 6.55. The cost auditor's understanding of internal control may raise doubts about the auditability of an entity's cost statements. For example:
- Concerns about the integrity of the entity's management may be so serious as to cause the cost auditor to conclude that the risk of management misrepresentation in the cost statements is such that an audit cannot be conducted.
 - Concerns about the condition and reliability of an entity's records may cause the cost auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the cost statements.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 5.15(b))

- 6.56. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration



directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the cost auditor may conclude that the identified risks relate more pervasively to the cost statements as a whole and potentially affect many assertions.

The Use of Assertions

- 6.57. In representing that the cost statements are in accordance with the applicable cost reporting framework, management implicitly or explicitly makes assertions regarding the measurement, classification, allocation, apportionment and absorption of cost; presentation and disclosure of the various elements of cost statements and related disclosures.
- 6.58. Assertions used by the cost auditor to consider the different types of potential misstatements that may occur fall into the following categories and may take the following forms:
- (a) Assertions about classes of transactions and events for the period under audit:
 - (i) Occurrence—costs that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness—costs that should have been recorded have been recorded.
 - (iii) Accuracy—amounts and other data relating to recorded costs have been recorded appropriately.
 - (iv) Cutoff—costs have been recorded in the correct accounting period.
 - (v) Classification—costs have been recorded in the proper cost centre.
 - (b) Assertions about presentation and disclosure:
 - (i) Occurrence and rights and obligations—disclosed transactions, costs and other matters have occurred and pertain to the entity.
 - (ii) Completeness—all disclosures that should have been included in the cost statements have been included.
 - (iii) Classification and understandability—cost and financial information is appropriately presented and described, and disclosures are clearly expressed.
 - (iv) Accuracy and valuation—financial, cost and other information are disclosed fairly and at appropriate amounts.
- 6.59. The cost auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about cost transactions and events



with the assertions about cost elements.

Process of Identifying Risks of Material Misstatement (Ref: Para. 5.16(a))

- 6.60. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed.
- 6.61. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions (Ref: Para. 5.16(c))

- 6.62. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.
- 6.63. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transaction or cost head. For example, the control activities that an entity established to ensure that its personnel cost are properly accounted and recorded to the appropriate cost centres relate directly to the existence and completeness assertions.
- 6.64. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 5.18)

- 6.65. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of cost estimates for which there is significant measurement



uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

6.66. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

6.67. Risks of material misstatement may be greater for significant judgmental matters that require the development of costing estimates, arising from matters such as the following:

- Cost Accounting principles for costing estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Understanding Controls Related to Significant Risks (Ref: Para.5.19)

6.68. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

For example where there are one off events of major break down or shut down, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts, whether an assessment has been made of the potential effect, and how the abnormal cost on account of this is to be calculated and disclosed in the cost statements.

6.69. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure



by management to implement such controls is an indicator of a significant deficiency in internal control.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para.5.20)

- 6.70. Where routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:
- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
 - The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

Revision of Risk Assessment (Ref: Para.5.21)

- 6.71. During the audit, information may come to the cost auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the cost auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the cost auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements.

Documentation (Ref: Para. 5.22)

- 6.72. The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.
- 6.73. For entities that have uncomplicated businesses and processes relevant to cost reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the cost auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the cost auditor include those on which the auditor based the assessment of the risks of material misstatement.



- 6.74. The extent of documentation may also reflect the experience and capabilities of the members of the audit team. An audit undertaken by an audit team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.
- 6.75. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

7. Effective Date

This standard is to be applied for the period commencing on or after

8. *Statement of Modifications: Modifications to ISA 315, "Identifying and Assessing the Risks of Material Misstatement"*

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.

Some of the provisions of ISA mentioned below, though have already been included in **CAAS 104-Cost Auditing Standard on Knowledge of Business, its Processes and the Business Environment** hence are deleted in proposed SCA for better understanding and clarity:

Para 11, 12, 13, 14, 18, A24, A35, A38, A43, A45, A119

Deletion

- Paragraphs.(19, A8, A13, A25-A34, A36-A37, A39-A42, A44, A46-A59, A70, A72, A74-A77, A80-A85, A89-A94, A98, A101, A110-A115, A117, A121, A126, A135, A136, A138, A140) have been deleted as those are not relevant to the Audit of Cost Statements in Indian context.



Appendix 1

(Ref: Para. 4.10, 5.10 -5.14,)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4.3 and 5.10 – 5.14, as they relate to a cost statement audit.

Control Environment

2. The control environment encompasses the following elements:

- (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior is the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
- (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
- (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
- (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward cost reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
- (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size



and the nature of its activities.

- (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.
- (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For cost reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of cost statements in accordance with the entity's applicable cost reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the cost statements.

4. Risks relevant to reliable cost reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the cost statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.



- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant to Cost Reporting, and Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

6. The information system relevant to financial and cost reporting objectives encompasses methods and records that:

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification, allocation, apportionment and absorption of all cost items in cost reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the cost statements.
- Determine the time period in which transactions occurred to permit accounting of cost in the proper accounting period.



- Present properly the cost statements and related disclosures.

7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial and cost reports.

8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over cost reporting, may take such forms as policy manuals, accounting and cost reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, standards, and prior period performance; relating different sets of data – operating or cost – to one another, together with determination/ analyses of the variances and investigative and corrective actions; comparing internal data with external sources of information (job work from or to third party); and review of functional or activity performance.
- *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing cost control accounts, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change data or records without leaving an audit trail.
- *Physical controls.* Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorization for access to computer programs and data files.



- The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of audit statement preparation.

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of reconciliations of cost and financial results are not monitored, personnel are likely to stop preparing them.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.



Appendix 2

(Ref: Para. 6.59)

Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets.
- Operations that are subject to a high degree of complex regulations.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of resources, manpower and credit facility.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold or plant and facilities likely to be leased.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting, recording and apportionment of cost and reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial and cost reporting.
- Inquiries into the entity's operations or cost reporting framework by regulatory or government bodies.



- Past misstatements, history of errors or significant adjustments at period end.
- Significant non-routine or non-systematic transactions including intercompany transactions and large cost transactions at period end.
- Cost transactions that are recorded based on management's intent, for example, allocation and apportionment of costs to unrelated products, wrong classification of expenses, items of cost and cost heads.
- Application of new techniques of costing.
- Cost measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including cost accounting estimates.
