



Exposure Draft
SCA- Standard on Cost Auditing
Related Parties
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The following is the **Standard on Cost Auditing on “Related Parties”**. 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 to assist the cost auditor in identifying and assessing the risks of material misstatement associated with related party relationship and transaction, and in designing cost audit procedures to respond to the assessed risk associated with such related party(s).

1.1 Nature of Related Party Relationships and Transactions

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the cost statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the cost statements than transactions with unrelated parties. For example:

- (i) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- (ii) Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- (iii) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

1.2 Responsibilities of the Cost Auditor

1.2.1 Because related parties are not independent of each other, many cost reporting frameworks establish accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the cost statements to understand their nature and actual or potential effects on the cost statements. Where the applicable cost reporting framework establishes such requirements, the cost auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity’s failure to appropriately account



for or disclose related party relationships, transactions or balances in accordance with the requirements of the cost reporting framework.

1.2.2 Even if the applicable cost reporting framework establishes minimal or no related party requirements, the cost auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the cost statements, insofar as they are affected by those relationships and transactions: (Ref: Para. 6.1)

- (i) Achieve a true and fair presentation (for true and fair presentation frameworks); or (Ref: Para. 6.2)
- (ii) Are not misleading (for compliance frameworks). (Ref: Para. 6.3)

1.2.3 In addition, an understanding of the entity's related party relationships and transactions is relevant to the cost auditor's evaluation of whether one or more fraud risk factors are present because fraud may be more easily committed through related parties.

1.2.4 Owing to the inherent limitations of an audit of cost statement, there is an unavoidable risk that some material misstatements of the cost statements may not be detected, even though the cost audit is properly planned and performed in accordance with the SCAs.

In the context of related parties, the potential effects of inherent limitations on the cost auditor's ability to detect material misstatements are greater for such reasons as the following:

- (a) Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable cost reporting framework does not establish related party requirements.
- (b) Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

1.2.5 Planning and performing an audit with professional skepticism is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this standard are designed to assist the cost auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

2. Objectives

The objective of this standard is to enable cost auditor:



2.1 Irrespective of whether the applicable cost reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(ii) To conclude, based on the audit evidence obtained, whether the cost statements, insofar as they are affected by those relationships and transactions:

(a) Achieve true & fair presentation (for true and fair presentation frameworks); or

(b) Are not misleading (for compliance frameworks); and

2.2 In addition, where the applicable cost reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the cost statements in accordance with the framework.

3. Scope

This Standard on Cost Auditing (SCA) deals with the cost auditor's responsibilities relating to related party relationships and transactions in an audit of cost statements. Specifically, it expands on how SCA are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

4. Definitions

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

4.1 Arm's length transaction – A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and reacting independently of each other and pursuing their own best interest.

4.2 Related party – A party that is either: (Ref: Para. 6.4-6.7)

(i) A related party as defined in the applicable law and regulations;

(ii) A related party as defined in the applicable cost reporting framework; or

(iii) Where the applicable cost reporting framework establishes minimal or no related party requirements;

(a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;



(b) Another entity over which the reporting entity has control/ voting power or significant influence, directly or indirectly through one or more intermediaries; or

(c) Another entity that is under common control with the reporting entity through having:

- 1. Common controlling ownership;**
- 2. Owners who are close family members; or**
- 3. Common key management.**

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

5. Requirements

Risk Assessment Procedures and Related Activities

5.1. As part of the risk assessment procedures and related activities that other SCAs require the cost auditor to perform during the audit, cost auditor shall perform the audit procedures and related activities set out in paragraphs 5.2-5.6 to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

Understanding the Entity's Related Party Relationships and Transactions

5.2 The engagement team discussion that SCAs require shall include specific consideration of the susceptibility of the cost statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. 6.8–6.9).

5.3 The cost auditor shall inquire of management regarding:

- (a) The identity of the entity's related parties, including changes from the prior period; (Ref: Para. 6.10–6.12)**
- (b) The nature of the relationships between the entity and these related parties; and**
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the type and business purpose of the transactions.**

5.4 The cost auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to: (Ref: Para. 6.13–6.18)



- (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable cost reporting framework;**
- (b) Authorize and approve significant transactions and arrangements with related parties; and (Ref: Para. 6.19)**
- (c) Authorize and approve significant transactions and arrangements outside the normal course of business.**

Maintaining Alertness for Related Party Information When Reviewing Cost Records and Other Related Documents

5.5 During the audit, the cost auditor shall remain alert, when inspecting cost records and other related documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the cost auditor. (Ref: Para. 6.20-6.22)

5.6 In particular, the cost auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the cost auditor:

- (a) Third party confirmations obtained as a part of auditor's procedures;**
- (b) Minutes of meetings of shareholders/ Board of Directors/ Committees and of those charged with governance; and**
- (c) Such other records or documents as the cost auditor considers necessary in the circumstances of the entity.**

5.7 If the cost auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures required by paragraph 5.4 or through other audit procedures, the cost auditor shall inquire of management about: (Ref: Para. 6.23-6.24)

- (a) The nature of these transactions; and (Ref: Para. 6.25)**
- (b) Whether related parties could be involved. (Ref: Para. 6.26)**

Sharing Related Party Information with the Audit Team

5.8 The cost auditor shall share relevant information obtained about the entity's related parties with the other members of the Audit team. (Ref: Para. 6.27)

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions



5.9 The cost auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the cost auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

5.10 If the cost auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the cost auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with other SCAs. (Ref: Para.6.28-6.29)

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

5.11 As part of the SCAs requirement that the cost auditor respond to assessed risks, the cost auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 5.12–5.15. (Ref: Para.6.30-6.33)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

5.12 If the cost auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the cost auditor, the cost auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

5.13 If the cost auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the cost auditor, the cost auditor shall:

(a) Promptly communicate the relevant information to the other members of the audit team; (Ref: Para.6.34)

(b) Where the applicable cost reporting framework establishes related party requirements:

(i) Request management to identify all transactions with the newly identified related parties for the cost auditor's further evaluation; and



- (ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;**
- (c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions; (Ref: Para. 6.35)**
- (d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the cost auditor, and perform additional audit procedures as necessary; and**
- (e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. (Ref: Para. 6.36)**

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

5.14 For significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the cost auditor's understanding of the entity and its environment and other information obtained during the cost audit, the cost auditor shall evaluate;

- (a) Inspect the underlying contracts or agreements, if any, and evaluate whether:**
 - (i) The business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent cost reporting or under valuation of transactions. (Refer 6.37-6.38)**
 - (ii) The terms of the transactions are consistent with management's explanations; and**
 - (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable cost reporting framework; and**
- (b) Obtain audit evidence that the transactions have been appropriately authorized and approved. (Ref: Para. 6.39–6.40)**

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to those prevailing in an Arm's Length Transaction

5.15 If management has made an assertion in the cost statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's



length transaction, the cost auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. 6.41-6.44)

Evaluation of the Cost Records and Other Related Disclosure of Identified Related Party Relationships and Transactions

5.16 In forming an opinion on the cost statements in accordance with SCAs the cost auditor shall evaluate: (Ref: Para. 6.45)

- (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable cost reporting framework; and (Ref: Para. 6.46)***
- (b) Whether the effects of the related party relationships and transactions:***
 - (i) Prevent the cost statements from achieving true & fair presentation (for true and fair presentation frameworks); or***
 - (ii) Cause the cost statements to be misleading (for compliance frameworks).***

Written Representations

5.17 Where the applicable cost reporting framework establishes related party requirements, the cost auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. 6.47–6.48)

- (a) They have disclosed to the cost auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and***
- (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.***

Communication with Those Charged with Governance

5.18 Unless all of those charged with governance are involved in managing the entity, the cost auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties. (Ref: Para. 6.49)

Documentation

5.19 The cost auditor shall include in the cost audit documentation: (Ref: Para. 6.50)



- (a) The names of the identified related parties and the nature of the related party relationships and transactions;**
- (b) The nature and extent of the audit procedures performed to comply with applicable legal and regulatory requirements.**

6. Application Guidance

Responsibilities of the Cost Auditor

Cost Reporting Frameworks That Establish Minimal Related Party Requirements (Ref: Para. 1.2.2)

6.1 An applicable cost reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in law and regulations, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions. The cost auditor is required to disclose all the substantial transactions set out in law and regulation.

True and Fair Presentation Frameworks (Ref: Para. 1.2.2(a))

6.2 In the context of a true and fair presentation framework, related party relationships and transactions may cause the cost statements to fail to achieve true and fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the cost statements. For instance, value of purchase and sale of raw materials, finished goods, rendering of services, utilization of plant services and technical know-how may not be achieved if these transactions with related parties are not at arm's length price.

Compliance Frameworks (Ref: Para. 1.2.2(b))

6.3 In the context of a compliance framework, whether related party relationships and transactions cause the cost statements to be misleading as discussed in SCAs depends upon the particular circumstances of the audit engagement. For example, even if non-disclosure of related party transactions in the cost statements is in compliance with the framework and applicable law or regulation, the cost statements could be misleading if the entity derives a very substantial portion of its revenue from transactions with related parties, and that fact is not disclosed. However, it will be extremely rare for the cost auditor to consider cost statements that are prepared and presented in accordance with a compliance framework.



Definition of a Related Party (Ref: Para. 4.2)

6.4 Many cost reporting frameworks discuss the concepts of control and significant influence. Although they may discuss these concepts using different terms, they generally explain that:

- (a) Control is the power to govern the operating policies of an entity so as to obtain benefits from its activities; and
- (b) Significant influence (which may be gained by share ownership, statute or agreement) is the power to participate in the operating policy decisions of an entity, but is not control over those policies.

6.5 The existence of the following relationships may indicate the presence of control or significant influence:

- (a) Direct or indirect equity holdings or other financial interests in the entity.
- (b) The entity's holdings of direct or indirect equity or other financial interests in other entities.
- (c) Being part of those charged with governance or key management (that is, those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
- (d) Being a close family member of any person referred to in subparagraph (c), and
- (e) Having a significant business relationship with any person referred to in sub para. (c).

Related Parties with Dominant Influence

6.6 Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs 6.29–6.30.

Special-Purpose Entities as Related Parties

6.7 In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

Risk Assessment Procedures and Related Activities

Risks of Material Misstatement Associated with Related Party Relationships and Transactions
Understanding the Entity's Related Party Relationships and Transactions Discussion among the Audit Team (Ref: Para. 5.2)

6.8 Matters that may be addressed in the discussion among the audit team include:



- (a) The nature and extent of the entity's relationships and transactions with related parties; (for example, the auditor's record of identified related parties updated after each audit).
- (b) An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions;
- (c) The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the cost auditor, for example, a complex organizational structure, use of special-purpose entities etc.;
- (d) The records or documents that may indicate the existence of related party relationships or transactions;
- (e) The importance that management and those charged with governance attach to the identification, appropriate accounting for, and related disclosure of related party relationships and transactions (if the applicable cost reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

6.9 In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- (a) How special-purpose entities controlled by management might be used to facilitate pricing management.
- (b) How transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriations of the entity's plant facilities and resources.

The Identity of the Entity's Related Parties (Ref: Para. 5.3(a))

6.10 Where the applicable cost reporting framework establishes related party requirements, information regarding the identity of the entity's related parties is likely to be readily available to management because the entity's information systems will need to record, process and summarize related party relationships and transactions to enable the entity to meet the accounting and disclosure requirements of the framework. Management is therefore likely to have a comprehensive list of related parties and changes from the prior period. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the cost auditor's record of related parties noted in previous audits.

6.11 However, where the framework does not establish related party requirements, the entity may not have such information systems in place. Under such circumstances, it is possible



that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 5.3 still applies because management may be aware of parties that meet the related party definition set out in applicable law and regulation. In such a case, however, the cost auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the cost auditor's risk assessment procedures and related activities performed in accordance with other SCAs to obtain information regarding:

- (a) The entity's ownership and governance structures;
- (b) The types of investments that the entity is making and plans to make; and
- (c) The way the entity is financed.

In the particular case of common control relationships, as management is more likely to be aware of such relationships if they have economic significance to the entity, the cost auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties.

6.12 The cost auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the audit engagement acceptance or continuance process.

The Entity's Controls over Related Party Relationships and Transactions (Ref: Para. 5.4)

6.13 Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:

- (a) Those charged with governance;
- (b) Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- (c) Internal Audit Function;
- (d) Auditors;
- (e) In-house legal counsel; and
- (f) The chief ethics / vigilance officer or equivalent person.

6.14 The cost audit is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have



responsibility for the preparation of the cost statements in accordance with the applicable cost reporting framework, including where relevant their true and fair presentation, and for such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of cost statements that are free from material misstatement, whether due to fraud or error. Accordingly, where the framework establishes related party requirements, the preparation of the cost statements requires management, with oversight from those charged with governance, to design, implement and maintain adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the reporting framework. In their oversight role, those charged with governance monitor how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in their oversight role, obtain information from management to enable them to understand the nature and business rationale of the entity's related party relationships and transactions.

6.15 In meeting the SCAs requirement to obtain an understanding of the control environment, the cost auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- (a) Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- (b) Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- (c) The assignment of responsibilities within the entity for identifying, recording, summarizing and disclosing related party transactions.
- (d) Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions.
- (e) Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- (f) Periodic reviews by internal Auditors, where applicable.



- (g) Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- (h) The existence of whistle-blowing policies and procedures, where applicable.

6.16 Controls over related party relationships and transactions within some entities may be deficient or non-existent for a number of reasons, the cost auditor shall evaluate:

- (a) The low importance attached by management to identifying and disclosing related party relationships and transactions.
- (b) The lack of appropriate oversight by those charged with governance.
- (c) An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive, for example, the existence of transactions involving family members of management.
- (d) An insufficient understanding by management of the related party requirements of the applicable cost reporting framework.
- (e) The absence of disclosure requirements under the applicable cost reporting framework.

Where such controls are ineffective or non-existent, the cost auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. If this were the case consider the implications for the cost audit, including the opinion in the cost auditor's report.

6.17 Fraudulent cost reporting often involves management override of controls that otherwise may appear to be operating effectively. The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by:

- (a) Directing the entity, against its interests, to conclude transactions for the benefit of these parties, or
- (b) Colluding with such parties or controlling their actions. Examples of possible fraud include:
 - (i) Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
 - (ii) Fraudulently organizing the transfer of resources and facilities from or to management or others at amounts significantly above or below arm's length price.



- (iii) Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the performance of the entity.

Considerations specific to smaller entities

6.18 Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions. An owner may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions. For such entities, the Cost Auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

Authorization and approval of significant transactions and arrangements (Ref: Para. 5.4(b))

6.19 Authorization involves the granting of permission by a party or parties with the appropriate authority (whether management, those charged with governance or the entity's shareholders) for the entity to enter into specific transactions in accordance with pre-determined criteria, whether judgmental or not. Approval involves those parties' acceptance of the transactions the entity has entered into as having satisfied the criteria on which authorization was granted. Examples of controls the entity may have established to authorize and approve significant transactions and arrangements with related parties or significant transactions and arrangements outside the normal course of business include:

- (a) Monitoring controls to identify such transactions and arrangements for authorization and approval.
- (b) Approval of the terms and conditions of the transactions and arrangements by management, those charged with governance.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

Records or Documents That the Cost Auditor May Inspect (Refer 5.5)

6.20 During the cost audit, the Cost Auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- (a) Third-party confirmations obtained by the cost auditor
- (b) Entity indirect tax returns.
- (c) Information supplied by the entity to regulatory authorities.



- (d) Statements of conflicts of interest from management and those charged with governance.
- (e) Contracts and agreements with key management or those charged with governance.
- (f) Significant contracts and agreements not in the entity's normal course of business.
- (g) Specific invoices and correspondence from the entity's professional advisors.
- (h) Significant contracts re-negotiated by the entity during the period.
- (i) Internal Auditors' reports.
- (j) Documents associated with the entity's filings with a securities regulator.

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions (Ref: Para. 5.5)

6.21 An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- (a) The establishment of a business relationship through appropriate vehicles or structures;
- (b) The conduct of certain types of transactions under specific terms and conditions;
- (c) The provision of designated services or support.

6.22 Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the cost auditor include:

- (a) Participation in unincorporated partnerships with other parties.
- (b) Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- (c) Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 5.7)

6.23 Obtaining further information on significant transactions outside the entity's normal course of business enables the cost auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable cost reporting framework establishes related party requirements, to identify the risks of material misstatement.

6.24 Examples of transactions outside the entity's normal course of business may include:

- (a) The leasing of plant facilities or the rendering of management services by the entity to another party if no consideration is exchanged.



- (b) Sales transactions with unusually large discounts or returns.
- (c) Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- (d) Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business (Ref: Para. 5.7(a))

6.25 Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

Inquiring into whether related parties could be involved (Ref: Para. 5.7(b))

6.26 A related party could be involved in a significant transaction outside the entity's normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary. Such influence may indicate the presence of a fraud risk factor.

Sharing Related Party Information with the Audit Team (Ref: Para. 5.8)

6.27 Relevant related party information that may be shared among the Audit team members includes, for example:

- (a) The identity of the entity's related parties.
- (b) The nature of the related party relationships and transactions.
- (c) Significant or complex related party relationships or transactions that may require special audit consideration, in particular transactions in which management or those charged with governance are involved.

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

Fraud Risk Factors Associated with a Related Party with Dominant Influence (Ref: Para. 5.10)

6.28 Domination of management by a single person or small group of persons without compensating controls is a fraud risk factor. Indicators of dominant influence exerted by a related party include:

- (a) The related party has vetoed significant business decisions taken by management or those charged with governance.
- (b) Significant transactions are referred to the related party for final approval.
- (c) There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.



- (d) Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

Dominant influence may also exist in some cases if the related party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

6.29 In the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud. For example:

- (a) An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the related party's purposes.
- (b) The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the related party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- (c) Evidence of the related party's excessive participation in or preoccupation with the selection of cost accounting policies or the determination of significant cost estimates may suggest the possibility of fraudulent cost reporting.

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions (Ref: Para. 5.11)

6.30 The nature, timing and extent of the further cost audit procedures that the cost auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity.

6.31 Examples of substantive audit procedures that the cost auditor may perform when the cost auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable cost reporting framework (whether due to fraud or error) include:

- (a) Confirming or discussing specific aspects of the transactions with intermediaries or third parties, where practicable and not prohibited by law, regulation or ethical rules.
- (b) Confirming the purposes, specific terms or amounts of the transactions with the related parties (this audit procedure may be less effective where the cost auditor judges that the entity is likely to influence the related parties in their responses to the cost auditor).



- (c) Where applicable, reading the cost statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' records.

6.32 If the cost auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the cost auditor may, in addition to the general requirements of SCAs, perform cost audit procedures such as the following to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive audit procedures:

- (a) Inquiries of, and discussion with, management and those charged with governance.
- (b) Inquiries of the related party.
- (c) Inspection of significant contracts with the related party.
- (d) Appropriate background research, such as through the Internet or specific external business information databases.
- (e) Review of employee whistle-blowing reports where these are retained.

6.33 Depending upon the results of the cost auditor's risk assessment procedures, the cost auditor may consider it appropriate to obtain audit evidence without testing the entity's controls over related party relationships and transactions. In some circumstances, however, it may not be possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the cost auditor may determine that it is not possible to design effective substantive cost audit procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such a case, in meeting the SCAs requirement to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, the cost auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.



Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

Communicating Newly Identified Related Party Information to the Audit Team (Ref: Para. 5.13 (a))

6.34 Communicating promptly any newly identified related parties to the other members of the audit team assists them in determining whether this information affects the results of, and conclusions drawn from, risk assessment procedures already performed, including whether the risks of material misstatement need to be reassessed.

Substantive Procedures Relating to Newly Identified Related Parties or Significant Related Party Transactions (Ref: Para. 5.13(c))

6.35 Examples of substantive audit procedures that the cost auditor may perform relating to newly identified related parties or significant related party transactions include:

- (a) Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as legal counsel, principal agents, major representatives, consultants, or other close business partners.
- (b) Conducting an analysis of cost records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- (c) Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been appropriately accounted for and disclosed in accordance with the applicable cost reporting framework.

Intentional Non-Disclosure by Management (Ref: Para. 5.13(e))

6.36 The requirements and guidance in SCAs regarding the cost auditor's responsibilities relating to fraud in an audit of cost statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the cost auditor. The cost auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the cost auditor's inquiries and management's representations to the cost auditor.



Identified Significant Related Party Transactions outside the Entity's Normal Course of Business
Evaluating the Business Rationale of Significant Related Party Transactions (Ref: Para. 5.14(a)(i))

6.37 In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the cost auditor may consider the following:

- (a) Whether the transaction:
 - (i) is overly complex (for example, it may involve multiple related parties within a consolidated group).
 - (ii) has unusual terms of trade, such as unusual prices, interest rates, payment terms.
 - (iii) lacks an apparent logical business reason for its occurrence.
 - (iv) involves previously unidentified related parties.
 - (v) is processed in an unusual manner.
- (b) Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
- (c) Whether management is placing more emphasis on a particular cost accounting treatment rather than giving due regard to the underlying economics of the transaction.
- (d) If management's explanations are materially inconsistent with the terms of the related party transaction, the cost auditor is required, in accordance with SCAs to consider the reliability of management's explanations and representations on other significant matters.

6.38 The cost auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the cost auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 5.14(b))

6.39 Authorization and approval by management, those charged with governance of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the cost statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion



with management or those charged with governance, may indicate risks of material misstatement due to fraud or error. In these circumstances, the cost auditor may need to be alert for other transactions of a similar nature. Authorization and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

Considerations specific to smaller entities

6.40 A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the cost auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the cost auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner involvement with the transactions.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those prevailing in an Arm's Length Transaction (Ref: Para. 5.15)

6.41 Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the cost auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the cost auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

6.42 The preparation of the cost statements requires management to substantiate an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:

- (a) Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.



- (b) Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

6.43 Evaluating management's support for this assertion may involve one or more of the following:

- (a) Considering the appropriateness of management's process for supporting the assertion.
- (b) Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- (c) Evaluating the reasonableness of any significant assumptions on which the assertion is based.

6.44 Some cost reporting frameworks require the disclosure of related party transactions not conducted on terms equivalent to those prevailing in arm's length transactions. In these circumstances, if management has not disclosed a related party transaction in the cost statements, there may be an implicit assertion that the transaction was conducted on terms equivalent to those prevailing in an arm's length transaction.

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

Materiality Considerations in Evaluating Misstatements [Ref: Para. 5.16]

6.45 SCA requires the cost auditor to consider both the size and the nature of a misstatement, and the particular circumstances of its occurrence, when evaluating whether the misstatement is material. The significance of the transaction to the cost statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship.

Evaluation of Related Party Disclosures [Ref: Para. 5.16(a)]

6.46 Evaluating the related party disclosures in the context of the disclosure requirements of the applicable cost reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

- (a) The business rationale and the effects of the transactions on the cost statements are unclear or misstated; or
- (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.



Written Representations (Ref: Para. 5.17)

6.47 Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- (a) When they have approved specific related party transactions that
 - (i) materially affect the cost statements, or
 - (ii) involve management or those charged with governance.
- (b) When they have made specific oral representations to the cost auditor on details of certain related party transactions.
- (c) When they have financial or other interests in the related parties or the related party transactions.

6.48 The cost auditor may also decide to obtain written representations regarding specific assertions that management may have made, such as a representation that specific related party transactions do not involve undisclosed side agreements.

Communication with Those Charged with Governance (Ref: Para. 5.18)

6.49 Communicating significant matters arising during the cost audit in connection with the entity's related parties helps the cost auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include:

- (a) Non-disclosure (whether intentional or not) by management to the cost auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware.
- (b) The identification of significant related party transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud.
- (c) Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable cost reporting framework.
- (d) Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions.
- (e) Difficulties in identifying the party that ultimately controls the entity.

Documentation (Ref: Para. 5.19)

6.50 The nature and extent of the audit procedures performed to comply with applicable legal and regulatory requirements in context of related party disclosures like:



- (a) the basis adopted to determine the value of transaction;
- (b) name of Related Parties identified indicating transactions or supplies made or service rendered.
- (c) matters arising during the audit and audit evidence obtained by the cost auditor. The conclusions reached during the course of audit through application of the significant professional judgments in reaching the conclusions.
- (d) contracts or agreements entered into or reached in respect of:
 - (i) purchase and sale of raw materials, finished good(s), rendering of services(s), process materials and rejected goods including scraps, etc;
 - (ii) utilization of plant facilities and technical know-how;
 - (iii) supply of utilities and any other services;
 - (iv) administrative , technical , managerial or any other consultancy services;
 - (v) purchase and sale of capital goods including plant and machinery; and
 - (vi) any other payment related to the production of goods or rendering of services under reference.

7. Effective Date

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

8. Statement of Modifications: Modifications to ISA 550, “Related Parties”

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:

- 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 certain similar terms; examples used; and in the Application Guidance.

Addition:

- Paragraph on Documentation (Paragraph 6.50) has been added to give effect to prevailing regulatory framework for audit of cost statements in Indian context.

Deletions:

- Paragraphs (A11) on “Considerations Specific to Public Sector Entities” have been deleted as those are not relevant to the Audit of Cost Statements in Indian context.



Standard on Cost Auditing - “Related Parties” should be read in conjunction with other SCAs, wherever it is with reference to other standards, the points have been incorporated as notes/Appendix (in Italics) in the respective places.