SCA-116
Standard on Cost Auditing
"Communicating Deficiencies in Internal Control to Those charged with Governance and Management"

Contents

The following is the **Standard on Cost Auditing, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"**. 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 The purpose of this Standard is to establish requirements and explains that the cost auditor is required to obtain an understanding of internal control relevant to the cost audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the cost auditor considers internal control in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. The cost auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the cost audit. This SCA specifies which identified deficiencies the cost auditor is required to communicate to those charged with governance and management.

1.2 This SCA does not impose additional responsibilities on the cost auditor regarding obtaining an understanding of internal control and designing and performing tests of controls over and above the requirements of SCAs.

2. Objectives

The objective of this standard is to enable the cost auditor to communicate appropriately to those charged with governance and management about deficiencies in internal control that the cost auditor has identified during the audit and that, in the cost auditor's professional judgment, are of sufficient importance to merit their respective attentions.

3. Scope

This standard deals with the cost auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the cost auditor has identified in an audit of cost statements. Nothing in this standard precludes the cost auditor from communicating to those charged with governance and management other internal control matters that the cost auditor has identified during the audit.

4. Definitions

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

4.1 Audit: Audit is an independent examination of financial, cost and other related information of an entity whether profit oriented or not, irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

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

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

4.4. Cost 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.

4.5 Deficiency in Internal Control: This exists when:

(a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the cost statements on a timely basis; or

(b) A control necessary to prevent, or detect and correct, misstatements in the cost statements on a timely basis is missing.

4.6 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 cost and 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.

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

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

4.9 Significant Deficiencies in Internal Control: A deficiency or combination of deficiencies in internal control that, in the cost auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

4.10 Those charged with governance: The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process and cost reporting framework. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

5. Requirements

5.1 The cost auditor shall determine whether, on the basis of the audit work performed, the cost auditor has identified one or more deficiencies in internal control. (Refer para 6.1 - 6.5)

5.2 If the cost auditor has identified one or more deficiencies in internal control, the cost auditor shall determine, on the basis of the audit work performed, whether individually or in combination, they constitute significant deficiencies. (Refer para 6.6 - 6.17)

5.3 The cost auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. **(Refer para 6.18 - 6.24)**

5.4 The cost auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Refer para 6.25)

(a) In writing, significant deficiencies in internal control that the cost auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Refer para 6.26 -6.27)

(b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the cost auditor's professional judgment, are of sufficient importance to merit management's attention. (Refer para 6.28 -6.31)

5.5 The cost auditor shall include in the written communication of significant deficiencies in internal control:

(a) A description of the deficiencies and an explanation of their potential effects; and (Refer para 6.32)

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the cost auditor shall explain that: (Refer para 6.33 -6.34)

(i) The purpose of the audit was for the cost auditor to express an opinion on the cost statements;

(ii) The audit included consideration of internal control relevant to the preparation of the cost statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(iii) The matters being reported are limited to those deficiencies that the cost auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

6. Application Guidance

Determination of Whether Deficiencies in Internal Control Have Been Identified (Refer para 5.1)

6.1 'Internal controls' wherever used in this SCA in the context of the responsibility of the cost auditor for reporting on such controls implies and relates to internal controls over cost reporting. In other words, it means a process designed to provide reasonable assurance regarding the reliability of cost reporting and the preparation of cost statements for external purposes in accordance with cost accounting standards. A process flow for the cost auditor to identify deficiencies in the internal controls is given in the appendix.

6.2 In determining whether the cost auditor has identified one or more deficiencies in internal control, the cost auditor may discuss the relevant facts and circumstances of the cost auditor's findings with the appropriate level of management. This discussion provides an opportunity for the cost auditor to alert management on a timely basis to the existence of deficiencies of which management may not have been previously aware. The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control. In some circumstances, it may not be appropriate for the cost auditor to discuss his findings directly with the management, (for example, if the findings appear to call management's integrity or competence into question).

6.3 In discussing the facts and circumstances of the cost auditor's findings with management, the cost auditor may obtain other relevant information for further consideration, such as:

(a) Management's, understanding of the actual or suspected causes of the deficiencies.

(b) Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.

(c) A preliminary indication from management response to the cost auditor's findings.

Considerations Specific to Smaller Entities

6.4 While the concepts underlying control activities in smaller entities are likely to be similar to those in larger entities, the formality with which they operate will vary. Further, smaller entities may find that certain types of control activities are not necessary because of controls applied by management.

6.5 Also, smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This higher level of management oversight needs to be balanced against the greater potential for management override of controls.

Significant Deficiencies in Internal Control (Refer para 5.2)

6.6 The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the cost auditor has not identified misstatements during the cost audit.

6.7 At the time of planning and performing the audit of internal controls, the cost auditor should take into account the results of fraud risk assessment. As part of identifying and testing entity-level controls and selecting other controls to test, the cost auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls.

6.8 If the cost auditor identifies deficiencies in internal controls designed to prevent or detect fraud during the audit of cost statements, the cost auditor should take into account those deficiencies when developing the response to risks of material misstatement during the statement of audit. Further the cost auditor would also need to consider the requirements of other guidance issued by the Institute for the procedures to be performed in connection with verification of deficiencies in internal controls.

6.9 Examples of matters that the cost auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

(a) The likelihood of the deficiencies leading to material misstatements in the measurement, classification, allocation, apportionment and absorption of costs.

(b) The susceptibility to loss or fraud relating to misappropriation of assets or over-valuation or under-valuation of inventories.

(c) The subjectivity and complexity in determining the quantity or value of consumption of raw materials, utilities and other inputs effecting true and fair value of cost of production or operations, cost of sales and margin for each product or service.

(d) The volume of activity that has occurred or could occur in the items of cost exposed to the deficiency or deficiencies.

(f) The importance of the controls to the cost reporting framework; for example:

(i) General monitoring controls (such as oversight of management);

(ii) Controls over the prevention and detection of fraud;

(iii) Controls over the selection and application of cost accounting policies;

(iv) Controls over significant transactions with related parties;

(v) Controls over the significant management estimates;

(vi) Controls over significant transactions outside the entity’s normal course of business; and

(vii) Controls over the period-end cost reporting framework.

(g) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

6.10 Indicators of significant deficiencies in internal control include, for example:

(a) Evidence of ineffective aspects of the control environment, such as:

(i) Indications that significant transactions in which management is financially interested are not being appropriately scrutinized by those charged with governance.

(ii) Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.

(iii) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

(b) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

(c) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the cost auditor would expect the entity's risk assessment process to have identified.

(d) Evidence of an ineffective response to identified significant risks (for example, absence of controls over such a risk).

(e) Misstatements detected by the cost auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

(f) Restatement of previously issued cost statements to reflect the correction of a material misstatement due to error or fraud.

(g) Evidence of management's inability to oversee the preparation of the cost statements.

6.11 Controls may be designed to operate individually or in combination to effectively prevent, or detect and correct, misstatements. For example, controls over inventory valuation may consist of both automated and manual controls designed to operate together to prevent, or detect and correct, misstatements in the inventory value. A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same items of inventory or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

6.12 Law or regulation in some jurisdictions may establish a requirement (particularly for cost audits of regulatory entities) for the cost auditor to communicate to those charged with governance or to other relevant parties (such as regulators) one or more specific types of deficiency in internal control that the cost auditor has identified during the cost audit. Where law or regulation has established specific terms and definitions for these types of deficiency and requires the cost auditor to use these terms and definitions for the purpose of the communication, the cost auditor uses such terms and definitions when communicating in accordance with the legal or regulatory requirement.

6.13 Where the jurisdiction has established specific terms for the types of deficiency in internal control to be communicated, but has not defined such terms, it may be necessary for the cost auditor to use judgment to determine the matters to be communicated further to the legal or regulatory requirement. In doing so, the cost auditor may consider it appropriate to have regard to the requirements and guidance in this SCA. For example, if the purpose of the legal or regulatory requirement is to bring to the attention of those charged with governance certain internal control matters of which they should be aware, it may be appropriate to regard such matters as being generally equivalent to the significant deficiencies required by this SCA to be communicated to those charged with governance.

Evaluating identified deficiencies

6.14 The cost auditor must evaluate the severity of each control deficiency that comes to his attention to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses as of the cost reporting date. In planning and performing the cost audit, however, the cost auditor is not required to search for deficiencies that, individually or in combination, are less severe than a significant deficiency.

6.15 A ‘deficiency’ in internal control over cost reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A ‘significant deficiency’ is a deficiency, or a combination of deficiencies, in internal control over cost reporting that is important enough to merit attention of those charged with governance since there is a reasonable possibility that a misstatement of the company's annual or interim cost statements will not be prevented or detected on a timely basis.

6.16 A deficiency in design exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively. A ‘material weakness’ is a deficiency, or a combination of deficiencies, in internal controls over cost reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim cost statements will not be prevented or detected on a timely basis.

6.17 The severity of a deficiency depends on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or items of cost or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Refer para 5.3)

6.18 Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. This standard establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.

6.19 In determining when to issue the written communication, the cost auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Normally, the cost auditor may issue written communication before the date of approval of the cost statements for regulatory or other purposes. Otherwise, the cost auditor may also issue the written communication at a later date. Nevertheless, as the cost auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement for the cost auditor to complete the assembly of the final audit file on a timely basis.

6.20 Regardless of the timing of the written communication of significant deficiencies, the cost auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the cost auditor of the responsibility to communicate the significant deficiencies in writing, as this standard requires.

6.21 The level of detail at which to communicate significant deficiencies is a matter of the cost auditor's professional judgment in the circumstances. Factors that the cost auditor may consider in determining an appropriate level of detail for the communication include, for example:

(a) The nature of the entity. For example, the communication required for a regulatory entity may be different from that for a non-regulatory entity.

(b) The size and complexity of the entity. For example, the communication required for multi-products or service providing entity may be different from that for an entity manufacturing a single product or sole service provider.

(c) The nature of significant deficiencies that the cost auditor has identified.

(d) The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.

(e) Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

6.22 Management and those charged with governance may already be aware of significant deficiencies that the cost auditor has identified during the cost audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

6.23 The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous cost audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The cost auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

6.24 In the case of cost audits of smaller entities, the cost auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

Communication of Deficiencies in Internal Control to Management **(Refer para 5.4)**

6.25 Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Refer para 5.4(a))

6.26 Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management or management may exhibit an inability to administrate the preparation of adequate cost statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

6.27 Other SCAs establish requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such noncompliance. SCAs also establish requirements and provide guidance regarding communication to those charged with governance when the auditor has identified fraud or suspected fraud involving management.

Communication of Other Deficiencies in Internal Control to Management (Refer para 5.4(b))

6.28 During the audit, the cost auditor may identify other deficiencies in internal control that are not significant deficiencies but that may be of sufficient importance to merit management's attention. The determination as to which other deficiencies in internal control merit management's attention is a matter of professional judgment in the circumstances, taking into account the likelihood and potential magnitude of misstatements that may arise in the cost statements as a result of those deficiencies.

6.29 The communication of other deficiencies in internal control that merit management's attention need not be in writing but may be oral. Where the cost auditor has discussed the facts and circumstances of the cost auditor's findings with management, the cost auditor may consider an oral communication of the other deficiencies to have been made to management at the time of these discussions. Accordingly, a formal communication need not be made subsequently.

6.30 If the cost auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the cost auditor need not repeat the communication in the current period. The cost auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as the internal audit function or regulators. It may, however, be appropriate for the cost auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the cost auditor's attention that alters the prior understanding of the cost auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the cost auditor's judgment in the circumstances.

6.31 In some circumstances, those charged with governance may wish to be made aware of the details of other deficiencies in internal control the cost auditor has communicated to management, or be briefly informed of the nature of the other deficiencies. Alternatively, the cost auditor may consider it appropriate to inform those charged with governance of the communication of the other deficiencies given to management. In either case, the cost auditor may report orally or in writing to those charged with governance as appropriate.

Content of Written Communication of Significant Deficiencies in Internal Control **(Refer para 5.5)**

6.32 In explaining the potential effects of the significant deficiencies, the cost auditor need not quantify those effects. The significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so. The cost auditor may also include in the written communication suggestions for remedial action on the deficiencies, management's actual or proposed responses, and a statement as to whether or not the cost auditor has undertaken any steps to verify whether management's responses have been implemented.

6.33 The cost auditor may consider it appropriate to include the following information as additional context for the communication:

(a) An indication that if the cost auditor had performed more extensive procedures on internal control, the cost auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not, in fact, have been reported.

(b) An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

6.34 Law or regulation may require the cost auditor or management to furnish a copy of the cost auditor's written communication on significant deficiencies to appropriate regulatory authorities. Where this is the case, the cost auditor's written communication may identify such regulatory authorities.

7. Effective Date

This standard is effective for audits on or after.......................

8. Statement of Modifications: Modifications to ISA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management"

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.

*** Additions**

Paragraph 6.1, 6.7, 6.8, 6.14, 6.15, 6.16 and 6.17 have been added to give effect to prevailing cost reporting framework for audit of cost statements in Indian context.

*** Deletions**

Paragraph (A11, A26) and ***(A27) on considerations Specific to Public Sector Entities*** has been deleted as the same is not relevant to the Audit of Cost Statements in Indian context.

Appendix

Process Flow of Audit of Internal Controls over Cost Reporting

Start
Identify significant balances of items of cost/ disclosure items
Identify & understand significant flows of cost transactions
Identify risk of material misstatements
Identify controls, which address risk of material misstatements
Identify applications, and associated IT environment
Assess the design of controls
Assess the implementation of controls
Assess audit impact and plan other suitable procedures
Plan nature, timing and extent of testing operative effectiveness
Perform operative effectiveness testing
Assess findings and conclude on operative effectiveness
Form opinion on Internal Controls
Assess impact on the audit opinion
Form audit opinion on cost statements
Submit the Report
Prepare Audit Documentation
End