CAAS 104
Cost Audit and Assurance Standard on
Knowledge of Business, its Processes and
the Business Environment

The following is the ***Cost Audit and Assurance Standard*** **(CAAS 104)** on "**Knowledge of Business, its Processes and the Business Environment**". 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. In performing an audit of cost statements and other related information, the cost auditor should have the knowledge of the client's business to enable him to understand the processes and express his opinion on the cost statements.

1.2. The cost auditor's level of knowledge for an engagement should include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates.

2. Objective:

The objective of this standard is to enable the cost auditor to have knowledge of the client's business which is sufficient to identify and understand the events, transactions and practices that, in the cost auditor's judgment may have a significant effect on the examination of cost statements or on the preparation of the cost audit report.

3. Scope:

This standard deals with obtaining the knowledge of the client's business, its processes and business environment as it is important for the cost auditor and members of the audit staff working on an engagement.

4. Definitions:

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

4.1 Audit: ***An 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. Audit includes cost audit.

4.2 ***Auditee: Auditee means a company or any other entity for which audit and or certification is carried out.***

4.3 Audit Risk: ***Audit risk is the risk that the cost auditor expresses an inappropriate audit opinion on the cost statements that are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk. The risk of material misstatement has two components viz. Inherent Risk and Control risk.***

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

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

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

4.4 Assurance engagement: An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria.

There are two types of assurance engagements a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

4.4.1 Reasonable assurance engagement: The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

4.4.2 Limited assurance engagement: The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

4.5 Assurance Engagement Risk: "The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated".

4.6 Audit Strategy: Audit Strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

4.7 Cost auditor: "Cost auditor" means an auditor appointed to conduct audit of cost records, under sub-section (2) of section 233B of the Companies Act and should be 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. Cost Auditor includes Audit Partner.

5. Requirements:

5.1. It is essential that the Cost Auditor should have adequate level of understanding of the knowledge of Business, its Processes and the Business Environment, to develop a reasonable assurance in order to express an opinion on the cost statements on which he is expressing an opinion.

5.2. The Entity and Its Environment: The cost auditor should obtain an understanding of the following:

5.2.1. The nature of the entity, including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc.

5.2.2. The entity's ownership and governance structure, relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.

5.2.3. The entity's selection and application of cost accounting policies.

5.2.4. The measurement and review of the entity's performance.

5.3. The Entity's Internal Control:

5.3.1. The cost auditor should obtain an understanding of internal controls relevant to the audit.

5.3.2. The cost auditor should evaluate whether management has created and maintained a culture of honesty and ethical behaviour.

5.3.3. The cost auditor should evaluate the adequacy of the internal audit function in relation to cost records.

5.4. IT Environment and Control: The cost auditor should evaluate and assess:

5.4.1. IT Architecture, Systems and programmes in use in the entity;
5.4.2. Controls on access to data;
5.4.3. Controls on changes to data in master files, systems or programmes; and
5.4.4. Integrity of information and security of the data.

5.5. The entity's risk assessment process: The cost auditor should obtain an understanding of whether the entity has a process for:

5.5.1. Identifying business risks relevant to cost reporting objectives;
5.5.2. Assessing the likelihood of their occurrence;
5.5.3. Estimating the significance of the risks; and
5.5.4. Deciding about actions to address those risks.

5.6. Cost Information System/ Management Information System: The cost auditor should obtain an understanding of the management information system, relevant to cost reporting, including the following areas:

5.6.1. The classes of transactions and their analysis, that are significant to the cost statements;

5.6.2. The procedures, by which those transactions and their analysis are initiated, recorded, processed, and reported in the management information systems and cost statements;

5.6.3. The related cost accounting records, supporting information that are used to initiate, record, process and report transactions; and

5.6.4. The reporting process used to prepare the entity's cost statements, including significant estimates and disclosures.

5.7. Identifying and Assessing the Risks of Material Misstatement: The cost auditor should identify and assess the risks of material misstatement at the cost statement level; and at the assertion level for classes of transactions and disclosures. For this purpose, the cost auditor should:

5.7.1. Identify risks including relevant controls that relate to the risk of material misstatements or a risk of fraud;

5.7.2. Assess whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;

5.7.3. Assess whether the risk involves significant transactions with related parties;

5.7.4. Assess the degree of subjectivity in the measurement of information related to the risk.

5.7.5. Assess whether there arises a need for revising the assessment of risk based on additional audit evidence obtained.

6. Application Guidance:

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 analysing information throughout the audit. The understanding establishes a frame of reference within which the cost auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the cost statements;
- 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.
- Developing Models for use in performing analytical procedures;
- 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. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments etc. Examples of matters the cost auditor may consider include:

- The market and competition
- Cyclical or seasonal activity
- Changes in product technology
- Business risk (for example, high technology, high fashion, ease of entry for competition)
- Declining or expanding operations
- Adverse conditions (for example, declining demand, excess capacity, serious price competition)
- Key ratios and operating statistics
- Specific cost accounting practices and problems

- Specific or unique practices (for example, relating to labor contracts, financing methods, accounting methods).
- Energy supply sources and cost
- Environmental requirements and problems

6.3. An understanding of the entity's selection and application of cost accounting policies may encompass matters such as:

- The methods the entity uses to account for significant and unusual transactions (abnormal events).
- The effect of significant cost accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's cost accounting policies.
- Cost reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

6.4. Management will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the cost or financial statements. Accordingly, an understanding of the entity's performance measures assists the cost auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the cost auditor may consider, include:

- Key performance indicators and key ratios (financial and non-financial).
- Key trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other unit level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

6.5. While understanding controls that are relevant to the audit, cost auditor should evaluate the design of those controls and determine whether they have been implemented properly, by performing procedures in addition to discussions with the entity's personnel.

6.6. 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 obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the cost statement and assertion levels. If based on responses to the cost auditor's inquiries, it appears that there are findings that may be relevant to the entity's audit; the cost auditor may consider it appropriate to read related reports of the internal audit function.

6.7. The cost auditor should assess the following with regard to IT environment and controls.

- 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 to 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 interventions.
- Potential loss of data or inability to access data as required.

6.8. If the entity has established such a process, the cost auditor should obtain an understanding of it, and the results thereof. If the cost auditor identifies risks of material misstatement that management failed to identify, the cost auditor should 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 cost auditor should 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.

6.9. As part of the risk assessment, the cost auditor should determine whether any of the risks identified are, in the cost auditor's judgment, a significant risk. In exercising this judgment, the cost auditor should exclude the effects of identified controls related to the risk.

6.10. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the cost statements. However, the cost auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

6.11. The cost auditor should obtain an understanding of control activities relevant to cost/ management information system 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.

6.12. The cost auditor should 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.

6.13. The cost auditor should understand the related cost accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred primarily to the accounting system and subsequently to cost accounting statement.

6.14. Risks at the cost statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the cost statements and may require an overall response by the auditor.

6.15. Risks of material misstatement at the cost statement level refer to risks that relate pervasively to the cost 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, 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.

6.16. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion

7. Effective Date

This standard is to be applied for the period commencing on or after 1st April 2013.

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