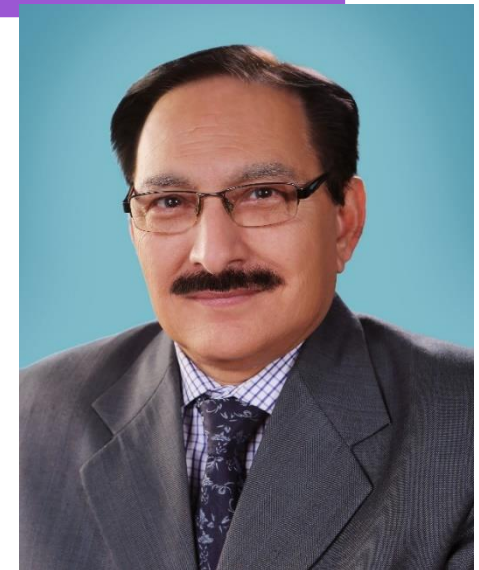


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SCA-104: Cost Auditing Standard on Knowledge of Business, its Processes and the Business Environment

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BRIEF ABOUT CMA J K BUDHIRAJA

- *Fellow Members of The Institute of Cost Accountants of India (ICAI) and The Institute of Company Secretaries of India (ICSI);*
- *Ex-Chief Executive Officer (CEO) of Insolvency Professional Agency of Institute of Cost Accountants of India (IPA ICAI);*
- *Ex-Senior Director (Technical), The Institute of Cost Accountants of India, HQ (Delhi Office), Lodhi Road, New Delhi-110003;*
- *Practiced as Cost Accountant and Registered Insolvency Professional, handled many cases CIRP under IBC 2016 and now Advisor, ICWAI MARF;*
- *Ex-General Manager (Finance)/CFO, Central Electronics Ltd. (CEL);*
- *Ex-Head (Finance)/CFO & Company Secretary, EdCIL (India) Ltd. (PSU). Also worked with National Fertilizers Ltd (NFL)-PSU, Hindustan Fertilizer Corporation Ltd (HFC)-PSU;*
- *Represented CMA Institute in Working Groups 2 & 3, constituted by MCA for drafting Rules and Regulations under IBC 2016;*
- *Ex-Member, Advisory Committee on Corporate Insolvency Process and Liquidation, constituted by Insolvency and Bankruptcy Board of India (IBBI);*
- *Ex-Member, Working Group constituted by IBBI for drafting Rules and Regulations relating to Guarantor Corporate Debtors, and Individuals having Businesses.*

COST AUDITING STANDARDS

- **Proviso to Section 148(3) of the Companies Act 2013 stipulates:** Provided further that the auditor conducting the cost audit shall comply with the cost auditing standards.
- ***Explanation given under Section 148(3) is as follows:***
- ***Explanation.—For the purposes of this sub-section, the expression “cost auditing standards” mean such standards as are issued by the Institute of Cost and Works Accountants of India, constituted under the Cost and Works Accountants Act, 1959, with the approval of the Central Government.***
- The Central Government vide its letter dated 10th September 2015 approved the following 4 Cost Auditing Standards which came into force with effect from 11th September 2015:
 1. ***Cost Auditing Standard-101 on Planning an audit of Cost Statements;***
 2. ***Cost Auditing Standard-102 on Cost Audit Documentation;***
 3. ***Cost Auditing Standard-103 on Overall objectives of the independent cost auditor and the Conduct of an Audit in Accordance with Cost Auditing Standards; and***
 4. ***Cost Auditing Standard-104 on Knowledge of business, its processes and the business environment***

Standards on Cost Auditing – Approved by Board

- *SCA-105 - Agreeing the Terms of Cost Audit Engagements*
- *SCA-106 - Audit Sampling*
- *SCA-107 - Audit Evidence*
- *SCA-108 - Materiality in Planning and Performing Cost Audit*
- *SCA-109 - Cost Auditor's Responsibility Relating to Fraud in an Audit of Cost Statements*
- *SCA-110 - Written Representations*
- *SCA-111 - Evaluation of Misstatements identified during the Cost Audit*
- *SCA-112 - Analytical Procedures*
- *SCA-113 - Using the Work of Internal Auditors*
- *SCA-114 - Using the Work of Cost Auditor's Expert*
- *SCA-115 - Communication with Those Charged with Governance*
- *SCA-116 - Communicating Deficiencies in Internal Control to those Charged with Governance and Management*
- *SCA-117 - Identifying and Assessing the Risks of Material Misstatement*
- *SCA-118 - The Cost Auditor's Response to the Assessed Risk*
- *SCA-119 - Related Parties*

Flow of Presentation

- 1. Summarized Requirements of SCA-104;***
- 2. Sources of Information About the Entity;***
- 3. Detailed Requirements as per Para 5 of SCA 104 along with Explanation as per Guidance Application- Para 6 and Presenter own Notes;***
- 4. Illustrative list of Key Performance Indicators (KPI's)***
- 5. Check List for Identification and Assessment of key Risk of Material Misstatements***
- 6. Check List- Knowledge of Business, Entity and its Environment***

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Knowledge of Business,
its Processes and
the Business Environment

Summarized Requirements of SCA – 104 Knowledge of Business, its Processes and the Business Environment

Essential for performing Audit of Cost Statements

- ✓ *In performing an audit of cost statements, cost records, and other related documents,*
- ✓ *the cost auditor should have the knowledge of the client's business; its processes and Business Environment,*
- ✓ *to enable him to understand them and express his opinion on the cost statements.*
- ✓ *For the purpose of cost audit engagement, knowledge of cost auditor may 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.***

Summarized Requirements of SCA – 104 Knowledge of Business, its Processes and the Business Environment

Cost auditor's understanding for:

- a) Nature of the entity, (including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc.) and the entity's ownership and governance structure.*
- b) Relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.*
- c) Entity's selection and application of cost accounting policies.*
- d) Measurement and review of the entity's performance.*

Summarized Requirements of SCA – 104 Knowledge of Business, its Processes and the Business Environment

In addition to above, cost auditor's understanding on:

- ✓ *internal controls,*
- ✓ *control environment,*
- ✓ *risk assessment process,*
- ✓ *identifying business risks,*
- ✓ *assessing the likelihood of their occurrence,*
- ✓ *estimating the significance of the risks and*
- ✓ *deciding about actions to address those risks relevant to the audit.*
- ✓ *understanding the IT (Information Technology) environment and control system of the entity.*

Summarized Requirements of SCA – 104 Knowledge of Business, its Processes and the Business Environment

Understanding on a framework, enabling cost auditor to plan audit and exercises professional judgment throughout the audit, for example, we have studied in the previous three presentations:

- *Assessing risks of material misstatement of the cost statements;*
- *Determining materiality;*
- *Considering the appropriateness of the selection and application of cost accounting policies, and the adequacy of cost statement disclosures;*
- *Identifying areas where special audit consideration may be necessary, **for example, abnormal losses, lower yields, higher wastages, higher utilities consumption, related party transactions, etc.***
- ***Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and***
- ***Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.***

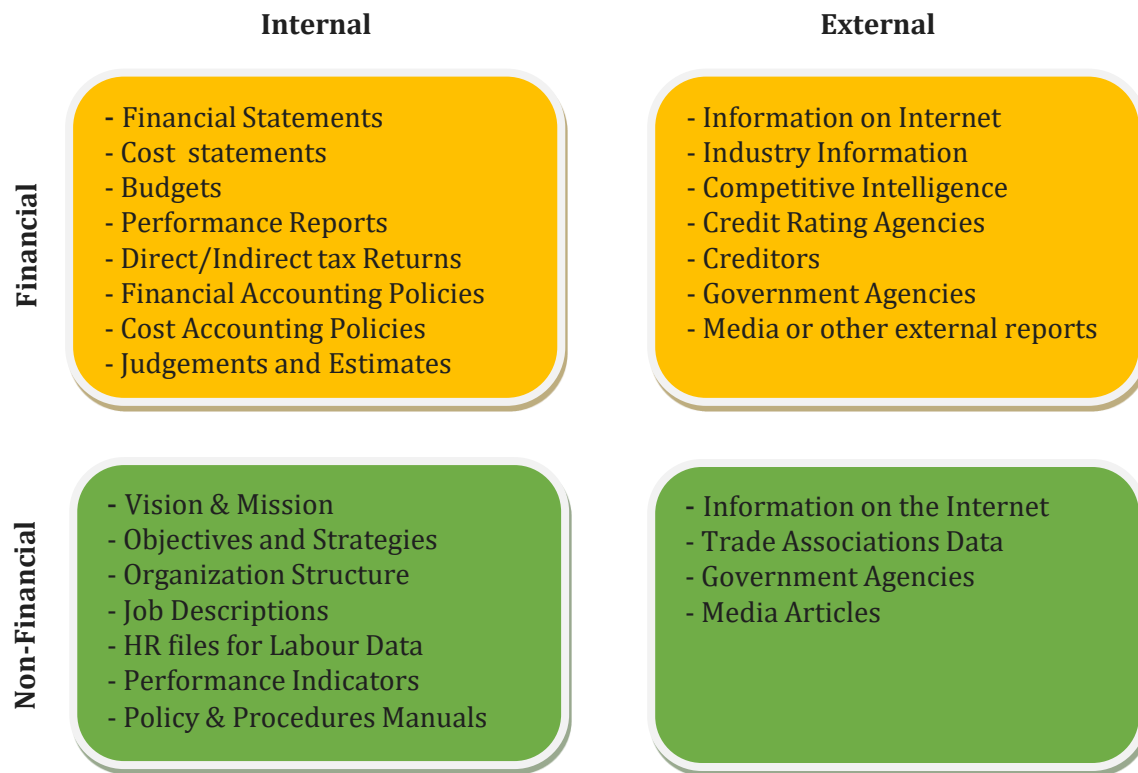
SOURCES OF INFORMATION ABOUT THE ENTITY

Cost Auditor may obtain Information about the entity and its environment through:

- ✓ *Internal; and external sources.*
- ✓ *In many cases, the cost auditor starts with internal sources of information.*
- ✓ *This information can then be checked for consistency with:*
- ✓ *information obtained from external sources **such as** trade association data and **data about general economic conditions**, which can often be obtained **from the Internet**.*

SOURCES OF INFORMATION ABOUT THE ENTITY

The following may be some of the potential sources of information:



SOURCES OF INFORMATION ABOUT THE ENTITY

Important Points

A major source of information from cost auditor's working paper files from previous periods' engagements:

- *Considerations or issues addressed in planning an audit of cost statements for the period;*
- *Evaluation and source of possible adjustments and uncorrected errors;*
- *Areas where there are recurring disagreements, such as the assumptions used for cost accounting estimates;*
- *Areas which appear to be susceptible* (liable to be influenced or harmed by a particular thing) *to error; and*
- *Matters raised in the auditor's communication with management and those charged with governance.*

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5. Requirements

5.1 The Cost Auditor shall 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.(refer 6.1)

Knowledge of Business

[Current Business scenario, Nature of Business, Product Portfolio, Raw Material Prices Global impact etc.]- **Balance Sheet, Chairman's Message to Members, Management Discussion & Analysis [Regulation 34 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and clause 7.5 of DPE Guidelines on Corporate Governance]**

its Processes

[Global and Domestic market scenario of the product and segments, Pricing impact, economic status of the country, growth potential, Future threats from competitors & imports its impact on cost and profitability etc.]

Business Organization

[The processes on which the organization works, its policies, controls]

Some sources to get the general information about the industry and entity are Annual Report of the organisation, Annual Report of Competitor Organisation, Internet surfing, Newspapers, Journals, Research Papers Published etc.

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

(a) The nature of the entity, (including its operations covering Business processes, major inputs, Joint & By-Products and Wastages and major outputs etc) and the entity's ownership and governance structure.

[Organizational Structure, Controls on or by Sister Organization etc.]

Presenter Notes:

Nature of the Entity

- *Nature of business operations;*
- *Nature of revenue sources (for example, manufacture, bought out, job worker, import/export trading, captive unit, generation, distribution and transmission of power utility, transportation, technology products and services);*

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Nature of the Entity (Contd...)

- *Products or services and markets (for example, major customers and contracts, competitors, exports, pricing policies, warranties, manufacturing processes);*
- *Conduct of operations (for example, stages and methods of production, business segments, delivery of products and services, details of declining or expanding operations);*
- *Alliances, joint ventures, and outsourcing activities;*
- *industry segmentation;*
- *Location of production facilities, warehouses, and offices;*
- *Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery);*

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Nature of the Entity (Contd...)

- *Employment (for example, by location, supply, wage levels, union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulations related to employment matters);*
- *Research and development activities and expenditures;*
- *Transactions with related parties.*

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5.2 (b) Relevant industry, regulatory, and other external factors including the applicable cost and financial reporting framework.(refer 6.2)

[Electricity, petroleum, telecommunication, fertilizer, sugar and drugs & pharmaceutical industries]

Relevant industry factors include industry conditions such as the **competitive environment, supplier and customer relationships, and technological developments** etc. **Examples, the cost auditor may consider to include:**

- (a) The market and competition
- (b) Cyclical or seasonal activity
- (c) Changes in product technology
- (d) Business risk **(for example, high technology, high fashion, ease of entry for competition)**
- (e) Declining or expanding operations
- (f) Adverse conditions **(for example, declining demand, excess capacity, serious price competition)**
- (g) Key ratios and operating statistics
- (h) Specific cost accounting practices and problems
- (i) Specific or unique practices **(for example, relating to labour contracts, financing methods, accounting methods).**
- (j) Energy supply sources and cost
- (k) Environmental requirements and problems

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5.2 (c) The entity's selection and application of cost accounting policies.(refer 6.3)

- (a) Methods to account for significant and unusual transactions **(abnormal events)**.
- (b) Effect of significant cost accounting policies in controversial or emerging areas; for which there is a lack of **authoritative guidance or consensus**.
- (c) **Changes** in cost accounting policies of entity.
- (d) **Cost reporting framework, and laws and regulations that are new to the entity** and **when and how the entity will adopt such requirements**.

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5.2 (d) The measurement and review of the entity's performance. (refer 6.4)

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.

[Key performance indicators, key ratios, key trends, operating statistics, financial performance analysis, Budgets, forecasts, variance analyses, segment information, divisional/department performance reports, employee performance measures, incentive compensation etc.]

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Illustrative list of Key Performance Indicator (KPI's)

Performance Area	KPI	Measurement
Financial Performance	Turnover	Segmental revenue to total revenue % Segmental turnover growth % Total turnover growth % Growth % in new product sales New product sales as % of total sales Customer-wise sales Top 5 customers, bottom 5 customers' sales
		Gross margin % on total sales Gross margin % on segmental sales Gross margin % on new products Customer-wise Gross margin %
	Cost	Element-wise cost % to total turnover Element-wise cost % to segmental turnover Cost composition – nature-wise, variability structure, functional split

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Illustrative list of Key Performance Indicator (KPI's)- Conti...

Performance Area	KPI	Measurement
Financial Performance	Returns	ROI on product groups ROI on geographical segments ROI on new products ROI on new markets Return on Capital Employed (ROCE) Value added to total income Earnings per share (EPS) Dividend per share (DPS) Retention ratio Price-Earnings (PE) ratio Market price per share
	Balance Sheet	Current ratio, quick ratio Asset turnover (current and fixed assets) Growth in assets Capital expenditure % to total assets Debt-equity ratio Debt to total capital employed

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Illustrative list of Key Performance Indicator (KPI's)- Conti...

Performance Area	KPI	Measurement
Productivity & Efficiency	Material	Material cost % to total cost
		Material wastage as % to total input
		Contribution per unit of material used
	Labour	Production per man hour
		Production per employee
		Employee cost % to sales
		Idle hours % to total available hours
	Machine	Production per machine hour
		Growth in machine capacity utilisation
		Machine downtime ratio
		Break-down hours
Manufacturing Performance	Operating	Material turnover
	Cycles	WIP turnover
		Finished goods turnover

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Illustrative list of Key Performance Indicator (KPI's)- Conti...

Performance Area	KPI	Measurement
Supplier Performance	<i>Delivery</i>	On time supplies
		Supply of full quantity
	<i>Quality</i>	% of rejections
	<i>Cost</i>	Price reductions agreed –cost effect
		Price escalations given –cost effect
	<i>Overall</i>	Supplier satisfaction index

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5.3 The Entity's Internal Control: The cost auditor shall obtain an understanding of internal controls relevant to the audit. (refer 6.5)

[Evaluate the design of those controls and determine their proper implementation]

Presenter Notes:

- 1. The control environment includes the governance and management functions; and the attitudes, awareness, and actions of those charged with governance.**
- 2. Matters such as independence of directors and their ability to evaluate the actions of management should also be considered.**
- 3. Whether there is an audit committee which understands the entity's business transactions and evaluates whether the financial and cost statements give a true and fair view.**

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Presenter Notes: (Conti..)

4. Understand Operational controls such as:

- *production and staff scheduling,*
- *quality control, and*
- *employee compliance with environmental and other regulatory requirements, to determine cost centre, profit centre or process wise cost.*

5. *If an entity has an internal audit function:*

- *inquiries with appropriate individuals in Internal Audit Department 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 audit; the cost auditor may consider it appropriate to read internal auditor's report.*

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5.3

- (a) Control Environment:** *The cost auditor shall evaluate whether management has created and maintained a culture of honesty and ethical behaviour.*
- (b) The entity's risk assessment process:** *The cost auditor shall obtain an understanding of whether the entity has a process for: (refer 6.6, 6.7, 6.8)*
- 1. Identifying business risks relevant to cost reporting objectives;*
 - 2. Assessing the likelihood of their occurrence;*
 - 3. Estimating the significance of the risks; and*
 - 4. Deciding about actions to address those risks.*

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Presenter Notes: (Conti..)

1. If the entity has **established risk assessment process**, the cost auditor should **obtain an understanding** of it, and the **results thereof**.
2. If cost auditor identified that management failed to assess the risk, then the cost auditor would evaluate why that process failed to identify it and evaluate whether there is deficiency in internal control.
3. If cost auditor finds that there is no risk assessment process available in the entity, he should prepare those audit procedures which are capable to obtain sufficient and appropriate evidence for those items **where he determines a significant deficiency in internal control**.
4. 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.
5. An auditor 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.

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5.3(c) Cost Information System/ Management Information System: The cost auditor shall **obtain an understanding of the Information System** including **Management Information System**, relevant to cost reporting, including the following areas: (refer 6.9)

- (1) The **classes of transactions** and their analysis, that are significant to the cost statements;
- (2) The **procedures**, by which those transactions and their **analysis** are initiated, **recorded, processed, and reported** in the management information systems and cost statements;
- (3) The related cost accounting records, **supporting information** that are used to **initiate, record, process and report transactions**; and
- (4) The **reporting process** used to prepare the entity's cost statements, including significant estimates and disclosures.

[Reviewing cost elements, GL mapping, assumptions, basis of apportionment should be checked and Product wise Profitability Statement in MIS if available]

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5.3 (d) Control Activities: The auditor shall obtain an *understanding of the control activities*, relevant to the audit.(refer 6.10)

[understanding of control activities relevant to cost/management information system in order to assess risks of material misstatement at assertion level and design further audit procedures responsive to assessed risks]

However, a cost auditor 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.

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5.3 (e) Monitoring of controls:

(1) The auditor shall obtain an understanding of the major activities, that the entity uses to monitor internal control over reporting.(refer 6.11)

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.

(2) The cost auditor shall evaluate the adequacy of the internal audit function in relation to cost records. (refer 6.12)

[If based on responses to inquiries by cost auditor, he found relevant may consider it appropriate to read the internal auditor's report]

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5.4 IT (Information Technology) Environment and Control: The cost auditor shall evaluate and assess: (refer 6.13)

(1) IT Architecture, Systems and programmes in use in the entity;

[Cost auditor needs to have knowledge of IT systems and its controls.]

(2) Controls on access to data;

(3) Controls on changes to data in master files, systems or programmes; and

[IT policy, control checks, authorization checks]

(4) Integrity of information and security of the data

[IT security policy, whether unauthorized changes can be made, level of authorization required to make changes]

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6.13 Cost auditor should assess the following with regard to IT environment and controls. (Refer 5.4)

- (a) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.**
- (b) 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.**
- (c) The possibility of IT personnel gaining access to privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.**
- (d) Unauthorized changes to data in master files.
- (e) Unauthorized changes to systems or programs.
- (f) Failure to make necessary changes to systems or programs.
- (g) Inappropriate manual interventions.
- (h) Potential loss of data or inability to access data as required.

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5.5. Identifying and Assessing the Risks of Material Misstatement: *The cost auditor shall identify and assess the risks of material misstatement at the cost statement level; and at the assertion level including items of cost, cost heads and disclosures thereof. For this purpose, the cost auditor shall: (refer 6.14, 6.15, 6.16)*

- (1) Identify risks including relevant controls that relate to the risk of material misstatements or a risk of fraud;*
- (2) Assess whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;*
- (3) Assess whether the risk involves significant transactions with related parties;*

*[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 such as** how special-purpose entities controlled by management might be used to facilitate pricing management **and** how transactions between the entity and a known business partner of a key member of management]*

- (4) Assess the degree of subjectivity in the measurement of information related to the risk.*
- (5) Assess whether there arises a need for revising the assessment of risk based on additional audit evidence obtained.*

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Assertions in the Audit of Cost Statements

- **Audit Assertions** are the implicit or explicit claims and representations made by the management responsible for the preparation of cost statements regarding the appropriateness of the various elements of cost statements and disclosures.

Various types are:

- ✓ **Occurrence** - Costs recognized in the cost statements have occurred and relate to the entity.
- ✓ **Completeness** - All costs that were supposed to be recorded have been recognized in the cost statements.
- ✓ **Accuracy** - Costs have been recorded accurately at their appropriate amounts.
- ✓ **Cut-off** - Costs have been recognized in the correct accounting periods.
- ✓ **Measurement** - Costs have been correctly measured as per the applicable Standards.
- ✓ **Classification** - Costs have been classified and presented fairly in the cost statements.
- ✓ **Presentation & Disclosure** - Costs have been correctly disclosed as per the applicable cost reporting framework.

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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. (Refer 5.5)

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Check List

Identification and Assessment of key Risk of Material Misstatements

(to be completed for all material cost heads, items of cost and disclosure)

Area	Observations/ Comments
Cost Head Balances / General Ledger Balance	
Components of the Cost Head / items of Cost / Sub G/L balances	
Understanding of the process based on inquiry with: <ul style="list-style-type: none">- Management Those charged with governance- Internal Auditor / Other Auditor(s)- Business Process Owners / Plant Manager/ Process Supervisor- Any other source	

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Check List

Identification and Assessment of key Risk of Material Misstatements
(to be completed for all material cost heads, items of cost and disclosure)

Area	Observations/ Comments
Results of preliminary audit procedures – any unusual or unexpected changes occurred or interrelationship	
Results of verifications of internal controls <ul style="list-style-type: none">- Control Environment / Control activities- Monitoring of controls- Risk Assessment- Information system and business process	
Results of observation and inspection of : <ul style="list-style-type: none">- Entity's operations- Documents, records and reports- Premises for forming opinion	

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Check List

Identification and Assessment of key Risk of Material Misstatements
(to be completed for all material cost heads, items of cost and disclosure)

Area	Observations/ Comments
Other information available <ul style="list-style-type: none">- Previous cost audits / experience- Other engagements with similar industry / entity.- Ongoing assessments- Interim review / limited review for period.- Discussion and supervision within team- Any other source	

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Identified risks	Risk description	Inherent / Detection / Control	Assertion
Key risks			
Non- key risks			
Impact on any other area			

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5.6 Documentation: The auditor shall document:

- (a) *Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 5.1 & 5.2 above and of each of the internal control components specified in paragraphs 5.3 above; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;*
- (b) *The identified and assessed risks of material misstatement at the cost statement level and at the assertion level including items of cost, cost heads and disclosure thereof as required by paragraph 5.5 above; and*
- (c) *The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 5.5 above.*

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Check List- Knowledge of Business, Entity and its Environment

Sr.	Para Ref	Particulars	Comments / Details
1.	5.2 a	<i>Classification of the Auditee</i>	PSU / Public / Pvt. / Subsidiary / MNC, etc
2.	5.2 a	<i>Nature of Business</i>	
		<i>Major Operations</i>	
3.	5.2 a	<i>Major Input Materials</i>	
4.	5.2 a	<i>Joint Products / Bye Products</i>	
5.	6.2 a	<i>Major Customers</i>	
6.	6.2 a	<i>Classification of Domestic Sales, Exports, etc.</i>	
7.	6.2 a	<i>Major Competitors</i>	
8.	6.2 b	<i>Whether the Company is subject to Cyclic / Seasonal Fluctuations</i>	Specify Yes / No. If yes, then specify the Cycles, impact on operations & comment on treatment given in Cost Audit.

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Check List- Knowledge of Business, Entity and its Environment

Sr.	Para Ref	Particulars	Comments / Details
9.	6.2 c	<i>Changes in Production Technology over Previous Period</i>	Specify Major Changes to the Production Technology over previous period.
10.	6.2 c	<i>Major Additions / Deletions to the Operational Capacity</i>	Specify & Quantify major additions/ deletions to the operational capacity in terms of Asset Value & Capacity. Comment on its treatment in the Cost Audit.
11.	6.2 c	<i>Industry Specific Unique Business Processes / Practices</i>	Specify such areas and its treatment in Cost Audit.
12.	6.2 k	<i>Whether the company follows the required norms for Environmental Standards</i>	Specify Yes / No. Collect relevant Certifications / Management Representations and keep in the Audit File.

*Thank
you*



**Former Senior Director
(Technical)
The Institute of Cost
Accountants of India**

**Former CEO, IPA of
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