Continuous Audit ('CA'): Way to better Assurance

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Consider the following practical example, an illustration which most of us would relate to:

In a classical internal audit program, expense reports for lunch/dinner claimed by staff were tested by randomly selecting a few individuals and reviewing these expense reports. While exceptions were found, there was no adverse conclusion and the area was assigned for review again during the first quarter of subsequent year. During that time, the Company experienced substantial growth.

In the subsequent year, the internal auditor decided to apply data analysis software for top-5 cost centres by value and looked for significant trends of anomalies or exceptions. Guided by findings during first quarter, he continued the analysis for subsequent 2 quarters. Findings revealed instances pertaining to five employees of the Accounts department who were consistently late in claiming expenses (after 2 months in some cases) and duplicative claims (i.e. same bill claimed at different times amongst those five employees). The relentless focus on the target expenses yielded good results for the Company which saw remarkable drop in the expense reports in the last quarter. Now, in a growth phase, any linear, upward variation of expenses would be logically justified; however, **through continuous audit & monitoring** of the expenses, the internal auditor was able to add value to the Company resulting in cost reduction.

In an ever-changing corporate world, the all-encompassing influence of Governance, Risk Management and Control, are consistently engaged in establishing transformed obligations of Internal Audit. The overarching effect of Companies Act 2013, in shaping the structured accountability of Boards and Audit Committees, logically led to the fortification of their oversight function. As an upshot, the importance of the role played by auditors is heightened to a level hitherto unforeseen.

Dynamic Business Environment

The business dynamics are constantly changing – factors which were conducive for business last year may have changed. Say a key employee has resigned or key vendor has gone bankrupt or a top customer has been lost to competition. Organization attention tends to focus on these emerging situations and devising adaptive strategies to meet the challenges arising from these developments and changing goal-posts. In the interim, it is the Internal Auditor who has to maintain vigil on the safekeeping of assets and corporate resources. In a classical audit program, the coverage of specific areas is governed on a time-bound manner which could result in a post-mortem situation. **Continuous auditing** ('CA') serves as the panacea for risk monitoring and resource protection.

Increasing dependence of electronic medium

Businesses today are becoming more integrated with the internet and cloud-based applications. Paper trails are increasingly becoming obsolete and hence the need for system-based controls. It follows as a corollary that these controls would require periodic validations as otherwise, the damage perpetrated by control violations could be severe and in extreme situations, catastrophic. Wouldn't rogue trading of the kind seen in the Barings Bank collapse been avoided, had the unauthorized speculative trades perpetrated by Nick Leeson been detected in time. Or could Jerome Kerviel have been prevented from causing the 2008 Société Générale trading loss for breach of trust, forgery and unauthorized use of the bank's computers, resulting in losses valued at €4.9 billion. As they say, **a stitch in time saves nine!** Certainly this amplifies the importance of an effective Continuous Audit mechanism.

Regulatory Triggers

The regulatory landscape keeps changing inevitably according to the vagaries of the economic and political situation. Incorporating those changes into the business policies and implementing course corrective actions become a peremptory imperative for business leaders.

Specific reference can be traced to a few, very important and strategic provisions of the Companies Act, 2013; which are historically transformational in nature. They are:-

Stipulation of audit committee's duty to call for comments of internal auditor on internal control system[section 177(5)], risk management policy [section 134(3)(n)], directors responsibility statement [section 135(5)(e)], the operating effectiveness of internal financial control [section 143(3)(i)], evaluation of internal financial control [section 177(4)(vii)] and code of independent directors [schedule IV] by Companies Act 2013 has increased the debate around making internal audit continuous in nature and effectively prescribes for Continuous Auditing.

Continuous Auditing - Definition

The Institute of Internal Auditors (IIA) defines **Continuous Auditing** as "any method used by Auditors to perform audit-related activities on a more continuous or continual basis. It is the **continuum of activities ranging from continuous controls assessment to continuous risk assessment – all activities on the control-risk continuum.**" Alternatively, it denotes supplementary stress on uninterrupted vigil over controls and their status assessment, risk assessment and ultimate alleviation.

Under Continuous Audit approach, 'pro-active engagement' is an important dynamic. The risks apprehended in the projected matrix are visited recurrently by the audit team to corroborate with their risk based relationship-matrix of audit processes and their seamless adaptability as envisaged. **Continuous Audit seeks to make the risk based plan** more dynamic, where **the audit plan based on risk matrix** (perceived and conceptualized by entity Management, Auditors or by both)**, is reviewed time and again for validation purposes.** The audit plans are modified on a continuous basis, based on the ceaselessly fluctuating business scenario of the entity concerned and their risk bearings. The unremitting focus on operation of the entity can be revealed through a vibrant planning and resourcing environment.

Continuous audit is the methodology, which allows nursing control effectiveness and timely identification of lapses. Continuous Auditing establishes mechanism for judicious identification of control issues, risk and mitigation virtually on real time basis.

As of now, audit teams of most of the entities predominantly follow **audit procedures to complete annual audit plan by bifurcating into time horizon (e.g. quarterly coverage) with** prioritization, to cover high risk areas during the plan-period. For outsourced audit services, the Company Management proposes the coverage area based on discussions with the internal auditors based on major risk and concerns at the time the plan is decided and thereafter a formal review may or may not happen to incorporate ever-changing business dynamics.

Advantages of Continuous Audit

- RBIA (Risk Based Internal Audit) Plan prepared and agreed upon for execution at the commencement of the year/period can be entirely harmonised with complete risk profile of the entity including unattended risks.
- It will enable capturing dynamic risk profiles based on continuous risk review of the entity concerned and mitigation programmes.
- Enhances flexibility of functioning of the Audit Team to report concerns emanated while conducting audit of an already committed area.
- Dynamic coverage of high risk areas (which ceaselessly change during audit period)
- Ability to address real time risk issues to Management/Audit Committee as well the steps taken by Management for mitigation.

In a recent Global survey conducted, the main reasons for adoption of Continuous auditing were:

- More assurance with greater coverage and depth
- Real-time operational assurance regarding business processes/activities
- Reduced burden for line management to facilitate audit activities (e.g. no or limited interviews, walkthroughs etc.)
- Reduced internal/ external audit costs/time.

Continuous auditing can add value to organisations where processes are repetitive and susceptible to risk. (Telecom industry for instance). It can improve the organisation's risk management and control activities. For e.g. internal audit's risk based approach to audit planning can be expanded to include Continuous auditing which would increase internal audit's coverage, regardless of how much risk is expected in those additional areas. Preventing errors from occurring improves the overall business process efficiency as well.

Typically, areas that tend to have the maximum return on investment (ROI) in an initial Continuous auditing implementation include:

- Manual journal entries;
- Time and expense;
- Purchase to pay;
- Order to cash;
- Inventory management

Challenges in implementation:

Adoption continues to be low despite awareness around the benefits of CA. Organisations find it difficult to quantify the benefits of CA which are needed to justify the business case for its implementation. Consequently, organisations take small steps in embedding CA by experimenting with tools on pilot projects.

CA/ functionality at the very minimum must include: data extraction (from source systems), data analysis, case management (Action on Exceptions) and reporting (Dashboards). Challenges include:

- Resistance to change
- Disintegrated/scattered IT environment and inferior quality source data
- Lack of internal resources and skills to manage CA, or a
- Lack of resources to implement CA tools.

If these risks can be mitigated, a successful implementation of CA will generally translate into reduced reporting costs, enhanced governance, risk mitigation and compliance outcomes, financial and non-financial ROI, as well as increased detection of frauds and errors.

The relentlessly evolving continuous auditing necessitates highly structured methodology. It needs to be aligned to the risk-base and leveraged through repeated evaluation. It has to be considered as a process, not an end in itself, depending on the outcomes of audit's assessment of management's monitoring process and the persistent emergence of new risks produced by peripheral factors as well as entity's internal control mechanism. Considering this, internal audit need to regularly engage in management's monitoring function and also in evaluating the risk scape. Key business processes are analysed for both anomalies at the transaction level and for data-driven indications on emerging risk and control weaknesses. Continuous audit is not something in addition to the normal audit activities; they are intertwined with ongoing audit exercises.

Considering the technological advances in Data Mining and analytics with several tools such as ACL IDEA SAS SPSS and CAATS, available the implementation of continuous auditing is in the realm of possibility. Sophisticated tools mining data and transactions on real time basis from the operating system based on defined parameters can throw up deviations from desired parameters which can be corrected.

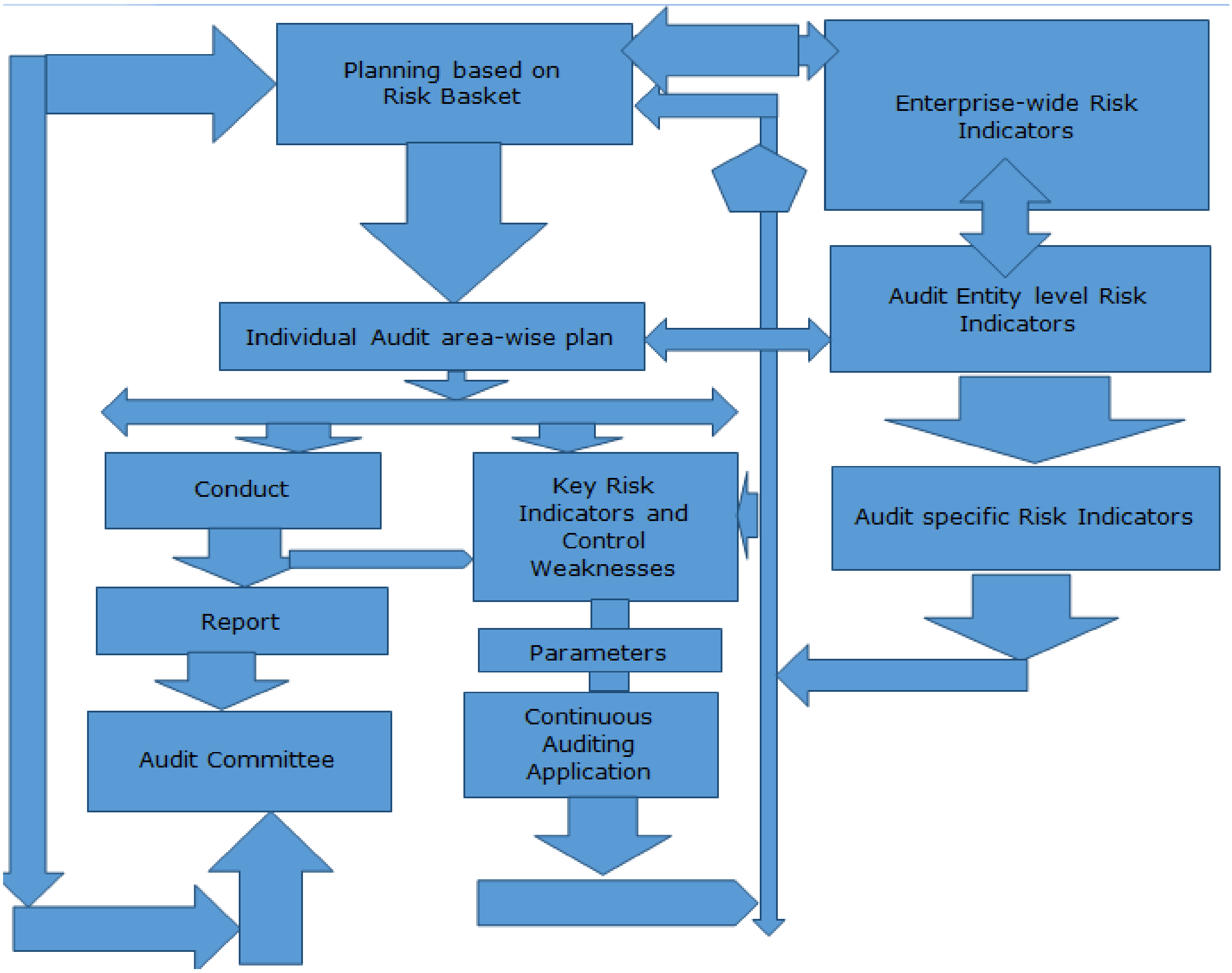
Many organisations have started to experiment with technology and standard tooling. Majority are using IT/office automation/standard auditing tools. Few use advanced business intelligence (BI) dashboards and dedicated CA tools from suppliers such as SAP GRC, BWise, Approva etc

Usage of the tools is high among internal audit, finance, and internal control and operational/ line management.

Transition to this approach can be done in a phased manner with the help of Consultants/IA teams which is separate topic by itself.

Approach to Continuous Audit

Assessment **Audit Process** **Risk**



We can inject additional precision on this subject through an illustration. A traditional risk based plan labels risks under different buckets, that is, High, Medium and Low for embarking on appraisal during the plan period. Such identification can be through existing database/Risk Register and /or a combination of **FOTP (Finger on the Pulse)** approach. Nevertheless, due to modification of an entity's financial policy entailing Dollarized Revenue Stream and payments by Rupee Term, 'currency fluctuation risk' is mitigated even under the scenario of 'rupee depreciation'. Consequently, risk matrices require immediate attention and so long as the management follows this principle and activities follow the suit, 'currency risk' classification needs to be downgraded. This creates a space for Auditor to channelize audit resources to other critical areas.

Conversely, the audit team routinely come across situations where multiple Vendor Accounts (for delivery of services) are opened for the same entity without disclosure of PAN (Permanent Account Number) and Service Tax Registration number. Since this is a 'compliance issue', Management attention needs to be drawn immediately for revision of 'risk' to upper strata (Low to Medium or Medium to High) in the ladder. Frequent review (continuity) of the complete Vendor database needs to be undertaken to enlighten Management towards the fatality of non-compliance and financial implications thereof.

Through the conception of modified risk based approach and their effective implementation, Continuous Auditing generates a forceful control assessment mechanism and risk mitigation procedure by indulging in perpetual review of exceptions (high risk) and omitting the low risk or the mitigated ones in the process. A pragmatic illustrative module is built hereunder to demonstrate the phenomenon. Business and strategic risk of an entity is captured first. Audit coverages are planned under different audit cycles. It is appropriate to mention here that cycles construe area of audit activity keeping in view of clarity of understanding and entity's process requirement. It is pertinent to mention here that a particular item in 'risk basket' may feature in multiple cycles and in turn audit areas.

A detailed illustrative module depicting the steps to be followed and result is indicated in **Appendix A**.

The comprehensive illustrative module as portrayed in the Appendix evidently depicts the change in entity's original Risk Matrices post 'Continuous Audit' reviews. Some risk scores (high) also remained unchanged, which need appropriate focus of Management.

Conclusion:

The success of a CA initiative is highly dependent upon the effective implementation and use of the right technology tools. In the same way, those tools will only be successful if used effectively. Organisations need to evaluate how suitable the features, functions and capabilities of a tool are for their needs before engaging a specific tool provider.

Appropriate application of Continuous Auditing in continuity would revolutionize the approach of our audit and lead to added efficacy of audit function. It is a transformative plan that hauls out hidden risk areas from apparently no-risk arena and converts potentially (or common understanding of high risk) high risk areas into no-risk areas. In other words, **this will help the audit committees in turning their hindsight into foresight and in developing further insight.** The evaluation of audit evidences calls for introspection on a two-way basis - by management as well as audit team towards risk and mitigation process and their seamless adaptation to specific operating environment.

APPENDIX A

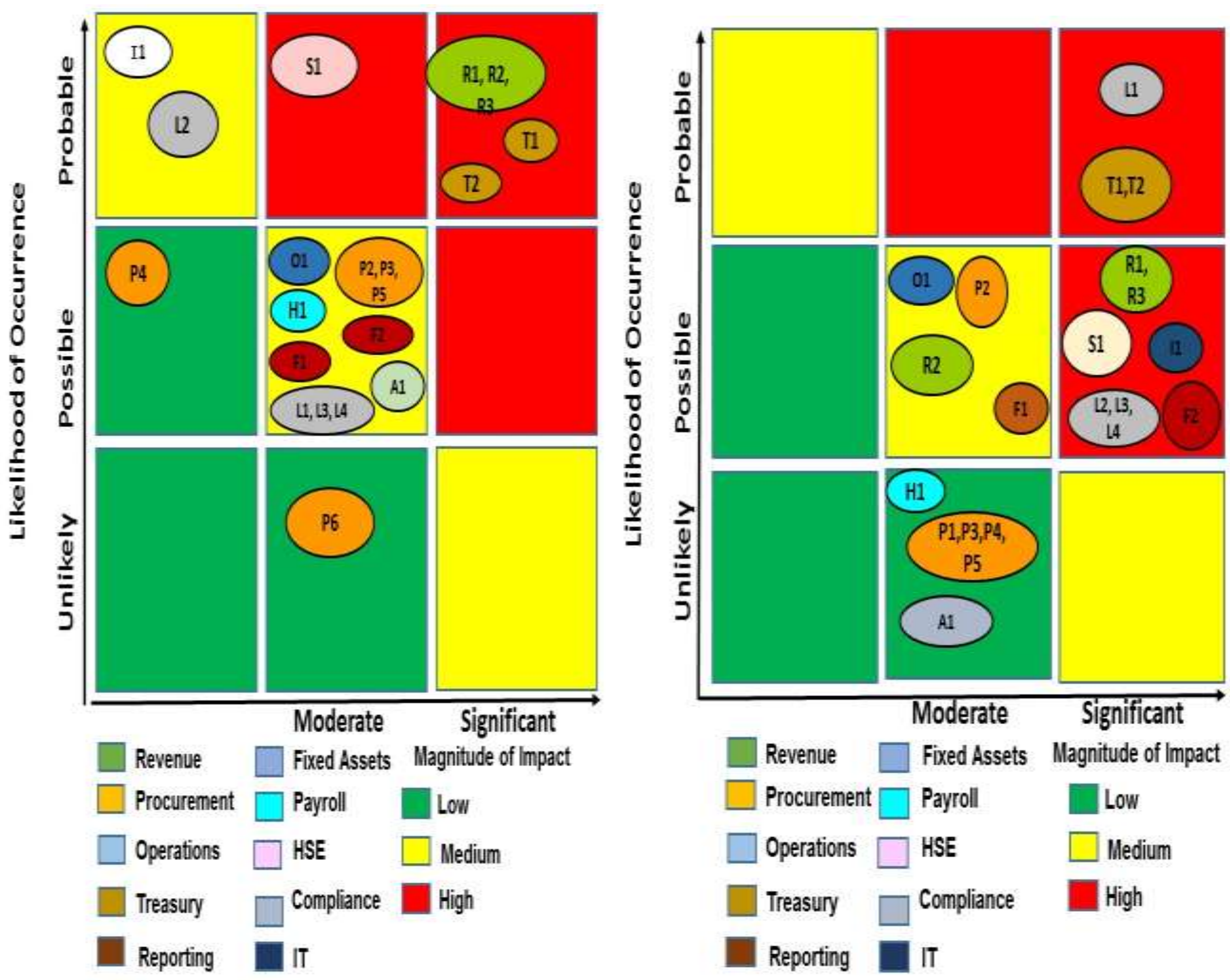
Business and Strategic Risk

Risk Basket	Audit Area
➢ Dependency on group Companies with fixed rate contracts	➢ Revenue Cycle
➢ Cyclical nature of industry attributing volatility to service rates	➢ Revenue Cycle
➢ Environmental pollution and property damages/losses	➢ Revenue Cycle ➢ Fixed Assets
➢ Currency fluctuations	➢ Treasury Cycle ➢ Revenue Cycle
➢ Dependency on contractual workforce for commercial operations	➢ Operating Cycle ➢ Treasury Cycle
➢ Increase in operating costs due to fuel price hike	➢ Operating Cycle
➢ Regulatory risk and Compliance	➢ Regulatory Cycle

The above risk and audit areas are perceptively tabulated in a risk matrix (as below) to produce correlated pictorial representation of likelihood of occurrence of risk and their potentiality for the initial and subsequent review.

Change in Risk Profile of the entity:

Pre and post review risk matrix with changes captured hereunder.



Ref.	Sr.	Business Process
R = Revenue	R1	Business Development
	R2	Order Management & Invoicing
	R3	Accounts Receivable & Collections
P = Payment	P1	Vendor Selection, Planning & Pricing
	P2	Purchase Ordering & Receipt
	P3	Inventory Management
	P4	Accounts Payable & Payments
	P5	Other Services and Expenses
O = Operation	O1	Operating Expenses
T = Treasury	T1	Loans (Secured & Unsecured)
	T2	Investments
F = Fin. Reporting	F1	Financial Reporting
	F2	Related Party/Inter group transactions
A= Assets	A1	Fixed Assets/CWIP
H = Human Resource	H1	HR and Payroll Process
S= Safety	S1	Health, Safety & Environment (HSE)
L = Legal	L1	Companies Act and SEBI Act
	L2	FEMA and allied Laws
	L3	Industrial and Labour relation
	L4	Other incidental /ancillary laws
I = Infotech	I1	Systems Controls

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The abbreviations used are as follows –

R=Revenue; P=Procurement and Payments; O=Operating Expenses; T=Treasury; A =Fixed Assets etc. Within each Cycle prioritization e.g. R1, R2 etc. made based on perceived risk score. The change in risk matrix consequent upon review and proposed corrective action/s can be seen in the risk matrix after final review.

Changes in Risk status after each review are reproduced hereunder:

Sr. No	Business Processes of the Entity	Assessment/Review during the Year			Reason for Change in Risk Classification
		1st	2nd	3rd	
R1	Business Development	**Medium**	**High**	**High**	No growth in new business initiatives High spent on initiatives taken
R2	Order Management and Invoicing	**High**	**High**	**Medium**	Timely execution & avoidance of Liquidated Damages
R3	Receivable & Collections	**Medium**	**High**	**High**	High Receivables, poor collection initiative Cost of fund blockage increased
P1	Vendor Selection, Planning, Pricing	**High**	**Medium**	**Low**	Prices benchmarked against market rates
P2	P.O and Receipts Logistics	**High**	**Medium**	**Medium**	Timely inventorization after quality check Just in time inventory maintained
P3	Inventory Management	**Medium**	**Low**	**Low**	Adequate inventory in terms of Production Plan
P4	Accounts Payable & Payments	**Medium**	**Medium**	**Low**	Accurate and timely release of payment
P5	Other Service and Expenses	**Medium**	**Low**	**Low**	Low involvement of fund
O1	Operating Expenses	**High**	**Medium**	**Medium**	Initiatives for expense curtailment
T1	Loans (Secured & Unsecured)	**High**	**High**	**High**	High borrowings with varied interest rate
T2	Investments	**High**	**High**	**High**	New business initiatives and huge fund deployment
F1	Financial Reporting	**Medium**	**Medium**	**Medium**	Adherence to Accounting Policies Adequate provisions for accounting events
F2	Related Party/Inter gr. transaction	**Medium**	**Medium**	**High**	Pending reconciliation between Group entities
A1	Fixed Assets/CWIP	**High**	**Medium**	**Low**	Timely capitalization and booking depreciation
H1	HR and Payroll Process	**Low**	**Medium**	**Low**	Adequacy of checks and balances
S1	Health, Safety and Environment	**High**	**High**	**High**	Nature of industry –pollutant
L1	Companies Act and SEBI Act	**High**	**Medium**	**High**	New regulations and compliance requirement
L2	FEMA and allied Laws	**High**	**Medium**	**Medium**	Min. fund movement and ensured compliance
L3	Industrial and Labour relation	**High**	**Medium**	**Medium**	IR Regulations mostly complied with
L4	Other incidental /ancillary laws	**Medium**	**Medium**	**Medium**	Transactional compliance
I1	Application Control (Systems)	**High**	**Medium**	**High**	Inadequate access control Improper mapping of Delegation of Authority in ERP

The aforesaid changes in the risk classification, is on account of prevalent business scenario at the time of each audit and management's approach towards their mitigation based on recommendation/suggestion from audit.

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