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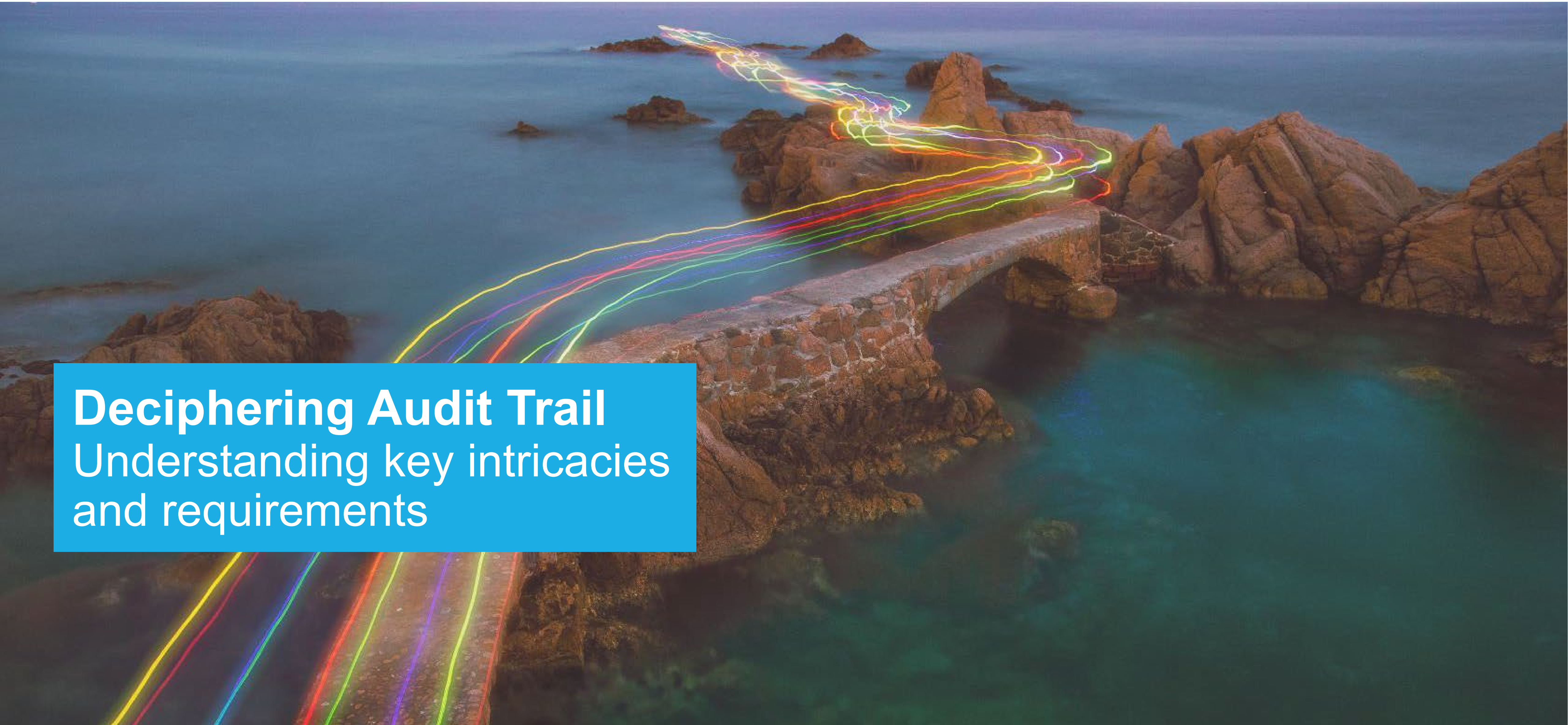
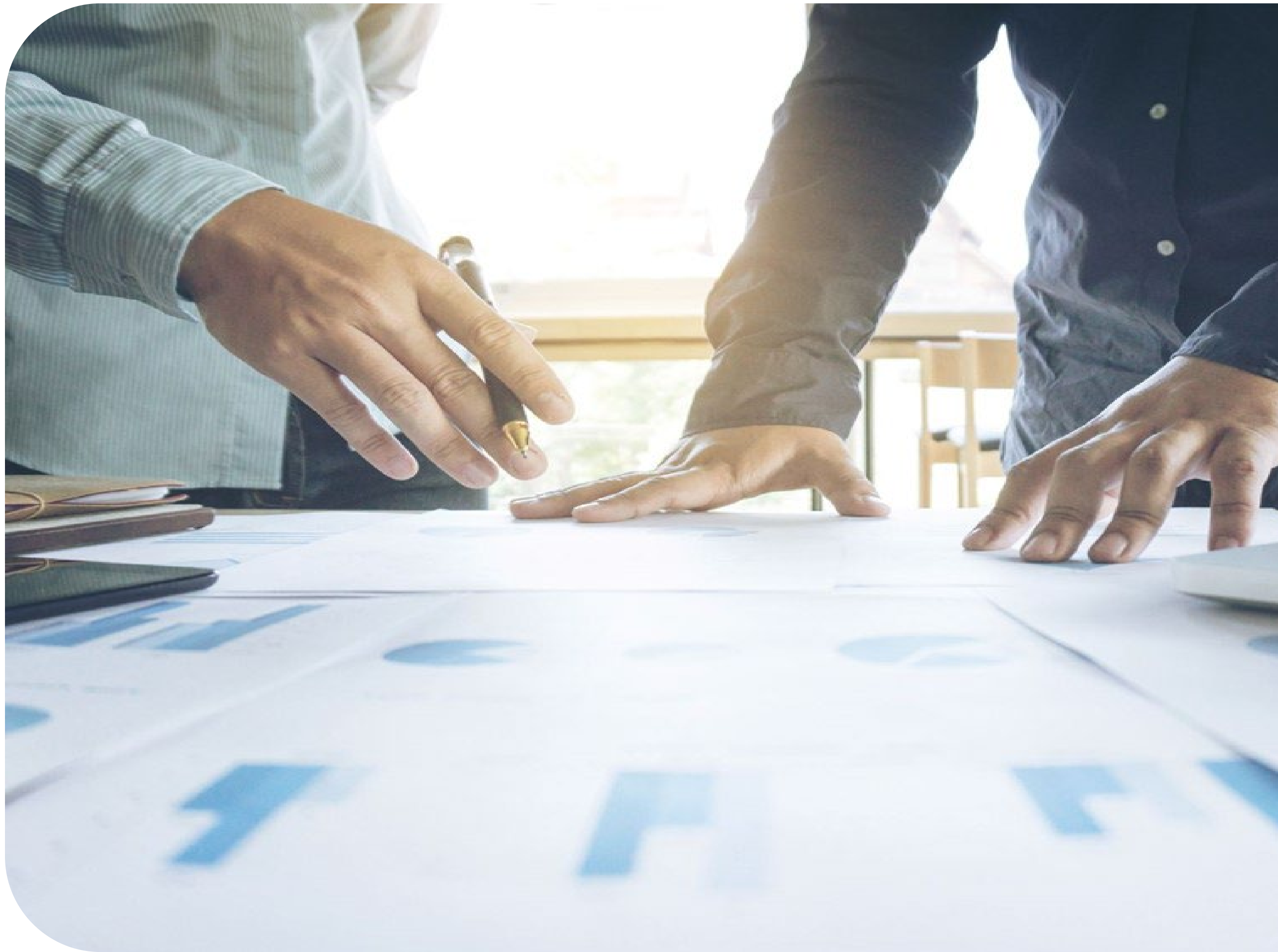


Deciphering Audit Trail
Understanding key intricacies and requirements

Audit Trail

Recently, India became the first country to introduce reporting requirements on the ‘Audit Trail’ to improve transparency and integrity of the financial reporting process. An Audit Trail is a key example of **regulators, corporations, and auditors working together** to improve transparency and trust in the financial reporting of companies. Investors consider this a step in the right direction to further strengthen corporate governance. Regulators have decided to incorporate this at an appropriate time in India’s growth journey, with the country attracting substantial foreign investments. This step will assist regulators in ensuring data availability in the country should there be a need for investigation into the company’s affairs.

This is the first of two articles on Audit Trail. In this article, we focus on understanding the Audit Trail and dive into the legal requirements and associated guidance. In the second article, we will touch upon the frequently asked questions on the subject.



What is an Audit Trail?

An Audit Trail, in the context of accounting software, is the process of creating a log or a trail of who has passed or made changes to the accounting entries/other data in the books of accounts and when such changes are made. (i.e. it identifies the 'who', 'when', and 'what' aspects of each accounting transaction). The concept is applicable in cases where accounting transactions are maintained in an electronic format.

Statutory Requirements

The Ministry of Corporate Affairs (MCA) initially planned to introduce the Audit Trail requirement under the Companies Act, 2013 (Act) with effect from 1 April 2021. However, the requirements were deferred and made applicable from 1 April 2023. Certain amendments were also made to the Act as covered below:

- The Act has now cast a responsibility on the management of companies to only use an accounting software that has a feature of recording the Audit Trail. While doing this, companies are also required to ensure that such logs have been operational throughout the year and cannot be disabled.
- A corresponding amendment has also been introduced relating to the maintenance of books of accounts in an electronic format. The Act now requires that a daily backup of books of accounts maintained in an electronic format be kept in servers physically located in India.
- Similar to the retention requirement for books of accounts, the company would need to retain an Audit Trail for a minimum of eight years.

Through additional amendments to the Act, company auditors have been given the responsibility to conduct fact-based reporting on the above. Such reporting may also have consequences on the opinion of the auditor on the financial statements.

The above requirements are applicable to all companies incorporated in India, including small and medium enterprises such as small companies, one-person companies, etc.

To assist the auditors with the above reporting requirements, the Institute of Chartered Accountants of India (ICAI) has issued an implementation guide titled 'Implementation Guide on Reporting under Rule 11(e) and Rule 11(f) of the Companies (Audit and Auditors) Rules, 2014' (Implementation Guide). We recommend that the management of companies also refer to this guidance to understand the reporting nuances in greater detail.

Understanding the Key Terminologies

The requirements relating to Audit Trail can be better understood by reference to three aspects, namely:

- Books of account
- Accounting software
- Audit Trail

Books of account is a term that is clearly defined under the Act (Section 2(13)) and includes records in respect of all amounts received and expended, all sales and purchases, the assets and liabilities, and also includes cost records if applicable to the company. Technically, all records maintained by the company in the core accounting software or otherwise in extended software, platforms, and applications where the details of base underlying accounting transactions are recorded would be included in this category.

The term **accounting software** is not defined under the Act. The ICAI has explained the term in its 'Implementation Guide' to mean, 'any software that maintains records or transactions that fall under the definition of books of accounts will be considered as accounting software for the maintenance of the Audit Trail.'[1]

Similarly, the term **Audit Trail** or edit log is not defined under the Act. As per the 'Implementation Guide' issued by ICAI, an Audit Trail (or edit log) is a visible trail of evidence enabling one to trace information contained in statements or reports back to the original input source. Audit Trails are a chronological record of the changes that have been made to the data. Any change to data including creating new data, updating, or deleting data that must be recorded.'[2]

Hence, any software whose output flows into the books of accounts will be termed accounting software and will be required to have the feature of an Audit Trail.

For all such software, companies would have to maintain the following information:

- When changes were made (i.e. date and time (timestamp))
- Who made the change (i.e. User ID)
- What data was changed (i.e. data/transaction reference; success/failure)

Audit Trails may be enabled at the accounting software level depending on the features available in such software or the same may be captured directly in the database underlying such accounting software.

The edit log is to be created for each change and this log cannot be disabled. The edit logs for eight financial years are to be retained as per the statutory requirements of retention for books of accounts. This retention requirement may increase the overall cost of compliance.

1. *As per the ICAI Implementation Guide on Reporting under Rule 11(e) and Rule 11(f) of the Companies (Audit and Auditors) Rules, 2014*
2. *As per the ICAI Implementation Guide on Reporting under Rule 11(e) and Rule 11(f) of the Companies (Audit and Auditors) Rules, 2014*

Outsourced Data Processing

In today's world, many corporations outsource a part of their accounting function, such as payroll processing, book-keeping, outsourced CFO services, etc. In such cases, the software used by the respective service organization containing core accounting information of the company will be covered under the definition of accounting software. Hence, the requirements related to Audit Trail will become applicable. To ensure adherence to such accounting records maintained externally by service organizations, the management of companies should request an Assurance Report on internal controls at such service organizations. This could be either in the form of an SOC 2 report (referred to by regulators in the US) or a more appropriate SAE 3402 report (based on Standards on Auditing issued by the ICAI or International Standards on Auditing issued by the International Auditing and Assurance Standards Board).

Companies should carefully ensure that in such cases:

- The accounting data is available with the company on an everyday basis by way of daily backup of data
- The Service Level Agreement (SLA) with the party to whom work is outsourced exists on record and is robust
- Where the service provider is outside India, the IP address of the service provider is to be kept on record and details are to be submitted to the Registrar of Companies (ROC)

Auditor's Responsibilities

The auditor must report on three aspects:

- Whether the accounting software has the feature of Audit Trail and the same has been in operation throughout the year and for all transactions.
- Whether the feature of the Audit Trail has been tampered with
- Whether the Audit Trail has been retained as per legal requirements

The auditor's reporting scope applies only to financial transactions and does not apply to other aspects such as the edit log of addition/deletion of users.

Globally, no similar reporting obligation exists for auditors and accordingly, there is no international guidance available on the subject to prescribe specific guidance to enable the auditor to obtain reasonable assurance and report accordingly under this clause.

The 'Implementation Guide' recommends procedures based on the Standards on Auditing. This could be in the form of inquiries to the management, those charged with governance, and the finance team. It also recommends reviewing finance processes, inspecting records, and observing the current processes being performed in the company.

Other Stakeholders

The investor community, as well as the audit committees, would appreciate these changes since they bring in transparency even though this requirement brings additional costs.

To the audit committees, this will be an important tool and will also help initiate dialogs with the management as well as auditors on the subject matter.

In terms of other regulators, India's financial crime agency has time and again encountered cases of money laundering. An important aspect here for regulators would be access to the accounting records to establish the flow of money. In this context, having a daily backup of electronic accounting records at a server physically located in India will be an advantage in favor of the investigating authorities rather than having the data reside outside India and not be available.

Gearing up for the Challenge

The management team and Board of Directors hold the primary responsibility for selecting the appropriate accounting software and related software to ensure compliance with applicable laws and regulations. Management teams need to perform an impact assessment to understand the different software that the company is using and then identify the software for which these requirements of an Audit Trail are applicable.

A good internal governance practice can be put in place for CFOs to report to the Board of Directors or the Audit Committee on compliance with these requirements. CFOs may require internal assistance from the Internal Audit Head and CISO. Since this compliance is required from 1 April 2023, we recommend that companies check on the adherence of this compliance at the earliest. A templated checklist-based questionnaire can be an important tool here to check adherence to the requirements of this compliance.

Concluding Thoughts

The Audit Trail is a part of the larger compliance requirements that are put in place by the authorities to achieve their ultimate objective of transparency. It is a responsibility cast on the management and, as a second layer, the auditor as well, who is required to report on the compliance. Hence, a company needs to maintain an Audit Trail, generate edit log reports, and ensure that these are not disabled at any time. Auditors then need to conduct a fact-based reporting on whether the Audit Trail feature has been successfully operated throughout the year and that no tampering has taken place.

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