Annual Transparency Report for Audit Firms- Will it make a difference

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Indian companies have become significant constituents of the global economy and India has evolved as a global centre of excellence in the delivery of financial reporting and audit services to a large number of multi-national corporations raising expectations for sound and high quality codes and practices comparable to global benchmarks. In today's complex and rapidly evolving business landscape, maintaining public trust in financial reporting and auditing practices is crucial. As a step towards enhancing the transparency about management and governance of audit firms and their internal policy framework to ensure high quality audits and preventing conflict of interest by maintaining independence, the National Financial Reporting Authority (NFRA) is in the process of mandating audit firms to prepare and publicize its Annual Transparency Report (ATR) containing certain critical information about the auditor's operational activities, management, governance and ownership structures, and policies and procedures necessary to deliver high-quality audits etc. The information contained in the ATR will be useful to the Investors, Audit Committees, Independent Directors and public at large.

Rule 8(2) of the NFRA Rules 2018 empowers the NFRA to require an auditor to report on its governance practices and internal processes designed to promote audit quality, protect its reputation, and reduce risks including risk of failure of the auditor and may take such action on the report as may be necessary. The Committee of Experts (COE) appointed by the Ministry of Corporate Affairs, Government of India in 2018 pursuant to Hon'ble Supreme Court direction in its report dated October 25, 2018 titled 'findings and recommendations on Regulating Audit Firms and the Networks' had also recommended inclusion of similar requirement in respect of every auditor and audit firm operating in India as a part/member of an international network. The COE recommended the introduction of ATR to enable NFRA to identify the instances of audit failure/ fraud caused due to faulty methodology followed by a particular network of which such an auditor is a part of and impose a monetary penalty on the members of such network.

The main objective of this reform is to restore the confidence of investors in the statutory auditors and the audit firms carrying out the statutory audit of 'Public Interest Entities ('PIEs'). The ATR requirements is in the process to be implemented in a gradual manner to begin with for PIEs starting with Statutory Auditors of Top 1000 Listed Companies (by market capitalisation). The ATR has to be published within three months from the end of each financial year.

The requirement requires auditors to disclose information such as

(i) Description of the legal, ownership, management, and governance structure of the audit firm.

(ii) If the audit firm is a member of any network in India or Overseas, description of the legal, operating structure and domicile of the network, requirements/ oversight of any professional accountancy body or independent regulator on such network, nature of the activities and services rendered by such network, name, domicile and legal and operating structure of the other members of the network operating in India and overseas and nature of their activities and total Income of the Network and the source of this income. In order to disclose the information as aforesaid, it is essential to understand the meaning of "Network" and the entities covered in the Network to which the auditor belongs. The term "Network" has been defined by the ICAI in the Guidelines for Networking of Indian CA firms, 2021 in the following manner – "Network means a larger structure of a group of Indian CA Firms that have come together for mutual benefits by pooling resources, showcase their combined strength, and have uniform policies, technology and collaterals, and showcase themselves as one big unit." However, while ICAI definition may limit the network to the Indian CA firms, the NFRA requirements extends beyond only Indian CA firms, and covers the overseas network as well.

(iii) Disclosure of details about the work alliances, collaboration, Licensing Arrangements, Knowledge/Resource Sharing Arrangements etc. with any third party or organisation, in India or International

(iv) Details and Descriptions of the Statutory Auditor's Policy and Procedures in respect of overall Internal Quality Control System, Monitoring and Ensuring Compliance with the Independence requirements for Independent Auditors, Acceptance and Continuation of Audit Clients, Audit Quality Control Mechanisms and Structures and its operating effectiveness, Brief description of Audit Methodology, Continuing Professional and Technical Education for all professional staff, Remuneration and Compensation of its Partners and Senior Staff, Transaction Pricing for Rendering Services to or Receiving Services among members of its network entities, date of the most recent internal review of its quality control mechanisms including compliance with Independence Requirements, results of this review and remedial actions to address the weaknesses and non-compliances, identified if any and information of the most recent review of quality control system review by the NFRA.

(v) Name and identification number of the entities that are within the purview of NFRA and are audited by the Statutory Auditor and/or other members of its network, alliances and/or collaborations in India.

(vi) Information about the total revenue of the Statutory Auditor and its network firms breaking up into Audit and Non-Audit services.

The disclosure is required to be made on a per-auditor basis, and not per-company basis. The entire requirement of publishing this ATR arises to avoid conflict of interest that the auditors may face as often firms forming part of the network of the audit firm engage in providing non-audit services to the auditee. This reporting is aimed at disclosing all such interests. The ATR aims at regulating the overall activities of the auditors, and therefore, the disclosures are also required to be made in respect of the auditor and not on a per-company basis. The ATR must be approved by the persons who approve the financial statements of the statutory auditor as per law. This would depend on the legal structure of the auditor, for instance, where the audit firm is carrying its business in the form of an LLP, the financial statements of the said LLP, and therefore the ATR must be approved by the designated partners of the LLP, similarly in case of a partnership firm, it is to be approved by the partners. In case of sole proprietorship, it is the proprietary of the concern who is required to approve the financials as well as the ATR. Further as per the requirements, this ATR must be prepared and published on the website of the auditor within the period of three months from the end of each financial year. Further, the same is required to be filed with NFRA before it is published on its website.

The concept of ATR is not new. A similar requirement has been in existence in some European countries and countries like Australia. Notable examples include the European Union's (EU) Directives and Section 322 of Corporations Act 2001, Australia and Schedule7A of Corporations Regulations 2001, Australia. Rule 14 of the EU Regulation No 537/2014 on specific requirements regarding statutory audit of public-interest entities specifies the requirement of a detailed report for the oversight of statutory auditors and audit firms. Similarly, section 322B of Corporation Act 2001, Australia read with Schedule 7A thereto, also requires auditors to publish transparency reports.

Will it make a difference

The role and responsibilities of the independent auditors have evolved significantly with focus on the need to build commensurate professional and operating capabilities within the auditing profession. Audit professionals have been augmenting their capabilities and resources. The benefits of an annual transparency report are two-fold- to the stakeholders and to the firms.

On one side, annual transparency reports have a significant impact on various stakeholders, instilling confidence in the auditing profession. Investors, regulators, and the public gain valuable insights into an audit firm's operations, governance, and commitment to quality. Transparent reporting helps various stakeholders make informed decisions, assess the reliability of financial statements, and understand the firm's approach to risk management and quality control.

On the other side, annual transparency report is a powerful instrument for audit firms to demonstrate their commitment to transparency, accountability, and audit quality. By complying with regulatory frameworks, implementing comprehensive reports, and disclosing meaningful information, audit firms can strengthen stakeholder confidence, foster continuous improvement, and contribute to the overall integrity of the financial reporting ecosystem. The impact of transparency reports extends beyond individual firms, positively influencing the auditing profession as a whole and enhancing trust in the reliability of audited financial statements. Transparency reports foster a culture of continuous improvement within audit firms. By publicly disclosing their quality control processes, audit firms are incentivized to enhance their practices continually. Inspection results and remedial actions help identify areas for improvement, leading to increased efficiency, effectiveness, and ultimately, higher audit quality.

In my view, the transparency reports will contribute to healthy competition and market efficiency. When audit firms disclose their operations and audit quality indicators, stakeholders can compare and evaluate different firms' performance. This promotes market discipline, encourages audit firms to compete based on quality, and incentivizes them to invest in resources and training to improve their services.