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

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Introduction

For a long time, transparency reports by audit firms have been used as a tool to instil public and regulatory confidence. The European Union was one of the foremost to mandate Annual Transparency Reports (ATRs) by firms that audit public interest entities. Laws in some countries outside the European Union also mandate ATRs, such as Australian law, Korean law, etc.

ATRs generally contain information related to the legal structure and ownership, governance structure, internal quality control system, quality assurance, education and independence practices, firm revenue information, partner remuneration and lists of PIE (Public Interest Entity) audit clients.

Corporates choose audit firms based on various criteria. While audit fees is one of them, much emphasis is given to the skills, experience and expertise when selecting an auditor. ATRs provide a ready reference to evaluate these criteria by supplying key information. Ultimately, ATRs will push firms on a fast-track mode to upgrade their quality systems to meet expectations and ensure timely disclosures.

That being said, while the intentions of ATRs are noble, it would be worthwhile to assess whether these disclosures will meet their objectives.

ATRs are our very own annual report

The very idea and practice of reading an annual report before investing is deeply ingrained in every investor's mind. It is an essential step before making any investment or business decision. The profession of chartered accountants, unlike corporates, is not mandated by laws to produce annual reports and leadership statements. ATRs can be seen as annual reports which can be read, assessed and evaluated before deciding to consider/ propose the audit firm to carry out the audit. ATRs have been accepted globally by corporates. Audit firms have in fact used this platform to make further voluntary disclosures to demonstrate prowess in their leadership, governance structure and committees, network arrangements, ethnic culture and strong clientele.

Scope/ Applicability of ATRs in India

ATRs are now well established and accepted in countries forming part of the European Union and Australia where they annually publish transparency reports. Firms in the United States also go for ATR disclosures. However, those are in accordance with the requirements of the European Union's Directive on Statutory Audit 2006/43/EC.

As the Statutory Auditor plays a significant role in upholding investors' confidence by exercising professional scepticism and judgment in the audit approach, National Financial Reporting Authority (NFRA), the audit regulator in India has expressed an urgent need for transparency in the functioning of audit firms and their audit quality.

The introduction of the requirement for audit firms to publish ATRs by NFRA of India is being seen as a welcome move and an initiative widely accepted and appreciated by various stakeholders from different industries, especially foreign investors. To date, information regarding governance structures and internal quality systems of audit firms have not been made public. Since its inception, the NFRA has issued and made public reports of certain firms inspected by them wherein they have made references to network arrangements and lapses in the internal control systems. However, these are very few and specific. Mandating ATRs in India will bring to public scrutiny and appreciation the audit firms' internal structure, thus allowing corporates to take more informed decisions.

The NFRA proposed a gradual approach to introducing ATRs in India. Some of the key steps are mentioned below.

- The ATR requirements were proposed to be implemented in a gradual manner for PIEs starting with Statutory Auditors of Top 1000 Listed Companies (by market capitalisation) with effect from the financial year ending on 31 March 2023.
- The ATR shall be published on the website of the Statutory Auditor within three months from the end of the relevant financial year for which the report is required.
- The ATR shall be approved by the persons required to approve the financial statements of the Statutory Auditor as per the law governing the Statutory Auditor or their governing body, if any.
- The Statutory Auditor shall file a copy of the ATR with the NFRA before it is published on its website.

The NFRA had sought public comments/ suggestions on the contents of the ATR by 16 February 2023 which was further extended to 24 February 2023. The proposed deadline of three months to publish ATRs from the end of the financial year, i.e. 30 June 2023 has already passed. It is surprising that the NFRA has not made any further announcements in this regard.

ATRs and Audit Quality

The underlying objective to require audit firms to issue public transparency reports is that more transparency on audit firms' governance and internal quality controls systems will reveal their audit quality competence and allow differentiation between them.

The effectiveness of these would need to be assessed vis-à-vis the various disclosures in the ATR. Some of these are discussed below:

1. Disclosures on Ownership and Governance Structure
   The governance of a firm is perceived to have a significant influence on audit quality. Without a sound governance system, creating a culture of audit quality is itself difficult. However, disclosures on audit firm governance will not reveal audit quality when the firms with weaker governance practices engage in a mimicking behaviour or issue boilerplate statements.

2. Disclosures on membership with any Network in India or Overseas/ Working alliances/ Knowledge/ Resources Sharing Arrangements
   Being part of a global network provides the firm access to various resources. These include the approach to audit methodologies, procedures, workpaper formats, audit tools and intellectual resources compliant with global standards which are considered strong pillars of audit quality.

3. A statement on the effectiveness of quality control system including ethics and independence, client acceptances, continuing professional and technical education, etc.
   A positive statement on quality control systems goes a long way in demonstrating the firm's commitment and infrastructure to carry out a quality audit. Firms with more robust descriptions and procedures are more likely to have better outcomes from an audit.
   ATRs will provide an opportunity to identify areas for improvement and implement necessary changes. Auditors can review their quality control processes, audit methodologies, training programs, and technology infrastructure to identify any shortcomings or areas for enhancement. By regularly evaluating and improving their practices, auditors can ensure that they are delivering high-quality audit services and maintaining their professional competence.
   The onus for making such a statement automatically brings about a structural and behavioural change in the firm towards independence, competence, and quality, especially if the statement is made by a small firm.

4. Audit fees for audit and non-audit services for PIEs, others, etc.
   There is a common notion that higher audit fees imply higher audit quality. Higher audit quality could be attributed to more audit effort (more hours) or greater expertise of the auditor (higher billing rates). However, it may not be correct to imply underperformance of an independent auditor if they charge lower fees. Similarly, higher fees cannot be a yardstick for better quality. Hence, correlating audit quality against fees may also not be very effective.

5. Disclosures of details of the latest internal/ NFRA review of its quality control mechanisms
   We believe this would be the most important differentiator for audit firms. Firms that demonstrate positive results stand to benefit. Firms that have any weaknesses or non-compliances reported in recent reviews would be motivated to demonstrate the remedial actions taken to remove the adverse remarks.

Going beyond traditional disclosures

Recently, audit firms are using ATRs to go beyond traditional disclosures. ATRs now demonstrate initiatives towards the adoption of technology and Environmental, Social and Governance (ESG) initiatives.

1. Technological advancements
   Technology in audit plays a critical role in improving quality. Every audit firm should plan to invest consistently in technology to enable a workforce that leverages technology while performing audits. ATRs are being used to demonstrate technology platforms, enhancement and innovation in their use of audit tools that will enable greater use of data analytics, better audit documentation, effective and secure communications, etc.

2. ESG Disclosures
   Firms are using ATRs to demonstrate their ESG Board and assessment of ESG initiatives during the year. ATRs are platforms for firms to demonstrate their efforts contribute to environmental sustainability, such as becoming carbon neutral, commitment to go net zero, etc. Firms' initiatives towards female empowerment, gender balance across partners and staff, voicing support for anti-slavery and anti-bribery laws, activities towards corporate and social responsibilities now find a place in ATRs.

3. Culture and People
   The culture of the firm and its people are crucial to ensure adherence to firm policies, appropriate mindsets, having experienced and skilled employees, exercising professional judgement and tolerance to non-compliance, and delivering high-quality audits. ATRs also mention leadership initiatives to achieve quality by incorporating advanced training programmes and seminars towards the overall welfare and development of their employees, professionals and partners, beyond just technical training. ATRs allow audit firms to demonstrate their policies and initiatives towards promoting a conducive culture for growth.

4. Sustainability
   There is a growing social, business, and ethical requirement to adopt sustainability in the firm's values, beliefs and approach. It emphasises the practices followed by the firm to identify the prevalent problems in the world and its strategic approach to deliver value to its stakeholders through its endeavours to resolve these problems. Disclosure of sustainability initiatives and policies in ATRs will enable stakeholders to understand the significant contributions made by the firm during the year and how consciously it is working to achieve sustainable growth.

Some NFRA disclosures go further than EU directive

While the disclosures proposed by the NFRA are largely in line with those prescribed for the EU, some require more detailed disclosures. Some of the more specific ones are discussed below.

Disclosures of remuneration and compensation of partners and senior staff

A firm is required to hire and engage experienced and skilled professionals to ensure compliance with various professional standards applicable to the audits conducted by them. Audit professionals are required to maintain a high level of scepticism, be skilled, possess sector specialisation, and be able to always deliver quality in addition to compliance with professional standards. Maintaining appropriate remuneration and compensation policies for partners and staff is essential to attract and retain rich talent, which ensures the delivery of quality services. Disclosures of the remuneration and compensation and their basis in ATRs will also demonstrate the firm's intention and commitment to remunerate and compensate their partners and staff based on performance and delivery of quality services.

Disclosure of name, domicile, legal and operating structure of the other members of the network operating in India and overseas; and the nature of their activities

These disclosures are very detailed and may not be useful to all corporates. However, strong infrastructure is required to maintain the entirety of this information. Network firms in India and overseas should be connected in a way that information can be pooled whenever required. To publish this information, audit firms may have to put in a significant amount of time, technology and infrastructure, which could be quite cumbersome.

Some challenges for India

The enhanced disclosures in ATRs may pose certain challenges for firms in India. Some of them are explained below:

1. Information pertaining to fees is sensitive in a competitive market like India and may not serve the interest of the firms or the stakeholders. Making such information available in the public domain may lead to competition/ undercutting, resulting in the dilution of audit quality.
2. A network firm will be required to invest more in technology to integrate all the information for presentation in the ATRs. This will enable it to customise information in accordance with the country-specific requirements, as every country has a different outlook on information disclosures.
3. As of now, the NFRA is yet to come up with the final framework to be followed by the audit firms. The proposed deadline (30 June 2023) to publish ATRs has already lapsed. It will take some time for the NFRA and then the audit fraternity to be able to re-accept the process, invest resources and finally mandate effective ATRs in India.

Costs and benefits – the universal test

Writing a good and effective ATR will require a firm to incur costs – tangible and intangible, and audit firms will invariably assess the associated costs and benefits. Disclosure costs are likely to be higher for smaller audit firms and the resulting benefits may be relatively low as, generally, their disclosures are of interest to fewer stakeholders. Large audit firms, which are part of networks, will have the advantage to leverage other jurisdictions for their ATRs.

Ultimately, the cost incurred on ATRs will lead to an increase in the cost of getting an audit done. Clients may or may not be willing to absorb this cost. Hence, it is very important that firms strike a proper balance between what is really required to be disclosed to gain public trust versus providing extensive disclosures that may not be very relevant.

Conclusion

Overall, ATRs will bring about an increase in scrutiny and enhancement in accountability by the audit firms. Auditors need to establish and maintain effective quality control measures to assure stakeholders that their work meets the highest professional standards.

The reputation of audit firms will surely improve as ATRs will communicate with the stakeholders, and they will demonstrate the willingness of audit firms to be accountable. Current and potential clients may view auditors who publish ATRs to be trustworthy and reliable. The effectiveness of the ATRs would greatly depend on audit firms going beyond just mandatory disclosures to provide useful information and demonstrate better governance, polices and controls. Such ATRs can serve as a differentiating factor in a highly competitive marketplace. This can lead to increased business opportunities, as clients are more likely to engage auditors who can demonstrate adherence to professional standards and a strong internal control environment. For this, auditors will need to ensure that their practices and procedures are in alignment with regulatory requirements and industry best practices.