

IMPACT OF RBI CIRCULAR ON AUDIT QUALITY OF BANKS AND NBFCS

Background

The Reserve Bank of India (“RBI”) issued new guidelines¹ for the appointment of Statutory Auditors² for Commercial Banks, Primary (Urban) Co-operative Banks and Non-Banking Finance Companies (NBFCs), including Housing Finance Companies. These Guidelines supersede all previous guidelines issued on the subject and were applicable for Financial Year 2021-22 onwards. However, non-deposit taking NBFCs with asset size³ below INR1,000 crores have the option to continue with their existing procedures.

As per the guidelines, entities with asset size of INR 15,000 crores and above as at the end of the previous year, should have their statutory audit conducted under the joint audit of a minimum of two audit firms. All other entities should appoint a minimum of one audit firm for their statutory audits. The actual number of Auditors to be appointed is to be decided by

the respective Boards subject to the limits on maximum number of joint auditors.

This circular has a significant impact on the sector and in this write-up we will look into some key issues related to the auditing of companies regulated by the RBI.

Independence

As per this circular, the time gap between any non-audit works⁴ e.g. internal assignments, special assignments, etc. by the auditor for its group entities should be at least one year, before or after its appointment as Auditor. This point attracted debate and later the RBI clarified its position through the FAQs. The circular also goes on to explain the procedures of auditors appointment in detail.

When we look at this requirement, it clearly demonstrates the objective of the regulators guidelines to prevent audit firms from

¹ Reference number DoS.CO.ARG/SEC.01/08.91.001/2021-22 dated April 27, 2021

² Statutory Central Auditors as well as Statutory Branch Auditors

³ Asset size means total assets.

⁴ Services mentioned under Section 144 of Companies Act, 2013

colluding and compromising on their audit procedures to get favours in the next year.

Tenure and Rotation

As per these guidelines, the auditors will be appointed only for three years and the same auditors will not be eligible for reappointment in the same organisation for next six years.

While this provision compels rotation of auditors, some argue that it is challenging to have new auditors every three years as the views on specific matters might be different and the task of getting the audit done becomes more complex because by the time this new auditor gains a complete understanding of all the issues involved, their tenure is up and a new firm rotates in.

Rotation of audit partner instead of audit firm should have also been a good control mechanism, some experts say.

Ceiling Limit for Audit Firms

One audit firm can concurrently take up statutory audit of a maximum of four Commercial Banks⁵, eight Urban Cooperative Banks and eight NBFCs during a particular year.

Now this has created an interesting situation in the market. While some firms with more than hundred audits of NBFCs had to shell

out everything other than those within the permissible limit, new market players came into the picture. While one may argue that sector specialization might be a missing factor in future, this certainly is going to help the industry as a whole, as the new auditors will have a fresh look into financial reporting. And of course, the National Financial Reporting Authority of NFRA, has already set the tone with issuing some harshly worded reports on working of the audit firms.

Audit Quality

Whether such guidelines will result in improving audit quality remains debatable, as it is not directly touching that point. In the same breath, having an independence certainly empowers the auditor. Looking from a macro perspective, this step will certainly help, though indirectly and only up to some extent by having new auditor every three years.

Power to appoint auditors and fixing their remuneration still remains with the management and THAT is a prime factor. With audit committees being the ultimate decision makers, promotor interference in the selection of auditors is a natural phenomena. If the regulator is really keen to improve the independence of auditors, and bring objectivity into the selection of the auditors, responsibility of allotment of audit work needs to remain with the regulator.

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⁵ Including not more than one PSB or one All India Financial Institution (NABARD, SIDBI, NHB, EXIM Bank) or RBI