BOMBAY CHAMBER'S
INPUTS/ RECOMMENDATIONS:

RBI Circular On Auditor's Appointment of Statutory Auditors - Implications & Recommendations

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BOMBAY CHAMBER

Bombay Chamber
of Commerce and Industry

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Overview of the RBI Circular

Background

- RBI has released this important Circular on 27 Apr 2021.
- Provides guidelines for appointment of Statutory Auditors of Commercial Banks and NBFCs.
- Immediately effective for 2021-22, with no transitional provisions.
- Certain matters require retrospective application and assessment.
- Significant changes compared to the extant regulations, including coverage of NBFCs for the first time.

Objective of the Circular

- Focus on enhancing audit quality, independence and accountability of auditors.
- Transparency in the process of selecting Statutory Auditors.
- Improvement in governance and monitoring process including empowering auditors to escalate to RBI.
- Increasing management oversight and responsibility.

Overview of the RBI Circular … Contd.

Area	Circular requirement
Applicability	▪ Commercial Banks (including PSB); NBFCs (including HFCs) with total assets above Rs. 1,000 crore (non-deposit taking) ▪ Effective for the year 2021-22
Tenure	▪ Appointment of auditors only for 3 years ▪ Cool-off period of 6 years
Limits on audits (covering network)	▪ Max. 4 Commercial Banks (including 1 PSBs, 1 FIs and RBI), 8 UCBs and 8 NBFCs
Independence	▪ Stricter independence rules (in comparison with Companies Act, ICAI Code of Ethics) ▪ Restrictions on audit/non-audit work with the Group: • during the tenure and one year prior/after appointment; • group includes entities using same brand.
Joint Audit	▪ Mandatory Joint Audits for banks/NBFCs with assets of Rs.15,000 crore or more
Others	▪ Firms having common partners and/or under the same network, to be considered as one ▪ Sharing/sub-contracting of audit not permissible.

Overview of the RBI Circular ... Contd.

Significant changes for Banks

- Max. 4 bank audits for the entire network of firms
- 3 years term as compared to 4 years
- Mandatory joint audits with assets of Rs.15,000 crore or more, for private banks

Significant changes for NBFCs (including HFCs)

- Max. limit of 8 (earlier, no limits, except under the Companies Act)
- 3 years term as compared to 2 terms of 5 years
- Mandatory joint audits with assets of Rs.15,000 crore or more

Significant other changes

- Restrictions on audit/non-audit services, covering the Group
- Independence evaluation covers one year before/after audit tenure
- Significant change in parameters for appointment of auditors
- Onus on board/audit committee/local management committee

Possible implementation challenges

Paucity of time to implement

- Requirement to appoint in the upcoming board meeting, leaving no time to evaluate based on established process. Sudden change may be disruptive to the entities and the overall sector.
- Requires senior level involvement to do justice to this critical and important process.
- Significant groundwork already done on auditor appointment may need to be redone.
- COVID-19 situation, lockdowns and work from home will pose practical challenges in physical meetings, orientation, and transition.
- Prior consultation would have helped the Industry in planning and preparing.

Restricted choice for the industry

- Stricter eligibility requirements including cap on audits, long cooling off period and restriction on services may reduce pool of eligible firms and restrict choice with the entity.
- Restricted choice with entities to select appropriate firms: size, scale, experience, reach.
- Groups deploying multiple firms across various entities in the group for audit/non-audit services will have additional challenge. The eligibility requirements may render all such firms, ineligible for appointment as audit for bank/ NBFC in the group.
- Unique challenges / priorities where there are subsidiaries, joint ventures and global holding.

Possible implementation challenges … Contd.

Specific challenges in group audits

- Challenges for the group in managing, monitoring and coordinating audit effort across different firms.
- Possible lack of responsibility in group audit opinions due to multiple firms.
- Lack of a holistic view of auditors on related party/group transactions, which may impact audit quality.
- There may be cascading / Indirect implications on entities within the group which are not otherwise regulated by RBI.
- Subsidiaries of global companies may face challenges due to multiple auditors.
- Inefficient audit procedures in audit of Consolidated Financial Statements.

Reduced value from audit

- Inability to leverage cumulative knowledge, experience and learning curve, gained over a reasonable tenure and association.
- Audit firms are required to deeply invest in technology, training, infrastructure and people. Given reduced audit tenure and cap on number of audits, certain firms may not be willing to commit significant investments, on a sustained basis. This can impact quality and value from audit.

Possible implementation challenges … Contd.

Impact on Ease of Doing Business

- Constant search and frequent rotation of auditors may not add value.
- Unproductive efforts on orientation about business, risks, systems, process, controls, and discussion on settled matters at frequent intervals to different and unfamiliar firms.
- Increased effort in coordinating for group audits.
- New entrants may be deprived of services and value of engaging with skilled and experienced firms.
- Possible impact on valuations, capital flows.

Inconsistent regulatory positions (Companies Act, Code of Ethics)

- Disregarding existing terms of contracts, due to lack of transitional provisions.
- Audit services to one entity in the group is considered to conflict with audit of bank/NBFC in the group.
- Inconsistency with existing provisions:
  - Appointment
  - Tenure and cool off
  - Joint audit
  - Non-audit services
- Related parties and definition of group including entities using the same ‘brand’ name.

Possible implementation challenges … Contd.

Joint audit considerations

- May have implications on audit effort and associate costs (both direct and indirect).
- Potential co-ordination challenges for management.
- Likelihood of overlap specifically in pervasive areas such as systems audit.
- Operational challenges to search for, appoint and transition to more than one audit firm.
- Chawla Commission of MCA has recommended to continue with voluntary adoption.

Retrospective implementation including lookback period of one year

- Indepndence restrictions considering 1 year look back period will pose additional challenge since:
  - Industry has not got opportunity to assess audit and advisory services and align choice of firms according to the restrictions imposed by the Circular.
  - Large business houses with multiple entities (including bank/NBFCs) will find this more difficult as they use services of various firms across the group, and which may not be tracked specifically since there was no such requirement earlier.

Possible implementation challenges … Contd.

Specific consideration for banks due to requirement of suggesting of 2 firms to RBI

- As per the RBI guidelines “ The Entities shall shortlist minimum of 2 audit firms for every vacancy of SCAs/SAs so that even if firm at first preference is found to be ineligible/refuses appointment, the firm at second preference can be appointed and the process of appointment of SCAs/SAs does not get delayed.
- This makes this guidance even more onerous as the companies will have to find four firms meeting these criteria while approaching RBI seeking approval.

Important matters for RBIs consideration

Review the extended coverage to the NBFCs, especially small and medium size NBFCs up to the asset size of Rs. 15,000 crore. RBI may consider applicability only to larger NBFCs

Provide adequate time for plan and implement including transitional provisions. Consider deferring implementation for 2 years

Reconsider severe restrictions on eligibility including cap on number of audits, tenure, cooling off period and coverage of group. Consider aligning with Companies Act,2013

Reconsider the applicability of joint audits and may consider voluntary appointment based on decision of board/ audit committees (as recommended by Chawla Committee of the MCA)

Important matters for RBIs consideration

Align the restrictions on audit/non-audit services for group entities, to the established principles in the Companies Act, 2013 and the ICAI's Code of Ethics.

Seek inputs from various stakeholders, including on specific challenges, and recommendations.

Allow for completion of term where reappointment is not due as per the extant provisions (e.g., NBFC's auditors appointed for 5 years should be allowed to complete the term)

Consider phase wise roll out to support holistic and successful implementation

Certain matters for clarification by the RBI

- The Circular may be interpreted to also extend to sectors and entities not regulated by the RBI, and accordingly to their auditors. A clarification should be issued to the effect that the circular is applicable only to banks and select NBFC's and their audit firms.
- Applicability of the Circular to various types of NBFCs (including those exempted from registration with RBI) such as certain CICs, Broking Companies, Insurance Companies, Asset Management Companies, Asset reconstruction companies, etc.
- RBI should clarify that the Circular is not applicable to Non-Deposit taking NBFCs.
- Clarify and provide implementation guidelines w.r.t the role of Board/Audit Committee's on any services provided to the Group and the governance process.
- Impact on audit tenure for existing NBFCs, crossing the threshold of Rs.1,000 crore after appointment and how the existing engagement tenure will be considered.
- RBI should clarify on the basis and process of factoring audit of entities with large exposure to Bank/NBFCs. It should also be clarified on how to deal with the dynamic nature of this exposure during middle of the year i.e. after the appointment of the auditor.
- RBI should provide clarification on the services to be regarded as internal and special assignments and regular process.

Recommendations for RBI’s consideration

Considering deferring the implementation of the Circular by 2 years

- Considering paucity of time and practical challenges it is requested that RBI may defer the implementation of the Circular for a period of 2 years.
- Provide specific transitional provision to assist in implementation.
- In the interim RBI may consider and evaluate recommendations of various stakeholders to make appropriate changes in the requirements.
- Provide stakeholders with much needed opportunity and time to assess, plan and prepare for these sweeping changes.

Consider alignment of the Circular with the Companies Act, 2013 and ICAI Code of Ethics

- This will ensure harmony amongst various regulations on matters related to auditor appointment, rotation, cooling off period, independence requirements, definition of group, joint audit, etc.
- Accordingly consider changes to the audit term, cap on number of audits and extended colling off period.
- Promote ease of doing business.

Reconsider extending the requirements to NBFCs.

- RBI may reconsider extending the strict provisions to NBFCs as NBFCs are already covered by the Companies Act,2013 and following the relevant provisions accordingly.
- Alternatively, the provisions may be applicable to large Deposit taking NBFCs i.e., NBFCs above a reasonable threshold.

Recommendations for RBI's consideration

Reconsider the wider definition of Group entities, align with Companies Act,2013

- No regulatory precedence of such wide definition of Group.
- Extremely difficult for banks/ NBFCs to enforce this requirement on many of the 'Group' entities some of which may not be under common control/ management.
- Definition of Group entities may be reviewed and aligned with provisions of Companies Act, 2013.

Reconsider retrospective implementation and assessment of services performed one year prior to appointment

- One year lookback period to assess eligibility for appointment as auditor of bank/ NBFCs may be done away with.
- Entities across the group would have used services of several firms not knowing that such firms will become ineligible for appointment as auditors of bank/NBFCs. Accordingly, retrospective application will severely constrain choice for suitable auditors for the bank and choice of auditors and consultants across the group. There are severe practical challenges in complying with this requirement.

Allow for completion of the present contracted audit term

- As a transitionary provision , auditors should be allowed to complete their unfinished term of appointment which was valid as per the then applicable regulations
  - ✓ Auditors of the banks should be allowed to complete 4-year term.
  - ✓ Auditors for NBFCs covered by the Circular should be allowed to complete 5-year term.

Recommendations for RBI's consideration

Reconsider stringent and unprecedented Independence restrictions on Audit and Non-Audit Services

- Audit is an independent service and accordingly two distinct and independent services should not be considered conflicting in nature. Accordingly, performing audit work at a group entity should not be considered as a conflict of interest for an auditor to be considered for audit assignment at the bank/NBFC.'
- Permissible non audit services (as per Companies Act, 2013 and ICAI Code of Ethics), should **not be** considered as conflicting services.

Reconsider requirement for mandatory joint audits

- Allow for voluntary appointment as per provisions of Companies Act,2013.
- A voluntary approach is consistent with global studies, experience as well as studies done in the Indian context, e.g., by Chawla Committee of MCA.

Provide much needed clarifications

- Various matters, as highlighted earlier, require further clarifications and implementation guidelines.
- Necessary clarifications and implementation guidelines will remove ambiguity, and support effective, consistent and timely compliance.

THANK YOU