



ENFORCEMENT ACTION FRAMEWORK IN RESPECT OF STATUTORY AUDITORS FOR THE LAPSES IN THE STATUTORY AUDIT OF COMMERCIAL BANKS¹

Statutory Auditors (SAs) of banks play an important role in contributing to financial stability when they deliver quality bank audits which foster market confidence in banks' financial statements. Quality bank audits are also a valuable input in the supervisory process of the Reserve Bank of India (RBI) for commercial banks.

2. In the interest of improving audit quality and with a view to instituting a transparent mechanism to examine accountability of SAs in a consistent manner, it has been decided to put in place a graded enforcement action framework to enable appropriate action by the RBI in respect of the banks' SAs for any lapses observed in conducting a bank's statutory audit. The framework would cover, inter alia, instances of divergence identified in asset classification and provisioning during the RBI inspection vis-à-vis the audited financial statements of banks above the threshold specified in the RBI circular DBR.BP.BC.No.63/21.04.018/2016-17 dated April 18, 2017. The circular could be accessed at <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10932&Mode=0>

The salient features of the framework are in the Annexure, as below:

Enforcement Action Framework in Respect Of Statutory Auditors for the Lapses in the Statutory Audit of Commercial Banks

1. The salient aspects underpinning the framework for enforcement action against the Statutory Auditors (SAs) for lapses in statutory audit of banks are summarised below.
2. Various statutes, viz., Banking Regulation Act, 1949, Banking Companies (Acquisition and Transfer of Undertaking) Act 1970/1980 and State Bank of India Act, 1955 stipulate that commercial banks shall obtain previous approval of the Reserve Bank of India (RBI) before appointing any SA. In exercise of these statutory powers, in case of those auditors whose audit quality or conduct is not found satisfactory by the RBI, it decides on enforcement action against them by way of not approving their appointments for undertaking statutory audit in commercial banks for a specified period. Further, the RBI may also not approve auditor/s, who have been debarred by other regulators/law-enforcement agencies/government agencies. As regards the cases pending against auditors with the aforesaid agencies, the RBI would debar such audit firms, provided the case is of serious nature, where public interest is involved and it is established, prima facie, that the firm is culpable, either by the RBI or by the above entities and brought to the RBI's notice.

Types of lapses to be considered

3. The lapses on the part of the SAs that would be considered for invoking the enforcement framework would, illustratively, cover the following areas:
 - a) Lapses in carrying out audit assignments resulting in misstatement of a bank's financial statements;
 - b) Wrong certifications given by the auditors with respect to list of certifications as advised by the RBI to banks;
 - c) Wrong information given in the Long Form Audit Report (LFAR);

¹ Available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=44357#A_1

- d) Issues related to misconduct by auditors in respect of their bank audit assignments; and
- e) Any other violations/lapses vis-à-vis the RBI's directions/guidelines regarding the role and responsibilities of the SAs in relation to banks.

Process of enforcement

4. The determination of actionable lapses on the part of the banks' SAs would be made on a case-specific basis, based on the following two dimensions:
 - a) The fact of lapse; and
 - b) The materiality of the lapse.
5. The **fact of the lapse** would be determined based on the existence of the following parameters:
 - a) Statutory provision and directive/guideline issued thereunder and violation thereof; and /or
 - b) Variance between the figures/statements as appearing in audited financial statements/certifications/LFAR given by the SA of the bank and the actuals, as determined later by the RBI; and/or
 - c) Non-adherence to/violation of the RBI's instructions/guidelines, etc.; and/or
 - d) Any other lapse/violation like misconduct of the SA.
6. The **materiality of lapse** would be determined based on the following aspects:
 - a) The **extent** of the violation, i.e., by what degree or percentage the figures in audited financial statements/certifications/LFAR given by SAs vary, vis-à-vis the actual figures, as determined later by the RBI, on account of the lapse/violation;
 - b) The **frequency** of the lapse/violation; and
 - c) The **impact** of the lapse/violation:

The impact of the violation would be assessed in terms of impact on a bank's Capital to Risk Weighted Assets Ratio (CRAR) considering the amount involved in the violation for divergence-related cases, and in case of other lapses, the impact would be calculated as the effect on the bank's business area concerned.
 - d) Aggravating factors such as repeated or persisting violations and wrong compliance, if any, would also be taken into account.

The adjudication process

7. For the purpose of providing a reasonable opportunity of being heard before adjudging the enforcement action, a notice in writing will be served on the SA by the RBI, requiring them to show cause, in writing, as to why the action as indicated in the Show-Cause Notice (SCN) should not be taken. A period of 15 working days would be given to the audit firms to reply to the SCN.
8. The RBI would provide a reasonable opportunity to the audit firm concerned for presenting its views in the matter, including through oral hearing, if it so desires or at the request of the audit firm. Based on the above, enforcement action, if any, would be taken by way of a Speaking Order served on the audit firm containing details of the lapses, written and oral submissions made by the audit firm, and findings and decision of the RBI.

The quantum of enforcement action

9. The quantum of enforcement action shall be determined based on the materiality of lapses/violations by audit firms. Lapses/violations that are determined to be **not material enough** would lead to the issuance of a Cautionary Advice to the audit firm. In case of a **violation determined to be material**, the enforcement action could be the RBI not

approving the audit firm for undertaking statutory audit assignments of banks for such periods as may be decided by the RBI.

Debarment by other regulators/law enforcement agencies and cases pending with them

10. In case of violations/lapses identified by any other regulators/ enforcement agencies/ judicial or government authorities, etc., the RBI would deny audit to such firms, provided the case is of serious nature, where public interest is involved and it is established, prima facie, that the firm is culpable, either by the RBI or by the above entities, and such violation / lapse is brought to the RBI's notice. Further, the RBI would also deny audit assignments to such audit firms as are blacklisted by the above entities and brought to RBI's notice, until the time their name is cleared by them.

Disclosure of enforcement action

11. Any enforcement action, including issuance of Cautionary Advice, on an audit firm will be communicated to the Institute of Chartered Accountants of India (ICAI), the professional body of the audit community, as and when such action is taken. The fact of such communication to the ICAI will also be placed in the public domain by the RBI.

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