Article

Practical Guide to Fraud Reporting – under Section 143 (12) of Act, 2013

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September 20, 2014

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Article

So, the Ministry's initiative of bringing the Companies Act, 2013 (the 'Act, 2013') in line with international laws is surely welcomed; a lot of new concepts have been aligned with international statutes. While the spirit of the lawmaker is well appreciated but unfortunately for India Inc. the intent did not get translated well in the letter leaving the regulations open to interpretation and corporate sector perplexed. What baffles us also, is the apex regulator's expectation on our ability of learning and practically implementing such enigmatic provisions of the Act. The requirement of Fraud Reporting by Auditors, definitely, is one such case!

Fraud Reporting is, unarguably, a very sensitive concept, for both the Auditors and the companies in the pretext of the corporate fiascos like Satyam and Reebok. But, unsurprisingly, the impulsive law makers' blanket approach towards the drafting ineptitude leaves glaring disparities for us to figure out…So come this financial year-end, India Inc. and the Audit professionals will all be left to make their own interpretations with regard to the reporting requirements. With the non- compliance penalty being as high upto Rs. 25 Lacs, one have no other option but to put in own thoughts to an unclear law!

Adding further to the duress, for an auditor penal provisions extend from imprisonment to payment of damages to *any* claimant for loss arising through any noncompliance of the said provisions. Consequences so high will transpire in putting the Auditors in a constant jeopardy, which surely may not have been the intent of lawmakers.

In this article we try to practically study the plausible impact arising from the said provisions and find a practicable approach towards its implementation.

Applicability and conditions of Fraud reporting - the provision of law

Let us first assimilate the reporting requirements regarding fraud as stated in the various provisions of the Act, 2013. Subsection (12) of Section 143 of Act, 2013 and allied Rules mandates that in case an Auditor has sufficient reason to believe that an offence involving fraud is being or has been committed against the company by its officers or employees, the Auditor shall report the matter within prescribed time to the Central Government.

As of date, this reporting requirement is ***applicable to*** Statutory Auditors, Cost Auditors as well as the Secretarial Auditors.

So, a few obvious questions arise –

- what would constitute as 'fraud' for reporting under Section 143 ?
- is it the onus of the Auditors to report all fraud(s);
- or one should assume there should be a reasonable, context of materiality to it ?

The section mandates the Auditors to report fraud(s) within a stipulated period of such knowledge of fraud(s) to the Central Government. If the intent of the legislation is to create a robust disciplinary mechanism by increasing the involvement of Audit professionals in perpetuating corporate misdemeanor, does the Ministry wish to be informed of all sundry fraudulent actions?? Therefore, for the reporting under Section 143, a mere identification of fraud should not be the only criteria of such reporting.

Before delving further, let us first understand the notion of 'fraud' as could be gathered from various statutes.

What constitutes a 'Fraud'?

Although Section 143 of Act, 2013 does not give us any basics for determining a 'fraud', one may look into Section 447 which entails to penal consequences for fraud. Explanation (i) to section 447 introduces a definition, reproduced herein below -

> *"fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss*

However, since the above definition has been given only in the context of prosecution, for understanding the notion of 'fraud' under Section 143, we certainly have to look for an independent rendition and cannot be read *pari materia* with the provisions of Section 447.

A extensive definition of 'fraud' can be drawn from section 17 of the Indian Contract Act, 1872, which states -

> *"Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto his agent, or to induce him to enter into the contract;*

So, for identifying an act to be fraudulent, the following ingredients have to be proved -

i. the suggestion as a fact, of that which is not true, by one who does not believe it to be true;

ii. the active concealment of a fact by one having knowledge or belief of the fact;

iii. the suggestion should be found to have been made with intent either to deceive or to induce the other party to enter into contract in question.

Similarly, the UK Contact Law also reiterates the above, where fraud has been defined as a deception or a fraudulent action, deliberately practiced in order to secure unfair or unlawful gain. Therefore, it would be fair to refer to the expansive meaning of 'fraud' as defined under the Indian Contract Act, 1872 for the purpose of Section 143.

Why the context of Materiality?

A corporate entity is a complex mesh of multiple functionalities where. Looking deeply into thestructural framework, there could be frauds committed by the management, committed by external individuals and small frauds or large sized frauds. Hence, there should be guidance on basis and extent of coverage of such reporting.

General fraud prohibitions are sprinkled throughout the international laws and statutes. The core concept in federal laws rests on a single word - *material*. Federal statutes and agency anti-fraud rules and disclosure requirements contain the term as an essential qualifier and identifier. The '*materiality*' qualifier first appeared explicitly in various sections of the U.S. Securities Act.

Here, let us look into the first major U.S. Supreme Court case to define materiality, *TSC Industries, Inc*. v. *Northway, Inc*. However, it was not *sui generis*; it followed Mills v. Electric Auto-Lite Co., a case in which the materiality of the omitted information was assumed and the issue before the court was causation. Both these cases dealt with proxy solicitations on a merger approval vote.[1]

In the *Mills* (Supra), the Court held that a defect in disclosure is material if the defect is of such a character which may have been considered important and reasonably effects the decision itself. It was also stated that the materiality standard would be considered not met, if *the defect was of merely trivial in nature, either in quantum or intent - "a defect was trivial, or rather unrelated to the transaction for which approval is sought . . .*"

In the *TSC Industries* (Supra), the above rendition was represented in a further structured manner. Although it stated that materiality should be seen on a balance of information available, it reiterated the common principle of law of *de minimis non curat lex,* which translates to 'the law does not concern itself with trifles'. That is to say, the Court is not bound to judge on minor transgressions of law.

[1] https://www.law.upenn.edu/live/files/157-oesterle14upajbusl1672011pdf

Applicability of materiality is also not new in our international accounting practices. Authoritative accounting bodies in the USA such as Financial Accounting Standard Board (FASB), General Accounting Office (GAO), Securities and Exchange Commission (SEC) and others have contributed in defining materiality as a mix of both quantitative and qualitative factors. In the international arena, The International Accounting Standards Committee (IASC) (1989) has defined the information as material, basing it on quantum and its intent to effect the decision making of the concerned stakeholders -

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. ***Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement****…" (emphasis supplied)*

Drawing an analogy from the above discussions, one can easily point the guiding factors for determining materiality –

- the concept of materiality has to be comprehensive in nature, both quantitative and qualitative
- Being a disclosure requirement, the quantitative substantiality of the error should be a deciding factor.

In Indian forum, the palpable concerns on the reporting requirements have been aptly brought forth by Mr. K. Raghu, President, Institute of Chartered Accountants of India (ICAI), in his recent interaction with ET NOW[2]. Being asked on how this inclusion of fraud reporting would improve the overall corporate governance, his thoughts echoed the glaring issue in the unclear law which nowhere guides us regarding the materiality and extent of frauds to be covered.

In line with his thoughts, the present legislation surely leaves the audit professionals with the baffling task of finding a road ahead as without the context of materiality, the basic intent of this provision will surely get lost in the course of implementation and in time, will just turn into another filing requirement!

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[2] http://articles.economictimes.indiatimes.com/2014-06-16/news/50623808_1_lilliput-kidswear-icai-chief-corporate-fraud

Fraud reporting under various reporting norms

The concept of materiality in fraud reporting, by intent and value, has already found its way in various other reporting requirements, both in Indian and international laws.

Under Reserve Bank of India (RBI) Regulations

Although the primary responsibility for preventing frauds lies with the banks and NBFCs themselves, the RBI has been the nodal advisory body for defining the safeguards necessary for fraud prevention and its reporting. RBI, the apex Banker, has taken a leaf from the international statutes and has devised a reporting system based on materiality and quantum of fraud involved. The reporting structure is based on the following three strata -

Frauds involving amounts less than Rs. 1 Lac – individual cases not required to be reported to the RBI; however, the same should be covered in the bank/NBFC's quarterly reporting on fraud.

Frauds involving amounts Rs. 1 – 25 Lacs - should be reported to the requisite reporting authority under RBI, in a prescribed format, within three weeks from the date of detection.

Frauds involving amounts above Rs. 25 Lacs - should be reported separately as each individual case to the requisite reporting authority under RBI, in a prescribed format, within three weeks from the date of detection.

Under CARO, 2003

The Auditors are only required to disclose in the Report the nature and amount of any fraud on or by the company has been noticed or reported during the year. It should be noted here, that CARO covers fraudulent actions, *both for and against* the company.

Under the Surbanes-Oxley Act, 2002

Section 303 of the Surbanes-Oxley Act, 2002 clarifies the nature of fraud committed *for and against* a company. In line with the federal laws, the reporting requirement covers the context of materiality of misrepresentations occurred. However while considering materiality of fraud, it may not be limited only to the quantum rather by intent. In other words, even if the quantum of fraud is comparatively low and there is intent of fraudulent misrepresentation materially affecting the financial position of the company, the same will tantamount to fraud.

The way ahead

In light of the above discussions, let us now sum up a possible outline for such reporting –

- ***what would constitute as 'fraud' for reporting under Section 143 ?***

  The expansive meaning under Indian Contract Act, 1872 to be considered for defining 'fraud' under Section 143.

- ***is it the onus of Auditors to report all fraud(s) or one may assume there is a reasonable, minimum, quantum to it ?***

  Considering the sensitivity and reporting mechanism involved, materiality and extent of fraud should be very much relevant.

  In this regard, a cue can be taken from the RBI Regulations where the context of materiality has been well imbibed in fraud reporting.

- ***in case where the management of a company is already aware of the fraud perpetrated and has also reported to any of competent authorities, will the Auditor require to make any further reporting under Section 143?***

  Since the context of the legislation is to draw attention of the stakeholders and apex regulators to the committed fraud and strengthen the disciplinary mechanism, the Auditors should still address the same even if it has been reported earlier to another authority by the company.

Applicability of Section 143(12) to be effective w.r.t. which financial year?

With the section being effective from April 1, 2014, the reporting requirement of course will arise in the relevant financial year, 2014-15. The ICAI in its recent announcement3 has taken a view on whether the applicability of reporting would trigger while carrying out the audits of financial statements for the interim periods, such as quarterly or half yearly audits, of financial year 2014-15.

The Council has taken a stance that since such quarterly/ half yearly audits are not carried out pursuant to the requirements of the Companies Act 2013 (rather to meet the specific requirements of the audited company, for example, to comply with the listing agreement requirements) as the latter only envisages audit of the annual financial statements), it

[3] http://taxguru.in/chartered-accountant/fraud-reporting-14312-applicable-auditors-quarterly-yearly-audits-icai.html

seems that reporting under section 143(12) would only be relevant with respect to a financial year (and not for any interm period), i.e., *f.y. 2014-2015 and onwards*.

Manner of reporting under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, is enumerated below -

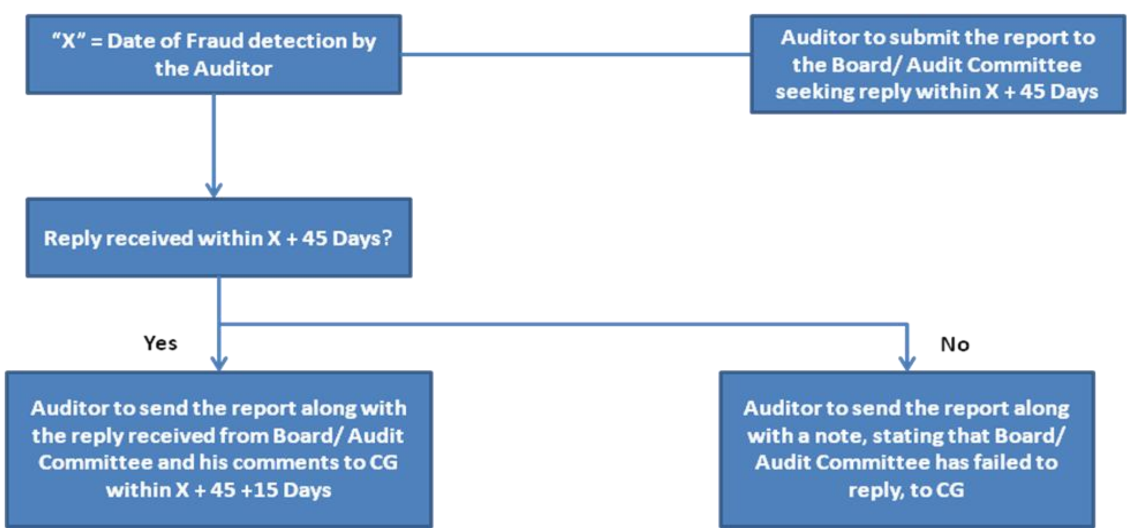
i. Immediately on detection of the fraud, the Auditor shall forward his report to the Board or the Audit Committee, as the case may be, seeking their replies /observations within 45 days from such intimation;

ii. In case replies/observations are received in due time, the Auditor shall forward his report along with his comments on the Board/Audit Committee's replies/observations to the Central Government within 15 days of receipt of such replies/observations;

iii. In case no replies/observations are received within the stipulated time of 45 days, the Auditor shall forward his report to the Central Government, along with a note stating that the report, earlier forwarded to the Board/Audit Committee, has failed to receive any reply/observation on it.

iv. The report should be sent in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.

For the purpose of this provision, 'Central Government' would mean the Secretary, Ministry of Corporate Affairs.



Conclusion

It's a fact that India Inc. and independent professionals would be facing a daunting task if such reporting be implied on all frauds, but will it be at all possible for the Ministry to assimilate the same?! The apex regulators, at one point, would have to realize that law-making cannot be a half-baked job and its implementation should not always look upto Ministry's grant of 'slow comforts' through continuing circulars.

Even with all the logical interpretations in place, for now, one can only hope for the Ministry to take note of the plausible impact and perhaps, address the issue at the earliest.