

Article



Fraud Reporting - Time To Act Now!

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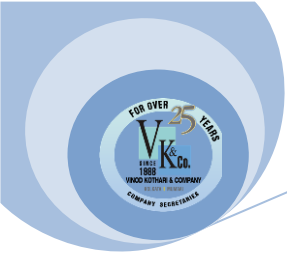
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Preface

The notification issued on the 15th of December, 2015¹, by the Ministry of Corporate Affairs (MCA), has made the provisions of section 13 of the Companies (Amendment) Act, 2015 (21 of 2015) effective from the December 14, 2015.

The Institute of Chartered Accountant of India (ICAI) has approved the “Revised Guidance Note on Reporting on Fraud” on the 10th of February, 2016², clarifying various issues with regard to the interpretation and implementation of the section on fraud reporting.

Section 13 of the aforementioned Act pertains to sub-section (12) of section 143 of the Companies Act, 2013 (the Act), which deals with reporting of fraud by the Auditor.

Section 143 (12) states that –

“Notwithstanding anything contained in this section, if an Auditor of a company in the course of the performance of his duties as Auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the Auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of a fraud involving lesser than the specified amount, the Auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose Auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, he shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.”

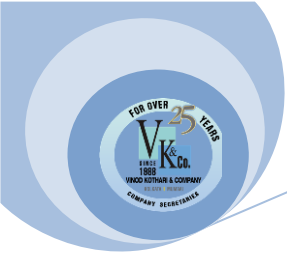
Section 143 (13) of the Act states that-

“No duty to which an Auditor of a company may be subject to shall be regarded as having been contravened by reason of his reporting the matter referred to in sub-section (12) if it is done in good faith.”

From the reading of the above provisions, one can deduce that the Auditor ought to report, if he has reason to believe, any offence involving fraud being committed in the company. This reporting of fraud will be construed to have been done in the best interests of the company

¹ http://mca.gov.in/Ministry/pdf/Amendment_Rules_14122015.pdf

² <http://resource.cdn.icai.org/41297aasb-gn-fraud-revised.pdf>



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without prejudice to the other obligations and duties of the Auditor.

Applicability

The Revised Guidance Note issued by the Auditing and Assurance Standards Board of the ICAI, has clarified that the applicability of this section on fraud reporting is applicable only to the statutory auditors of the company, the cost accountant in practice, conducting cost audit under section 148 of the Act; and to the company secretary in practice, conducting secretarial audit under Section 204 of the Act. It shall also extend to a branch auditor appointed under Section 139 ‘to the extent it relates to the concerned branch’.

However, the provisions of Section 143(12) shall neither apply to other professionals who are rendering other services to the company nor to the internal auditors required to be appointed under section 138 of the Act.

Implication of the phrase “*in the course of performance of his duties as an auditor*”

The duty of the auditor in an audit conducted under section 143 is to comply with the Standards on Auditing (SAs). Further, Section 143(2) requires the auditor to prepare his report after taking into account the auditing standards. Accordingly, the term, “*in the course of performance of his duties as an auditor*” implies in the course of performing an audit as per the SAs.

What is fraud?

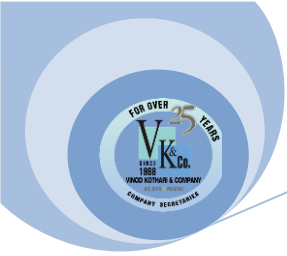
At this juncture we need to understand what constitutes the term “fraud”. Though the word “fraud” is subjective and might take in its ambit any degree, types or acts as fraud, it is important for us to have a distinct view on the same.

Although Section 143 of Act, 2013 does not give any basis for determining an act or deed as ‘fraud’, we may refer to Section 447 which states the 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 is restricted to prosecution and for understanding the notion of ‘fraud’ under Section 143, we certainly have to look for an independent rendition and cannot



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read it restricting ourselves to the provisions of Section 447.

An 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;

This indicates that to identify an act to be fraudulent, the following points have to be proved -

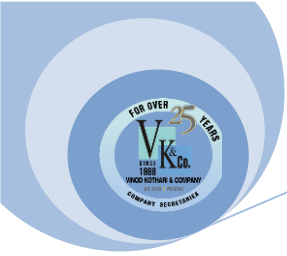
1. the suggestion as a fact, of that which is not true, by one who does not believe it to be true;
2. the active concealment of a fact by one having knowledge or belief of the fact;
3. the suggestion should be found to have been made with intent either to deceive or to induce the other party to enter into contract in question. The course of action
4. Now comes in the question whether all kinds of frauds irrespective of the magnitude ought to be reported. In a company numerous kinds of fraud may occur. These may be in any department done by any individual. This indicates that fraud reporting is nothing less than entering a maze. Hence there should be some guidance on the basis of which the Auditors decide upon which frauds to report about. Rule 13 (1) of the Companies (Audit and Auditors) Rules, 2014 specifies the amount of Rupees One Crore and above, individually, against the company.

Few guiding factors which may be taken into consideration are:-²

- 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.
- The intent behind the fraud committed and the extent of the after-effects should also be taken into consideration

This has been inferred from the International Accounting Standards Committee (IASC) (1989) where information has been considered as material, on the basis of quantum and the 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



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misstatement...” (Emphasis supplied)

With the previous rule 13 of the Companies (Audit and Auditors) Rules, 2014 being substituted, Auditors have a quantum defined on the basis of which he has to report. If the amount of fraud is rupees One Crore or above the Auditor shall report to the Central Government and if the amount of fraud involved is less then, the Auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud.

Clarifying the uncertainty behind this, the Revised Guidance Note states that the inference for “fraud” should be drawn from the SA 240.

“Fraud”, as per the SA 240 means- *“an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”*³

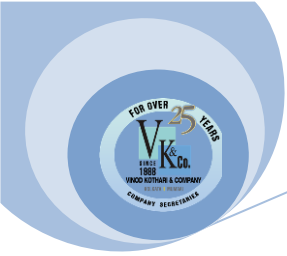
SA 240 also states that there are two types of misstatements to be considered by the auditors in the context of fraud-misstatements. *“Two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.”*

Hence, the auditor shall consider the requirements of the SAs, insofar as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statement.

Elements of fraud

The elements of fraud, on the basis of definition of fraud as per the SA 240, have been diagrammatically depicted below:-

³ http://resource.cdn.icai.org/15373Link8_240SA-AAS4.pdf



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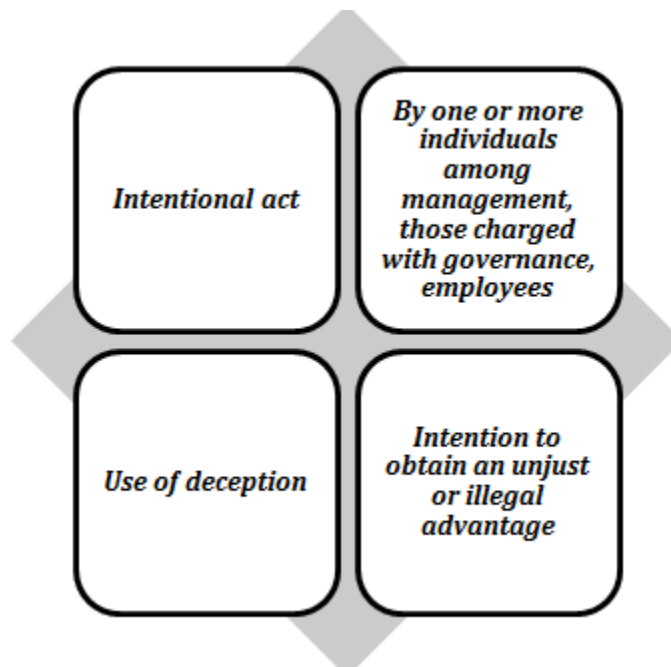


Figure 1: The elements of fraud

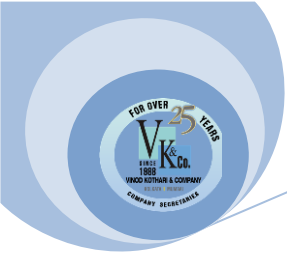
Manner of reporting

The manner of reporting by auditors under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, is explained further -

- i. As per the rule, fraud is to be reported immediately on detection of the fraud, even if he has sufficient reason to believe the committing of a 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.

But, the form ADT-4 makes use of the term “*Suspected offence involving fraud*”. Hence, based on a harmonious reading of both the rules (as amended) and the contents of the form ADT-4, reporting of fraud in this context, will have to be done only when the auditor has “*reason to believe*” and “*has knowledge*” that a fraud has occurred or is occurring. Summing up, it infers that auditor should report a fraud if he has evidence supporting his belief of the existence of the fraud.

- 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



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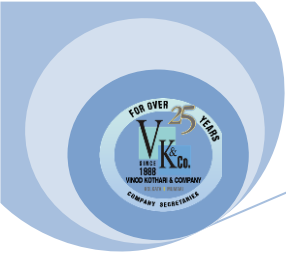
- reply/observation on it.
- iv. The report (in the format of ADT-4) should be sent to the Secretary, Ministry of Corporate Affairs, in a sealed cover by Registered Post with Acknowledgement Due or by Speed post followed by an e-mail in confirmation of the same.
 - v. These shall apply to both the cost as well as the secretarial Auditor.

In case of a fraud involving lesser than the amount specified in sub-rule (1), the reporting will be in the following manner-

- i. The Auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than two days of his knowledge of the fraud and
- ii. he shall report the matter specifying the following:-
 - (a) Nature of Fraud with description;
 - (b) Approximate amount involved; and
 - (c) Parties involved.
- iii. The following details of each of the fraud reported to the Audit Committee or the Board during the year shall be disclosed in the Board's Report:-
 - (a) Nature of Fraud with description;
 - (b) Approximate Amount involved;
 - (c) Parties involved, if immediate action is not taken: and
 - (d) Remedial actions taken.

A chart depicting the above mentioned routes of reporting is shown below in-

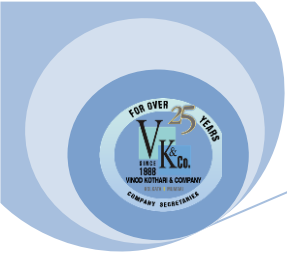
1. Figure 2: Modes of fraud reporting under section 143 (12), when amount is Rs.1 Crore or above [Part-1] and;
2. Figure 3: Modes of reporting fraud U/s 143 (12), when amount is less than Rs. 1 Crore [Part-2]



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Figure 2: Modes of fraud reporting under section 143 (12), when amount is Rs.1 Crore or above [Part-1]



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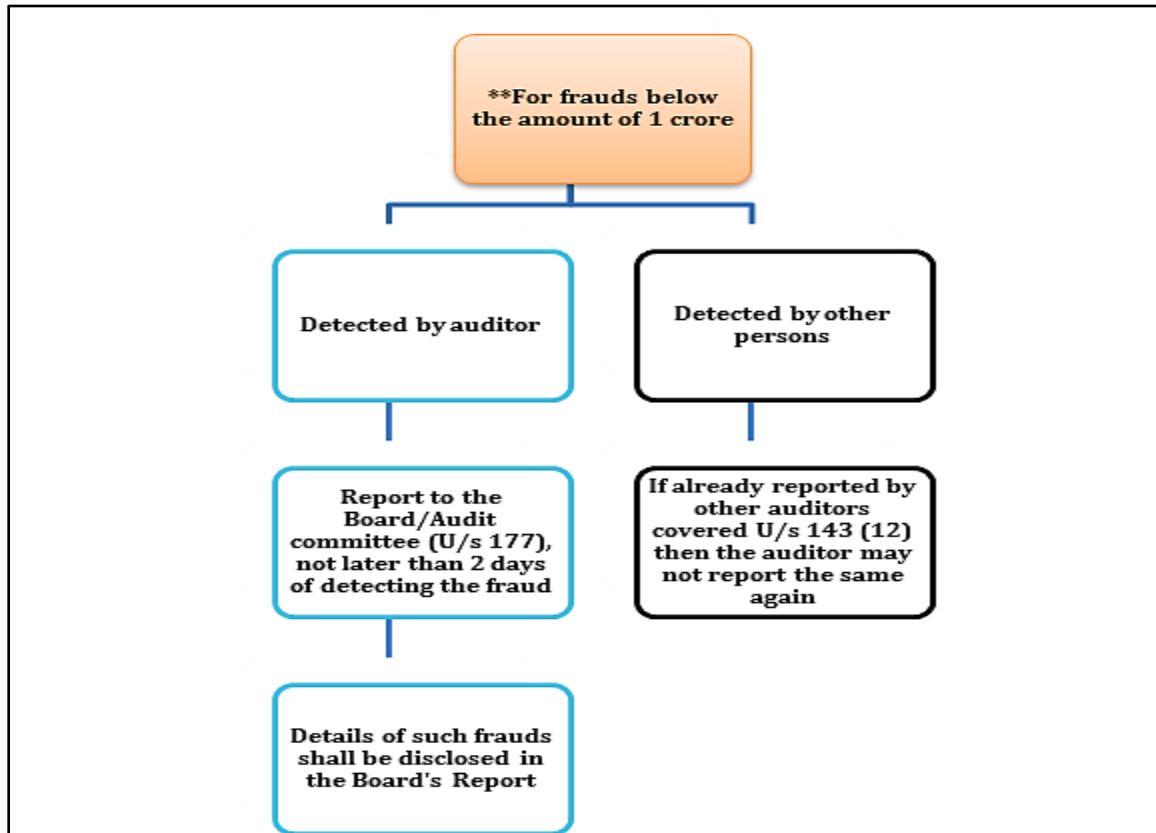


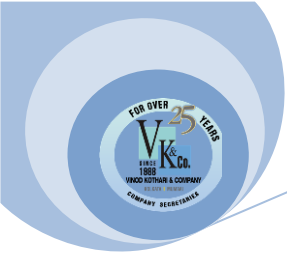
Figure 3: Modes of reporting fraud U/s 143 (12), when amount is less than Rs. 1 Crore [Part-2]

Applicability of “materiality”

Materiality is applicable wherever the amount is quantifiable. Where the amount is not quantifiable, the auditor should apply professional judgement to estimate the likelihood of the amount exceeding the aforesaid limit of Rupees One Crore prescribed for reporting to the Central Government.

Since the auditor is required to comply with the SAs during the course of performing his duties as an auditor, the audit will be performed applying the concept of materiality provided in the SAs.

Section 143(9) requires the auditor to comply with the SAs, which, *inter alia*, includes consideration of materiality, applying materiality in evaluating misstatements and disposition of the same. The auditor should continue to apply the concept of materiality in performing the audit



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in accordance with SA 320⁴ “Materiality in Planning and Performing an Audit” and SA 450⁵ “Evaluation of Misstatements Identified during the Audit”

Some curious questions

- **What if the company commits the fraud?**

Section 143(12) take into its ambit the frauds committed by the officers or employees of the company against the company and not by the company. Hence, only those frauds are to be reported under this section which has been committed against the company by employees and officers of the company.

- **Will the Auditor be held responsible for the frauds known and identified by the Board of Directors but not disclosed in the Board’s Report?**

In case any fraud is identified by the Board of directors but has not been reflected in the Board’s Report and the Auditor is not aware of the same, the Auditor **cannot** be held responsible for the same. This is so because Rule 13(4) of the Companies (Audit and Auditors) Rules, 2014 clearly states that in compliance of the provisions of section 143, the Board’s report shall include the fraud reported by the Auditor to the Board or the audit committee under Rule 13 (3) of the Companies (Audit and Auditors) Rules, 2014.

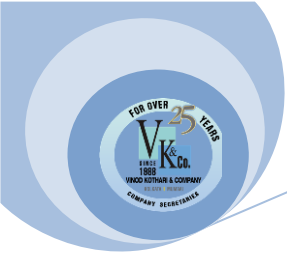
- **In case where the management of a company is already aware of the fraud perpetrated and has also reported to any of competent authorities, will the Auditor be required to make any further reporting under Section 143?**

An auditor for the purpose of reporting fraud shall report those frauds which he has “*per se*” identified. But, 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 address the same only if it distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

However, as clarified in the Guidance Note, in case of a fraud which involves or is expected to involve individually, an amount of rupees one crore or more, the auditor should review the steps taken by the management / those charged with governance with respect to the reported instance of suspected offence of fraud.

⁴ http://resource.cdn.icai.org/17644SA_320.pdf

⁵ <http://jssca.in/wp-content/uploads/2013/09/standardforms/Auditing,%20Review%20and%20Other%20Standards/16841sa450revised.pdf>



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If he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed.

If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Amendment Rules, 2015.

The auditor is expected to use professional skepticism in reporting such cases.

- **Is the amount of rupees one crore to be considered in aggregate or individually?**

The amount specified is on an individual basis with regard to any fraud involving or is expected to involve an amount of rupees one crore or above.

- **Report under Section 143(12) on frauds noted in the course of providing such other attest or non-attest services?**

Whilst Section 143 deals with auditor's duties and responsibilities under the Act, 2013 with respect to financial statements prepared under the Act, 2013, the auditors perform other attest services in their capacity as auditors of the company as well.

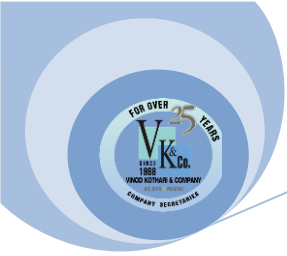
Examples of attest services are as follows:-

(a) Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements), Regulations 2015 requires the statutory auditor to perform limited review/audit of the quarterly financial results published by the listed companies;

(b) the auditor may also be engaged by the Board of directors of the company to carry out the audit of interim financial statements prepared by the management as per Accounting Standard 25 and report on such interim financial statements to the Board of Directors; (c) the auditor may also perform Tax Audit under the Income-tax Act; or

(d) the auditor may be engaged to issue certificates, etc.

If an offence of fraud in the company by its officers or employees that is identified/noted by the auditor in the course of providing attest or non-attest services as referred above, is of such amount/s as specified in Rule 13 of the Companies (Audit and Auditors) Rules, 2014 [as amended by the Companies (Audit and Auditors) Amendment Rules, 2015] which, the auditor uses or intends to use the information, that is obtained in the course of performing such attest or non-attest services, when performing the audit under the 2013



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Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder.

Penal provisions in case of non-compliance of section 143 sub-section 12

The reporting of fraud has been taken as a serious duty of any genre of Auditor. If the Auditor fails to report the fraud, as required under section 143(12), he has to face penal provisions stated under of section 143(15).

Section 143 (15) states that-

“If any Auditor, Cost accountant or Company Secretary in practice do not comply with the provisions of sub-section (12), he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

It also takes into its ambit the Company Secretary along with Cost accountant and Auditor. Hence compliance must be strictly done so as to avoid the penalty and also for the best interests of the company.

Conclusion

With the rule being made effective, the auditors will have to be prudent enough to report the frauds accordingly. This would mean that the company would be exposed to minute scrutiny and have to think twice before even thinking to commit any fraud. Not only the companies, but also the auditors have to be very diligent in performing their duties. The onus is on the auditor to report the fraud and if he fails to do so, he will be subjected to a hefty monetary penalty. Implementing the rule in the intent that it was framed would be something to look out for.

Another related article from our vault where this matter has been extensively dealt with - [A Practical Guide to Fraud Reporting](#)

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