

# FAQs on Fraud Reporting

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updated on September 12, 2023

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## Background

The world was never without frauds, and possibly will never be. However, every fraud makes us sit up, put in place mitigants, controls and checks. When it comes to the corporate sector, the importance of having controls becomes all the more significant as directors are sitting in the position of fiduciaries. Further, given the size and systemic significance of corporates, a fraud may shake the very foundations of our economic system. Corporates are, at times, victims of fraud, and sometimes the culprits. While the latter case may not be the subject matter for immediate discussion, the former has become quite common.

Fraud may be painful; the consequential reporting requirements may only increase the pain. Here is a guide to fraud reporting under Companies Act, 2013, SEBI Regulations and RBI Regulations in case of NBFCs read with [ICAI Guidance Note on Reporting on Fraud under Section 143\(12\) of the Companies Act, 2013 \(Revised 2016\) \(“Guidance Note”\)](#) and [SA 240 - The Auditor's responsibilities relating to fraud in an audit of financial statements \(“SA 240”\)](#).

## Meaning of fraud

### 1. What is the dictionary meaning of fraud?

As per Black Law Dictionary<sup>1</sup>, fraud means

*“an intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right.*

It refers to *all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.*

### 2. What is fraud in terms of Companies Act, 2013 (“Act”)?

As per Explanation (i) to section 447, “*fraud*” in relation to affairs of a company or any body corporate, **includes**

- a. any act,
- b. or omission, or
- c. concealment of any fact;
- d. 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.*

### 3. Are there other definitions of “fraud” in any other statute?

The term “fraud” draws its inference from section 17 of the Indian Contract Act, 1872 as “*the acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract-*

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<sup>1</sup> Black Law Dictionary, 5th edition, by Henry Campbell Black

- a. *the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;*
- b. *the active concealment of a fact by one having knowledge or belief of the fact;*
- c. *a promise made without any intention of performing it;*
- d. *any other act fitted to deceive;*
- e. *any such act or omission as the law specially declares to be fraudulent.”*

The above term is also defined under Regulation 2(1)(c) of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, as reproduced below:

*“fraud” includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include—*

- (1) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;*
- (2) a suggestion as to a fact which is not true by one who does not believe it to be true;*
- (3) an active concealment of a fact by a person having knowledge or belief of the fact;*
- (4) a promise made without any intention of performing it;*
- (5) a representation made in a reckless and careless manner whether it be true or false;*
- (6) any such act or omission as any other law specifically declares to be fraudulent;*
- (7) deceptive behaviour by a person depriving another of informed consent or full participation;*
- (8) a false statement made without reasonable ground for believing it to be true;*
- (9) the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price and “fraudulent” shall be construed accordingly.*

**Here are some judicial precedents which helps one to understand the meaning and the ingredients of a fraud**

### **Indian rulings**

a. *State of Maharashtra vs Dr. Budhikota Subharao, 1993 SCC<sup>2</sup>*

The Supreme Court in the above matter held that, *“'Fraud' is false representation by one who is aware that it was untrue with an intention to mislead the other who may act upon it to his prejudice and to the advantage of the representor.”*

b. *Vimla (Dr.) vs. Delhi Administration, 1963 SCC<sup>3</sup>*

*“whenever the words "fraud" or intent to defraud" or "fraudulently" occur in the definition*

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<sup>2</sup> <https://indiankanoon.org/doc/722778/>

<sup>3</sup> <https://indiankanoon.org/doc/1035719/>

*of a crime two elements at least are essential to the commission of the crime: namely, first, deceit or an intention to deceive or in some cases mere secrecy; and secondly, either actual injury or possible injury or to a risk of possible 'injury by means of that deceit or secrecy.'*"

*c. Kamlaben Punjabhai Solanki v/s Tensile Steel Limited, 2013 HCC<sup>4</sup>,*

*"Fraud means an intrinsic, collateral act, and fraud of an egregious nature would vitiate the most solemn proceedings of court of justice. Fraud is an act of deliberate deception with a design to secure something, which is otherwise not true. The expression fraud involves two elements, deceit and injury to the person deceived. It is a cheating intended to get an advantage."*

### **Foreign rulings**

*d. In Haycraft v. Creasy (1) LeBlanc, observed (1) (1801) 2 East 92*

*"by fraud is meant an intention to deceive; whether it be from any expectation of advantage to the party himself or from the ill-will towards the other is immaterial."*

In essence, it is not important that the fraudster should be standing to gain by virtue of the fraud.

#### **4. What is the meaning of fraud as per Standards on Auditing ("SA") issued by the Institute of Chartered Accountants of India ("ICAI")?**

As per [SA 240](#) i.e. the Auditor's responsibility relating to fraud, as issued by ICAI, fraud shall mean:

*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.*

#### **5. What are the elements of fraud?**

The United States common law generally identifies nine elements needed to establish fraud:

- a. a representation of fact;
- b. its falsity;
- c. its materiality;
- d. the representer's knowledge of its falsity or ignorance of its truth;
- e. the representer's intent that it should be acted upon by the person in the manner reasonably contemplated;
- f. the injured party's ignorance of its falsity;
- g. the injured party's reliance on its truth;
- h. the injured party's right to rely thereon; and
- i. the injured party's consequent and proximate injury.

#### **6. What can be the possible instances for occurrence of fraud?**

Fraud has to be differentiated from error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery,

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<sup>4</sup> <https://indiankanoon.org/doc/150366901/>

deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

The common element behind any fraud is the intent to deceive; hence it will be impossible to populate all the instances of fraud, as the limit may be only the limits of ingenuity of the fraudster. Some of the instances for the same can be as represented below:

- a. Manipulation of accounts
- b. Misstatement of assets and liabilities
- c. Misrepresentation or omission of facts
- d. Misapplication of accounting principles
- e. Misuse of information
- f. Corruption, bribes or kickbacks
- g. Theft/ misuse of assets
- h. Improper payments/ false expenses
- i. Corruption, bribery, money laundering

**7. What would amount to fraud under 143(12) of the Act?**

Section 143(12) of the Act requires an auditor to report a fraud if it is in the course of performance of his duties as an auditor and he has reason to believe that an offence of fraud is being/ has been committed in the company by its officers or employees.

Although section 143 of Act, 2013 does not give us any basis for determining a 'fraud', one may look into section 447 (as detailed above). However, since the above definition has been given only in the context of prosecution, for understanding the notion of 'fraud' u/s 143, we certainly have to look for an independent rendition and cannot be read *pari materia* with the provisions of Section 447

Section 143(9) r/w 143(2) mentions that an auditor shall comply with the SAs and prepare his report after taking into account *inter- alia* the auditing standards.

As per Para III of the Guidance Note, the definition of fraud as per SA 240 and Explanation to section 447 (both detailed above) are similar, except that u/s 447 fraud includes acts with an intent 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. The auditor may not be able to detect acts that may have intent to injure the interests or cause wrongful gain/ loss unless the financial effects of such acts are reflected in the books of account/ financial statements of the company. Thus, auditors shall take into account the requirements of SAs *inter- alia* including the definition of fraud as stated in SA 240.

**8. In the context of section 143(12), are we referring to frauds where the company is the victim, and / or frauds where the company, that is, the driving force behind the company (its management) is the culprit?**

The Explanation (i) to section 447 of the Act defines fraud. Refer Q1 above. In the context of the same, fraud in relation to the affairs of a company would mean 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 an intent to deceive, to gain undue advantage from or to injure the interests of the **company, or its shareholders or creditors or any other person.**

On a plain reading of the above, it seems that the victim could be the company or its stakeholders. Also the culprit could be the management of the company or an external person.

However, in terms of section 143(12) of the Act read with Rule 13 of Companies (Audit and



Auditors) Rules, 2014 (“Auditors Rules”), only such frauds are required to be reported by the auditors which are committed in the company by its officers/ employees.

The [Guidance Note](#) further clarifies that section 143(12) includes only fraud by officers or employees of the company and does not include fraud by third parties such as vendors and customers.

## **Legal implications - civil and criminal consequences of frauds**

### **9. What are the examples of civil consequences of fraud?**

Section 19 of the Indian Contract Act, 1872 outlines the consequences when consent to an agreement has been obtained through fraud. In such cases, the agreement becomes a contract voidable at the option of the party whose consent was so caused. Alternatively, the party may also affirm the contract and seek remedies thereafter.

Another remedies that may be available are:

- a. recovering any losses suffered;
- b. seeking compensation and damages for loss suffered as a result of fraud;
- c. disgorgement of profits illegally made to the company;
- d. re- establishing the rights of the victim of fraud.

### **10. What are the criminal provisions w.r.t frauds under the Act?**

Different statutes concerning frauds prescribe different sets of punishment for the persons found guilty with respect to the same.

Section 447 of the Act specifically prescribes that the person who is guilty of fraud involving an amount of at least 10 lakh rupees or 1% of the turnover of the company, whichever is lower, shall be punishable with:

- imprisonment for a term not less than 6 months and up to 10 years; and
- fine, which shall not be less than the amount involved in the fraud and may extend to thrice of such amount.

*However, if the fraud involves public interest, the minimum imprisonment to be awarded shall be 3 years.*

In case the fraud involves an amount less than 10 lakh rupees or 1% per cent. of the turnover of the company, whichever is lower, and does not involve public interest, any person guilty of such fraud shall be punishable with:

- imprisonment for a term which may extend to 5 years; or
- with fine which may extend to 50 lakh rupees or with both.

### **11. What is the punishment for frauds u/s 420 of the Indian Penal Code, 1860 (“IPC”)?**

Section 420 of IPC deals with cheating and dishonestly inducing delivery of property. Under the same, any person who

- cheats; or
- dishonestly induces the person deceived to
  - i. deliver any property to any other person, or
  - ii. to make, alter or destroy the whole or any part of a valuable security, or anything that is signed/ sealed and is capable of being converted into a valuable security



shall be punished with:

- a. imprisonment of either description for a term which may extend to seven years; and
- b. fine.

The same provision forms part of the Bhartiya Nyaya Sanhita Bill, 2023 as well, seeking to replace IPC.

## **Detection of fraud**

### ***12. Which organs or systems in a company may help to detect fraud?***

Apart from those persons in every organization who are responsible for ensuring the adequacy of compliances or scrutinizing the events which occurred, any person may act like a whistleblower in detecting frauds and bringing the same to light.

Following are the persons/ mechanisms most likely to detect the occurrence of any fraud:-

- a. Audit Committee
- b. Risk Management Committee
- c. Management
- d. Auditors (Internal, statutory, secretarial, cost, branch, tax etc.)
- e. Employees
- f. External Authorities
- g. Business Partners
- h. Other stakeholders
- i. Whistle blower/ Vigil mechanism [Refer Q 16]

## **Responsibilities w.r.t fraud**

### ***13. What is the Board of Directors' (Board's) responsibility with respect to fraud?***

The ultimate responsibility for prevention and detection of frauds lies with the Board. This includes creating a 'zero-tolerance to frauds' structure, setting systems for timely identification and detection and taking appropriate actions to ensure that internal controls with respect to the same are adequate. The Board is also required to set the 'tone at the top' and ensure that the management is actively working towards fraud prevention and detection.

*As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on **fraud prevention**, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.*

Directors' Responsibility Statement ('DRS') u/s 134(5) of the Act is a crucial disclosure wherein the directors affirm that they had taken proper and sufficient care for safeguarding the assets of the company and for **preventing and detecting fraud** and other irregularities.

To put it simple, following are the responsibilities of the Board w.r.t frauds:

- a. Having strong and efficient internal controls that aids in
  - i. Prevention of fraud
  - ii. Detection of fraud in a timely manner
- b. Reporting of fraud as per applicable laws
- c. Measuring the loss to the company pursuant to the fraud
- d. Taking adequate measures to prevent the occurrence of fraud in future, including
  - i. making appropriate changes in the internal controls
  - ii. punishing the culprit(s)
  - iii. making rules / SOPs that act as a deterrance towards irregularities / frauds

**14. What is the role of CFO and CEO with respect to fraud?**

In case of a listed company, as per Part B of Schedule II of Listing Regulations, the compliance certificate issued by the CEO and CFO shall confirm that they have indicated to the auditors and the audit committee “instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the listed entity’s internal control system over financial reporting.”

**15. What is the relevance of internal control mechanism in detection and prevention of frauds?**

As discussed above, the primary responsibility to establish and monitor adequate internal controls and systems to prevent and detect frauds and errors is that of the management of the company. The Board is required to ensure that frauds are prevented in the first place, however, if any frauds are detected, necessary actions should be taken for the same.

The same is confirmed in the DRS forming part of Board’s report in terms of the provisions of section 134(5) of the Act, wherein the Board of Directors are required to inter- alia state that they had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

For listed companies, DRS shall also contain a statement that the directors had laid down Internal Financial Controls (IFCs) to be followed by the company and that such IFCs are adequate and were operating effectively.

*Explanation to section 134(5) of the Act defines the term “internal financial controls” as “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”*

*Further, as per section 143(3)(i), the auditors’ report should inter-alia state whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls.*

The fact that a fraud gets detected by an Auditor during the course of audit indicates serious lapses issues in the internal control systems of the company and therefore the Board and management are required to lay down strong systems involving prevention and detection of fraud.

**16. Is the role of whistleblower policy relevant for fraud detection?**

The vigil/whistleblower mechanism in a company, set up as per section 177 of the Act read with

Regulation 4(2)(d)(iv) read with Regulation 22 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“Listing Regulations”), is for the directors and employees (and other stakeholders as per Reg 4(2)(d)(iv)) to report genuine concerns or grievances about illegal or unethical practices inter alia including frauds in the company. The mechanism makes provision for direct access to the chairperson of the audit committee in appropriate cases. It also provides for adequate safeguards against victimization of employees and directors who avail of the same.

A well administered, adequate and functional vigil mechanism can be an effective tool of reporting, detecting suspected fraud and thereby controlling the probability of occurrence of the same in the future.

*Our video on Corporate Whistle Blowing can be seen [here](#).*

**17. What is the role of the audit committee w.r.t fraud?**

- a. As per Para A Part C of Schedule II of Listing Regulations, the role of the audit committee includes “*reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board*”
- b. As per section 177 of the Act and Regulation 22 of the Listing Regulations, the chairperson of the audit committee shall have direct access to the vigil mechanism in appropriate cases and therefore he is to address the concerns/ grievances, that may also involve suspected cases of fraud, arising out of the same [as detailed above in Q 16]

## **Auditors’ responsibility with respect to fraud**

**18. What is the responsibility of the auditor with respect to detection of fraud?**

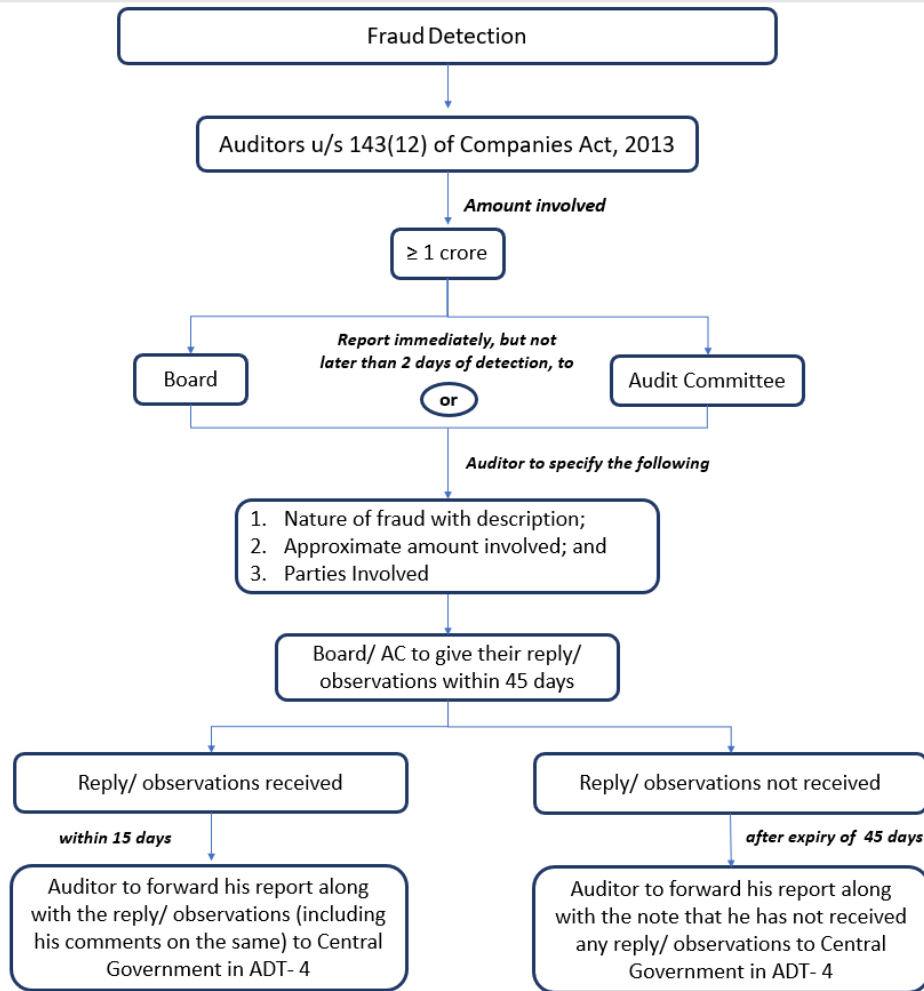
- a. As per section 143(12) read with Auditors Rules, the statutory auditor (also the secretarial and cost auditor) is required to report fraud if, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud is being or has been committed in the company by its officers or employees.
  - Where the fraud involves an amount of Rs 1 crore or above - the fraud is to be reported by the auditor to the Central Government in Form ADT-4, after taking comments / explanation of the audit committee / Board;
  - Where the fraud involves a lesser amount - the fraud is to be reported to the audit committee / Board and in the Board’s Report (section 134(3)(ca) of the Act).
- b. As per Companies (Auditor's Report) Order, 2020 (“CARO 2020”), the auditors’ report shall include:
  - Whether any fraud by the company/ on the company has been noticed during the year as well as the nature and amount involved in the same;
  - Whether any reporting u/s 143(12) of the Act has been done to the Central Government in Form ADT- 4;
  - Whether the auditor has considered whistle- blower complaints (if any) received during the year.

**19. What frauds are required to be reported by the auditors u/s 143(12)?**

Section 143(12) read with Auditors Rules prescribes reporting of frauds by the auditors. Fraud involving an amount of Rs 1 crore or above are required to be reported to the Central Government, after reporting the same to the Board or the audit committee, while those below 1 crore are to be reported to the audit committee/ Board. Section 134(3)(ca) specifies that the latter shall also be disclosed in the Board’s Report.

**20. What is the manner of reporting fraud to the Central Government u/s 143(12)?**

As aforesaid in Q 19, Auditors Rules, along with quantum of fraud, also specifies the manner of reporting the fraud involving an amount of 1 crore or above to the Central Government, as detailed in the flowchart below:



**21. When does the auditor commence reporting under 143(12)?**

Section 143(12) states that an auditor should report under the section if he has “*reason to believe*” that an offence of fraud has or is being committed in the company by its officers or employees. Form ADT- 4 in which the auditor is required to report to the Central Government uses the term “*suspected offence involving fraud*”. Thus it is important to understand the aforesaid terms in order to determine the point of time i.e. based on suspicion/ reason to believe/ knowledge/ determination of offence, when the auditor is required to report the fraud under 143(12).

As per [Para VIII](#) of the Guidance Note,

“Suspicion” is a *state of mind more definite than speculation but falls short of knowledge based on evidence. Simple speculation that a person may be engaged in fraud is not sufficient grounds to form a suspicion. Suspicion is a slight opinion but without sufficient evidence.*

For 'reason to believe' to come into existence, it cannot be based on suspicion. There needs to be sufficient information or convincing evidence to advance beyond suspicion that it is possible someone is committing or has committed a fraud.

When complying with the requirements of SA 240, an auditor might be considered to have reasons to believe that a fraud has been or is being committed if he had actual knowledge of, or possessed information which would indicate to a reasonable person, that another person was committing or had committed a fraud. The condition of 'reason to believe' would be met if on evaluation of all the available information with the auditor and applying appropriate level of skepticism the auditor concludes that a fraud is being or has been committed on the company. Having 'knowledge' means knowing 'that' something.

Accordingly, based on a harmonious reading of section 143(12), Auditors Rules and Form ADT - 4, reporting on fraud in the course of performance of duties as auditor, is applicable only when the auditor has **reason to believe and has knowledge** that a fraud has occurred or is occurring i.e., when the auditor has evidence that a fraud exists.

Therefore, in this regard, the auditor should further be guided by SA 240.

**22. Should the auditor report u/s 143(12) on frauds noted in the course of providing other attestation/ permitted non- attestation services?**

The auditor apart from auditing financial statements of the company provides certain other attestation services as well *inter-alia*, performing limited review/ audit of the quarterly financial statements as per regulation 33 of the Listing Regulations, tax audit, other certifications, etc. Similarly the auditor can be engaged to provide certain non attest services as well, not prohibited u/s 144 of the Act.

Para IV of Guidance Note, mentions that, *if an offence of fraud in the company by its officers or employees, identified/noted by the auditor in the course of providing such attest or non-attest services, 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} and 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 Act, then in such cases, the matter may become reportable under section 143(12).*

**23. While auditing the Consolidated Financial Statements (“CFS”), is the auditor of the parent company required to report on suspected offence involving fraud that may have taken place in the subsidiary, associate or joint venture?**

Let us first take note of the provisions of the Act.

As per section 129(4) of the Act, the provisions relating to audit of the standalone financial statements of the holding company shall also apply to the audit of the CFS. Further, reporting u/s 143(12) arises only if a suspected offence of fraud is being or has been committed **in the company** by its officers or employees.

Considering conflicting positions in the Act, one needs to refer to the Guidance Note. Para VI of Guidance note, in this regard mentions that:

*The auditor of the parent company is not required to report on frauds u/s 143(12) if they are not*

*being or have not been committed in the parent company by the officers or employees of the parent company but relate to frauds in:*

- a. a component that is an Indian company, since the auditor of that Indian company is required to report on suspected offence involving frauds u/s 143 (12) in respect of such company; and*
- b. a foreign corporate component or a component that is not a company since the component auditors' of such components are not covered under Section 143(12).*

**24. What is the responsibility of the auditor if the fraud is detected by any other person than the auditor himself?**

Section 143(12) of the Act requires an auditor to report the matter under this section only if in the course of performance of his duties as auditor, he has reason to believe that an offence of fraud has been/ is being committed in the company.

Para V of the Guidance Note also mentions that, *it may be considered that Section 143(12) envisages the auditor to report to the Audit Committee under section 177 of the Companies Act, 2013 or to the Board of Directors and thereafter, where applicable, to the Central Government an offence of fraud in the company by its officers or employees only if he is the **first person to identify/note such instance** in the course of performance of his duties as an auditor.*

*Accordingly, in case a fraud has already been reported or has been identified/detected by the management or through the company's vigil/whistle blower mechanism and has been/is being remediated/dealt with by them and such case is informed to the auditor, he will not be required to report the same under Section 143(12) since he has not **per se** identified the fraud.*

The auditor should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil mechanism and should verify the steps taken by the management with respect to the reported fraud.

If the auditor is not satisfied with such steps, he should request the management to perform additional procedures so that the matter is appropriately addressed. If the management 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 the Auditors Rules.

**25. Does the National Financial Reporting Authority ("NFRA") Circular<sup>5</sup> dated 26.06.2023, in any way, require the auditor to also report frauds detected by the management/ other persons?**

As mentioned later in Q 28, the NFRA Circular is primarily based on SC ruling on Union of India and Another v/s Deloitte Haskins and Sells LLP, 2023 SCC<sup>6</sup> which lays down the responsibility of the auditor with respect to reporting of fraud in case of resignation.

However, Para 4.2 of the said circular mentions the following:

*4.2 The Statutory Auditor is duty bound to submit Form ADT-4 to the Central Government u/s 143 (12) even in cases where the Statutory Auditor is not the first person to identify the fraud/suspected fraud.*

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<sup>5</sup> <https://cdnbbsr.s3waas.gov.in/s3e2ad76f2326fbc6b56a45a56c59fafdb/uploads/2023/06/2023062612.pdf>

<sup>6</sup> <https://indiankanon.org/doc/136418404/>



This does not flow with the rest of the flavor of the NFRA Circular and seems to be an *obiter dictum*.

Therefore, in our view, from the harmonious reading of sec 143(12) read with [Para V](#) of the Guidance Note, the auditor is required to report fraud detected firsthand by him. Where the auditor gets knowledge of fraud detected by any other person, he is required to:

- apply professional skepticism to evaluate that such fraud has been detected in all aspects so that distinction can be clearly made between frauds detected by the auditor *vis- a- vis* those identified by the management;
- review the steps taken by the management with respect to the reported fraud;
- request the management to perform additional steps/ procedures, if not satisfied with the steps already performed;
- evaluate whether the report would require reporting in accordance with the Auditors Rules, if management fails to perform the additional procedures as asked/ suggested by him.

## **Non- compliance of section 143(12)**

### ***26. What if the auditor does not comply with section 143(12)?***

Pursuant to section 143(15) of the Act, if the auditor does not comply with the provisions of section 143(12), he shall in case of a listed company be liable to a penalty of 5 lakh rupees and in case of any other company be liable to a penalty of 1 lakh rupees.

## **Resignation of auditor**

### ***27. What are the consequences for the auditor of the company where the management acts in a fraudulent manner?***

Section 140 (5) of the Act contains consequences for auditors if they have acted, directly or indirectly, in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers. Under the same, the auditor shall be liable for action u/s 447 of the Act apart from removal and debarment for a period of five years.

Section 140(5) along with the proviso has been reproduced below for easy reference.

*Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo moto or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors:*

*Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place*

*Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.*



**28. Assume an auditor has detected fraud in the course of his audit, and having done so, he puts in his papers. What are the consequences of resignation of an auditor during or prior to enquiry/proceeding u/s 140(5)?**

In Union of India and Another v/s Deloitte Haskins and Sells LLP, 2023 SCC<sup>7</sup>, the Hon'ble Supreme Court of India held that the consequences of section 140(5) of the Act will be applicable also on those auditors who resign from their audit engagements without reporting fraud/suspected fraud. The Hon'ble Apex Court observed:

*7... Therefore, on true interpretation, even on resignation by an auditor of a company even during the enquiry/proceedings under section 140(5) or even prior to that, there shall not be any termination of the proceedings under section 140(5) as observed and held by the High Court. At the cost of repetition, it is observed that in a given case, an auditor, who in fact has, directly or indirectly, acted in a fraudulent manner, to avoid any further consequence under the second proviso to section 140(5), resigns to avoid any consequence under the second proviso to section 140(5), it cannot be permitted.*

*14...Acting in a fraudulent manner, directly or indirectly, by an auditor is a very serious misconduct and therefore the necessary consequence of indulging into such fraudulent act shall follow."*

The NFRA Circular, in light of the above ruling, mentions that *there is a misconception amongst some auditors that resigning from an ongoing audit engagement absolves them of their reporting obligations related to fraud and the consequences under the Act for non-reporting of the same.*

Para 4.3 of the circular is reiterated here which says that:

*4.3 Resignation does not absolve the Auditor of his responsibility to report suspected fraud or fraud as mandated by the law.*

## Reporting of fraud

**29. What are the compliances on occurrence of fraud in the company?**

Lack of effective corporate governance undermines any fraud risk management policies or controls functioning in an organization. It is only through meticulous and ongoing effort by an organization through which it can protect itself against significant acts of fraud.

Considering the provisions of the Act and Listing Regulations, following shall be the actionables in the event of occurrence and detection of frauds:

### Under the Listing Regulations

**a. Regulation 30 r/w Schedule III**

- Intimate the details of frauds/ defaults by a listed entity, its promoter / director/ KMP / senior management or subsidiary or arrest of KMP / senior management / promoter/ director of the listed entity to stock exchange(s) within 24 hours from the occurrence of the event.
- Intimate the details of frauds/ defaults by employees of the listed entity upon application of the guidelines for materiality

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<sup>7</sup> <https://indiankanoon.org/doc/136418404/>

**b. Regulation 30(8)**

- Disclose on its website all such events or information which has been disclosed to stock exchange(s) under Regulation 30

**c. Part C Para A of Schedule II**

- In case the fraud was disclosed by the internal auditors, the audit committee shall review their findings where there is suspected fraud of material nature and shall report the matter to the board.

**d. Regulation 17 (8) r/ w Schedule II**

- The compliance certificate provided by the CFO and CEO to the board of directors u/r 17, shall state that they have indicated the auditors and the audit committee the instances of significant fraud on becoming aware and the involvement therein, if any, of the management or an employee having a significant role in the cCompany's internal control system over financial reporting.

**Under the Act**

**e. Section 134(3) read with Section 143(12)**

- Board Report shall consist of details in respect of frauds reported by auditors u/s 143(12) other than those which are reportable to the Central Government i.e. details of fraud amounting to less than Rs. 1 crore shall be a part of Board's Report.

**30. What is the fraud reporting requirement under CARO 2020?**

CARO 2020 requires auditors to make statements relating to reporting of fraud in his report. Para 3 clause (xi) mentions that the auditor's report shall contain a statement with respect to the following:

- whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;*
- whether any report under sub-section (12) of section 143 of the Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;*
- whether the auditor has considered whistle-blower complaints, if any, received during the year by the company.*

**31. Whether frauds identified/ detected by the management are required to be reported in the Board's Report as well?**

As discussed above, the Board is required to detect as well as ensure that frauds are prevented in the first place. Necessary controls and systems are required to be established and monitored in respect of the same.

If a fraud reported by the auditor comes before the Board, it is a statement indicating lack of adequate controls on the part of the Board and the entire responsibility of the Board with respect to the same is put to question. While frauds involving Rs. 1 crore or more are reported to the Central Government,

those of a lesser amount are reported to the audit committee/ Board. The latter are then also required to be disclosed in the Board's Report [134(3)(ca)].

Such statement in the Board's Report addressed to the shareholders, is an admission on the part of the Board that a fraud has been detected by the auditor despite the existence of internal control systems and the remedial steps that are being taken by the Board with respect to the same.

Further, there can be various kinds of frauds ranging from borrowing in excess of limits, misappropriation to cheating and forgery, etc., detected by the management itself. Reporting of all frauds in the Board's Report will not only lead to loads of details in the Board's Report but also dilute the very gravity with which section 134(3)(ca) was introduced i.e. indicating that the duty of the Board has been affected.

**32. Is there any impact on the IFC reporting, done earlier of fraud detection?**

As mentioned above, all the companies are required to conform to the requirements of IFCs. However, despite having such a system, the occurrence of fraud depicts some gap / lack of system / practice in the way they are working. Accordingly, this puts a question on the reporting on IFC done previously. In general practice, the companies disclose such inadequacy which relates to the financial statements under the specified heading in the Board's report for the year in which the fraud has been detected. However, in case the investigation/ detection of fraud reveals some gap in the internal controls which actually existed in the past, the same should form a part of the declaration made by the directors in this regard under the DRS in the Board's Report.

## **Reporting of Frauds for Financial Entities**

*'The need for a distinct fraud reporting framework for financial entities in India is driven by a complex regulatory landscape, specialized nature of financial fraud, and the critical role of the financial sector in the nation's economy.'* For Non-Banking Financial Companies ('NBFCs'), the monitoring and reporting of fraud is governed through Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016, ('NBFC Fraud directions') and for banks and select financial institutions the same is governed by Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs (Updated as on July 03, 2017) (Banks and FI Fraud directions).

## **Applicability & Meaning of Fraud**

**33. Which NBFCs are covered under the NBFC Fraud directions ?**

The NBFC Fraud directions are applicable to all deposit-taking NBFCs and all systemically important non-deposit taking NBFCs ('NBFC-ND-SI')

**34. What about the NBFCs not covered in the parameters mentioned above?**

For Housing Finance Companies (HFCs) registered with National Housing Bank, fraud monitoring and reporting shall be governed by "[Guidelines on Reporting and Monitoring of Frauds in Housing Finance Companies](#)" ('NHB Guidelines')<sup>8</sup>. These guidelines are almost akin to the master directions issued for NBFCs and Banks<sup>9</sup>.

**35. Post the introduction of the Scale Based Regulatory framework ('SBR framework'), what would be the revised applicability?**

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<sup>8</sup> [Actionables under Fraud reporting framework for HFCs](#)

<sup>9</sup> Read our article on [Guidelines on reporting & monitoring of frauds in HFCs](#)

Since the introduction of SBR Framework, all NSI and SI NBFCs with an asset size of less than 1000 crore are now categorized as Base layer (BL) NBFCs. Therefore the reporting requirement of Frauds shall only be applicable to the NBFCs of Middle layer and above. That is to say Base layer entities are not required to follow the above mentioned fraud reporting guidelines.

**36. What is the definition of fraud in the context of financial entities ?**

In furtherance to Q 6 stated above , frauds have been classified as under in Chapter III of NBFC Fraud directions and Chapter II of Banks and FI Fraud directions, and are mainly based on the provisions of the Indian Penal Code:

- a. Misappropriation and criminal breach of trust
- b. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property
- c. Unauthorized credit facilities extended for reward or for illegal gratification.
- d. Negligence and cash shortages
- e. Cheating and forgery
- f. Irregularities in foreign exchange transactions / Fraudulent transactions involving foreign exchange
- g. Any other type of fraud not coming under the specific heads as above.

Further, the following table summarizes which transactions shall be deemed to be treated as fraud and which ones shall be categorized as fraud based on its intent.

Fraud only when fraudulent intention is suspected / proved	Deemed to be treated as fraud (irrespective of the fraudulent intention)
<ul style="list-style-type: none"> <li>a. Negligence</li> <li>b. Cases of cash shortages of less than Rs. 10,000/-</li> <li>c. Irregularities in foreign exchange transactions</li> </ul>	<ul style="list-style-type: none"> <li>a. Misappropriation and criminal breach of trust</li> <li>b. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property</li> <li>c. Unauthorized credit facilities extended for reward or for illegal gratification</li> <li>d. Cheating and forgery</li> <li>e. Cases of cash shortages more than Rs. 10,000/-</li> <li>f. Cases of cash shortages more than Rs. 5000/- if detected by management /auditor/inspecting officer and not reported on the occurrence by the persons handling cash.</li> <li>g. Any other type of fraud not coming under the specific heads as above</li> </ul>

## Reporting of Fraud

**37. Who will be responsible for submitting the returns and reporting to RBI under the abovementioned directions?**

The NBFCs and Banks both are required to specifically nominate an officer of the rank of general

manager or equivalent for the purpose of submitting returns and reporting to RBI.

**38. What are the different types of fraud and their threshold for reporting them to RBI?**

As per the NBFC Fraud directions, the following types of frauds are to be reported;

1. Frauds involving ₹ 1 lakh and above
2. Frauds committed by unscrupulous borrowers
3. Frauds involving ₹ 1 crore and above

**39. Are NBFCs allowed to close the fraud cases ?**

NBFCs are allowed to close the fraud cases provided that

- Actions with respect to the cases are complete
- Prior approval is obtained from the respective Regional offices of DNBS

**40. When will the actions be considered as complete as referred to in the above question?**

The action would be considered complete when

- a. the fraud cases pending with CBI/Police/Court are finally disposed of;
- b. the examination of staff accountability has been completed;
- c. the amount of fraud has been recovered or written off;
- d. insurance claim wherever applicable has been settled; and
- e. The applicable NBFC has reviewed the systems and procedures, identified as the causative factors and plugged the lacunae and the fact of which has been certified by the appropriate authority (Board / Audit Committee of the Board).

**41. What cases would come under attempted fraud? What is the reporting requirement of the same?**

There is no specific regulation for reporting the cases of attempted fraud to RBI. However a report with respect to the cases of attempted frauds need to be placed before the Audit committee of the Board specifying the details as mentioned in the circular.

**42. Does the borrower whose account has been classified as fraudulent have an opportunity to be heard?**

No, there are no provisions in the master direction which provide the borrower with an opportunity of being heard, before his/her account is classified as fraudulent. However, the action of classifying an account as a fraudulent account is a drastic step and carries significant after-effects in the form of serious civil and penal consequences. Thus, affording an opportunity of being heard is essential before such classification is finalized.

**43. Why should the borrower be given an opportunity of being heard?<sup>10</sup>**

The principles of natural justice are not just some mere formalities but are those principles which all judicial, quasi judicial and administrative authorities should follow in the course of decision making. The basic intent of the Fraud Directions, is to effectively and efficiently ensure that frauds are classified and reported in a timely manner. However, the mere reason for the requirement to adhere to reasonable timelines does not justify or validate the exclusion of the principles of natural justice. Moreover, as it is understood from the Fraud Directions, there is no specific provision contained therein to ensure that the borrower is sufficiently involved during the course of the forensic audit. However, no such statutory provision exists, it is likely that the inclusion of the borrower in the process rests solely on the discretion of the concerned authority that undertakes such an audit.

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<sup>10</sup> Read our detailed article on [Classification of Fraud reporting](#)

## Filing of Returns

### 44. List of returns to be filed with RBI w.r.t. to Fraud?

The following table is curated pursuant to RBI internal circulars i.e.

- June 06, 2022 on 'Introduction of XBRL based online fraud-reporting system for NBFC
- July 11, 2022 on 'Commencement of XBRL based online fraud-reporting system for NBFCs

Return	Information to be filed	Whether a new/ existing requirement	Frequency	Due date	Remarks
Assignment of Super Users	For onboarding the XBRL online fraud reporting system Assign role of Super Users	New Earlier, NBFCs had to nominate an official of the rank of General Manager or equivalent			Super users shall- 1) Submit frauds online on the XBRL portal 2) Provide access to other users of the NBFC for submitting frauds
FMR-1	Reporting actual and suspected frauds of more than Rs. 1 lakh	Same	As and when basis	within 21 days (3 weeks) from date of detection	
Fraud Update Application (FUA)	Updating details of frauds	FMR-3 (consolidated progress report on frauds of above Rs. 1 lakh) Quarterly	As and when basis	As and when, so immediately	
Reporting of security incidents	Reporting security incidents i.e. cases of theft, burglary, dacoity and robberies	New	As and when basis	Immediately	
FMR-4		New		15 days from end of quarter in which the incident occurred	Effective from September 30, 2022 NIL report to be submitted This is separate from FUA

Return	Information to be filed	Whether a new/ existing requirement	Frequency	Due date	Remarks
					Also report (email) to - i) Fraud Monitoring Group, Department of Supervision ii) Regional Office
Monthly certificate	Reporting frauds reported during the month- 1) Party name/ account 2) Amount involved 3) Date of reporting	New (Substitution to FMR-2, quarterly submission of outstanding frauds)	Monthly	7 days from end of each month	Effective from July 31, 2022 In the format of Annex II Nil report to be submitted

**45. Is the Board to be made aware of the fraud detected in the NBFC? If yes, what is the minimum information to be placed before the Board ?**

Yes, all frauds of ₹ 1 lakh and above are to be reported to the board. The Board should be apprised on factors such as failure on the part of the concerned officials and consideration of appropriate action against the concerned officials responsible for the fraud. In addition to the above, the Company may also discuss the steps taken to avoid occurrence of same events in the future.

### **Review of frauds by Board/ Audit Committee**

**46. What is the timeline for periodic review of frauds by the Board?**

The board is required to conduct a Quarterly as well as Annual review of frauds.

**47. While reviewing the frauds on a quarterly basis, what all is to be considered?**

Information pertaining to frauds for quarter ended March, June and September of the year shall be placed before the Board during the subsequent quarter to which it pertains. Such report should include adequate information which supplements the analyze the statistics and details of each frauds should be presented to enable the Board to decide the further course of action whether punitive or preventive with respect to the fraud. For frauds amounting to ₹ 1 crore shall be reviewed by the Audit Committee of the Board.

**48. What would be the focus matters for the annual review of frauds?**

At the outset, the annual reviews of frauds are not to be reported to RBI. But these shall be documented and preserved for review of the inspecting officers of RBI. While conducting the annual review the following shall be considered;

1. Systems put in place for detecting fraud;



2. Examining staff angle in the fraud;
3. Punishing those responsible for fraud;
4. Corrective and preventive actions taken where frauds were perpetrated using the loopholes in the systems, and the extent of the implementation;
5. Reporting of fraud to local police.
6. Total number frauds detected during the year compared with previous two years;
7. Analysis of frauds according to different categories and business areas;
8. Modus operandi of major frauds;
9. Detailed analysis of frauds involving ₹ 1 lakh and above;
10. Estimated loss to the NBFC during the year pursuant to frauds, and the recovery and provisioning thereof;
11. Number of cases including amounts where staff are involved and the action taken thereof;
12. Time taken to detect frauds;
13. Position of frauds with respect to police;
14. Number of frauds where final action has been taken by the NBFCs and cases disposed of;
15. Preventive/punitive steps taken by the NBFC during the year to reduce/minimise the incidence of frauds;
16. Timely reporting of frauds to the concerned authorities.

**49. Are the NBFCs required to file a nil report, in case no frauds are detected?**

No, in cases where no frauds are detected, the NBFCs are not required to submit a 'Nil' report to the authorities.

**50. What are the penalties for not reporting fraud or failing to comply with reporting requirements?**

On failing to meet the requirements as entailed in the Master directions, the NBFCs would be liable for penal actions as enumerated in Chapter V of RBI Act, 1934.

**51. What are the details that need to be included in the annual review of frauds conducted by NBFC? Is the Annual Review of Fraud required to be disclosed to RBI?**

- a) Total number of frauds detected during the year and comparisons with the frauds detected during the previous year
- (b) Analysis of frauds according to different categories detailed in Chapter IV and also the different business areas indicated in the Quarterly Report on (vide FMR – 2);
- (c) Modus operandi of major frauds reported during the year along with their present position;
- (d) Detailed analyses of frauds of ₹ 1 lakh and above;
- (e) Estimated loss to the NBFC during the year on account of frauds, amount recovered and provisions made;
- (f) Number of cases (with amounts) where staff are involved and the action taken against staff;
- (g) Time taken to detect frauds (number of cases detected within three months, six months and one year of their taking place);
- (h) Position with regard to frauds reported to Police;
- (i) Number of frauds where final action has been taken by the NBFC and cases disposed of;
- (j) Preventive/punitive steps taken by the NBFC during the year to reduce/minimise the incidence of frauds;
- (k) Timely reporting of frauds to the concerned authorities

Additional details may be added too. It is to be noted that the master direction specifies that the Annual Review of Fraud is not required to be disclosed to RBI. However, it shall be preserved for verification by the Bank's inspecting officers.

***52. The Master Direction provides guidelines for reporting of frauds to the Police. Is reporting also required in cases where the person who committed the fraud is punished and the amount involved in fraud is recovered?***

The Master Directions states that the reporting to the police authority has to be done not only with an intention to recover the amount involved but also has to be done in public interest.

Therefore, the directions require the following cases to be reported with the police authorities:-

- Cases of fraud involving an amount of ₹ 1 lakh and above, committed by outsiders on their own and/or with the connivance of applicable NBFCs staff/officers;
- Cases of fraud committed by employees of applicable NBFCs, when it involves the NBFC funds exceeding ₹ 10,000/-.