Reporting On Fraud By Auditors U/S 143(12) Of The Companies Act 2013

AT WIRC OF ICAI, MUMBAI

28th April, 2016

By Ca Durgesh Kabra

DMKH & CO.

durgeshkabra@gmail.com

CONTENTS

CONTENTS

BACKGROUND

BACKGROUND

- Section 143 of the Companies Act, 2013 (2013 Act) has been effective from 1 April, 2014.
- The central government seeks to provide more robust framework for Financial Reporting and place more reliance on the work of the Auditors in bringing:
  - Transparency And Discipline in the corporate world to protect the interests of the shareholders and public at large.

BACKGROUND (Contd.)

- Fraud in not a new concept introduced in Companies Act,2013
- Companies Act,1956 had provisions for punishment regarding fraud.

  For example:

  i) 5 years imprisonment or with fine or with both for fraudulently inducing persons to invest money

  ii) Reference to court when Central Government is of the opinion that any person connected to conduct and management of the company is guilty of fraud
- So what changes are made in Companies Act,2013?

  i) Fraud has been explicitly defined

  ii) Statutory Auditor to report fraud

  iii) Same punishment for all types of frauds

DEFINITION OF FRAUD

- Section 447 (Punishment for fraud) explains fraud as: “fraud” in relation to affairs of a company or any body corporate and 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.

- As per SA 240 : 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.

FRAUD TREE

- As per ACFE, following are the three types of occupational frauds:

Corruption	Asset Misappropriation	Financial Statement Fraud
• Conflict of interest • Bribery • Illegal Gratuities • Economic Extortion	• Cash • Inventory • Other all assets	• Understatement of Income/ net worth • Overstatement of income/ net worth

FRAUD STATISTICS

Fraud survey conducted by ACFE from January 2016 to October 2017 involving 2690 cases across 125 counties

- The total loss caused by the cases in the study exceeded $7 billion, with an average loss per case of $1.3 lakh
- Asset misappropriation was by far the most common form of occupational fraud, occurring in more than 89% of cases, but causing the smallest median loss of $114,000. Financial statement fraud occurred in less than 10% of cases but causing a median loss of $800,000. Corruption cases fell in the middle, with 38% of cases and a median loss of $250,000
- In 97% of the cases in the study, the perpetrator took some efforts to conceal the fraud. The most common concealment methods were creating and altering physical documents.
- The median loss suffered by small organizations (those with fewer than 100 employees) was $200,000 while that incurred by the largest organizations (those with more than 10,000 employees) was $104,000. However, this type of loss is likely to have a much greater impact on smaller organizations.

FRAUD STATISTICS (Contd.)

- Corruption was more prevalent in large organizations while cheque tampering, skimming, payroll frauds were more prevalent in small organizations.
- The most common detection method in our study was tips (40% of cases), but organizations that had reporting hotlines were much more likely to detect fraud through tips than organizations without hotlines (46% compared to 30%, respectively).
- When fraud was uncovered through active detection methods, such as surveillance and monitoring or account reconciliation, the median loss and median duration of the schemes were lower than when the schemes were detected through passive methods, such as notification by police or by accidental discovery.
- The presence of anti-fraud controls was correlated with both lower fraud losses and quicker detection. We compared organizations that had specific anti-fraud controls in place against organizations lacking those controls and found that where controls were present, fraud losses were 12%–56% lower and frauds were detected 33%–58% more quickly.

FRAUD STATISTICS (Contd.)

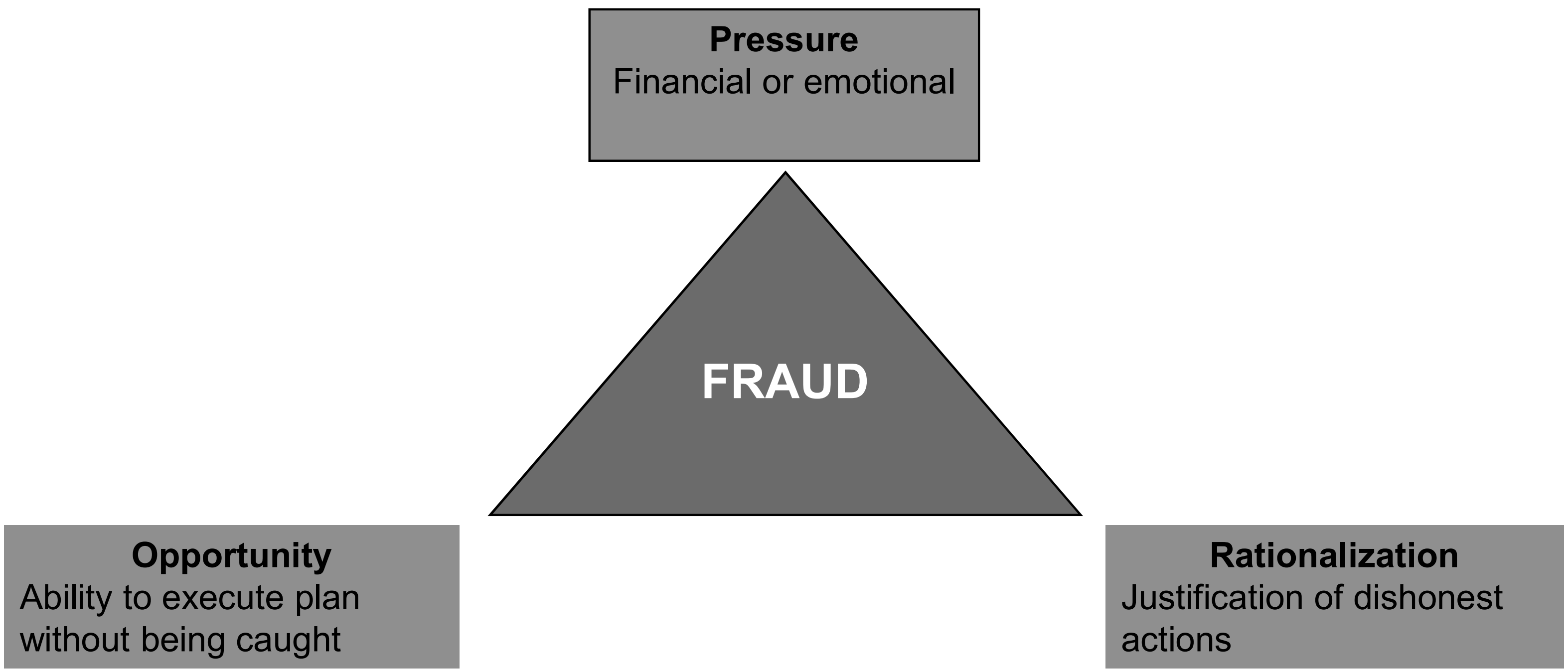
- While the implementation rates of anti-fraud controls varied by geographical region, several controls—external audits of the financial statements, code of conduct, and management certification of the financial statements—were consistently among the most commonly implemented across organizations in all locations.
- The most prominent organizational weakness that contributed to the frauds in the study was a **lack of internal controls**, which was cited in 30% of cases, followed by an override of existing internal controls, which contributed to just over 19% of cases.
- More occupational frauds originated in the accounting department (14%) than in any other business unit. Of the frauds we analysed, more than three-fourths were committed by individuals working in seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing and finance.

FRAUD STATISTICS (Contd.)

- Fraud perpetrators tended to display behavioural warning signs when they were engaged in their crimes. The most common red flags were living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general “wheeler-dealer” attitude involving unscrupulous behaviour, and recent divorce or family problems. At least one of these red flags was exhibited during the fraud in 85% of cases.
- Most occupational fraudsters are first-time offenders. Only 4% of perpetrators in this study had previously been convicted of a fraud-related offense, and only 9% had previously been fired by an employer for fraud-related conduct

FRAUD TRIANGLE

- The fraud triangle is a model advocated by Donald Cressy for explaining the factors that cause someone to commit occupational fraud. It consists of three components which, together, lead to fraudulent behaviour:



CONTENTS

Overview of section 143(12) of the Companies Act, 2013

OVERVIEW OF SECTION 143(12) OF THE COMPANIES ACT, 2013

- **Section 143(12) requires that:**
- If an auditor of a company
  - in the course of the performance of his duties as an auditor
  - has reason to believe
  - that an offence involving fraud is being or has been committed against the company
  - by officers or employees of the company
  - shall immediately report the matter to the Central Government within such time and in manner as prescribed considering threshold limit
  - If fraud is less than specified amount, report to ACM/Board

WHEN DOES AN AUDITOR COMMENCE REPORTING UNDER SECTION 143(12) OF THE COMPANIES ACT, 2013

Based on Suspicion

Reasons to believe?

Reasons to believe and knowledge

Knowledge?

Determination of offence

REPORTING OF FRAUD (BY OFFICERS OR EMPLOYEES) IDENTIFIED BY AUDITOR – ICAI GUIDANCE

Auditor in course of performance of duties has reasons to believe that fraud is being/ has been committed against company by its officers or employees

In its Revised Guidance Note (February 2016) ICAI has inter alia given guidance/ interpretations of section 143(12)

Report such fraud to Board/ Audit Committee (as applicable)

- Within 2 days of knowledge of fraud
- Specify nature, description, approximate amount and parties

Fraud involves/ expected to involve individually INR 1 crore or more*

Audit Committee/ Board (as applicable) to reply within 45 days

Auditor to submit his report alongwith the reply of Board/ Audit Committee (as applicable) to Central Government within 15 days

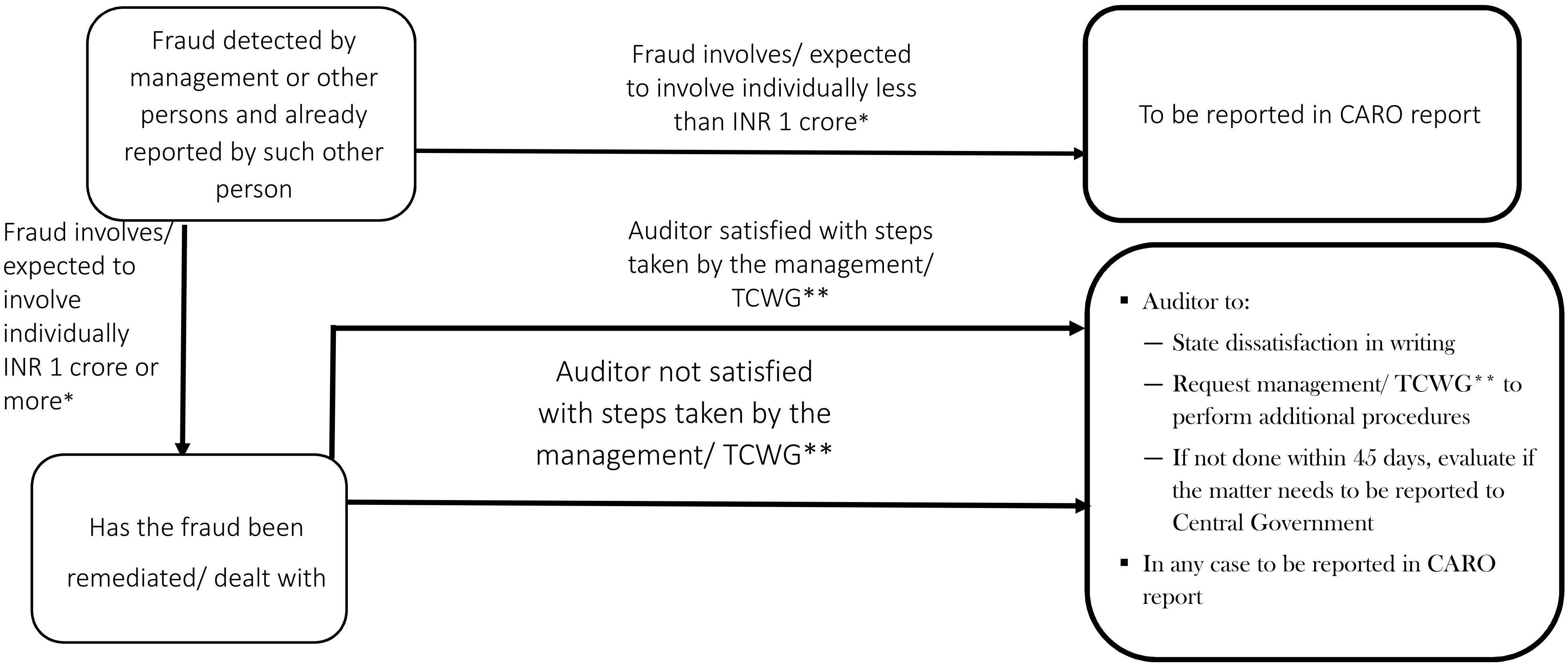
Fraud involves/ expected to involve individually less than INR 1 crore*

Board Report to disclose:

- nature of fraud,
- approximate amount
- parties involved (if remedial action not taken) and
- remedial action taken

***Materiality threshold prescribed by MCA wef 14 December 2015**

REPORTING OF FRAUD NOT IDENTIFIED BY AUDITOR – ICAI GUIDANCE



*Materiality threshold prescribed by MCA wef 14 December 2015 *Materiality threshold prescribed by MCA wef 14 December 2015

RESPONSIBILITY OF THE MANAGEMENT FOR PREVENTION AND DETECTION OF FRAUD

- **As per section 134(5) (c) of the 2013 Act, directors responsibilities include safeguarding of the assets of the Company and preventing and detecting fraud and other irregularities.**
- Primary responsibility for the prevention and detection of fraud rests with both **those charged with governance** of the entity and management
- Board's report to include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and preventing and detecting fraud and other irregularities.

AUDITOR RESPONSIBILITY FOR CONSIDERATION OF FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

- **Scope of the guidance note is as follows:**
  - Frauds detected '*in the course of performance of duties as an auditor*' implies in the course of performing an audit as per the Standards on Auditing
  - An auditor has to consider the requirements of Standards on Auditing for assessing risk of fraud
  - Reporting is applicable only when an auditor has evidence that fraud exists
  - Fraud by officers or employees of the company and not by third parties such as, vendors and customers.

FRAUD REPORTING (UNDER COMPANIES ACT 2013)

- **Compliance with Standards on Auditing:**
  - ➢ As per sections 143(9) and 143 (10), Statutory Audit is to be conducted in accordance with accounting standards i.e. Standards on Auditing ("SA")**.** And as per sec 143(2), report is to be issued considering the SA.
  - ➢ As such, SA 240 – 'The Auditors responsibility relating to Fraud in in an audit of Financial Statements' should be considered while performing the Statutory Audit
  - ➢ Paragraph 5 of SA 240 states that - 'An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error'.
  - ➢ Paragraph 40 states that the Auditor has to communicate fraud to appropriate level of management if he has identified or has obtained information about fraud

FRAUD REPORTING (UNDER COMPANIES ACT 2013)

- **Compliance with Standards on Auditing:**
  - Paragraph 10 of SA 240 requires an auditor to obtain sufficient appropriate evidence about the assessed risk of material misstatement due to fraud
  - **SA 250-** “Consideration of Laws and Regulations in an Audit of Financial Statements”- Paragraphs 22 and 23- require auditor to communicate to Audit Committee or Board non –compliance with laws and regulations, that come to auditor’s notice
  - Paragraph 27 of SA 315- “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, requires the auditor to consider the risk of fraud in determining which risks are significant risks
  - SA 230 - Audit Documentation
  - SA 315- Identifying and Assessing the Risk of Material Misstatement

SOME AUDIT PROCEDURES FOR SA 240 COMPLIANCE

- **Gain knowledge of the client's business**- Assess potential high risk areas
- **Modify audit procedures:**
  - Performing analytical procedures
  - verifying inventory near the period close instead of at period close
  - visiting locations not earlier visited etc.
  - Incorporate surprise element in audit procedures
  - Performing Ratio analysis
  - Apply test of reasonableness and test of absurdity
  - Compare mutually exclusive things- Sales and Production, Production with Machine capacity
  - Juxtaposition – can be used in contracts, signatures, invoices
  - Review of IT Security

SOME AUDIT PROCEDURES FOR SA 240 COMPLIANCE

- **Observe Red Flags:**
  - Non availability of records
  - Consistent losses in an otherwise thriving industry
  - Sudden Profits
  - Too many cancellations/reversals
  - Chaotic sate of affairs ,bookkeeping mess, unreconciled accounts
  - Close nexus of employee and vendor / customer
  - Selling flagship assets
  - Dwindling cash and mounting losses
  - Increase in debts

SOME AUDIT PROCEDURES FOR SA 240 COMPLIANCE

- **Observe Green Flags:-**
  - One way mistakes- cash-always in excess
  - Employee does not take travel advance
  - Very friendly or very harsh
  - Too Good to be True
- **Observe Behavioral Aspects**
  - Living beyond means
  - Divorce
  - Addiction
  - Significant debt and personal problems
  - Not taken leave for a long period

SOME AUDIT PROCEDURES FOR SA 240 COMPLIANCE

- **Some novel Methods of audit:**
  - Use of Benford's Law –good for sampling
  - Use of CAATS or Excel for data analysis
  - **Relative Size Factor –**Largest number/Second Largest number. If this ratio is 10, largest transaction needs to be investigated
  - Check Missing numbers in- invoices, cheques
  - Check Duplicates

CONTENTS

Persons covered for reporting under section 143(12) of the Companies Act, 2013

PERSONS COVERED FOR REPORTING UNDER SECTION 143(12) OF THE COMPANIES ACT, 2013

Persons covered

- Statutory Auditors of the company
- Company Secretary in practice conducting secretarial audit under section 204 of the 2013 Act
- Cost Accountant in practice conducting cost audit under section 148 of the 2013 Act
- Branch Auditors appointed under section 139 of the 2013 Act

Persons not covered

- Other professionals appointed under other statutes rendering other services to the company such as a tax auditor appointed under Income tax act, Sales tax or VAT auditors appointed under the respective Sales tax or VAT legislations.
- Internal Auditors

CONTENTS

Reporting On Frauds

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

- **It would be an auditor's responsibility to report about frauds in the following scenarios:**
- **Fraud noted by an auditor first before the management**
- Report to the management first and then the Central Government.
- **While providing attest or non-attest services, audit/limited review of interim period financial statements/results**
- Exercise professional judgment to evaluate materiality of the information
- Uses or intends to use the information obtained in the course of attest or non-attest services when performing an audit under the 2013 Act.

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

Frauds already reported by the management

Frauds already reported by other persons (Company Secretary and Cost Accountant)

No Reporting

But review the steps taken by the management

On dissatisfaction, state reasons and request the management to perform additional procedures

If additional procedures are not performed within 45 days of request, consider reporting the matter to the Central Government

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

- **Reporting in case of Consolidated Financial Statements: for frauds in any subsidiary, joint venture or associate:**

▪ An auditor of the parent company is not required to report on frauds under section 143(12) if frauds are not being or have not been committed against the parent company by the officers or employees of the parent company but relate to frauds in:

  – a component which is an Indian company as the auditor of that Indian company has the responsibility

  – a foreign corporate component that is not a company.

▪ An auditor of the parent company to report frauds in a component of the parent company only if:

  – fraud has been committed by employees or officers of the parent company and

  – such fraud is against the parent company.

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

- **Reporting when fraud relates to periods prior to the 2013 Act became effective**

- An auditor would report on fraud relating to earlier years under section 143(12) of the 2013 Act only if:

  The suspected offence involving fraud is identified by the auditor in the course of performance of his duties as an auditor during the financial years beginning on or after 1 April 2014, and

  To the extent that the same was not dealt with in the prior financial years either in the financial statements or in the audit report.

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

- **Reporting when fraud relates to Corruption, Bribery, Money Laundering and Non-compliance with other laws and regulations**
  - An auditor would report on fraud on the above matters under section 143(12) of the 2013 Act only if:
    - Such acts have been carried out by officers or employees of the company, and
    - Also take into account guidance in para 28 of SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements.*

REPORTING ON FRAUDS IN VARIOUS SCENARIOS

- **Reporting In Case Of Fraud Noted In An Audit Of A Bank**
  - An auditor would report on fraud in this case under section 143(12) of the 2013 Act to:
    - the Reserve Bank of India in addition to the Chairman/Managing Director/Chief Executive of the concerned bank
    - if the bank is a company under the 2013 Act, then to the Central Government

FRAUD REPORTING (UNDER COMPANIES ACT 2013)

- **Other Reporting Considerations:**

➢ **Frauds noticed during bank audits-** The RBI issued Circular No. DBS.FGV.(F).No.

- BC/23.08.001/2001-02 dated May 3, 2002 requires auditing professional to report any fraud to the RBI. However, as per Chartered Accountants Act,1949 prohibits a member to disclose any information to any person other than the Client. However, he can do so if the circular is included in the appointment letter. RBI has issued a Master Circular no.DBS.CO.CFMC.BC.No. 1/23.04.001/2015-16 dated July 1,2015 on "Frauds– Classification and Reporting" on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As such, auditor has to report the frauds to the RBI in addition to the Chairman/ Managing Director of the concerned Bank.

CERTAIN OTHER CONSIDERATIONS FOR FRAUD REPORTING

Consider the following scenarios:

- A purchase manager receiving a pay-off to favour a specific vendor
- An employee carries on business parallel to and in competition with the company's business
- The managing director's password is misused by the IT Administrator to leak certain critical information of the company's business to its competitors.
- All the above acts 'injure the interests of the company or its shareholders whether or not there is a wrongful gain or wrongful loss'.
- Is the auditor expected to detect all such acts?
- Is it pertinent to note that the financial effects of such acts are not reflected in the books of account?

CERTAIN OTHER CONSIDERATIONS FOR FRAUD REPORTING

- How does the auditor determine whether the value of individual fraud exceeds rupees one crore?
- Can auditor apply concept of materiality? What if materiality for a particular audit exceeds rupees one crore?
- Can a range of estimates be applied in arriving at the value of fraud where a definite amount determination is difficult?
- Is the auditor expected to perform a ‘forensic audit’?

CERTAIN OTHER CONSIDERATIONS FOR FRAUD REPORTING

- Where an auditor reports a fraud under Section 143(12), he would need to evaluate whether there is any reportable matter under Section 143(1) to Section 143(3) as also his report on IFC.
- How would reporting under Section 143(12) work for joint audits?
- On receiving response from the company disagreeing with the initial belief of the auditor that a suspected offence involving fraud is being or has been committed, if the auditor is convinced that his initial suspicion was incorrect, does the auditor still need to report the matter to the Central Government?
- Does the auditor have any responsibility of verifying Board's disclosures around fraud in the Board Report?

CARO 2016 Versus CARO 2015 IN RESPECT OF FRAUD

Frauds already reported by the management

New Clause No.	CARO 2016	CARO 2015	Difference
3(x) earlier (Clause (xii))	whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;	whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.	Responsibility now restricted to fraud by the Officers or employees of the company. This is in line with the provisions of section 143(12).

MATTERS TO BE KEPT IN MIND

- **Consider the impact of fraud on Financial Statements and Internal Financial Controls**
- **Obtain Management Representations confirming that they have disclosed to the auditor the results of Management's assessment of risk that financial statements may be materially misstated due to fraud and their knowledge about fraud**

CHALLENGES IN FRAUD REPORTING

- **Auditor's will face challenges in reporting the following frauds:**
  - Frauds not in books- e.g. accepting bribe to favour a vendor
  - Frauds involving theft of code, drawings

“when we are no longer able to change a situation,

we are challenged to change ourselves!”

Victor Frank

Source

Guidance Note on Reporting on Fraud under section 143(12) of the Companies Act, 2013 issued by The Institute of Chartered Accountants of India (ICAI).

Thanks