



Fraud Prevention, Detection and Reporting

Auditor's Duty

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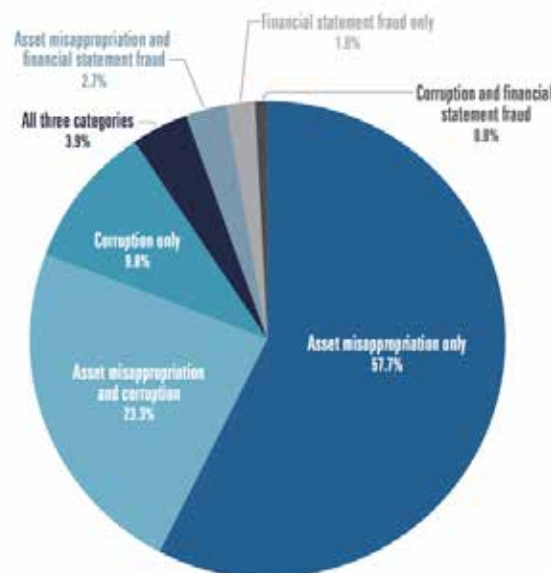
Fraud Prevention, Detection and Reporting

Preamble

A Global Fraud study conducted in 2014 by the Association of Certified Fraud Examiners titled, “Report to the Nations on Occupational Fraud and Abuse” reveals that typically an organization loses 5% of its revenue each year due to fraud. If applied to the 2013 estimated Gross World Product, this translates to a potential projected Global Fraud Loss of nearly \$ 3.7 trillion. This study classifies occupational fraud into three broad categories:

- Misappropriation of Assets
- Corruption
- Financial Statements Fraud

The following chart depicts the classification in terms of percentage:



2014, Global Fraud Study, Association of Certified Fraud Examiner

That said, the reporting responsibility of the Auditors have been crucial for all stakeholders of the Company and the regulators surrounding the business environment. The concept of fraud is not unknown to the Auditor. The Companies Act, 1956 did provided various sections where the concept of fraud was covered. The Companies Auditor's Report Order, 2003, Para (xxi) required the Auditor to report on Fraud "on or by the Company". With the introduction of Fraud reporting in The Companies Act 2013 ("**Act**") it is evident that the regulators are seeking assistance from the "watchdog" to bring greater transparency and discipline in the corporate world.

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Definition

Explanation to Section 447 of the Act defines fraud as:

“fraud in relation to affairs of a company or anybody 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.”

This definition is rather not exhaustive. It is an inclusive definition and with the usage of the term “any person” the definition provides a wider range to include “any person” who has committed the fraud, instead of restricting it to certain officers, directors or employees of the Company.

Standards on Auditing (“SA”) 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” defines fraud as:

“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”

Who should report Fraud?

Sub-section 12 of Section 143 of the Act states,

“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 involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.”

This reporting responsibility applies to:

- Statutory Auditor;
- Cost accountant conducting cost audit under Section 148 of the Act;
- Company secretary conducting secretarial audit under Section 204 of the Act.
- Branch Auditor appointed under Section 139 to the extent it relates to the concerned branch

The provision of Section 143(12) does not apply to:

- Professionals rendering other services to the Company. For example, tax auditor appointed under the Income Tax Act and VAT Auditors appointed for audit under the respective VAT legislation
- Internal Auditors covered under Section 138.

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“Against the Company” Vs. “By the Company”

The Companies Auditor’s Report Order, 2003, Para (xxi) required the Auditor to report on Fraud **“on or by the Company”**. However, it is important to note that the Act provides a clear indication that the Auditor is required to report only the Frauds committed by persons **“against the Company”**. There is no requirement envisaged under the Act for reporting Frauds committed **“by the Company”**. If the Auditor comes across such a situation which provides a reason to believe that Fraud is being or has been committed **“by the Company”** during the course of the audit, the auditor should consider the requirements stipulated as per SA 240.

The Code of Ethics under the Chartered Accountants Act, 1949 requires the Auditors to maintain utmost confidentiality and bars Auditors from reporting to third parties without the consent of the client, unless there is a professional obligation. Reporting under Section 143(12) of the Act is a professional obligation. However, it may be inferred that if the Auditor reports Fraud committed **“by the Company”**, he shall be guilty of professional misconduct for breach of confidentiality.

Fraud Committed by?

The definition stipulates reporting responsibility in respect of frauds committed by **“Officers or Employees”** of the Company and does not include fraud by third parties such as vendors and customers.

Section 2(59) of the Act, defines the term **“Officer”** to include any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act.

The Act does not define the term **“Employee”**, however in common parlance it is generally understood that Employees are persons who are on the payroll of the Company. Employees would therefore not include those who are engaged on contract basis as they are considered as Vendors and not Employees.

Auditor’s Responsibility Vs. Management’s Responsibility

The “Safeguard of Assets” being the key responsibility of the management of the Company, the management shall ensure that adequate internal controls are installed for prevention and detection of fraud. Section 135(5) clearly indicates that the Board Report shall include a responsibility statement that the directors had taken proper and sufficient care for safeguard of assets and for prevention and detection of fraud.

Section 177(9) and (10) also requires the every listed company and the specified class or classes of companies, to establish a vigil mechanism for directors and employees to report genuine concerns in the manner as prescribed. The vigil mechanism needs to provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.

The roles and responsibilities of Independent Directors as specified in Schedule IV to the Act, include review of reporting concerns reporting concerns about unethical behaviour, actual or suspected fraud

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or violation of the company's code of conduct or ethics policy. The Independent directors shall satisfy themselves on the integrity of the financial information.

By virtue of the definition, the Auditor's reporting responsibility arises during the course of the performance of his duties as auditor. This undoubtedly indicates that the Auditor need not perform any procedures envisaged outside the scope of the Auditing Standards (SA 240, in specific) in regard to fraud detection. The auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account or financial statements of the company.

When should fraud be reported?

The definition clarifies that the auditor shall report only if he has reason to believe that an offence involving fraud is being or has been committed. During the course of audit, the auditor may obtain several information about possible offence involving fraud, which can be broadly classified into:

- Speculation - refers to information from unrelated source which is a rumour, hearsay, gossip, assumption, guess, thought or supposition.
- Suspicion - is a state of mind more definite than speculation, but falls short of knowledge based on evidence. It must be based on some evidence, even if that evidence is tentative. Suspicion is a slight opinion but without sufficient evidence.
- Reason to Believe - indicates that the matter should be more than just a suspicion. Suspicion when corroborated with supporting evidence can provide reason to believe.
- Sufficient Reason to Believe or Knowledge - indicates reason to believe with more persuasive evidence based on further procedures performed by the auditor.

The reporting responsibility under Section 143(12) is triggered when the Auditor has **“sufficient reason to believe or knowledge”** that an offence involving fraud is being or has been committed.

Fraud noted or identified by the Auditor while providing other attest or non-attest services

The auditors of the Company may also perform certain other services in their capacity as statutory auditors of the Company, like:

- Performance of Limited Review as per requirements of Clause 41 of the Listing Agreement
- Report on the Interim Financial Information as per Accounting Standard 25
- Tax Audit under Income Tax Act.
- Issue of Certificates.

If an offence involving fraud is noted or identified by the Auditor in the course of performing the aforementioned other services, the auditor shall report such offence involving fraud if:

- the fraud involves such amount that may be material to the financials, or
- he uses or intends to use the information obtained in the course of performing the other services when performing the audit.

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Frauds detected by Management or Other Person

An offence involving fraud may be detected identified by:

- the management through its vigil or whistle blower mechanism and has been or is being remediated dealt with by them
- Cost Auditor
- Secretarial Auditor

In such cases, the auditor will not be required to report the same under Section 143(12) since he has not per se identified the fraud.

Consolidated Financial Statements

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 consolidated financial statements. The following example elucidates reporting requirement by principal auditor on suspected offence involving frauds that may have taken place in any of the subsidiaries, joint ventures, associates of the company. For convenience let us assume that the Holding Company is ABC Ltd and Subsidiary is XYZ Ltd.

XYZ Ltd Jurisdiction	Fraud by Officers/ Employees of	Identified by Auditor of	Involving	Against	Reporting by Auditor of ABC Ltd
India	XYZ Ltd	XYZ Ltd	XYZ Ltd	XYZ Ltd	Not required as Auditor of XYZ Ltd would have reported
Foreign	XYZ Ltd	XYZ Ltd	XYZ Ltd	XYZ Ltd	Not required as Auditor of XYZ Ltd is not covered u/s 143(12)
India	ABC Ltd	ABC Ltd	XYZ Ltd	ABC Ltd	Required to Report
India	ABC Ltd	XYZ Ltd	XYZ Ltd	ABC Ltd	Required to Report
Foreign	XYZ Ltd	XYZ Ltd	XYZ Ltd	ABC Ltd	Required to Report
Foreign	XYZ Ltd	ABC Ltd	XYZ Ltd	ABC Ltd	Required to Report

Fraud relates to Prior Periods

In case of fraud relating to earlier years to which the Companies Act, 1956 was applicable, reporting under Section 143(12) will arise 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 April 1, 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 or in the Board's report under the Companies Act, 1956.

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Materiality

The auditor should necessarily apply the concept of materiality in performing the audit in accordance with SA 320, "Materiality in Planning and Performing an Audit". It is also a fundamental guiding principle for the management to set up an appropriate system of internal control and preparation of financial statements. As per the amendment tabled as part of the Companies (Amendments) Bill, 2014 on provisions relating to auditors reporting on fraud, in case of a fraud involving:

- lesser than a specified amount, the auditor shall report the matter to the Audit Committee or to the Board in other cases within such time and in such manner as may be prescribed;
 - amount exceeding the specified amount, the auditor shall reported to the Central Government
- It may be noted that as on date, the above amendment is pending approval of the Rajya Sabha and Presidential assent. Pending further clarity on this issue, the Auditor is required to exercise his professional judgement.

Timelines

As per requirements of the Companies (Audit and Auditors) Rules, 2014, the Auditor is expected to report the fraud to the Central Government not later than 60 days. The steps involved are:

Steps	Details
Step 1	Auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company
Step 2	Auditor to immediately forward the report on Fraud to the Board or the Audit Committee, as the case may be
Step 3	Board or Audit Committee shall reply with their observations within 45 days from the date of report by Auditor
Step 4 (a)	Auditor receives reply from Board or Audit Committee
Step 4 (a)(i)	Audit shall forward his report (Form ADT-4) along with replies and observations of the Board or Audit Committee with his comments to the Central Government within 15 days
Step 4 (b)	Auditor does not receive reply from Board or Audit Committee
Step 4 (b)(i)	Audit shall forward his report (Form ADT-4) 15 days to Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time of 45 days.

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Penal Provisions

Section 143(15) of the Act provides that if any auditor, cost accountant or Company Secretary in practice do not report the fraud and contravenes the provisions of Section 143(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.

Conclusion

These new provisions relating fraud clearly indicate the intention of the regulators. The concept is novel indeed, however yet to be tested. Implementation of these provisions along with swift action by the Regulators would be the key challenge along with the imminent need by the Corporate to understand the regulatory provisions and develop a strong control framework for prevention and detection of Fraud.

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CHENNAI

48, Masilamani Road,
Balaji Nagar, Royapettah,
Chennai - 600014.
Phone: +91 - 044 - 28131 128/38/48
Fax: +91 - 28131 158

BENGALURU

Khivraj Mansions, 10/2 Kasturba Road,
Bangalore - 560001.
Phone: +91 - 080 - 22274 551/52
Fax: +91 - 22212437

VISAKHAPATNAM

1-88-19, Plot No: 135/4,
Sector 4, MVP Colony,
Visakhapatnam 530 017
Phone: (0891) 2755821 & 2755848,
Fax: (0891) 2755848

GUNTUR

10-3-21, 3rd Lane,
Sambasivapet, Guntur - 522001.
Phone: +91 - 863 - 2220347/2224924
Fax: +91 - 2220347

TANUKU

22-29/5 Gubbalavari Street,
Society Road, Tanuku - 534211.
Phone: +91 - 8819 - 221 234/224 911

HYDERABAD

No 403&404, Golden
Green Apartments,
Erra Manzil Colony,
Hyderabad - 500082.
Phone: +91 - 040 - 23370 002/04
Fax: 23379 988

GURGAON (New Delhi)

404, DLF City Court,
Sikandarpur, Mehrauli_Gurgaon Road
(MG Road), Gurgaon,
Haryana - 122002
Phone : +91 - 0124 - 4235 522

VIJAYAWADA

No 33-25-33/3, Govinda
Rajulu Naidu Street,
Surya Rao Pet,
Vijayawada - 520010.
Phone: +91 - 866 - 2444 592/93/94

KAKINADA

3-16C-40/1, 8th Road, Santhi Nagar,
Kakinada - 5330003.
Phone: +91 - 884 - 2374 402/04
Fax: +91 - 2374 402, 2363 656

ADONI

142/6, Sri Krishnadevaraya Colony,
Adoni - 518301.
Phone: +91 - 8512 - 253 447/222 377
Fax: +91 - 253 447