

## Fraud Reporting Under Section 143(12) of the Companies Act, 2013 - An Added Responsibility on Auditors



*Corporate fraud has been ranked as one of the topmost risks to the entire economic system of the country, according to a latest survey conducted by the industry chamber FICCI. In addition to substantial economic losses, such fraudulent acts also undermine the integrity and reliability of financial statements and reports. It is important to control this pervasive phenomenon which is haunting the entire economy with serious risks and threats. The Government, with the introduction of Section 143(12) of the Companies Act, 2013, is seeking the auditors' support for the purpose, since auditors have always had an important role to play in enhancing the credibility of financial information. Section 143(12) has casted an onerous and arduous duty on the auditors to report fraud committed by officers/employees of the company against the company, to the Central Government, in accordance with the provisions of the section. How an auditor should deal with this? To properly understand, we have to go through the intents, contents and specifics of Section, along with the Rules framed thereunder, together with the Guidance Note recently issued by the ICAI. Please read on...*

The auditors' responsibility as to report fraud so long originated from the CARO clause 4(xxi) which specifically deals with the fraud reporting and further, with the issuance of *Standard on Auditing (SA) 240 The Auditors' Responsibility related to fraud in an Audit of Financial Statements*. Neither the Audit Report under the Companies Act, 1956 nor SAs 700/705/706 have a specific clause on fraud reporting, though it has to be necessarily indicated in the audit opinion where warranted. But, the New Companies under Section 143(12), in addition to the given responsibility, have added additional responsibility to immediately report the matter to the Central Government within such time and in such manner as may be prescribed, if he 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. As on date, the present CARO appears to be operative until an improved form is introduced in consultation with NFRA as per Section 124 (11) of the new Act.

As per Rule 13 of the Companies (Audit and Auditors) Rules, 2014, the auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to the knowledge of fraud, seeking their reply or observations within 45 days; on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations) to the Central Government within 15 days of receipt of such reply or observations. In case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report in Form ADT-4 to the Central Government along with a note containing the details of his report that was earlier forwarded

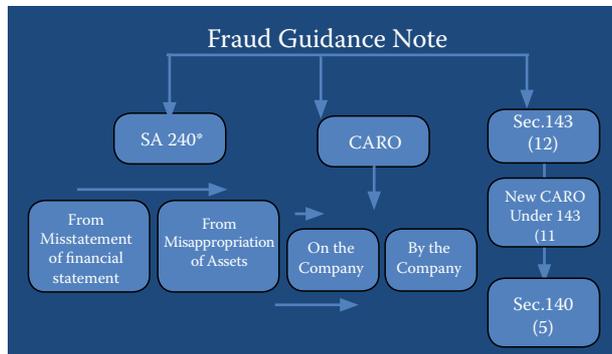


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to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time. This reporting will not be construed as professional misconduct.

The *Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013* (the 'Guidance Note' or 'GN') recently issued can be represented as below:



## Role of CARO in Fraud Reporting vis-a-vis Section 143(12) of the 2013 Act

Clause 4(xxi) of CARO runs as follows-

*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.*

Two important things are noticeable in the said clause. One is 'any fraud on or by the company' and the other is that fraud has been 'noticed or reported during the year'. What is fraud *on the company* as distinct from *by the company*? Company by itself is an artificial legal entity. It cannot by itself commit fraud. According to Guidance Note 2005, fraud involving one or more members of management or those charged with governance is referred to as 'management fraud'; fraud involving only employees of the entity is referred to as 'employee fraud'. In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the management fraud can be construed as 'fraud by the company' while fraud committed by the employees or third parties may be termed as 'fraud on the company'.

### Will management fraud come under the mischief of Section 143(12)?

In all fairness and likelihood, it appears to be yes. Though the management is at higher echelons of the company, they derive salary from the company, thus, to be called/labelled as officers/employees of the company.

## Noticeable Differences Between CARO and Section 143(12) of the Act

Let us first quote Section 143(12):

"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."

As compared to CARO, three different things have been noticed in the sub-Section.

- i. The Section begins with the words 'notwithstanding anything contained in this Section...' signifying that the responsibility to report fraud to the Central Government is in addition to other existing reporting requirements to members.
- ii. The auditor has a reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company.
- iii. Again, a duty has been casted on the auditors to 'immediately report the matter to the Central Government within such time and in such manner as may be prescribed'.

As against clause 4(xxi) of CARO, which states that the fraud has been 'noticed or reported during the year', the words used under Section 143(12) of the new Act, that 'the auditor has a reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company', are more vocal and pronounced warranting added responsibility. As per Rules prescribed, auditor is required at first to report the fraud to the board and the audit committee, seek their reply within forty-five days period and within fifteen days of their reply report the fraud to the Central Government together with the response of the board and audit committee. Well, this places rightly some obligation on the board and audit committee. The profession has to wait and see how this mechanism pans out in fraud reporting.

## Can Fraud Happen Without the Connivance of Officers/Staff?

Now a question arises, how fraud can be committed without employees'/ officers' participation? Wrongful acts like money fraudulently withdrawn from ATM, theft by outsiders, cybercrimes, *etc.* are in the guild

of theft by outsiders, not amounting to fraud by the company's officers or employees. Hence, these may be kept outside the purview Section 143(12).

## Persons Covered for Reporting on Fraud Under Section 143(12) of the Act

The reporting requirement under Section 143(12) applies to:

1. Statutory Auditors of the company: Section 143 (2) of the Act
2. Cost Accountant in practice, conducting cost audit under Section 148 of the Act
3. Company Secretary in practice, conducting secretarial audit under Section 204 of the Act.
4. Branch Auditors: As per sub-rule (3) of Rule 12 of the Companies (Audit and Auditors) Rules, 2014, the provisions of sub-Section (12) of Section 143 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014 shall also extend to Branch Auditors appointed under Section 139 to the extent it relates to the concerned Branch.

The provisions of Section 143(12) do not apply to the following professionals rendering other services to the company:

1. Tax Auditor appointed for audit under Income-tax Act.
2. Sales Tax or VAT Auditors appointed for audit under the respective Sales Tax or VAT legislations.
3. Internal Auditors covered under Section 138 are not specified as persons who are required to report under Section 143(12). However, internal auditors are responsible to review the compliance.

## Should The Auditor Report Under Section 143(12) on Frauds Noted In the Course of Providing Other Attest Or Non-Attest Services?

Such attest services may not be pursuant to any requirement of the 2013 Act. The objective and scope of such attest services and the procedures performed by the auditor may not be of the same extent and level as in the case of the audit of the financial statements prepared under the 2013 Act. If an offence, involving fraud against the company by its officers or employees that is identified/noted by the auditor in the course of providing such attest or non-attest services, is material to the financial statements to be prepared under the 2013 Act, the auditor should report the offence involving such fraud to

the Central Government as per the requirements of Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014, and as per the provisions of the Guidance Note. (Refer paragraphs 49 to 55 of the Guidance Note)

## Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements-Compliance of Auditing Standards/Provisions of the Act

It may be noted that under Section 143(9) read with Section 143(10), the duty of the auditor, *inter alia*, in an audit is to comply with the Standards on Auditing (SAs). Further, Section 143(2) requires the auditor to make out his report after taking into account, *inter alia*, the auditing standards. Accordingly, the term, "in the course of performance of his duties as an auditor" implies in the course of performing an audit as per the SAs.

The definition of fraud as per SA 240 and the explanation of fraud as per Section 447 of the 2013 Act are similar, except that under Section 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.'

**Guidance as per GN:** However, an 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 accounts/ financial statements of the company. For example, receiving pay-offs for favouring a specific vendor, the password of key managerial personnel is stolen and misused, employee carrying on business parallel to the company's business and diverting customer orders to his company, *etc.* Therefore, the auditor shall consider the requirements of the SAs, insofar as it relates to the risk of fraud, including the definition of fraud as stated in SA 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

## Reporting on Frauds Detected by the Management or Other Persons and Already Reported Under Section 143(12) by Such Other Person

Paragraph 4 of SA 240 states and clarifies that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. In the

context of the 2013 Act, this position is reiterated in Section 134(5) which states that the Board Report shall include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

**Guidance as per GN:** Based on the above, it may be considered that Section 143(12) envisages the auditor to report to the management and thereafter to the Central Government an offence involving fraud against 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. It will not apply when company's vigil/whistle blower mechanism has already reported fraud and has been/is being remediated/dealt with and such case is informed to the auditor. If a suspected offence involving fraud has already been reported under Section 143(12) by other professionals like Cost Accountant/Chartered Secretary and the auditor becomes aware of such suspected offence involving fraud, he need not to report the same to the Central Government under the Section, since he has not *per se* identified the suspected offence involving fraud.

### Reporting on Suspected Offence Involving Fraud in Case of Consolidated Financial Statements

Since the audit of the consolidated financial statements has also been made one of the duties of the auditor, a question that arises is – should the auditor report on suspected offence involving frauds that may have taken place in any of the subsidiaries, joint ventures, associates of the company?

**Guidance as per GN:** Reporting under Section 143(12) arises only if a suspected offence involving fraud is being or has been committed against the company by its officers or employees. Accordingly, the auditor of the parent company is not required to report on frauds under Section 143(12) if they 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. A component that is an Indian company, since the auditor of that Indian company is required to report on suspected offence involving frauds under Section 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).

However, the auditor of the parent company in India will be required to report on suspected offence involving frauds in the components of the parent company, if the suspected offence involving fraud in the component is being or has been committed by employees or officers of the parent company and if such suspected offence involving fraud in the component is against the parent company, if:

- a. the principal auditor identifies/detects such suspected offence involving fraud in the component "in the course of the performance of his duties as an auditor" of the consolidated financial statements; or
- b. the principal auditor is directly informed of such a suspected offence involving fraud in the component by the component auditor and the management had not identified/is not aware of such suspected offence involving fraud in the component; or
- c. a component that is not a company since the component auditors of such components are not covered under Section 143(12).

### Reporting Under Section 143(12) When the Suspected Offence Involving Fraud Relates to Periods Prior to Coming into Effect of the 2013 Act

Requirements similar to Section 143(12) of the 2013 Act were not prescribed in the 1956 Act. Even the reporting under the Companies (Auditor's Report) Order, 2003 (CARO) only required the auditors to report to the members on any fraud on or by the company that had been noticed or reported during the year.

**Guidance as per GN:** As such, auditors would not have reported on frauds as envisaged under Section 143(12) in those periods prior to coming into effect of the 2013 Act. Accordingly, 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 1<sup>st</sup> 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 or in the Board's report under the Companies Act, 1956.

# Auditing

## When Does An Auditor Commence Reporting Under Section 143(12) – Based on Suspicion– Reason to Believe – Knowledge – or on Determination of Offence?

1. **“Suspicion”**: It is only a state of mind. Suspicion is a slight opinion but without sufficient evidence.
2. **“Reasons to believe”**: There needs to be sufficient information or convincing evidence to advance beyond suspicion that it is possible that someone is committing or has committed a fraud.
3. **“Sufficient reason to believe” and “knowledge”**: Rule 13 of the Companies (Audit and Auditors) Rules, 2014 specifies the threshold for reporting as “sufficient reason to believe” and “knowledge”. The condition of ‘sufficient 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. In the case of reporting on fraud under Section 143(12), it occurs when the auditor has sufficient reason to believe that a fraud has been or is being committed on the company by its officers or employees. This implies that there exists a fraud.
4. **“Suspected offence involving fraud”**: used in the Form ADT – 4
5. **“Legal Determination”**: whether fraud has actually taken place?

**Guidance as per GN** : Accordingly, based on a harmonious reading of Section 143(12), Rule 13 of the Companies (Audit and Auditors) Rules, 2014 and Form ADT - 4, reporting on fraud in the course of performance of duties as auditor is applicable only when the auditor has sufficient 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.

### Can the Auditor Apply the Concept of Materiality for Reporting on Fraud?

Section 143(12) that deals with fraud reporting to the Central Government is silent on the application of materiality concept. As a result, an amendment has been passed in Lok Sabha according to which in case of a fraud involving lesser than a specified amount, the auditor shall report the matter to the Audit Committee constituted under Section 177 or

to the Board in other cases within such time and in such manner as may be prescribed. Accordingly, only those frauds, where the amount exceeds the specified limit, shall be reported to the Central Government. It is yet to be cleared by the Rajya Sabha and the President.

**Concept of Materiality in SAs for reporting to the members**: This concept of materiality is fundamental to the entire auditing process and was applied even when reporting under CARO. For example, paragraph 36 of the statement on CARO states, ‘where a requirement of the Order is not complied with but the auditor decides not to make an adverse comment, he should record in his working papers the reasons for not doing so, for example, the immateriality of the item.

**Guidance as per GN**: Materiality is applicable where the amount is quantifiable, if not, the auditor should apply professional judgment to estimate the likelihood of the amount exceeding the aforesaid threshold wherever the amount is quantifiable. For this purpose, it can be based on management estimate or reasonable range of estimates made by the auditor. Subsequent reporting may be required if the amount initially estimated was lower than the aforesaid threshold but was eventually determined to be higher than such threshold. Under these circumstances, the timeline for reporting under Rule 13 of the Companies (Audit and Auditors) Rules, 2014 will commence when the amount involved is determined to be in excess of the threshold.

### Should the Auditor Report Under Section 143(12) in Case of Corruption, Bribery, Money Laundering and Non-compliance with Other Laws and Regulations

With respect to reporting under Section 143(12), consequent to corruption, bribery, money laundering and other intentional non-compliance with other laws and regulations, the auditor should consider whether such acts have been carried out by officers or employees of the company for the purpose of reporting and also take into account the requirements of SA 250, particularly paragraph 28 of SA 250 read with paragraphs A19 and A20.

### Applicability of Standards on Auditing in Relation to Fraud

Reporting Section III of the Guidance Note deal with applicability of Standards on Auditing in relation to fraud reporting. The following listing will highlight

the provisions of various SAs as paragraphed in the GN to be mandatorily complied:

- Professional Skepticism (SA 200)- Para 60
- Audit Documentation (SA 240/315/ 330)- Para 61---Appendix -1
- Inquiries with those Charged with Governance (SA-240) --- Appendix -2
- Communications with those Charged with Governance (SA-240)- Para63
- Risk Assessment Procedures and Related Activities (SA 315) -Para 64
- Inquiries with Management and Others within the Entity(SA 240)-Para 65--- Appendix -2
- Identification & Assessment of the Risks of Material Misstatement Due to Fraud (SA 240/315) -Para-66
- Responses to the Assessed Risks of Material Misstatement (SA240/330)- Para -67
- Evaluation of Misstatements Identified during the Audit (SA 240/450)- Para -68
- Analytical Procedures (SA-315/520)- Para-69
- Review of Accounting Estimates (SA 240/540)- Para-70
- Related Parties (SA 240)/550)- Para- 71
- Written Representations ( SA 240)- Para- 72
- Inquiries with Internal Auditors (SA 240/610)- Para-73

Technical guidance is elaborated in Section IV of the Guidance Note. Section V deals with appendices that chart out various procedures/*modus operendi* to be deployed in discussion with various levels with well charted check lists. It also gives formats of reporting to the Audit Committee/the Board/ Central Government. Appropriate management letters are also suggested.

## Audit Approach- Tracing the Fraud

- While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries from management to determine whether the management is aware of any known fraud or suspected fraud that the company is investigating.
- The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minutes' book of the board meeting of the company in this regard.

The applicable SAs referred to above in Section III, technical guidance covered in Section IV as well as the procedures suggested above would go long way in tracing the fraud.

## Conclusion

There is a saying- '*error is human*'. That is highly disputable, since the animal kingdom also commits error and gets trapped. But, regarding fraud, it is entirely the domain of human kingdom because of the play by the sixth sense. Frauds are ingeniously committed and perpetrated by the sixth sense. It is difficult to prevent and catch fraud. The Companies Act, 2013 has imposed an ardent responsibility on the auditors to deal with fraud reporting. It is expected that the extent of fraud could be limited and minimised in the times to come. The Guidance note will immensely help the auditors to discharge their responsibilities in this direction. ■

