

Guidance Note on Reporting on
Fraud under Section 143(12) of
the Companies Act, 2013



The Institute of Chartered Accountants of India

(Set up by an Act of Parliament)

New Delhi

© The Institute of Chartered Accountants of India

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form, or by any means, electronic mechanical, photocopying, recording, or otherwise, without prior permission, in writing, from the publisher.

Edition : February, 2015

Committee : Auditing and Assurance Standards Board

E-mail : aasb@icai.in

Website : www.icai.org

Price : Rs. 200/-(Including CD)

ISBN No : 978-81-8441-741-8

Published by : The Publication Department on behalf of the Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi - 110 002.

Printed by : Sahitya Bhawan Publications, Hospital Road, Agra - 282 003

February/2015/1,000 Copies

FOREWORD

The Companies Act, 2013 has introduced many new reporting requirements for the statutory auditors of companies. One of these requirements is given under the Section 143(12) of the Companies Act, 2013 which requires the statutory auditors to report to the Central Government about the fraud/suspected fraud committed against the company by the officers or employees of the company.

A need was felt for providing appropriate guidance on this section so that the requirements and expectations of the section can be fulfilled in letter and spirit by the auditors.

I am happy that the Auditing and Assurance Standards Board has brought out this Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 for the benefit of the members. The Guidance Note has been developed in an easy to understand language. I am also happy that the Guidance Note is comprehensive and self contained reference document for the members.

At this juncture, I wish to place my appreciation for CA. Abhijit Bandyopadhyay, Chairman, Auditing and Assurance Standards Board for bringing out guiding literature for the benefit of the members. I am sure that the members would find this Guidance Note immensely useful in discharging their responsibilities under the section.

February 3, 2015
New Delhi

CA. K. Raghu
President, ICAI

PREFACE

Financial fraud is a phenomenon that haunts everyone alike. Not only does it mean loss of an asset for the one who has been at the receiving end of a fraud, it has the capability of shaking the roots of “confidence” and “trust” that anchor a society and/or an economy. Governments and other policy makers therefore remain keen to control the menace.

Auditors have always had an important role to play in enhancing the credibility of the financial information. With the introduction of section 143(12) of the Companies Act, 2013, the Central Government is apparently seeking the support of the auditors in bringing in greater transparency and discipline in the corporate world to protect the interests of the shareholders as also the public, at large. The intent, scope, implementability and collateral repercussions of the provisions of this section and the related Rules on the auditors and the companies have been, or rather, still are, a subject matter of much debate, the fact remains that this section is here on the statute book.

The other thing that is quite clear from the section itself is that the auditor’s reporting responsibilities under this section are squarely within the framework of performance of his duties as an auditor of the company and in no other manner/ capacity. So while the auditors, while carrying out audits, comply with various Standards on Auditing (SAs) including SA 240, *The Auditor’s Responsibilities relating to Frauds in An Audit of Financial Statements*, there were many open issues in section 143(12) on which members needed to be guided properly. These include responsibilities where the auditor is also carrying out a limited review or other attest services, issues in reporting on section 143(12) in audit of consolidated financial statements, frauds that are identified first by the management and duly rectified, to name a few. Besides, auditors also need guidance on the concepts of “reasons to believe”, “suspicion”, etc., and other procedures involved. This Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 is aimed to address these and more of such incidental issues that would arise before the auditors in complying with the requirements of this section and the related Rules.

At this juncture, I wish to place on record my sincere thanks to CA. K. Sairam, Chennai and CA. V. Balaji, Bangalore for taking time out of their other pressing preoccupations to develop this Guidance Note and to give it its present shape and form.

I also wish to express my deep gratitude to CA. K. Raghu, President, ICAI and CA. Manoj Fadnis, Vice President, ICAI for their vision, guidance and support to the activities of the Board. I also wish to thank all my colleagues at the Central Council for their cooperation and guidance in formulating and finalising the various authoritative pronouncements of the Board.

My sincere thanks are also due to the Board members, viz., CA. Shrinivas Y Joshi, Vice Chairman, CA. Rajkumar S. Adukia, CA. Nihar Niranjana Jambusaria, CA. Sanjeev K. Maheshwari, CA. Nilesh S. Vikamsey, CA. Shiwaji Bhikaji Zaware, CA. V. Murali, CA. S. Santhanakrishnan, CA. J. Venkateswarlu, CA. Subodh Kumar Agrawal, CA. Mukesh Singh Kushwah, CA. Sanjiv Kumar Chaudhary, CA. Atul Kumar Gupta, Shri P. Sesh Kumar, Shri Bhaskar Chatterjee, CA. Sanjay Kumar Jain, CA. Sunil Ramakant Bhumralkar, CA. Navin Tilakraj Gupta, CA. Ravi Prasad and CA. Uttam P. Agarwal for their support and guidance to the Board. I also wish to thank the special invitees to the Board, viz., CA. Amit Roy, Shri Anindya Kumar Das, CA. Vijay Sachdeva, CA. Sanjay Vasudeva and Shri R. Kesavan for their support and guidance to the Board.

Before I end my message, I am tempted to quote Alan Greenspan, former Chairman, Federal Reserve, USA, "*Corruption, embezzlement, fraud, these are all characteristics which exist everywhere. It is regrettably the way human nature functions, whether we like it or not. What successful economies do is keep it to a minimum. No one has ever eliminated any of that stuff.*"

I am confident that this Guidance Note would be well received by members and other interested readers.

February 3, 2015
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

CONTENTS

| Section | Topic | Paragraph Reference | Page No(s) |
|---------------|--|---------------------|-------------|
| PART A | OVERVIEW | | 1-18 |
| I | Persons covered for Reporting on Fraud under Section 143(12) of the Companies Act, 2013 | | 3 |
| II | Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements | | 4 |
| III | Reporting on Suspected Offence Involving Frauds Identified/Noted during Audit/Limited Review of Interim period Financial Statements/Results, Other Attest Services and Permitted Non-attest Services | | 5 |
| IV | Reporting on Frauds Detected by the Management or Other Persons and already Reported under Section 143(12) by such Other Person | | 7 |
| V | Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements | | 9 |
| VI | Reporting under Section 143(12) when the Suspected Offence Involving Fraud Relates to Periods Prior to Coming into effect of the 2013 Act | | 10 |
| VII | When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence? | | 11 |

| Section | Topic | Paragraph Reference | Page No(s) |
|------------------|---|----------------------------|-------------------|
| VIII | Can the Auditor apply the Concept of Materiality for Reporting on Fraud? | | 13 |
| IX | Should the Auditor Report under Section 143(12) in case of Corruption, Bribery, Money Laundering and Non-compliance with Other Laws and Regulations | | 15 |
| X | Reporting on Fraud under Section 143(12) – Decision Tree/Flow Chart | | 17 |
| PART B | DETAILED GUIDANCE | | 19-147 |
| Section I | Introduction | 1-16 | 21-36 |
| | Introduction | 1 - 2 | 21 |
| | Requirements for Reporting on Fraud under the Companies Act, 2013 | 3 - 8 | 21 |
| | Consideration of Fraud in an Audit of Financial Statements as required by Standards on Auditing | 9 | 25 |
| | Reporting on Fraud under Section 227 (4A) of the Companies Act, 1956 as per the Companies (Auditor's Report) Order, 2003 (as amended) ('CARO') | 10 | 26 |
| | Reporting to RBI in case of Fraud noted in Audit of Banks | 11 | 29 |
| | Responsibility of Management | 12 | 32 |
| | Audit Committee's Responsibility on Vigil Mechanism | 13 | 33 |
| | Code of Conduct for Independent Directors | 14 | 33 |
| | Various Definitions of Fraud | 15 – 16 | 34 |

| Section | Topic | Paragraph Reference | Page No(s) |
|-------------------|--|----------------------------|-------------------|
| Section II | Auditors' Reporting on Fraud under Section 143(12) | 17-58 | 37-56 |
| | Auditors' Reporting on Fraud under Section 143(12) | 17 – 25 | 37-39 |
| | Issues for Consideration by Auditors for Reporting under Section 143(12): | 26-58 | 40-56 |
| | Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements | 26 – 32 | 40 |
| | Reporting on Suspected Offence Involving Frauds noted during Audit/Limited Review of Interim Period Financial Statements/Results and Other Attest Services | 33 – 35 | 42 |
| | Reporting Responsibility in case of Suspected Offence Involving Fraud Noted during Performance of Permitted Non-attest Services | 36 – 38 | 44 |
| | Reporting on Frauds Detected by the Management or Other Persons and already Reported under Section 143(12) by such Other Person | 39 – 41 | 45 |
| | Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements | 42 – 43 | 48 |
| | Reporting under Section 143(12) when the Suspected Offence Involving Fraud Relates to Periods Prior to Coming into effect of the 2013 Act | 44 – 45 | 49 |

| Section | Topic | Paragraph Reference | Page No(s) |
|--------------------|--|----------------------------|-------------------|
| | When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence? | 46 – 48 | 50 |
| | Can the Auditor apply the Concept of Materiality for Reporting on Fraud? | 49 - 55 | 52 |
| | Should the Auditor Report under Section 143(12) in case of Corruption, Bribery, Money Laundering and Non-compliance with Other Laws and Regulations | 56 – 58 | 55 |
| Section III | Applicability of Standards on Auditing | 59 – 73 | 57-66 |
| Section IV | Technical Guidance on Reporting on Fraud under Section 143(12) | 74 – 112 | 67-92 |
| | Modifications to Terms of Engagement with regard to Reporting on Fraud under Section 143(12) | 77 | 67 |
| | Fraud Risk Factors – Assessed Risk of Material Misstatement due to Fraud | 78 | 69 |
| | Audit procedures to Address Assessed Risk of Material Misstatement due to Fraud | 79 | 69 |
| | Stages of Identification of Fraud | 80 - 82 | 70 |
| | Audit Procedures If Auditor has Reasons to Believe a Fraud has Occurred or is being Carried Out | 83 | 76 |

| Section | Topic | Paragraph Reference | Page No(s) |
|------------------|--|----------------------------|-------------------|
| | Working with the Board or the Audit Committee in case the Auditor has Reasons to Believe a Fraud may Exist | 84 - 85 | 77 |
| | Reporting to the Board or Audit Committee on Auditor's Sufficient Reason to Believe and Knowledge of Fraud against the Company by Officers or Employees of the Company | 86 - 89 | 78 |
| | Obtaining response from the Board or Audit Committee | 90 – 95 | 79 |
| | Evaluating reply of the Board or Audit Committee | 96 – 100 | 82 |
| | Reporting to Central Government in Form ADT – 4 | 101 – 104 | 84 |
| | Management Representation | 105 | 86 |
| | Audit Documentation and Quality Control | 106 – 109 | 87 |
| | Evaluation of Impact on the Financial Statements, Audit Opinion on the Financial Statements and Internal Financial Controls | 110 | 90 |
| | Consideration in Joint Audits | 111 | 91 |
| | Consideration of disclosure of frauds in the Board's report | 112 | 91 |
| Section V | Appendices | | 93-147 |
| | 1. Illustrative Matters for Engagement Team Discussion on Fraud | | 93-97 |
| | 2. Illustrative Checklist for Inquiries with Board/Audit Committee, Management and Internal Auditor | | 98-104 |

| Section | Topic | Paragraph Reference | Page No(s) |
|----------------|---|----------------------------|-------------------|
| | 3. Illustrative Fraud Risk Factors | | 105-118 |
| | 4. Illustrative Possible Audit Procedures to Address the Assessed Risks of Material Misstatement due to Fraud | | 119-136 |
| | 5. Illustrative Format for Reporting to Board or the Audit Committee on Fraud | | 137-139 |
| | 6. Form ADT-4 | | 140-141 |
| | 7. Illustrative Management Representation Letter | | 142-147 |

PART - A
OVERVIEW

OVERVIEW

I. **Persons Covered for Reporting on Fraud under Section 143(12) of the Companies Act, 2013**

Sub-section 12 of Section 143 of the Companies Act, 2013 (“the 2013 Act” or “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.”

The reporting requirement under Section 143(12) is for the statutory auditors of the company and also equally applies to the cost accountant in practice, conducting cost audit under Section 148 of the Act; and to the company secretary in practice, conducting secretarial audit under Section 204 of the Act.

However, ***the provisions of Section 143(12) do not apply to other professionals who are rendering other services to the company.*** For example, Section 143(12) does not apply to auditors appointed under other statutes for rendering other services such as tax auditor appointed for audit under Income-tax Act; Sales Tax or VAT auditors appointed for audit under the respective Sales Tax or VAT legislations.

It may also be noted that internal auditors covered under Section 138 are not specified as persons who are required to report under Section 143(12).

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 regarding reporting of frauds by the auditor shall also extend to a branch auditor appointed under Section 139 to the extent it relates to the concerned branch.***

Guidance Note on Reporting on Fraud

It may be noted 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.**

II. Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements

Section 143(12) requires an auditor to report on fraud if ***in the course of performance of his duties as an auditor***, the auditor has reason to believe that an offence involving fraud is being or has been committed against the company by its officers or employees.

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.'***

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 account/financial statements of the company. For example,

- an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;
- if the password of a key managerial personnel is stolen and misused to access confidential/restricted information,

Overview

the effect of the same may not be determinable by the management or by the auditor;

- if an employee is alleged to be carrying on business parallel to the company's business and has been diverting customer orders to his company, the auditor may not be able to detect the same since such sales transactions are not recorded in the books of the company.

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.***

III. Reporting on Suspected Offence Involving Frauds Identified/Noted during Audit/Limited Review of Interim period Financial Statements/Results, Other Attest Services and Permitted Non-attest Services

Section 143 of the 2013 Act was notified and is effective from April 1, 2014. Whilst Section 143 deals with auditor's duties and responsibilities under the Act with respect to financial statements prepared under the Act, the auditors perform other attest services in their capacity as auditors of the company. For example, (a) Clause 41 of the Listing Agreement with Stock Exchanges requires the statutory auditor to perform limited review/audit of the quarterly financial results published by the listed companies; (b) the auditor may also be engaged by the Board of directors of the company to carry out the audit of interim financial statements prepared by the management as per Accounting Standard 25 and report on such interim financial statements to the Board of Directors; (c) the auditor may also perform Tax Audit under the Income-tax Act; or (d) the auditor may be engaged to issue certificates, etc.

Guidance Note on Reporting on Fraud

In the case of the aforesaid attest services for financial years beginning on or after 1st April, 2014, the following needs to be considered:

- (a) Such attest services may not be pursuant to any requirement of the 2013 Act. They may rather be prepared to meet the specific requirements of the company (such as complying with the equity listing agreement, to meet the requirements of the Board of Directors of the company, etc.).
- (b) Wherever a statute or regulation requires such attest services to be performed by the auditor of the company, the auditor should consider the requirements and provisions of Section 143(12) since any such work carried out by the auditor during such attest services could be construed as being in the course of performing his duties as an auditor, albeit not under the Companies Act, 2013.
- (c) 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. For example, the quarterly results under clause 41 of the equity listing agreement may be subject to a limited review performed in accordance with the Standards on Review Engagements and hence would not have been performed in accordance with the SAs.

Auditors could be engaged to provide non-attest services that are not prohibited under Section 144 of the Act. It is possible that the auditor, when providing such non-attest services may become aware of a fraud that is being or has been committed against the company by its officers or employees.

A question that arises is – should the auditor report under Section 143(12) on frauds noted in the course of providing such other attest or non-attest services?

If an offence involving fraud against the company by its officers or employees that is identified/noted by the auditor in

Overview

the course of providing such attest or non-attest services as referred above, is of such amount that may be considered to be material to the financial statements of the company prepared under the 2013 Act or if the auditor uses or intends to use the information that is obtained in the course of performing such attest or non-attest services when performing the audit under the 2013 Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note. This would require exercise of professional judgement in evaluating if the amount involved will be material to the financial statements to be prepared under the 2013 Act. (Refer paragraphs 49 to 55 of this Guidance Note). If the auditor considers that the amount involved will be 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 this Guidance Note.

IV. 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. ***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***

Guidance Note on Reporting on Fraud

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/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under Section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, ***if a suspected offence involving fraud has already been reported under Section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same to the Central Government under the section since he has not per se identified the suspected offence involving fraud.***

However, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence involving fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to

undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

V. Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements

As per Section 129(4) of the 2013 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. 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?

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***

Guidance Note on Reporting on Fraud

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).***

VI. 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.

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 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.***

VII. When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence?

Section 143(12) states that an auditor should report under the Section if he has “reasons to believe” that an offence involving fraud has or is being committed against the company by its officers or employees. Rule 13 of the Companies (Audit and Auditors) Rules, 2014 specifies the threshold for reporting as “sufficient reason to believe” and “knowledge”. The Form ADT – 4 in which the auditor is required to report to the Central Government uses the term “suspected offence involving fraud”.

It is important to understand the terms “reason to believe”, “sufficient reason to believe”, “knowledge” and “suspected offence involving fraud” to determine the point of time when the reporting requirement is triggered for an auditor under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

- ‘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 – 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. For example, identification of fraud risk factors in itself cannot cause ‘reason to believe’ that a fraud exists.
- The term ‘reason to believe’ creates an objective test. SA 240, “The Auditor’s Responsibilities Relating to Frauds in an Audit of Financial Statements” specifies the

Guidance Note on Reporting on Fraud

requirements to be complied by the auditors in assessing and responding to the risk of fraud in an audit of financial statements. For example, 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 term 'reason to believe' which has been used in the SAs indicate that it arises when:
 - Evaluating audit evidence and information provided; or
 - Evaluating misstatements, including deviations noted on audit sampling and further audit procedures carried out; or
 - Exercising professional skepticism.
- ***Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has used the terms 'sufficient reason to believe' and 'knowledge' (of fraud). 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.***
- Whilst Section 143(12) uses the term 'offence involving fraud' and the Form ADT – 4 uses the term "suspected offence involving fraud". ***As per paragraph 3 of SA 240,***

Overview

although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determination of whether fraud has actually occurred. Determination of “offence” is legal determination and accordingly, the auditor will not be able to legally determine that an “offence or suspected offence involving fraud” has been or is being committed against the company by its officers or employees.

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.***

VIII. Can the Auditor apply the Concept of Materiality for Reporting on Fraud?

The Companies (Amendments) Bill, 2014 that has been introduced and approved by the Lok Sabha to amend certain provisions of the Companies Act, 2013 includes an amendment to the provisions relating to auditor reporting on frauds. As per this amendment, 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 amount, shall be reported to the Central Government. However, in the case of frauds that are reported by the auditors only to the Audit Committee or the Board of Directors, where the amounts involved are less than the threshold that may be specified by the Ministry of Corporate Affairs, the details of such fraud will need to be disclosed in the Board’s report in such manner as may be prescribed. It may be noted that as on date of issuance of this Guidance Note, the above amendment is pending approval of the Rajya Sabha and Presidential assent.

Guidance Note on Reporting on Fraud

The concept of materiality is fundamental for setting up an appropriate system of internal control, preparation of financial statements and its audit. Due to its inherent limitations, internal control systems cannot provide absolute assurance that no fraud or error has taken place.

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

It may be noted that even when reporting on fraud under CARO, the Statement on CARO issued by the ICAI referred to procedures that were required to be performed by the auditor, taking into account the concept of materiality, with respect to misstatements in the financial statements resulting from fraud. 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.

The auditor should continue to apply the concept of materiality in performing the audit in accordance with SA 320, "Materiality in Planning and Performing an Audit".

SA 450, "Evaluation of Misstatements Identified During the Audit" considers the concept of materiality in classifying the manner of disposition of misstatements, including those arising from fraud. Misstatements, including those arising from fraud, that are less than the threshold, as may be specified by the Ministry of Corporate Affairs, will need to be communicated to the management and/or those charged with governance as required under paragraphs A21 to A23 of SA 450 and the Rules specified under Section 143(12) in this regard. *

* The draft Rules pursuant to the proposed amendment to Section 143(12) have not been issued as on date of issuance of this Guidance Note. Such Rules, when issued, should be considered by the auditors when reporting on frauds to the Audit Committee / Board of Directors or to the Central Government.

Overview

Materiality is applicable wherever the amount is quantifiable. Also aggregation is required for each fraud separately to compare with the threshold to be specified by the Ministry of Corporate Affairs. Where the amount is not quantifiable, the auditor should apply professional judgement to estimate the likelihood of the amount exceeding the aforesaid threshold. 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 such threshold.

IX. Should the Auditor Report under Section 143(12) in case of Corruption, Bribery, Money Laundering and Non-compliance with other Laws and Regulations

In case of corruption, bribery and money laundering, the direct effect of such act (benefit or penal consequence) is on the company.

The auditor should comply with the relevant SAs with regard to illegal acts (e.g. SA 240 and SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements") when performing the audit. If the auditor, in the course of performance of his/her duties as the auditor, comes across instances of corruption, bribery and money laundering and other intentional non-compliances with laws and regulations, the auditor would need to evaluate the impact of the same in accordance with SA 250 to determine whether the same would have a material effect on the financial statements.

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

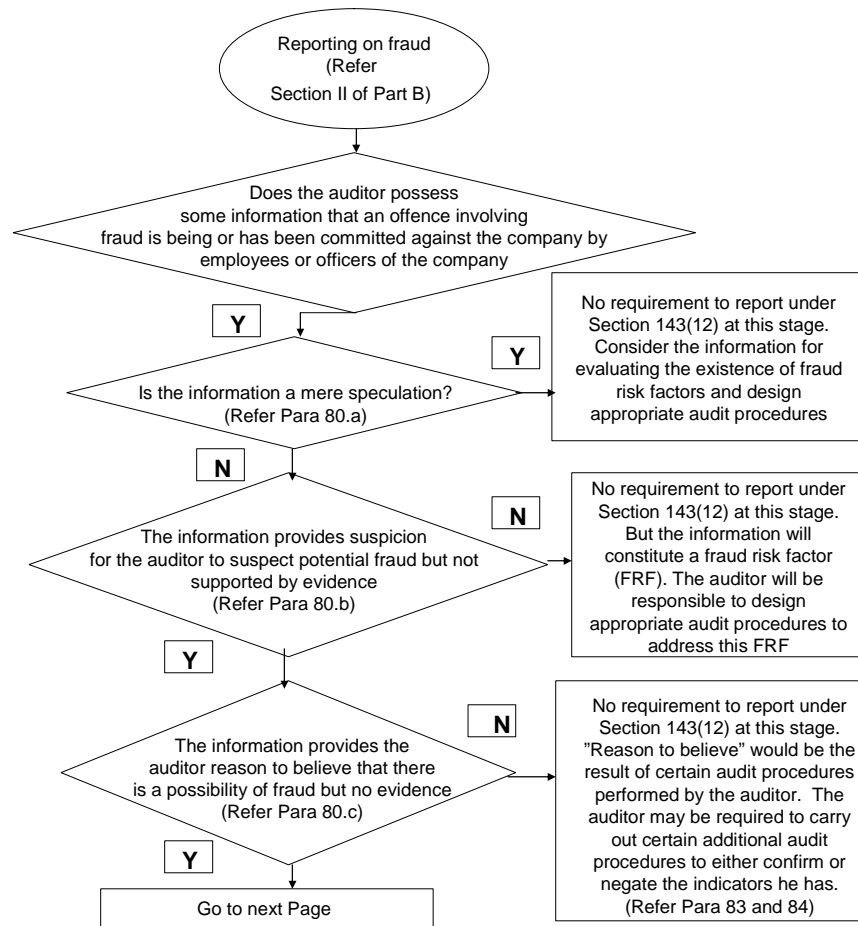
Guidance Note on Reporting on Fraud

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.

For example, if the auditor comes to know that the company has filed a fraudulent return of income to evade income tax, he may have to report this fraud under Section 143(12) irrespective of whether adequate provision has been made in the books of accounts or not.

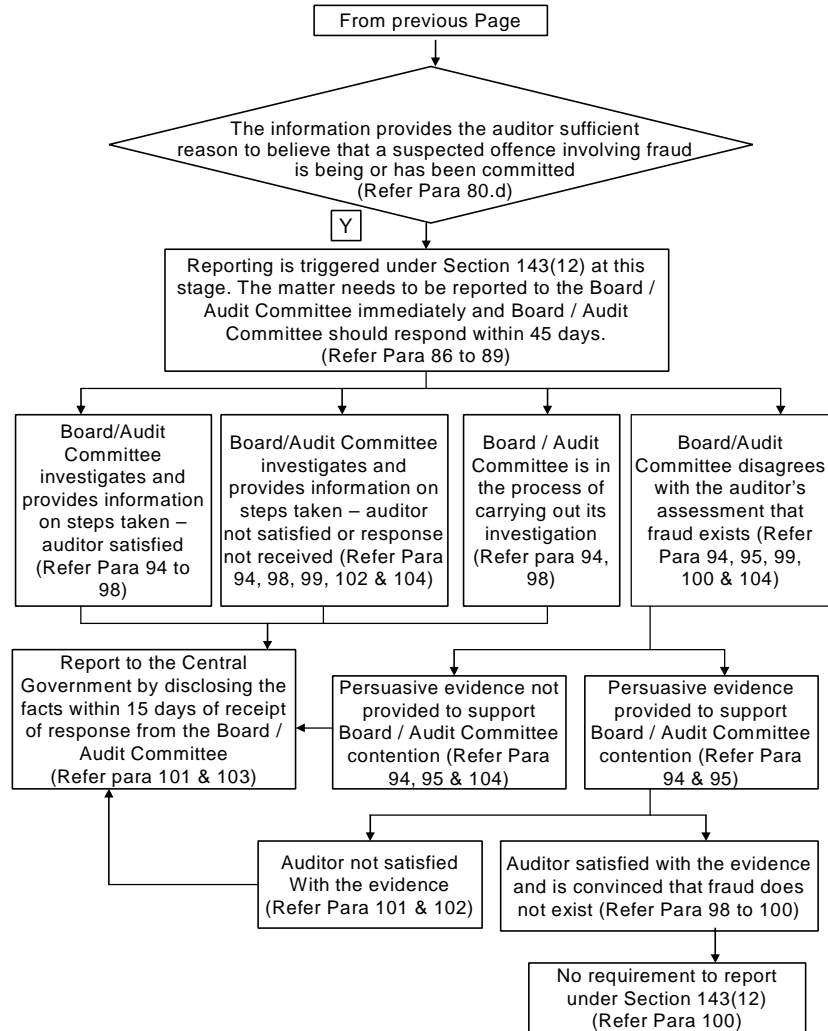
It may be noted that the proviso to Section 147(2) in the context of punishment to auditors for contravention with the provisions, inter alia, of Section 143 of the 2013 Act, states, “if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.”

X. Reporting on Fraud under Section 143(12) – Decision Tree/Flow Chart [≠]



[≠] Pursuant to the proposed amendments to Section 143(12) of the 2013 Act, auditors may be required to report to the Central Government only those frauds where the amount involved is in excess of the threshold that may be specified by the Ministry of Corporate Affairs. Accordingly, the guidance given in paragraphs 101 to 104 of this Guidance Note with respect to reporting to the Central Government will become applicable only for those frauds that are in excess of the specified threshold.

Guidance Note on Reporting on Fraud



PART - B
DETAILED GUIDANCE

SECTION I

INTRODUCTION

Introduction

1. Fraud has the capacity to undermine the confidence of stakeholders in an organisation and there is a strong nexus between prevention of fraud and good corporate governance.

2. Consideration of fraud in financial reporting and the auditor's responsibility on reporting on fraud has always been an integral part of an audit of financial statements carried out in accordance with the Standards on Auditing. Misstatements in the financial statements can arise from either fraud or error and the distinguishing factor between the two is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. ***The auditor is required to consider fraud as a risk that could cause a material misstatement in the financial statements and plan and perform such procedures that mitigate the risk of material misstatement due to fraud. These requirements are specified in Standard on Auditing (SA) 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".***

Requirements for Reporting on Fraud under the Companies Act, 2013

3. Section 143(12) of the Companies Act, 2013 ('the 2013 Act' or 'the Act') states that "Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall

Guidance Note on Reporting on Fraud

immediately report the matter to the Central Government within such time and in such manner as may be prescribed.”¹

Rule 13 of the Companies (Audit and Auditors) Rules, 2014 specifies the manner in which the auditor is required to report on fraud to the Central Government and Form ADT 4 to these Rules (Refer **Appendix 6**) provides the format and information to be included in such report.

4. In terms of provisions of Section 143(14) of the 2013 Act, the reporting requirement under Section 143(12) is for auditors of the company and also equally applies to the cost accountant in practice conducting cost audit under Section 148 of the Act; as well as the company secretary in practice conducting secretarial audit under Section 204 of the Act. However, the provisions of Section 143(12) do not apply to other professionals who are rendering other services to the company. Further, Section 143(12) also does not apply to auditors appointed under other statutes for rendering services such as Tax Audit under the Income-tax Act, 1961; Sales Tax audit or VAT audit.

¹ The Companies (Amendments) Bill, 2014 that has been introduced and approved by the Lok Sabha to amend certain provisions of the Companies Act, 2013 includes an amendment to the provisions of Section 143(12) relating to auditor reporting on frauds. It may be noted that as on date of issuance of this Guidance Note, the above amendment is pending approval of the Rajya Sabha and Presidential assent. The proposed amendment reads as under:

“(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 of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

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

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

Introduction

It may be noted that internal auditors covered under Section 138 are not specified as persons who are required to report under Section 143(12.)

5. 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.

Suspected fraud by vendors, customers and other third parties should be dealt with in accordance with SA 240.

Section 2(59) of the 2013 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 2013 Act does not define the term “employees”. However, in common parlance, the term “employees” implies those persons who are on the payroll of the company. ***Employees would, therefore, not include those persons who are engaged on a contract basis e.g. security, house-keeping, canteen staff, who work in the company premises on behalf of a contractor who has been given the contract to provide such services to the company. In this instance, the contract workers will be considered as vendors and not employees.***

6. This Guidance Note aims to provide guidance to the auditors on matters that may arise pursuant to the reporting requirements on fraud under Section 143(12) of the Act. Section 143(12) specifically states that the auditor should report to the Central Government if he has reason to believe that an offence involving fraud is being or has been committed against the company by its officers or employees if the auditor has noted it “in

Guidance Note on Reporting on Fraud

the course of the performance of his duties as auditor”.² Accordingly, the Guidance Note should be read in conjunction with the Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI) since Section 143(9) of the 2013 Act read with Section 143(10) casts a duty and responsibility on the auditor to comply with the SAs.

7. Reporting by the auditor on fraud is not a new concept in India. Such reporting exists under the SAs, the Companies Act, 1956, RBI Regulations, etc. The guidance provided by the ICAI in these contexts continues to be relevant and applicable even in the case of reporting by the auditor on fraud under Section 143(12) of the 2013 Act.

8. ***The requirements for reporting by auditors under Section 143(12) would apply even if the fraud is required to be/has been reported under any other statute or to any other Regulator.*** For example, in case of a fraud identified in a Bank, the auditor of the Bank should report the fraud to the RBI as per the requirements of the RBI Regulations on audit of Banks (Refer paragraph 11 below). If the Bank is a company and is governed by the provisions of the 2013 Act, in addition to the reporting to the RBI, the auditor may also be required to report the offence involving fraud to the Central Government if such instance is covered under Section 143(12) of the 2013 Act, as specified in this Guidance Note.

² The Companies (Amendments) Bill, 2014 that has been introduced and approved by the Lok Sabha to amend certain provisions of the Companies Act, 2013 includes an amendment to the provisions of Section 143(12) relating to auditor reporting on frauds. As per this amendment, 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 amount, shall be reported to the Central Government. However, in the case of frauds that are reported by the auditors only to the Audit Committee or the Board of Directors, where the amounts involved are less than the threshold that may be specified by the Ministry of Corporate Affairs, the details of such fraud will need to be disclosed in the Board's report in such manner as may be prescribed. It may be noted that as on date of issuance of this Guidance Note, the above amendment is pending approval of the Rajya Sabha and Presidential assent.

9. Consideration of Fraud in an Audit of Financial Statements as required by Standards on Auditing

Various SAs state the requirements for the auditor to consider the risk of fraud in an audit of financial statements and the manner of dealing with the same:

- a. SA 240, *inter alia*, states the following:

Paragraph 5 - '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. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.'

Paragraph 40 - 'If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities'.

Paragraph 43 - 'If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances'.

Paragraph A66 - 'In some clients, requirements for reporting fraud, whether or not discovered through the audit process, may be subject to specific provisions of the audit mandate or related legislation or regulation'.

Guidance Note on Reporting on Fraud

- b. Paragraphs 22 and 23 of SA 250 – “Consideration of Laws and Regulations in an Audit of Financial Statements”, requires the auditor, *inter alia*, to communicate to those charged with governance (the Audit Committee/Board of Directors) when there is a non – compliance with laws and regulations, that come to the auditor’s attention during the course of the audit, which he/she believes is intentional and material, without delay.
- c. 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.

10. Reporting on Fraud under Section 227 (4A) of the Companies Act, 1956 as per the Companies (Auditor’s Report) Order, 2003 (as amended) (‘CARO’)

(Note: The following guidance is included here only to briefly explain the erstwhile reporting requirements of the statutory auditor relating to fraud for a better understanding of and comparison with the current reporting requirements).

Clause 4(xxi) of CARO requires the auditor to report 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. The Statement on the Companies (Auditor’s Report) Order, 2003 (‘the Statement’) issued by the ICAI specified the responsibilities of the auditor when reporting under clause 4(xxi) of CARO. As per the Statement:

- a. Clause 4(xxi) does not require the auditor to discover the frauds on the company and by the company. The scope of auditor’s inquiry under this clause is restricted to frauds ‘noticed or reported’ during the year. The use of the words “noticed or reported” indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor’s report. It may be noted

Introduction

that this clause of the Order, by requiring the auditor to report whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements"*.

- b. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. 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".
- c. Two types of intentional misstatements are relevant to the auditor's consideration of fraud—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
- d. Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

* Now known as SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

Guidance Note on Reporting on Fraud

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
 - Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
 - Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
- e. Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.
- f. Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.
- g. 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 of management to determine

Introduction

whether management is aware of any known fraud or suspected fraud that the company is investigating.

- h. 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 of 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.
- i. The auditor should obtain written representations from the management, stating, *inter alia*, (i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error; (ii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and (iii) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- j. Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate.

11. Reporting to RBI in case of Fraud noted in Audit of Banks

The RBI issued Circular No. DBS.FGV.(F).No. BC/23.08.001/2001-02 dated May 3, 2002 relating to

Guidance Note on Reporting on Fraud

implementation of recommendations of the Committee on Legal Aspects of Bank Frauds (Mitra Committee) and the recommendations of the High Level Group set-up by the Central Vigilance Commission applicable to all scheduled commercial banks (excluding RRBs). Regarding responsibility and liability of accounting and auditing professionals, the said Circular provides as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

Paragraphs 2.30 to 2.36 of the Guidance Note on Audit of Banks 2015 edition provides guidance to the auditors with respect to fraud noted in an audit of Banks and, *inter alia*, states as follows.

- a. As per the above requirement, the member shall be required to report the kind of matters stated in the circular to the regulator, i.e., RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that “A chartered accountant in practice shall be deemed guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.”
- b. Under the said provision, if a member of the Institute *suo moto* discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would

Introduction

amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.

- c. Thus, auditors while reporting such a matter to CMD of the Bank should also report the matter simultaneously to the Department of Banking Supervision, RBI, provided the terms of the audit engagement require him to do so.
- d. Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". Para A19 of the said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts (for example, the auditor is required to report certain matters of non-compliance to RBI as per the requirements of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1988, issued by the RBI).
- e. RBI has issued a Master Circular no. DBS.CO.CFMC.BC.No. 1/23.04.001/2014-15 dated July 1, 2014 on "Frauds—Classification and Reporting" on the matters relating to classification and reporting of frauds and laying down a suitable reporting system. As per the said circular, the primary responsibility for preventing frauds is that of the Bank management. Banks are required to report frauds to the Board of Directors and also to the RBI.
- f. In the aforesaid context, it may be emphasised that such a requirement does not extend the responsibilities of an auditor in any manner whatsoever as far as conducting the audit is concerned. The requirement has only extended the reporting responsibilities of the auditor. As far as conduct of audit is concerned, the auditor is expected to follow the SAs issued by the ICAI and perform his functions within that framework. SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial

Guidance Note on Reporting on Fraud

Statements" 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.

- g. The auditor should also refer to reports of internal auditors, concurrent auditors, inspectors, etc., which may point out significant weaknesses in the internal control system. Such an evaluation would also provide the auditor about the likelihood of occurrence of transactions involving exercise of powers much beyond those entrusted to an official. It must be noted that the auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to the Chairman/Managing Director/Chief Executive of the concerned Bank.

Responsibility of Management

12. It may be noted that the primary responsibility to establish adequate internal control systems to prevent and detect frauds and errors is that of the management of the entity. In the case of a company, the Board of Directors, in terms of the provisions of Section 134(5) of the 2013 Act, are required to, *inter alia*, state as a part of the directors' responsibility statement in the Board report to the shareholders, that they had taken proper and sufficient care for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

In the case of a listed company, clause (e) of Sub-section 5 of Section 134 to the Act requires the directors' responsibility statement to also state that the directors, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. This clause explains the meaning of 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

Introduction

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.”

13. Audit Committee’s Responsibility on Vigil Mechanism

Sections 177(9) and (10) of the 2013 Act requires every listed company and the specified class or classes of companies³, to establish a vigil mechanism for directors and employees to report genuine concerns in the manner as prescribed under the Companies (Meetings of Board and its Powers) Rules, 2014. 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 details of establishment of such mechanism are required to be disclosed by the company on its website, if any, and in the Board’s report.

14. Code of Conduct for Independent Directors

Section 149(8) of the 2013 Act deals with appointment and qualification of directors and prescribes the code of conduct for independent directors (Schedule IV to the Act). The Code provides a broad framework for, among other things, role and responsibilities of the independent directors, including:

- a. paying sufficient attention and ensuring that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company;
- b. ascertaining and ensuring that the company has an adequate and functional vigil mechanism and to ensure

³ As per Rule 7(1) of the Companies (Meetings of Board and Its Powers) Rules, 2014, the following classes of companies are also required to establish a vigil mechanism:

- (i) companies which accept deposits from the public.
- (ii) companies which have borrowed money from banks and public financial institutions in excess of Rs. 50 crores.

Guidance Note on Reporting on Fraud

that the interests of a person who uses such mechanism are not prejudicially affected on account of such use;

- c. reporting concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy;
- d. satisfying themselves on the integrity of the financial information and that the financial controls and the systems of risk management are robust and defensible;
- e. safeguarding the interests of all the stakeholders, particularly, the minority shareholders;
- f. ensuring that their concern about the running of the company or a proposed action are addressed by the Board and to the extent they are not resolved, insist that their concerns are recorded in the minutes of the meeting of the Board

Various Definitions of Fraud

15. In the 2013 Act, the meaning of fraud has been considered in two specific sections viz. Section 143(10), where the SAs specified by the ICAI are deemed to be the auditing standards for purposes of the Act, which, *inter alia*, define fraud, and in Section 447, where punishment for fraud has been prescribed.

- a. Fraud has been defined in paragraph 11(a) of SA 240 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.'
- b. ***In the context of stating the provisions for punishment for fraud, Section 447 of the Act has explained the term 'fraud'*** as "fraud in relation to affairs of a company or any body corporate, includes any act, omission, concealment of 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

Introduction

shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.”

This Section further explains the terms ‘wrongful gain’ and ‘wrongful loss’ to mean the gain by unlawful means of property to which the person gaining is not legally entitled; and the loss by unlawful means of property to which the person losing is legally entitled, respectively.

16. Fraud has also been defined by various other regulators/statutes.

- a. The Insurance Fraud Monitoring Framework of the IRDA defines fraud in insurance as ‘an act or omission intended to gain dishonest or unlawful advantage for a party committing the fraud or for other related parties.’
- b. Reserve Bank of India, *per se*, has not defined the term ‘fraud’ in its guidelines on Frauds. A definition of fraud was, however, suggested in the context of electronic banking in the Report of RBI Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds, which reads as, ‘a deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank’.
- c. Fraud, under Section 17 of the Indian Contract Act, 1872, includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:
 - the suggestion as a fact, of that which is not true, by one who does not believe it to be true;
 - the active concealment of a fact by one having knowledge or belief of the fact;

Guidance Note on Reporting on Fraud

- a promise made without any intention of performing it;
- any other act fitted to deceive;
- any such act or omission as the law specially declares to be fraudulent.

SECTION II

AUDITORS' REPORTING ON FRAUD UNDER SECTION 143(12)

Auditors' Reporting on Fraud under Section 143(12)

17. Sections 143(12) to 143(15) of the 2013 Act states the provisions of the 2013 Act with regard to auditor's reporting on fraud. Rule 13 of the Companies (Audit and Auditors) Rules, 2014 provides the timeline and manner in which the auditor should report on fraud.

18. As per 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.' (Emphasis added)

19. As per Rule 13⁴ of the Companies (Audit and Auditors) Rules, 2014,

- (1) For the purpose of Sub-section (12) of Section 143, in case the 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, he shall report the matter to the Central Government immediately but not later than sixty days of his knowledge

⁴ The draft Rules pursuant to the proposed amendment to Section 143(12) have not been issued as on date of issuance of this Guidance Note. Such Rules, when issued, should be considered by the auditors when reporting on frauds to the Audit Committee / Board of Directors or to the Central Government.

Guidance Note on Reporting on Fraud

and after following the procedure indicated herein below:
(Emphasis added)

- (i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within forty-five days;
 - (ii) 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 of the Board or the Audit Committee) to the Central Government within fifteen days of receipt of such reply or observations;
 - (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of forty-five days, he shall forward his report to the 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.
- (2) The report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same.
 - (3) The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact number and be signed by the auditor with his seal and shall indicate his Membership Number.
 - (4) The report shall be in the form of a statement as specified in Form ADT-4.
20. Section 143(13) states that 'No duty to which an auditor of a company may be subject to shall be regarded as having been

Auditors' Reporting on Fraud under Section 143(12)

contravened by reason of his reporting the matter referred to in Sub-section (12) if it is done in good faith'.

Accordingly, the auditor will not be subject to professional misconduct if he discloses information acquired in the course of his professional engagement with respect to compliance with Section 143(12), since it is as required by law.

21. Further, Section 456 of the Act also, *inter alia*, provides that no suit, prosecution or other legal proceeding shall lie against any person in respect of anything which is in good faith done or intended to be done in pursuance of this Act or of any rules or orders made thereunder.

22. As per Section 143(15), if any auditor does not comply with the provisions of Sub-section 143(12), he shall be punishable with fine of at least one lakh rupees, which may extend to twenty-five lakh rupees.

23. 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 regarding reporting of fraud by the auditor also extend to a branch auditor appointed under Section 139 to the extent it relates to the concerned branch.***

24. ***While the reporting responsibility under Section 143(12) is to the Audit Committee or the Board of Directors of the Company and / or to the Central Government, the auditor would also need to consider whether such matter also needs to be disclosed in the auditor's report under Section 143(3)(f) which requires the auditor to state his/her observations on financial transactions/matters, which have any adverse effect on the functioning of the company.***

25. It is pertinent to note that an Order similar to CARO has not been issued under the 2013 Act and hence reporting by the auditor on fraud is covered only under Section 143(12) and under Section 143(3)(f) of the Act, where applicable.

Guidance Note on Reporting on Fraud

Issues for Consideration by Auditors for Reporting under Section 143(12)

Auditors' Responsibility for Consideration of Fraud in an Audit of Financial Statements

26. Paragraph 10 of SA 240 states that the objectives of the auditor are:

- (a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- (b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- (c) To respond appropriately to identified or suspected fraud.

27. Paragraph 4 of SA 240 also 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.

28. 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.

Auditors' Reporting on Fraud under Section 143(12)

29. Section 143(9) read with Section 143(10), requires the auditor to comply with the SAs issued by ICAI. 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" may be understood to mean in the course of performing an audit in accordance with the SAs.

30. Based on the above, it is reasonable to conclude that the objective of an auditor in the course of performance of duties as an auditor in accordance with the SAs, is to perform such procedures that provide sufficient appropriate audit evidence about the risks of material misstatement in the financial statements due to fraud that have been assessed by him through designing and implementing appropriate responses, and to respond appropriately to identified or suspected fraud.

31. 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.'

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 account/financial statements of the company. For example,

Guidance Note on Reporting on Fraud

- an auditor may not be able to detect if an employee is receiving pay-offs for favoring a specific vendor, which is a fraudulent act, since such pay-offs would not be recorded in the books of account of the company;
- if the password of a key managerial personnel is stolen and misused to access confidential/restricted information, the effect of the same may not be determinable by the management or by the auditor;
- if an employee is alleged to be carrying on business parallel to the company's business and has been diverting customer orders to his company, the auditor may not be able to detect the same since such sales transactions would not be recorded in the books of the company.

32. Therefore, for the purpose of Section 143(12) ***the auditor would need to consider the requirements of the SAs, insofar as they relate 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 Suspected Offence involving Frauds noted during Audit/Limited Review of Interim period Financial Statements/Results and Other Attest Services

33. Section 143 of the 2013 Act was notified and is effective from April 1, 2014. Whilst Section 143 deals with auditor's duties and responsibilities under the Act with respect to financial statements prepared under the Act, the auditors, normally, also perform other attest services in their capacity as auditors of the company. For example, clause 41 of the Listing Agreement with Stock Exchanges requires the statutory auditor to perform limited review/audit of the quarterly financial results published by the listed companies. The auditor may also be engaged by the Board of Directors of the company to carry out the audit of interim financial statements prepared by the management and report on such interim financial statements to the Board of Directors. The

Auditors' Reporting on Fraud under Section 143(12)

auditor may also have been engaged to perform tax audit under the Income-tax Act, 1961.

34. In the case of the aforesaid attest services for financial years beginning on or after 1st April, 2014, the following needs to be considered:

- a. Such attest services may not be pursuant to any requirement of the 2013 Act. They may rather be prepared to meet the specific requirements of the company (such as complying with the equity listing agreement, to meet the requirements of the Board of Directors of the company, etc.).
- b. Wherever a statute or regulation requires such attest services to be performed by the auditor of the company, the auditor should consider the requirements and provisions of Section 143(12) since any such work carried out by the auditor during such attest services could be construed as being in the course of performing his duties as an auditor, albeit not under the Companies Act, 2013.
- c. 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. For example, the quarterly results under clause 41 of the equity listing agreement may be subject to a limited review performed in accordance with the Standards on Review Engagements and hence would not have been performed in accordance with the SAs.

35. ***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 services as referred above, is of such amount that may be considered to be material to the financial statements of the company prepared under the 2013 Act or if the auditor uses or intends to use the information that is obtained in the course of performing such attest services when performing the audit***

Guidance Note on Reporting on Fraud

under the 2013 Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note. This would require exercise of professional judgement for the purpose of evaluating if the amount involved will be material to the financial statements to be prepared under the 2013 Act. (Refer paragraphs 49 to 55 below). If the auditor considers that the amount involved will be 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 this Guidance Note.

Reporting Responsibility in case of Suspected Offence involving Fraud noted during Performance of Permitted Non-attest Services

36. Auditors could be engaged to provide non-attest services that are not prohibited under Section 144 of the Act. It is possible that the auditor, when providing such non-attest services may become aware of a fraud that is being or has been committed against the company by its officers or employees. A question that arises is – should the auditor report under Section 143(12) on frauds noted in the course of providing non-attest services?

37. It may be noted that reporting under Section 143(12) arises only 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.

38. ***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 non-attest services as referred above, is of such amount that may be considered to be material to the financial statements of the company prepared under the 2013 Act or if the auditor uses or intends to use the information that is obtained in the course of performing such non-attest services when performing the***

Auditors' Reporting on Fraud under Section 143(12)

audit under the 2013 Act, then in such cases, the matter may become reportable under Section 143(12), read with the Rules thereunder, as specified in this Guidance Note. This would require exercise of professional judgement for the purpose of evaluating if the amount involved will be material to the financial statements to be prepared under the 2013 Act. (Refer paragraphs 49 to 55 below). If the auditor considers that the amount involved will be 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 this Guidance Note.

Reporting on Frauds detected by the Management or Other Persons and already Reported under Section 143(12) by Such Other Person

39. 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. ***Based on the above, it may be considered that Section 143(12) envisages the auditor to report to the management and thereafter the Central Government an offence involving fraud/suspected 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.***

The auditor, in the course of the performance of his duties as an auditor, is required to make inquiries with the management and the Board or Audit Committee about reported or identified/detected instances of fraud through any other internal or external sources and, consequently, the auditor may become

Guidance Note on Reporting on Fraud

aware of those frauds which have been/are being remediated/dealt with by them. Though the auditor becomes aware of such frauds when he/she is informed of the same by the management, he/she, *per se*, has not identified them on his/her own and is, therefore, not the first person to identify the fraud in those cases.

For example, in the case of Banks and NBFCs there is a requirement of reporting frauds to the Audit Committee/Board and to the Reserve Bank of India and, hence, to the extent such cases have already been identified and reported by the management, the auditor cannot be considered as the person who first identified them. Further, many companies have or are required to have a vigil/whistle blower mechanism through which instances of fraud may have already been reported.

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, the latter 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/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanisms.

For example, in a fraud involving vendor payments, if the company identified the fraud and its nature and cause through its internal control mechanism but did not identify all the vendor accounts involved in the fraud that were identified by the auditor, it may need to be considered that the fraud was not identified in all aspects by the management and the auditor may need to report the same under Section 143(12) of the 2013 Act. This would

Auditors' Reporting on Fraud under Section 143(12)

require the auditor to exercise professional judgement in evaluating if the amount involved will be material to the financial statements to be prepared under the 2013 Act (Refer paragraphs 49 to 55 below). If the auditor considers that the amount involved will be 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 this Guidance Note.

40. Since reporting on fraud under Section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud. Here too, ***if a suspected offence involving fraud has already been reported under Section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same to the Central Government under the section since he has not per se identified the suspected offence involving fraud.***

41. ***However, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence involving fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed (Refer paragraphs 96 to 100). If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.***

Guidance Note on Reporting on Fraud

Reporting on Suspected Offence Involving Fraud in case of Consolidated Financial Statements

42. As per Section 129(4) of the 2013 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. 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?

43. In the case of an audit of consolidated financial statements, as per paragraph 1 of SA 600 “Using the Work of Another Auditor” read with paragraph 9 of SA 200, when the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

It may be noted that the auditors of foreign components and those components that are not companies as defined under the 2013 Act are not covered under the requirements of Section 143(12), since it applies only to the auditor of the company under the Companies Act 2013.

Accordingly, the auditor of the parent company is not required to report on frauds under Section 143(12) which are not being or have not been committed against the parent company by the officers or employees of the parent company and relate only to:

- 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; or***

Auditors' Reporting on Fraud under Section 143(12)

- b) A foreign corporate component since they are not covered by the Companies Act, 2013; or***
- c) 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 (a) such fraud is being or has been committed by employees or officers of the parent company; (b) if such suspected offence involving fraud in the component is against the parent company; and (since the requirement for reporting under Section 143(12) arises only if the suspected offence involving fraud is being or has been committed against the company by officers or employees of the company), if:

- (i) 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***
- (ii) 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. (Also refer paragraphs 36 to 38 above.)***

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

44. An auditor, in the current year, may identify a possible or committed fraud that relates to an earlier year covered under the 1956 Act. The question that arises is - whether such frauds should also be reported under Section 143(12).

Guidance Note on Reporting on Fraud

45. Requirements similar to Section 143(12) of the 2013 Act were not prescribed in the 1956 Act. Even the reporting under 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.

As such, auditors would not have reported on frauds as envisaged under Section 143(12) in those years. 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 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.***

When does an Auditor Commence Reporting under Section 143(12) – Based on Suspicion - Reason to Believe – Knowledge – or on Determination of Offence?

46. Section 143(12) states that an auditor should report under the Section if he has “reasons to believe” that an offence involving fraud has or is being committed against the company by its officers or employees. Rule 13 of the Companies (Audit and Auditors) Rules, 2014 specifies the threshold for reporting as “sufficient reason to believe” and “knowledge”. The Form ADT – 4 in which the auditor is required to report to the Central Government uses the term “suspected offence involving fraud”.

47. ***It is important to understand the terms “reason to believe”, “sufficient reason to believe”, “knowledge” and “suspected offence involving fraud” to determine the point of time when the reporting requirement is triggered for an auditor under Section 143(12) read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.***

- ‘Suspicion’ is a state of mind more definite than speculation, but falls short of knowledge based on

Auditors' Reporting on Fraud under Section 143(12)

evidence. It must be based on some evidence, even if that evidence is tentative – 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. For example, identification of fraud risk factors in itself cannot cause 'reason to believe' that a fraud exists.
- The term 'reason to believe' creates an objective test. SA 240 specifies the requirements to be complied by the auditors in assessing and responding to the risk of fraud in an audit of financial statements. For example, 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 term 'reason to believe' which has been used in the SAs indicate that it arises when
 - Evaluating audit evidence and information provided; or
 - Evaluating misstatements, including deviations noted on audit sampling and further audit procedures carried out; or
 - Exercising professional skepticism.
- ***Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has used the terms 'sufficient reason to believe' and 'knowledge' (of fraud). The condition of 'sufficient reason to believe' would be met if on evaluation of all***

Guidance Note on Reporting on Fraud

the available information with the auditor and applying appropriate level of professional 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.***
- Whilst Section 143(12) uses the term ‘offence involving fraud’ and the Form ADT-4 uses the term “suspected offence involving fraud”. ***As per paragraph 3 of SA 240, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.*** Determination of “offence” is legal determination and accordingly, the auditor will not be able to determine whether under legal parlance an “offence or suspected offence involving fraud” has been or is being committed against the company by its officers or employees,

48. 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, would be 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?

49. The Companies (Amendments) Bill, 2014 that has been introduced and approved by the Lok Sabha to amend certain provisions of the Companies Act, 2013 includes an amendment to the provisions relating to auditor reporting on frauds. As per this

Auditors' Reporting on Fraud under Section 143(12)

amendment, 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 amount, shall be reported to the Central Government. However, frauds that are reported by the auditors only to the Audit Committee or the Board of Directors where the amounts involved are less than the threshold that may be specified by the Ministry of Corporate Affairs, the details of such fraud will need to be disclosed in the Board's report in such manner as may be prescribed. It may be noted that as on date of issuance of this Guidance Note, the above amendment is pending approval of the Rajya Sabha and Presidential assent.

50. The concept of materiality is fundamental for setting up an appropriate system of internal control, preparation of financial statements and its audit. Due to its inherent limitations, internal control systems cannot provide absolute assurance that no fraud or error has taken place. Since the auditor is required to comply with the SAs in performance of duties as an auditor, the audit will be performed applying the concept of materiality provided in the SAs.

51. It may be noted that even when reporting on fraud under CARO, the Statement on CARO issued by the ICAI referred to procedures that were required to be performed by the auditor, taking into account the concept of materiality, with respect to misstatements in the financial statements resulting from fraud. 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 stated, '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.'

52. Section 143(9) requires the auditor to comply with the SAs, which, *inter alia*, includes consideration of materiality, applying

Guidance Note on Reporting on Fraud

materiality in evaluating misstatements and disposition of the same.

53. The auditor should continue to apply the concept of materiality in performing the audit in accordance with SA 320 “Materiality in Planning and Performing an Audit”.

54. Fraud results in misstatement of financial statements. The SAs outline the procedures to be performed by an auditor in case a misstatement due to fraud is identified by the auditor. For example, paragraph A52 of SA 240 states that in evaluating and disposing the misstatements identified, the auditor should consider the requirements of SA 450 “Evaluation of Misstatements Identified during the Audit”.

SA 450 considers the concept of materiality in classifying the manner of disposition of misstatements, including those arising from fraud. Misstatements, including those arising from fraud, that are less than the threshold, as may be specified by the Ministry of Corporate Affairs, will need to be communicated to the management and/or those charged with governance as required under paragraphs A21 to A23 of SA 450 and the Rules specified under Section 143(12) in this regard.⁵

55. Materiality is applicable wherever the amount is quantifiable. Also aggregation is required for each fraud separately to compare with the threshold to be specified by the Ministry of Corporate Affairs⁶. Where the amount is not quantifiable, the auditor should apply professional judgement to estimate the likelihood of the amount exceeding the aforesaid threshold. For this purpose it can be based on management estimate or reasonable range of estimate made by the auditor. Subsequent reporting may be required if the amount initially

⁵ The draft Rules pursuant to the proposed amendment to Section 143(12) have not been issued as on date of issuance of this Guidance Note. Such Rules, when issued, should be considered by the auditors when reporting on frauds to the Audit Committee / Board of Directors or to the Central Government.

⁶ The threshold in respect of reporting under Section 143(12) that may be prescribed by the Ministry of Corporate Affairs would have to be considered by the auditors. Also refer to footnote 1 to paragraph 3 and footnote 2 to paragraph 6 of Section I of this Guidance Note.

Auditors' Reporting on Fraud under Section 143(12)

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 such threshold.

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

56. In case of corruption, bribery and money laundering, the direct effect of such act (benefit or penal consequence) is on the company.

57. The auditor should comply with the relevant SAs with regard to illegal acts (e.g. SA 240 and SA 250) when performing the audit. If the auditor, in the course of performance of his/her duties as the auditor, comes across instances of corruption, bribery and money laundering and other intentional non-compliances with laws and regulations, the auditor would need to evaluate the impact of the same in accordance with SA 250 to determine whether the same would have a material effect on the financial statements.

58. ***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, for the purpose of reporting, 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 thereof.***

For example, if the auditor comes to know that the company has filed a fraudulent return of income to evade income tax, he may have to report this fraud under Section 143(12) irrespective of whether adequate provision has been made in the books of accounts or not.

Guidance Note on Reporting on Fraud

It may be noted that the proviso to Section 147(2) in the context of punishment to auditors for contravention with the provisions, inter alia, of Section 143 of the 2013 Act, states “if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.”

SECTION III

APPLICABILITY OF STANDARDS ON AUDITING

59. Since reporting on fraud arises only in the course of performing duties as an auditor, the auditor should, *inter alia*, take into consideration the requirements of the following provisions of the SAs (Refer paragraphs 60 to 73 below) for purposes of designing audit procedures which are effective in identifying and assessing the risks of material misstatement due to fraud. ***These are in addition to SA 240 and SA 250 which Standards are required to be mandatorily complied in entirety insofar as they relate to audit of the financial statements and also for reporting on fraud under Section 143(12) and Rule 13 of the Companies (Audit and Auditors) Rules, 2014.***

60. Professional Skepticism (SA 200)

Paragraph 13(l) – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Paragraph A18 - Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

Guidance Note on Reporting on Fraud

Paragraph A19 - Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Paragraph A20 - Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Paragraph A21 - The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

Paragraph A22 - The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be

Applicability of Standards on Auditing

satisfied with less-than persuasive audit evidence when obtaining reasonable assurance.

61. Audit Documentation

As per paragraph 44 of SA 240 and paragraph 32 of SA 315, the auditor's documentation of the understanding of the entity and its environment and the assessment of the risks of material misstatement required by SA 315 would include:

- a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; (Refer **Appendix 1**) and
- b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

As per paragraph 45 of SA 240 and paragraph 28 of SA 330, the auditor's documentation of the responses to the assessed risks of material misstatement required by SA 330 shall include:

- a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
- b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The auditor should document communications about fraud made to management, those charged with governance, regulators and others.

When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the

Guidance Note on Reporting on Fraud

engagement, the auditor shall document the reasons for that conclusion.

62. Inquiries with those Charged with Governance

Paragraph 20 of SA 240 states that unless all of those charged with governance are involved in managing the entity, the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.

Paragraph 21 of SA 240 requires that the auditor makes inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management. (Refer **Appendix 2**)

Paragraph A20 of SA 240 states that an understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of the management.

63. Communications with those Charged with Governance

Paragraph 40 of SA 240 states that if the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

Paragraph 41 of SA 240 requires that unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspect's fraud involving:

- a) Management;
- b) Employees who have significant roles in internal control; or

Applicability of Standards on Auditing

- c) Others where the fraud results in a material misstatement in the financial statements.

The auditor should communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor should communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit.

Paragraph 42 of SA 240 requires the auditor to communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities.

64. Risk Assessment Procedures and Related Activities

Paragraphs 5 to 24 of SA 315 require the auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor is required to perform procedures to obtain information for use in identifying the risks of material misstatement due to fraud.

65. Inquiries with Management and Others within the Entity

Paragraph 17 of SA 240 requires the auditor to make enquiries of management regarding:

- a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
- b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;

Guidance Note on Reporting on Fraud

- c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

Paragraph 18 of SA 240 requires the auditor to make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Refer **Appendix 2**)

66. Identification and Assessment of the Risks of Material Misstatement Due to Fraud

In accordance with paragraph 25 of SA 315, the auditor needs to identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 of SA 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. As per paragraph 27 of SA 240, the auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks.

67. Responses to the Assessed Risks of Material Misstatement

In accordance with paragraph 5 of SA 330, "The Auditor's Responses to Assessed Risks", the auditor shall determine overall

Applicability of Standards on Auditing

responses to address the assessed risks of material misstatement due to fraud at the financial statement level.

Paragraph 29 of SA 240 requires that in determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor should:

- a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement;
- b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
- c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

Further, in accordance with Paragraph 6 of SA 330, the auditor is also required to design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

68. Evaluation of Misstatements Identified during the Audit

Paragraph A52 of SA 240 states - "SA 450, "Evaluation of Misstatements Identified during the Audit", and SA 700, "Forming an Opinion and Reporting on Financial Statements", establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report."

Paragraph A50 of SA 240 states - Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the

Guidance Note on Reporting on Fraud

cumulative net effect is not material, may be indicative of a risk of material misstatement due to fraud.

69. Analytical Procedures

The use of analytical procedures as risk assessment procedures is dealt with in SA 315. Use of analytical procedures as substantive procedures (substantive analytical procedures) and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements is dealt with in SA 520. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement especially risks of material misstatement due to fraud.

The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.(Paragraph 6 of SA 520)

If analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- (b) Performing other audit procedures as necessary in the circumstances. (Paragraph 7 of SA 520)

The auditor should evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may

Applicability of Standards on Auditing

indicate risks of material misstatement due to fraud (Paragraph 22 of SA 240).

70. Review of Accounting Estimates

Paragraph 6 of SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” requires the auditor to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework, the accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable, and related disclosures in the financial statements are adequate.

The auditor should review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud (Paragraph 32(b) of SA 240).

71. Related Parties

Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management. Consideration of such behavior is relevant when identifying and assessing the risk of material misstatement due to fraud (Paragraph A6 of SA 550)

If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risk of material misstatement due to fraud in accordance with SA 240 (Paragraph 19 of SA 550)

If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a related party with dominant influence, the auditor may, in addition to the general requirements of SA 240, perform certain audit procedures to obtain an understanding of the business relationships that such a related party may have established directly or indirectly with the

Guidance Note on Reporting on Fraud

entity and to determine the need for further appropriate substantive audit procedures (Paragraph A33 of SA 550).

72. Written Representations

SA 580, "Written Representations", establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. As per paragraph A57 of SA 240, in addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

73. Inquiries with Internal Auditors

SA 610, "Using the Work of Internal Auditors", establishes requirements and provides guidance in audits of those entities that have an internal audit functions. For those entities that have an internal audit function, paragraph 19 of SA 240 states that the auditor shall make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

SECTION IV

TECHNICAL GUIDANCE ON REPORTING ON FRAUD UNDER SECTION 143(12)

74. The duty of auditor with respect to fraud in the course of his performance of duties as an auditor is to comply with the requirements of SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”.

75. Therefore, the auditor is required to carry out the following procedures as specified in SA 240:

- a) To identify and assess the risks of material misstatement in the financial statements due to fraud;
- b) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
- c) To respond appropriately to identified or suspected fraud.

76. In addition to the above procedures, the auditor is required to report on fraud in accordance with Section 143(12) of the 2013 Act. For purposes of reporting under Section 143(12) to the Audit Committee/Board and the Central Government, the auditor is required to carry out certain specific procedures with respect to the identified offence involving fraud against the company by its officers or employees.

The objective of this part of the Guidance Note is to provide supplementary guidance to the SAs for consideration by auditors when complying with the requirements of Section 143(12) of the 2013 Act.

77. Modifications to terms of Engagement with regard to Reporting on Fraud under Section 143(12)

Reporting by the auditor on fraud is not a separate engagement and is a part of the performance of the duties as an auditor of the financial statements of the company under the 2013 Act.

Guidance Note on Reporting on Fraud

The terms of engagement between the auditor and the client as required under SA 210 will require certain modifications to incorporate the management's responsibility with regard to fraud and the auditor's reporting responsibility for reporting under Section 143(12).

The following clauses may be added to the auditor's engagement letter with regard to reporting on fraud under Section 143(12):

As part of auditor's reporting responsibilities:

In accordance with the provisions of Section 143(12) and 143(13) of the 2013 Act, if in the course of performance of my/our duties as auditor, I/we have reason to believe that an offence involving fraud is being or has been committed against the Company by officers or employees of the Company, I/we will be required to report to the Central Government, in accordance with the rules prescribed in this regard which, *inter alia*, requires me/us to forward my/our report to the Board or Audit Committee, as the case may be, seeking their reply or observations, to enable me/us to forward the same to the Central Government. Such reporting will be made in good faith and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the 2013 Act or of any rules or orders made thereunder.

Because of the inherent limitations of an audit, including the possibility of collusion or improper management override of controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As part of management's responsibility:

Management is responsible for taking proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the Company and for preventing and detecting fraud and other irregularities.

Technical Guidance on Reporting on Fraud

Management is responsible to provide me/us access to reports, if any, relating to internal reporting on frauds (e.g., vigil mechanism reports etc.), including those submitted by cost accountant or company secretary in practice to the extent it relates to their reporting on frauds in accordance with the requirements of Section 143(12) of the Act.

78. Fraud Risk Factors – Assessed Risk of Material Misstatement due to Fraud

SA 240 provides examples of fraud risk factors that may be faced by auditors in a broad range of situations, specifically relating to the two types of frauds relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets.

Examples of fraud risk factors stated in SA 240 and additional examples of fraud risk factors are given in **Appendix 3** for consideration by auditors during the course of their audit.

Although the fraud risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different fraud risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of fraud risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

79. Audit Procedures to Address Assessed Risk of Material Misstatement due to Fraud

Based on the nature, size and circumstances of the fraud risk factors, the auditor will have to design appropriate audit procedures to address the assessed risk of material misstatement due to fraud. SA 240 provides examples of possible audit procedures to address the assessed risk of material misstatement due to fraud.

Additional examples of possible audit procedures to address the assessed risk of material misstatement due to fraud are given in

Guidance Note on Reporting on Fraud

Appendix 4 for consideration by auditors during the course of their audit.

Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance.

80. Stages of Identification of Fraud

The information about possible offence involving fraud, obtained by the auditor during the course of his audit, can be classified into four stages:

- a) Speculation.
 - b) Suspicion.
 - c) Reason to Believe.
 - d) Sufficient Reason to Believe or Knowledge.
- a) **Speculation** - "Speculation" refers to information from unrelated source which is a rumour, hearsay, gossip, assumption, guess, thought or supposition. Examples of information which could be classified as speculation are provided below:
- Rumours about management accepting kick-backs from suppliers/service providers for awarding contracts, but no proof.
 - Based on specific industry risk, there is an assumption that there will be transactions involving cash and money laundering.
 - Media reports indicating that the company is planning to invest in totally unrelated, high-risk business.
 - Board of Directors consisting of some persons exposed to illegal acts.
 - Gossip that certain business groups/entities are front end for an undisclosed owner.
 - Rumour that promoters of certain companies have accounts in tax havens and are involved in circulating monies through such tax havens.

Technical Guidance on Reporting on Fraud

At this stage, the auditor may have to perform engagement risk assessment procedures to determine if there is any merit in the speculation and whether or not to accept or continue with the engagement and the level of staffing that will be required to address any fraud risk factors identified from the above.

b) **Suspicion** –‘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.

In other words, a “suspicion” will lead to identification of fraud risk factors during the course of audit. Examples of information which could be classified as suspicion are provided below:

- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.
- Accounting and information systems those are not effective, including situations involving significant deficiencies in internal control.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Use of business intermediaries for which there appears to be no clear business justification.
- Domination of management by a single person or small group (in a non-owner managed business) without compensating controls.
- Overly complex organisational structure involving unusual legal entities or managerial lines of authority.

Guidance Note on Reporting on Fraud

- The practice by management in maintaining or increasing the entity's stock price or earnings trend.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant related party transactions which appear to be not in the ordinary course of business or with related entities not audited or over which the auditor does not have information.

At this stage, the auditor will have to identify the information leading to "suspicion" as "fraud risk factor" and design appropriate audit procedures to address this assessed risk of misstatement due to fraud.

c) **Reason to Believe** - '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'.

Examples of information which could be classified as "reason to believe" are provided below:

- Material misstatement identified during the course of audit.
- Identification of any material weakness in the internal controls.
- Significant related party transactions not at arm's length and not supported by a proper business rationale.
- Sudden resignation of an employee belonging to the senior management and when proper reason is not assigned for his leaving.
- Resistance from the management with regard to certain disclosures in the financial statement.
- Material discrepancies between book stock and physical stock.
- Acquisition of significant assets which are unrelated to the business.

Technical Guidance on Reporting on Fraud

- During the course of perusal of the bank statements, when the auditor observes frequent transfer in and transfer out of funds from a particular account balance belonging to the promoter or an employee.
- Matters reported through the whistle blower mechanism on an incidence of fraud.
- Notices from regulators and government authorities on violations of laws and regulations.
- E-mail or written communication received directly by the auditor from a whistle blower.

At this stage the auditor has performed planned procedures to address the assessed risk of misstatement due to fraud. Certain evidences, which he obtained and evaluated during this process, indicate that there is a “reason to believe” that an offence involving fraud has been or is being committed. The auditor would now be required to carry out procedures as referred to in paragraphs 83 and 84 with a higher level of professional skepticism with a view to obtain more persuasive evidence to enable him to conclude whether he has “sufficient reason to believe” or has “knowledge” of fraud.

d) **Sufficient reason to believe or knowledge** – “Sufficient reason to believe” indicates “reason to believe” with more persuasive evidence based on further procedures performed by the auditor. Examples of information which could be classified as “Sufficient reason to believe” are provided below:

- Material misstatement identified during the course of audit not supported by appropriate rationale/explanation from the management, indicating that the misstatement was intentional.
- Identification of any material weakness in the internal controls which has resulted in material damage/huge loss for the company.
- Significant related party transactions not at arm’s length and not supported by appropriate evidence. Management is not able to provide appropriate rationale/substantiation

Guidance Note on Reporting on Fraud

for undertaking such transactions and such transactions may be prejudicial to the interests of the shareholders, based on the materiality determined by the auditor.

- Sudden resignation of an employee belonging to the senior management. On performing further procedures, it is noted that the employee had committed an offence involving fraud.
- Resistance from the management with regard to certain disclosures in the financial statements. On further inquiry, it comes to light that management had concealed certain information from the bankers/regulators and hence the resistance to disclose.
- Material discrepancies between book stock and physical stock. On examination, the auditor noted that the unit of measures were misstated for several items as against a one-off instance, which indicates that the misstatement could be intentional.
- Acquisition of significant assets which are unrelated to the business. On further inquiry with the project department, it appears that the acquisition was made to accommodate a related party or boost the sales of a related party.
- During the course of perusal of the bank statements, when the auditor observes frequent transfer in and transfer out of funds from a particular account balance belonging to the promoter or an employee. On further inquiry and procedures, the auditor notes that the employee involved was the person who is involved in preparing bank reconciliation statements (BRS) and there is no review of the work performed by this staff.
- Matters reported through the whistle blower mechanism on an incidence of fraud and the procedures performed by the management to investigate the reported matter were biased to protect the interests of the persons against whom the allegations were made.

At this stage, the auditor has sufficient reason to believe or has knowledge of fraud and therefore, the auditor's responsibility to

Technical Guidance on Reporting on Fraud

report on the suspected offence involving fraud to the Central Government is triggered.

81. Section 143(1) of the Act requires the auditor, *inter-alia*, to perform the following inquiries and determine if any specific reporting to the members of the company is required under the said section:

- (a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
- (c) Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) Whether loans and advances made by the company have been shown as deposits;
- (e) Whether personal expenses have been charged to revenue account;
- (f) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Any adverse comment on the above may also be considered as matters where the auditor has sufficient reason to believe that a suspected offence involving fraud is being or has been committed.

82. A decision tree summarising the action required to be carried out by an auditor at different stages of information/extent of evidence obtained is provided as part of the overview to this Guidance Note.

Guidance Note on Reporting on Fraud

83. Audit Procedures If Auditor has reasons to Believe a Fraud has Occurred or is being Carried Out

As discussed in the earlier sections of this Guidance Note, Section 143(12) of the 2013 Act requires the auditor to report to the Central Government if he has “reasons to believe” that an offence involving fraud is being or has been committed against the company by officers or employees of the company. Clearly, section 143(12) does not envisage reporting in Form ADT 4 by the statutory auditor during the “speculation” and “suspicion” stages. During these stages, the auditor’s procedures would be as provided under the SA 240. Having reached the stage of “reason to believe”, the auditor would be guided by the requirements of paragraphs 83 and 84 of this Guidance Note.

Examples of audit procedures which the auditor can perform when he has “reason to believe” that an offence involving fraud is being or has been committed is given below:

- a. Evaluating the evidences obtained or misstatements identified with professional skepticism.
- b. Introducing elements of unpredictability/surprise in carrying out specific audit procedures (for example, visiting certain sales locations normally not visited at year end to evaluate if there are any “Billed but Not Delivered” sales transactions).
- c. If considered necessary, recommending to the Board or Audit Committee to involve experts such as information technology specialists, forensic experts or fair valuation experts, etc., to carry out data analytics and investigation (Refer paragraph 84 below).
- d. Seeking additional audit evidence from sources outside of the entity being audited. For example, external confirmations which could be tailored to specific circumstances such as confirming the terms and conditions relating to sale, confirming the occurrence of specific transactions, etc.

Technical Guidance on Reporting on Fraud

- e. Focussed testing on period-end and year-end journal entries by a senior member of the engagement team.
- f. Carrying out a more critical evaluation and retrospective testing of accounting estimates to evaluate the reasonableness of management's judgement and existence of management bias.
- g. Consulting with experts to evaluate unusual and complex transactions.
- h. Performing certain procedures specific to account balance when such evidences particularly relate to any specific class of transaction or account balance. For example, in addition to sending written confirmations, major customers and suppliers could be directly contacted in order to seek more or different information.
- i. Where related party transactions are involved, critically evaluating the business rationale of the transactions and arm's length nature of such transactions.
- j. Re-performing certain critical reconciliations carried out by the entity.

84. Working with the Board or the Audit Committee in case the Auditor has Reasons to Believe a Fraud may Exist

There could be circumstances where the auditor identifies misstatements in account balance where a fraud or a significant risk factor was identified by him and therefore has reason to believe that a fraud may exist. However, the auditor may not have sufficient reason to believe that a fraud actually exists. As per the SAs, the auditor may communicate such misstatements to the management and request them to carry out additional reviews to ensure that there are no other undetected misstatements.

The auditor may perform parallel procedures or work with the management to identify any other misstatement due to fraud within those account balances that may have remained undetected.

Guidance Note on Reporting on Fraud

The outcome of such audit procedures will help the auditor conclude whether he has sufficient reason to believe or not, that the suspected offence involving fraud has been or is being committed.

85. It may be noted that the above procedures (Refer paragraphs 83 and 84) represent enhanced audit procedures which the auditor carries out in the course of his audit with professional skepticism with the primary objective to ensure that the financial statements are not materially misstated due to fraud. The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

Further, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determination of whether fraud has actually occurred. Therefore, an auditor cannot make an assertion that an 'offence' involving fraud has been or is being committed against the company. Accordingly, in Form ADT – 4 the terminology used is 'suspected offence involving fraud'.

86. Reporting to the Board or Audit Committee on Auditor's Sufficient Reason to Believe and Knowledge of Fraud against the Company by Officers or Employees of the Company

Clause (i) of Sub-Rule 1 of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 requires the auditor to forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to (have) knowledge of the suspected offence involving fraud, seeking their reply or observations within forty-five days. The Rule does not prescribe the form or format in which the auditor should communicate to the Board or the Audit Committee.

87. Therefore, the auditor may use the Form ADT – 4 itself to report to the Board or Audit Committee duly filling in the necessary details, other than those relating to items (11), (12) and (14) of the Form relating to date of receipt of response from the Board or

Technical Guidance on Reporting on Fraud

Audit Committee; the auditor's opinion if the reply of the Board or Audit Committee was satisfactory; and the details of steps taken by the company in this regard. Refer **Appendix 5** for illustrative format of reporting to the Board or the Audit Committee.

88. The auditor may send additional details of the basis on which the fraud is suspected, the period to which it relates to and the basis of estimating the amounts involved, to enable the Board or Audit Committee to pursue the matter further.

89. It may be noted that the timeline for reporting under Section 143(12) starts immediately as soon as the auditor has sufficient reason to believe and knowledge of fraud. The auditor is not required to investigate the fraud so as to establish the entire magnitude, the period, the *modus operandi* and the persons involved since the requirement of Section 143(12) read with the Rule 13 of the Companies (Audit and Auditors) Rules, 2014 is not that the auditor has to perform a forensic audit.

90. Obtaining Response from the Board or Audit Committee

When a fraud is reported by the auditor to the Board or Audit Committee, they are required to evaluate the matter, where applicable and take appropriate action on the matter, including, where required an investigation/forensic audit conducted either by appropriate internal specialists of the company or external specialists/experts, and respond to the auditor within 45 days of the date of the auditor's communication.

91. It will be the responsibility of the Board or Audit Committee to have appropriate procedures performed, including, where required an investigation/forensic audit. The action taken by the Board or Audit Committee pursuant to receipt of communication from the auditor may involve investigation/forensic audit by their internal auditors, internal team of senior management or by an external agency. Based on the steps taken, including any investigation/forensic audit on the matter reported, they are required to reply to the auditors.

92. An investigation will include a planning stage, a period when evidence is gathered, a review process, and a report to the

Guidance Note on Reporting on Fraud

client. The purpose of the investigation, in the case of an alleged fraud, would be to discover if a fraud had actually taken place, to identify those involved, to quantify the monetary amount of the fraud (i.e., the financial loss suffered by the client), and to ultimately present findings to the client and potentially to court. It is normally not as in-depth as a forensic audit and in fact may not be performed by forensic auditors.

93. 'Forensic audit' refers to the specific procedures carried out in order to produce evidence. Specialised audit techniques are used to identify and to gather evidence to prove, for example, use of information technology and data retrieval tools, data analytics, interrogation (not interview), critical evaluation of evidence, motive, evaluating patterns of information, duration of the alleged fraud and how it was conducted and concealed by the perpetrators, etc.. Evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include:

- the suspect's motive and opportunity to commit fraud;
- whether the fraud involved collusion between several suspects;
- any physical evidence at the scene of the crime or contained in documents;
- comments made by the suspect during interviews and/or at the time of arrest; and
- attempts to destroy evidence.

Forensic audit is a very specialised engagement, which requires highly skilled team members who have experience not only of accounting and auditing techniques, but also, among other things, of the relevant legal framework.

94. Rule 13 of the Companies (Audit and Auditors) Rules, 2014 does not state what should be the contents of the reply of the Board or Audit Committee in case a report on a suspected offence involving fraud is received by them from the auditor. However, it would be reasonable to presume that the reply of the Board or Audit Committee will include the following:

Technical Guidance on Reporting on Fraud

- An acknowledgement of having received the report on fraud from the auditor.
- Brief description of the fraud or suspected fraud.
- The steps taken by them pursuant to receipt of the report, including:
 - a. The manner in which they have followed up on the matter reported to them;
 - b. Involvement of specialists, internal and/or external, who have carried out investigation/forensic audit on their behalf;
 - c. The period covered by such investigation/forensic audit;
 - d. Their assessment of areas impacted by the fraud – company locations, account balances, categories of assets/liabilities/income/expenses, categories of customers/vendors, off-balance sheet items, etc.
 - e. The conclusion drawn by them based on such investigation/forensic audit:
 - *If the Board or Audit Committee is in agreement with the auditor's conclusion on fraud – the cause of the fraud, persons involved, estimate of amounts involved, the period to which the fraud relates to, steps taken by them to remediate the reasons which caused the occurrence of the fraud, including changes to the internal control systems or plans thereto, the action taken on the persons involved in the fraud (including filing of civil/criminal complaints with law enforcement agencies, disciplinary actions, etc.), the status of reporting the matter to any other regulator (e.g. RBI, Tax authorities, etc.).*
 - *If the investigation/forensic audit ordered by them is in progress as on the date of the reply - the status of the investigation, the*

Guidance Note on Reporting on Fraud

persons allegedly involved in the fraud, any preliminary amounts quantified on the fraud, steps taken in the interim including any action taken on the persons allegedly involved in the fraud (including filing of civil/criminal complaints with law enforcement agencies, disciplinary actions, etc.), the status of reporting the matter to any other regulator (e.g. RBI, Tax authorities, etc.), remediation plan to prevent further occurrences, etc.

- A copy of the investigation report/report on the forensic audit (preliminary/draft/final) or the procedures performed/being performed by them to substantiate the items stated above.

95. There may be instances where the Board or the Audit Committee does not concur with the auditor's belief that a suspected offence involving fraud is being or has been committed. If the Board or Audit Committee is not in agreement with the auditor's belief that a suspected offence involving fraud has been or is being committed, the persuasive reasons therefor with supporting evidence should be provided in their reply to the auditor along with the other matters described in paragraph 94 above.

96. Evaluating Reply of the Board or Audit Committee

The auditor should evaluate the reply of the Board or Audit Committee received by him in response to his report to them on the suspected offence involving fraud. Such evaluation is required to enable the auditor to state if he is satisfied or not satisfied with the reply of the Board or Audit Committee on the matter reported to them.

97. Whilst Sub-Rule (1)(ii) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 requires the auditor to forward his report along with his comments on the reply received from the Board or the Audit Committee, Form ADT-4 requires the auditor to only state if he is satisfied or not satisfied with the reply of the

Technical Guidance on Reporting on Fraud

Board or the Audit Committee. Accordingly, the comments of the auditor as specified in the Sub-rule implies the statement of the auditor in Form ADT – 4 about his satisfaction or otherwise with the reply of the Board or the Audit Committee. For this purpose, the auditor should review the reply from the Board or the Audit Committee with the supporting evidence provided to determine the reasonability of the same.

98. Where the Board or the Audit Committee has provided its reply on the basis of an investigation/forensic audit, the auditor is not expected to re-perform or carry out an independent investigation/forensic audit to validate the same. The auditor should, however, review the process followed by the investigation/forensic audit to gain comfort on:

- the scope of the investigation/forensic audit,
- the period covered,
- the persons covered,
- information gathered/obtained,
- specific scope exclusions or limitations, if any, in the investigation/forensic audit,
- the reasonableness of the amounts identified as involved based on his professional judgement and his understanding of the suspected offence involving fraud, and
- the competence, experience and seniority of the persons who conducted the investigation/forensic audit and their independence and objectivity.

99. If the Board or the Audit Committee disagrees with the belief of the auditor that a suspected offence involving fraud exists and provides evidence in this regard, the auditor would consider such evidence and perform such further procedures as may be necessary to determine if his initial belief was appropriate under the circumstances. In addition to reviewing the matters stated in paragraph 98 above with increased professional skepticism, the following additional factors should also be considered by the auditor:

Guidance Note on Reporting on Fraud

- Whether the evidence provided in the reply was available when the auditor initially concluded that there was a fraud or is it new evidence. If it was an evidence or information that was previously considered by the auditor, the reason why the company has considered the same evidence or information differently.
- The reliability of the evidence now provided considering the risk of bias to overlook a fraud that is existing.
- The persuasiveness of the company's evidence or information that the suspected offence involving fraud does not exist, that is included in the company's reply.

100. Based on the additional procedures carried out by the auditor after considering the factors stated in paragraph 99 above, pursuant to the reply of 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, the need for reporting the matter to the Central Government would not be applicable. This situation would arise only if the auditor did not have the evidence or information that is now provided as part of the reply or additional information has now been provided to the auditor and there is persuasive evidence now available to convince the auditor that the suspected offence involving fraud does not exist.

Reporting to the Central Government in Form ADT-4⁷

101. It may be noted that Sub-rule (1)(ii) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 requires the auditor to 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. Consequently, it is not necessary that the auditor will always have 60 days to submit the Form ADT-4 to the Central

⁷ Pursuant to the proposed amendments to Section 143(12) of the 2013 Act, auditors may be required to report to the Central Government only those frauds where the amount involved is in excess of the threshold that may be specified by the Ministry of Corporate Affairs. Accordingly, the guidance given in paragraphs 101 to 104 with respect to reporting to the Central Government will become applicable only for those frauds that are in excess of the specified threshold.

Technical Guidance on Reporting on Fraud

Government since if the Board or the Audit Committee replies prior to 45 days of the date of the auditor reporting to them on the suspected offence involving fraud, the Form ADT – 4 will need to be submitted within 15 days of the receipt of reply from the Board or the Audit Committee. For example, if the Board or the Audit Committee replies in 24 days, the auditor will need to report in Form ADT–4 within 39 days i.e., 15 days of receipt of reply from the company.

102. If the auditor does not receive a reply to his communication to the Board or Audit Committee within 45 days, he shall forward his report to the 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 within 15 days of the expiry of the 45 days.

103. If the auditor receives a reply from the Board or Audit Committee within the stipulated time of 45 days of his communication to them, the auditor should within 15 days of receipt of the reply send his report in Form ADT–4 (Refer **Appendix 6**) to the Central Government stating the following:

- the date on which he received the reply;
- a gist of the reply or observations of the Board or the Audit Committee to his report;
- whether he is satisfied or not satisfied with the reply of the Board or Audit Committee;
- details of steps, if any, taken by the company in this regard (furnishing full details with references); and
- any other relevant information.

A copy of the reply received from the Board or Audit Committee should also be attached to the Form ADT–4 when submitted to the Central Government.

104. In case the auditor is not satisfied with the reply of the Board or the Audit Committee, he should state the reasons for the same in the Form ADT–4 as part of item 15 to the Form “Any

Guidance Note on Reporting on Fraud

other relevant information". The reasons the auditor may not be satisfied with the reply of the Board or the Audit Committee may, *inter alia*, include any of the following:

- He is not satisfied with the competence or seniority/experience of the person who has carried out the investigation/forensic audit on behalf of the Board or the Audit Committee.
- If only an investigation was carried out but considering the nature, size, complexity, motive of the suspected offence involving fraud, it needed a forensic audit to be carried out, thereby impacting the comprehensiveness of the procedures performed by the Board or the Audit Committee. (Refer paragraphs 92 and 93)
- Facts produced by the auditor in his report were overlooked by the Board or the Audit Committee resulting in differing conclusions with that of the auditor.
- Based on further procedures performed and evaluation of the additional evidence or information provided, if the auditor not convinced with the Board or the Audit Committee reply that the suspected offence involving fraud does not exist.
- Period of coverage, persons covered, and areas covered or scope of the investigation/forensic audit was not adequate or appropriate.
- If the reply of the Board or the Audit Committee does not include any of the matters referred to in paragraph 94 above and the auditor considers such matter to be significant for the Board or the Audit Committee to have considered in their reply.

105. Management Representation

SA 580 - "Written Representations", establishes requirements and provides guidance on obtaining appropriate representations from management. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the

Technical Guidance on Reporting on Fraud

auditor obtains a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

- a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and
- b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

In addition to the management representations as discussed above, the auditor will be required to obtain certain specific representations with regard to the following:

- a) Steps taken on fraud committed or being committed against the company.
- b) Matters included in the reply to the report of the auditor on suspected fraud.

Further when management is involved or suspected to be involved, the auditor should insist that the representations need to be provided by the Board or Audit Committee of the company.

Illustrative Management Representation Letter for steps taken by the Board or the Audit Committee on fraud reported by the auditor is provided in **Appendix 7**.

In the exceptional circumstances where the auditor has doubts about the integrity or honesty of those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

106. Audit Documentation and Quality Control

The documentation of the audit procedures performed from identifying the fraud risk till the identification of existence of fraud is critical as this would form the basis for matters reported to the Board or the Audit Committee and thereafter to the Central Government in Form ADT-4. This would also enable the auditor to demonstrate reporting in good faith to ensure protection under Section 143(13) and Section 456.

Guidance Note on Reporting on Fraud

107. Auditors should, taking into account the provisions of SA 230, *inter alia*, consider the following items for being maintained as part of the audit documentation in connection with reporting under Section 143(12):

- a) Minutes of inquiries conducted with those charged with governance, internal auditors, senior management and relevant employees during the course of planning and minutes of engagement team discussions on fraud risk factors. (Refer paragraphs 61 and 62)
- b) The fraud risk factor or suspicion which led to identification of evidences which provided the knowledge to the auditor that a suspected offence involving fraud is being or has been committed. (Refer paragraphs 80.a and 80.b)
- c) Specific and additional audit procedures carried out by the auditor to address the assessed risk of material misstatement due to fraud. (Refer paragraphs 80.c, 80.d, 83 and 84)
- d) Memo documenting the professional judgement exercised by the auditor at various stages of performing the planned procedures.
- e) Details of evidences obtained during the course of performing the planned procedures. (Refer paragraphs 80.c, 80.d, 83 and 84)
- f) Copies of correspondences with the Board or Audit Committee on the procedures/investigations carried out, to conclude on matters reported by the auditor.(Refer paragraph 84)
- g) Copy of the report to the Board or Audit Committee along with attachments thereto. (Refer paragraphs 86 to 89)
- h) Copy of response received from the Board or the Audit Committee along with the supporting documents provided by them in their response. (Refer paragraphs 90 to 95)
- i) If an investigation/forensic audit was carried out by the Board or Audit Committee, how the auditor evaluated the competency and independence of the person who carried

Technical Guidance on Reporting on Fraud

out the investigation and adequacy of the scope of work provided to them. (Refer paragraphs 96 to 100)

- j) Details of other procedures carried out to evaluate the reasonableness of investigation/forensic audit/action taken by the Board or Audit Committee in respect of the matter reported. (Refer paragraphs 96 to 100)
- k) Conclusions on whether or not the auditor was satisfied with the procedures carried out by the Board or the Audit Committee along with the basis and reasons therefor. (Refer paragraphs 98 to 104)
- l) If the auditor is satisfied with the Board or the Audit Committee response that the suspected offence involving fraud does not exist, the details of additional procedures performed, supporting evidence and additional evidence received by the auditor in this regard.(Refer paragraphs 99 and 100)
- m) Copy of the report submitted to the Central Government. The matters included in this report needs to be appropriately cross-referenced to the source documents. (Refer paragraphs 102,104 and paragraph 109)
- n) Management representations.(Refer paragraph 105)
- o) Documentation on how the auditor evaluated the implications of the suspected offence involving fraud on other aspects of audit and on the financial statements—whether the impact is isolated occurrence or pervasive (Refer paragraphs 106 and 110).
- p) If experts and specialists were involved in carrying out these procedures, then their work papers should also form part of the auditor’s work papers.
- q) Any memo on consultations the auditor had during the course of carrying out the procedures with regard to fraud.
- r) Evidence of a quality control review having been performed on the audit procedures carried out and the report submitted to the Board or Audit Committee and the Central Government. (Refer paragraph 108)

Guidance Note on Reporting on Fraud

108. Whilst reporting under Section 143(12) is not a separate engagement from an audit of financial statements, it arises from such an audit, since reporting under Section 143(12) is consequent to any fraud noted in the course of performance of duties as auditor. Further, since the auditor is required to report to the Central Government in case of fraud against the company, and given the exceptional nature of circumstances, the auditor should ensure that the reporting under Section 143(12) is subject to quality control considering the provisions of SA 220 – “Quality Control for an Audit of Financial Statements”.

109. Whilst the Act or the Rules do not specify that the auditor should send a copy of the Form ADT-4 sent to the Central Government to the Board or the Audit Committee, the Act or the Rules do not prohibit the same. Accordingly, the auditor may send a copy of the Form ADT-4 and the documents annexed thereto to the Board or the Audit Committee for their information and records.

110. Evaluation of Impact on the Financial Statements, Audit Opinion on the Financial Statements and Internal Financial Controls

If a fraud has been noted and reported under Section 143(12), the auditor will have to evaluate the implications of the matter reported in the financial statements, on his audit opinion on the financial statements and on any other matter to be included in his report under Sections 143(1) to (3) including with regard to reporting on the adequacy and operating effectiveness of the internal financial controls. The following will need to be considered by the auditor in this regard:

- When the auditor has reason to believe that the management is involved in the fraud, how the auditor re-evaluated the risks of material misstatement due to fraud and reliability of the evidences previously obtained.
- When the auditor confirms that, or is unable to conclude whether the financial statements are materially misstated due to fraud, how the auditor evaluated the implications for the audit.

Technical Guidance on Reporting on Fraud

111. Consideration in Joint Audits

In case of joint audits, where a suspected offence involving fraud against the company by its officers or employees is identified/noted by one of the joint auditors, such joint auditor should communicate the same to the other joint auditor(s) to enable them to consider and evaluate if the same could exist in the areas/account balances audited by them and each of the joint auditor should individually comply with the requirements of this Guidance Note.

The reporting to those charged with governance and to the Central Government as required under Rule 13 to the Companies (Audit and Auditors) Rules, 2014 may be carried out by the joint auditor who identified/noted the suspected fraud or by any or all of the joint auditors together.

When the reporting in Form ADT – 4 is carried out only by the joint auditor who identified/noted the suspected fraud, such joint auditor should provide a copy of the Form ADT – 4 to the other joint auditors.

112. Consideration of Disclosure of Frauds in the Board's Report

SA 720 – “The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements” requires the auditor to read the other information in documents that contain audited financial statements because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

Pursuant to the proposed amendments to Section 143(12) of the Companies Act, 2013, the auditor may be required to report frauds only to the Audit Committee or the Board of Directors if the amounts involved are less than the thresholds that may be specified by the Ministry of Corporate Affairs. Such frauds may have been appropriately dealt with in the audited financial statements of the company. However, as per the proposed

Guidance Note on Reporting on Fraud

amendment, the company should disclose details of such fraud in its Board's report.

Since the Board's report also includes audited financial statements, the auditor should read the disclosures relating to fraud in the Board's report to determine if they are consistent with the matter reported by the auditor and dealt with in the audited financial statements. In case the auditor observes any material inconsistency in the disclosure in the Board' report in this regard, the auditor should consider the requirements of SA 720 to determine the manner of dealing with the inconsistency observed.

SECTION V

APPENDICES

APPENDIX 1

(Refer paragraph 61)

Illustrative Matters for Engagement Team Discussion on Fraud

Discussion among the engagement team

A discussion among the engagement team members and a determination by the engagement partner of matters which are to be communicated to those team members not involved in the discussion should place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

The discussion should occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

Guidance Note on Reporting on Fraud

The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalise committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's

Appendices

financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.

- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Illustrative matters for consideration during engagement team discussions on fraud risk factors

- What are the business risks that the entity is subject to?
- How might fraud, including fraudulent financial reporting, occur at the entity? How can it be concealed?
- Have there been any frauds that have been reported in the same industry as the entity? If so, is it possible that the fraud identified is applicable to the entity and should be considered?
- Where are the financial statements susceptible to material misstatement as a result of fraud or error?
- How could assets at the entity be misappropriated?
- Is there a high risk of management override of controls?
- What is the susceptibility of financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions?
- Are there circumstances that indicate earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting?
- Are there known external or internal factors affecting the entity that may create an incentive or pressure for management and others to commit fraud, provide the opportunity for fraud to be perpetrated, indicate a culture or

Guidance Note on Reporting on Fraud

environment that enables management or others to rationalise committing fraud?

- Is the financial stability or profitability of the entity threatened by economic, industry, or other operating conditions?
- Does the nature of the entity's operations provide opportunities to engage in fraudulent financial reporting?
- Does the entity have a complex or unstable organisational structure?
- Are there any unusual or unexplained changes in behavior or lifestyle of management and/or others?
- Have there been any actual frauds uncovered at the entity?
- If so, what was the circumstances surrounding the fraud and what was the outcome of the investigation?
- Did management and others take the appropriate actions to address the fraud?
- Have there been any allegations of fraud?

In addition to assessing the susceptibility to fraud, engagement teams may consider the following matters in addressing the fraud risk factors:

- What insights can be shared amongst engagement team members based on the knowledge of the entity?
- Does each engagement team member understand the potential for material misstatements related to each audit area they have been assigned to?
- What types of circumstances, if encountered, during the engagement could indicate a possibility of fraud?
- What type of procedures might be selected to respond to possible fraud?

Appendices

- Are there certain types of procedures that are more effective than others?
- Is the engagement team aware of the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud?
- How will the element of unpredictability be incorporated into the nature, timing and extent of the audit procedures to be performed?
- What happens if fraud is identified during the engagement?

Guidance Note on Reporting on Fraud

APPENDIX 2

(Refer paragraphs 62 and 65)

**Illustrative Checklist for Inquiries with Board/
Audit Committee, Management and Internal
Auditor**

**Inquiries of Management and Others regarding the risk
of fraud:**

Document responses after each chart within the space provided.

**Questions Regarding the Identification of Fraud Risks and
Other Risks of Material Misstatement**

The following questions are designed to identify fraud risks that are known to management. Questions may be directed to those individuals indicated:

| Questions | Board/ Audit Committee | CEO | CFO | Internal Audit | Others |
|---|-----------------------------------|------------|------------|-----------------------|---------------|
| What are your views regarding the risks of fraud? | * | * | * | * | |
| Do you have knowledge of any actual or suspected fraud affecting the entity? If so, describe each instance including: a. The individual's position within or relationship to the entity. | * | * | * | * | |
| b. Identification of others involved or that may have been involved in the matter and their relationship to the entity or any of its employees. | | | | | |

Appendices

| | Board/ Audit Committee | CEO | CFO | Internal Audit | Others |
|---|---------------------------|-----|-----|----------------|--------|
| Questions | | | | | |
| c. The scheme used or possibly used to misstate the financial statement amounts and/or disclosures. | | | | | |
| d. Whether the misstatement or potential misstatement was detected in a timely manner by the internal controls, especially the antifraud programs and controls, established by management. | | | | | |
| e. If the misstatement or potential misstatement was not detected in a timely manner, indicate whether it was because the programs and controls were: <ul style="list-style-type: none"> <li data-bbox="472 1079 678 1108">i. Not in place <li data-bbox="472 1115 776 1144">ii. Improperly designed <li data-bbox="472 1150 894 1220">iii. Properly designed but not operating effectively. | | | | | |
| f. How management (or others, such as the Audit Committee) became aware of the scheme used or possibly used to misstate the financial statements. | | | | | |
| g. The actual or potential effect on the financial statement amounts and/or disclosures. | | | | | |
| h. The actions that management and/or those charged with governance (e.g., the Audit Committee) took in response to each instance described (e.g., investigation, restating the financial statements). If no action was taken, please explain the reasons for that | | | | | |

Guidance Note on Reporting on Fraud

| Questions | Board/ Audit Committee | CEO | CFO | Internal Audit | Others |
|--|-----------------------------------|------------|------------|-----------------------|---------------|
| decision. | | | | | |
| i. Any disciplinary actions that management and/or those charged with governance (e.g., the Audit Committee) took with respect to the individual(s) involved in the matters described. If there was no disciplinary action taken, please indicate such and explain why no action was considered necessary. | | | | | |
| j. How management plans to prevent, deter, and detect the risks relating to such schemes in the future. | | | | | |
| Provide copies of reports on suspected fraud received from the cost auditors, secretarial auditors and erstwhile statutory auditors in the last year in terms of Section 143(12) of the Companies Act, 2013 and the Rules thereunder, along with the responses of the company provided to such persons and copies of reporting on fraud to any other regulatory authority. | * | | | | |
| Are you aware of allegations of fraud or suspected fraud affecting the entity (e.g., received in communications from employees, former employees, analysts, regulators, short sellers, or other investors)? If so, describe each instance, addressing items (a) through (j) from the above question as applicable. | * | * | * | * | |
| Is the entity in compliance with laws and | * | * | * | | |

Appendices

| Questions | Board/ Audit Committee | CEO | CFO | Internal Audit | Others |
|---|-----------------------------------|------------|------------|-----------------------|---------------|
| regulations that may have a material effect on the financial statements? | | | | | |
| Are you aware of tips or complaints regarding the entity's financial reporting (including those received through any internal whistleblower program, if such program exists) and, if so, what were your responses to such tips and complaints? | * | * | * | | |
| Have you reported to those charged with governance on how the entity's internal control serves to prevent and detect material misstatements due to fraud? | | * | * | | |
| Are you aware of instances of management override of controls and the nature and circumstances of such overrides? | | | | * | |
| <i>[To the extent necessary, expand inquiries of the audit committee, or equivalent (or its chair), management, the internal audit function, and others within the entity who might reasonably be expected to have information that is important to the identification and assessment of risks of material misstatement,]</i> | * | * | * | * | * |
| Other: _____ | | | | | |

Documentation

Questions Regarding Processes to Prevent or Mitigate Fraud Risks

Guidance Note on Reporting on Fraud

The following questions are designed to identify the processes, including absence thereof or weaknesses therein, to prevent or mitigate fraud risks. Questions may be directed to those individuals indicated:

| Questions | Board or the Audit Committee | CEO | CFO | Internal Audit | Others |
|---|-------------------------------------|------------|------------|-----------------------|---------------|
| Does management perform an assessment of the risk that the financial statements may be materially misstated due to fraud (e.g., processes used to identify, analyse, and manage fraud faced by the entity)? If so, describe such processes, including the nature, extent, and frequency of such assessments. | | * | * | | |
| Describe your understanding about management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist. | * | * | * | * | |
| Has the entity established programs and controls to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud? If so, describe such programs and controls, including how management monitors them. | | * | * | | |
| Describe how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate | * | * | * | | |

Appendices

| Questions | Board or the Audit Committee | CEO | CFO | Internal Audit | Others |
|--|------------------------------|-----|-----|----------------|--------|
| these risks. | | | | | |
| Has management communicated with those charged with governance (e.g., Audit Committee; others with equivalent authority and responsibility such as the Board of Directors, the board of trustees, or the owner-manager of the entity) regarding its processes for identifying and responding to the risks of fraud in the entity? Describe the frequency, nature, and extent of such communications. | | * | * | | |
| Has management communicated to employees its views on business practices and ethical behavior? If so, how? | | * | * | | |
| Does the entity have a compliance-monitoring process? If so, describe the process. | | * | * | | |
| Describe controls that the entity has established to address risks of fraud the entity has identified, or that otherwise help to prevent and detect fraud, including how management monitors those controls. | | * | * | | |
| For entities with multiple locations, describe (a) the nature and extent of monitoring of operating locations or business segments, and (b) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist. | | * | * | | |
| Has the entity established policies and procedures regarding compliance with laws and regulations (including the prevention of non-compliance)? If so, describe those policies. If not, explain why. | | * | * | | |

Guidance Note on Reporting on Fraud

| Questions | Board or the Audit Committee | CEO | CFO | Internal Audit | Others |
|---|------------------------------|-----|-----|----------------|--------|
| What do you do to check compliance with this policy? | | | | | |
| Has the entity issued directives requiring periodic representations from management at appropriate levels of authority concerning compliance with laws and regulations? If not, why? | | * | * | | |
| Has the entity obtained periodic representations from management at appropriate levels of authority concerning compliance with laws and regulations? | | * | * | | |
| <p>Has internal audit performed any procedures during the year to identify or detect fraud? If yes, has management satisfactorily responded to any findings resulting from those procedures performed?</p> <p>Note: Consider any significant risks identified when describing the role of those charged with governance (e.g., the Audit Committee) in addressing the risk that management may commit fraud through an override of existing controls.</p> | | | | * | |
| Other: | | | | | |

Documentation

Appendices

APPENDIX 3

(Refer paragraph 78)

Illustrative Fraud Risk Factors

(Refer Appendix I of SA 240)

The fraud risk factors identified in this Appendix are examples of such factors that may be faced by auditors in a broad range of situations. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e., fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: (a) incentives/pressures, (b) opportunities, and (c) attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting.

Incentives/Pressures

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins.

Guidance Note on Reporting on Fraud

- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Significant declines in customer demand and increasing business failures in either the industry or overall economy.
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
- New accounting, statutory, or regulatory requirements.

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
- Need to obtain additional debt or equity financing to stay competitive - including financing of major research and development or capital expenditures.
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

Appendices

- Significant financial interests in the entity.
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.
- Personal guarantees of debts of the entity.
- There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
- Use of business intermediaries for which there appears to be no clear business justification.

Guidance Note on Reporting on Fraud

- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non-owner managed business) without compensating controls.
- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity.
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
- High turnover of senior management, legal counsel, or those charged with governance.

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
- High turnover rates or employment of accounting, internal audit, or information technology staff that are not effective.
- Accounting and information systems that are not effective, including situations involving significant deficiencies in internal control.

Attitudes/Rationalizations

- Communication, implementation, support, or enforcement of the entity's values or ethical standards by management,

Appendices

or the communication of inappropriate values or ethical standards, that are not effective.

- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
- The practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to remedy known significant deficiencies in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
 - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.

Guidance Note on Reporting on Fraud

- Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report.
- Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Arising from Misstatements Arising from Misappropriation of Assets

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and other deficiencies in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

Incentives/Pressures

- Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those

Appendices

assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs.
- Recent or anticipated changes to employee compensation or benefit plans.
- Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed.
- Inventory items that are small in size, of high value, or in high demand.
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - Inadequate segregation of duties or independent checks.
 - Inadequate oversight of senior management expenditures, such as travel and other reimbursements.
 - Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.

Guidance Note on Reporting on Fraud

- Inadequate job applicant screening of employees with access to assets.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorization and approval of transactions (for example, in purchasing).
- Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- Lack of mandatory vacations for employees performing key control functions.
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

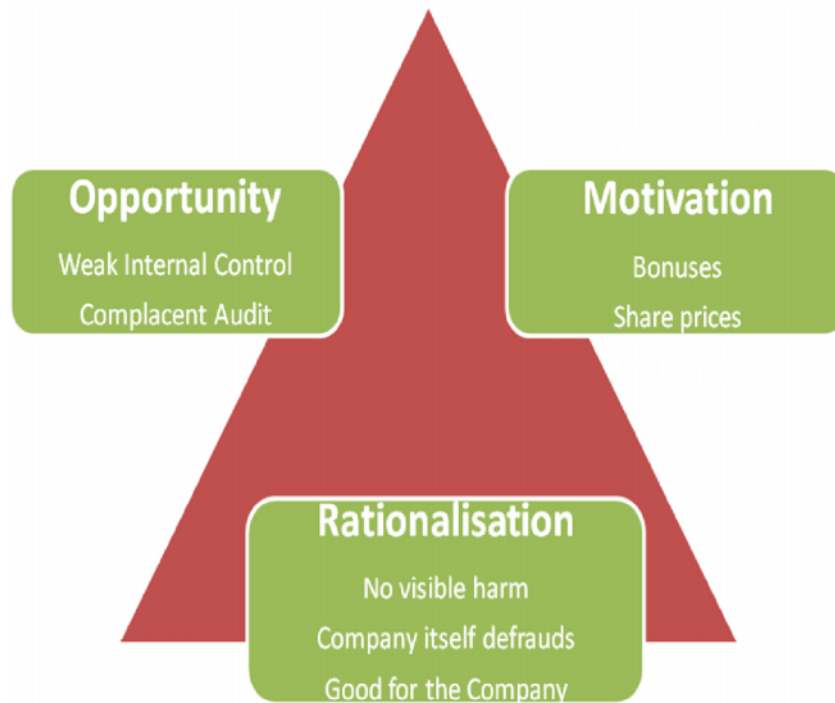
Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.

Appendices

- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
- Tolerance of petty theft.

The Fraud Triangle – Risk factors



Guidance Note on Reporting on Fraud

Additional Examples of Fraud Risk Factors for Consideration by Auditors (these are in addition to those stated in SA 240)

Probable areas where fraud may occur:

- Improper Disclosures.
- Expenses.
- Liabilities.
- Reserves.
- Bribery and kickbacks.
- Cash and bank balances.
- Inflating the purchase consideration for acquisition of business and thereby recording fictitious Goodwill.
- Investments.
- Asset misappropriation.
- Trade Receivable.
- Inventory.
- Revenue Recognition.

Adverse situations impacting the company:

- Heavy rejections of stores, spares and equipment in a factory could be used as means for smuggling good stocks.
- Situation of disorderliness.
- Non-reconciliation of Bank Statements for a long period of time.
- Disaster situations like floods or fire whereby assets are deliberately pilfered.

Appendices

- Sudden profits in otherwise loss making business not supported by any reasonable change in environment.
- Consistent losses in otherwise thriving industry.
- Situation of incomplete information like missing records.
- Absence of rotation of duties or prolonged exposure in the same area.
- Close nexus with vendors, clients or external parties whereby preference is given to one party over the other though the terms of trade may be unfavorable.
- Domination of management by a single person.

Favorable situations that could also be indicative of fraud:

- One way errors – Where the store keeper always show excessive inventory and has never reported shortages.
- Inefficient accountant suddenly turns very responsible and undertakes extraordinary work such as a reconciliation of long-outstanding/overdue receivable or payable balances, which bears fruits.
- An accountant/employee pays up from his own pocket to make up for the lapse.
- Employee does not take advances/cash float when he goes on outstation tours for company purposes.
- Extreme behavior of being very obedient or friendly or compliant.
- No significant over-dues/delinquencies not commensurate with industry norms.

Common situations in computerised environments where frauds are likely to take place:

- Migration from manual system to computerised system or migration from one application to a new one where

Guidance Note on Reporting on Fraud

migration is enforced on staff, the timeline for migration appears inadequate or parallel alternate records in the erstwhile system are not maintained.

- Implementing computerised system without staff orientation.
- Teething problems in implementation or customisation of computerised systems could be used as camouflaging or cloaking devices for frauds or hiding one's own inefficiencies.
- Frauds using excel spread sheets – cells with values hidden but included in totals; values directly input in cells which normally have formulas or values added in cells which have formulas, etc.

Discrepancies/unusual transactions in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorised balances or transactions.
- Inter-company funding arrangements not in a transparent manner.
- Funding from unknown parties or at valuations that do not appear arm's length.
- Ownership changes in a dormant company or significant business activity in an otherwise dormant company.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorised duties.
- Tips or complaints to the auditor about alleged fraud.

Appendices

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.

Common fraud schemes in revenue recognition:

- Recording of fictitious revenues.
- Recognition of revenue when products or services are not delivered, delivery is incomplete, or delivered without customer acceptance.
- Recognition of revenue from sales transactions billed, but not shipped ("bill and hold").
- Recognition of revenue from excessive shipments to resellers beyond actual demand ("channel stuffing").
- Recognition of revenue from sales where collectability is not reasonably assured.
- Recognition of revenue from sales improperly financed by the selling entity.

Guidance Note on Reporting on Fraud

- Recognition of revenue for goods on consignment.
- Recognition of revenue when disputes or claims exist.
- Recognition by a lessor of revenue from an operating lease as a sale.
- Failure to establish appropriate provisions for sales discounts and other allowances.
- Failure to establish appropriate provisions for rights to refunds or exchange, cancellation or refusal rights, or liberal unconditional rights of return granted through undisclosed verbal or written agreement (“side agreements”).
- Recognizing inappropriate amount of revenue from swaps or barter arrangements.
- Improper recognition of revenue from long-term contracts (including those accounted for using percentage of completion).
- Recognition of revenue in the wrong period either by holding the books open after period-end or by closing the books prior to period-end.
- Recognition of revenue where there are contingencies associated with the transactions that have not yet been resolved.
- Recognition of revenue associated with undelivered elements of multiple-elements contracts (“bundled contracts”).

APPENDIX 4

(Refer paragraph 79)

Illustrative Possible Audit Procedures to Address the Assessed Risks of Material Misstatement due to Fraud

(Refer Appendix 2 of SA 240)

The following are examples of possible audit procedures to address the assessed risks of material misstatement due to fraud resulting from both fraudulent financial reporting and misappropriation of assets. Although these procedures cover a broad range of situations, they are only examples and, accordingly they may not be the most appropriate nor necessary in each circumstance. Also the order of the procedures provided is not intended to reflect their relative importance.

Consideration at the Assertion Level

Specific responses to the auditor's assessment of the risks of material misstatement due to fraud will vary depending upon the types or combinations of fraud risk factors or conditions identified, and the classes of transactions, account balances, disclosures and assertions they may affect. The following are specific examples of responses:

- Visiting locations or performing certain tests on a surprise or unannounced basis. For example, observing inventory at locations where auditor attendance has not been previously announced or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.

Guidance Note on Reporting on Fraud

- Altering the audit approach in the current year. For example, contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the assessed risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the assessed risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.

Appendices

- Performing audit procedures to analyse selected opening balance sheet accounts of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example, an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example,

Guidance Note on Reporting on Fraud

acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.

- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labelled, and the quality (that is, purity, grade, or concentration) of liquid

Appendices

substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.

- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts - for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses - Misstatements Due to Misappropriation of Assets

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.

Guidance Note on Reporting on Fraud

- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analysing recoveries of written-off accounts.
- Analysing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analysing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Possible other audit procedures for consideration by auditors

A. Illustrative Q & A for Evaluating the Fraud Risk Assessment process of the company

Fraud Risk Assessment

1. Does the company have formal and regularly scheduled procedures to perform fraud risk assessments?
2. Are appropriate personnel involved in the fraud risk assessments?
3. Are fraud risk assessments performed at all appropriate levels of the organization (such as the entity level, significant locations or business units, significant account balance or major process level)?
4. Does the fraud risk assessment include consideration of internal and external risk factors (including pressures or incentives, rationalizations or attitudes, and opportunities)?
5. Does the fraud risk assessment include the identification and evaluation of past occurrences and allegations of fraud within the entity and industry? Does it include the evaluations of unusual financial trends or relationships identified from analytical procedures or techniques?
6. Does the fraud risk assessment consider the risk of management's override of controls?
7. Does management consider the type, likelihood, significance, and pervasiveness of identified fraud risks?
8. Are fraud risk assessments updated periodically to include considerations of changes in operations, new information systems, acquisitions, changes in job roles and responsibilities, employees in new positions, results from self-assessments of controls, monitoring activities, internal audit findings, new or evolving industry trends, and revisions to identified fraud risks within the organization?

Guidance Note on Reporting on Fraud

9. Does management assess the design and operating effectiveness of the fraud risk assessments?
10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the fraud risk assessments?
11. Is the fraud risk assessment designed and operating effectively?

Control Environment

1. Does the company maintain a proper tone at the top? Did management assess the tone of the organisation to determine if the culture encourages ethical behaviour, consultation, and open communication? (This assessment can be made through inquiries and interviews, or by internal audit review.)
2. Do the audit committee and the Board of Directors have sufficient oversight of management's anti-fraud programs and controls?
3. Does the internal audit function have sufficient involvement in anti-fraud programs and controls, including monitoring of the effectiveness of anti-fraud programs and controls, given the size and complexity of the organization? Does the internal audit function reports directly to the audit committee?
4. Does the company have a published code of ethics/conduct (with provisions related to conflicts of interest, related-party transactions, illegal acts, and fraud) made available to all personnel and does management require employees to confirm that they accept and agree to follow it? Does the frequency of exceptions undermine the code's effectiveness? Does the code comply with all applicable rules and regulations?
5. Does the company have an ethics/whistle blower hotline with adequate procedures to handle anonymous complaints (received from inside and outside the

Appendices

company), and to accept confidential submission of concerns about questionable accounting, internal accounting control, or auditing matters? Are tips and whistle blower complaints investigated and resolved in a timely manner?

6. Does the company have formal hiring and promotion policies, including background checks for those employees with influence over financial reporting or involved in the preparation of the financial statements?
7. Does the company have formal and effective training for employees and new hires on issues of fraud, ethics, and the code of ethics/conduct?
8. Does the company respond in a timely and appropriate manner to significant control deficiencies, allegations or concerns of fraud, and violations of the code of ethics/conduct?
9. Does management assess the design and operating effectiveness of the control environment?
10. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the control environment?
11. Is the control environment designed and operating effectively?

Anti-fraud Control Activities

1. Does the company adequately map or link identified fraud risks to control activities designed to mitigate the fraud risks?
2. Does management design and implement preventative and detective controls (preventative controls are designed to stop fraud from occurring and detective controls are designed to identify the fraud if it occurs)?

Guidance Note on Reporting on Fraud

3. Does the company have controls that restrain the misappropriation of company assets that could result in a material misstatement of the financial statements?
4. Does the company have controls that address the risk of management's override of controls (including controls over journal entries and adjustments, estimates, and unusual or non-routine transactions)?
5. Does the company consider security controls (including IT controls and limited access to accounting systems), and consider the adequacy of fraud detection and monitoring activities utilizing information systems?
6. Does management assess the design and operating effectiveness of anti-fraud control activities?
7. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of antifraud control activities?
8. Are anti-fraud control activities designed and operating effectively?

Information & Communication

1. Is information on ethics and management's commitment to anti-fraud programs and controls effectively communicated throughout the organisation to all employees?
2. Does management have procedures to disseminate and collect information regarding anti-fraud programs and controls, fraud risks, allegations of fraud, and concerns of improper accounting to and from all levels of the organization and external parties (where appropriate)?
3. Does management assess the design and operating effectiveness of information and communication?
4. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of information and communication?

Appendices

5. Are procedures and activities for communicating information regarding anti-fraud programs and controls designed and operating effectively?

Monitoring Activities

1. Are internal audit and others actively involved in monitoring and assessing anti-fraud programs and controls?
2. Is the internal audit activity adequate for the size and operations of the organization?
3. Are findings and weaknesses identified during monitoring activities incorporated back into the fraud risk assessment, the design of the control environment and anti-fraud control activities?
4. Does the audit committee have oversight of monitoring activities?
5. Does management assess the design and operating effectiveness of monitoring activities?
6. Does management adequately document its assessments and conclusions regarding the design and operating effectiveness of the monitoring activities?
7. Are monitoring and assessment activities designed and operating effectively?

B. Additional examples of audit procedures to address fraud risk factors

Incorporate “element of surprise” in the audit procedures and timeliness

- Existence of assets is generally confirmed through physical verification. To re-verify the existence of assets at a later date to ensure that they were not borrowed or temporarily created.
- Compliance tests of internal controls, disbursement of wages, procedures for obtaining quotations for sale and

Guidance Note on Reporting on Fraud

disposal of scrap, material weighments, etc. can be verified repeatedly. Such procedures may reveal inconsistencies, if any.

- Element of unpredictability/surprise should be incorporated in physically verifying stocks with third parties.
- Rotate the components between audit team members to overcome familiarity threat with regard to audit procedures.
- Visiting locations or performing certain tests on a surprise or unannounced basis.

Apply test of reasonableness and test of absurdity

- Existence of vendor/customer website for all huge value bills and payments. Also check the date on which the website was hosted. A recently uploaded webpage is also suspicious.
- Two or more employees arriving and departing at the same time consistently.
- Are stocks ordered irrespective of large existing balances.
- Whether value of property acquired is within the acceptable range of prevailing market value.
- Check for inconsistent facts while reading the contracts and agreements.

Search for mutually exclusive events

- Production quantity cannot be greater than machine capacity; sales cannot be quantitatively greater than opening stocks plus purchases/production.
- Production cannot be possible in periods of strike, downtime etc.
- Fuel for diesel cars cannot be supported by petrol bills or *vice versa*.

Appendices

- Stocks cannot be physically greater than the volumetric capacity of storage place.
- An employee who has left cannot approve any transactions after the date of departure or before the date of appointment.
- Yield and rejection ratio for identical machines in different locations should theoretically be the same.
- Sales returns and warranty claims for the same products across different sales locations should be more or less consistent. If they are grossly inconsistent, analyse reasons.

Possible Other Audit Procedures – Cash and Bank

| Risks | Audit Procedures |
|--|---|
| Cheque signing mandate given to more number of persons which is not commensurate with the nature, size of the business. This may increase the risk of collusion between cheque signing authorities in remote locations | Review the cheque signing mandate for both crossed and bearer cheque. Evaluate whether the authority levels set are strong and is commensurate with the nature and size of the business. |
| Possibilities of cheques being forged and payment vouchers being approved by unauthorised persons | Obtain specimen signatures of all authorised signatories and share it with the engagement team members during the planning stage. |
| Snowballing of bank charges and forex gains/losses | Check all cash contras and inter-back transfers – Ensure that cash withdrawals as per the bank statement is reflected as cash withdrawal in the bank book as well on the same date. |

Guidance Note on Reporting on Fraud

| | |
|---|--|
| Duplicates in cheque numbers could indicate double accounting of expense or payment. | The "IF" function in Excel along with its derivative usage with "And/or" can be useful for detecting gaps, finding duplicates and locating multiple records. |
| Gaps in cheque numbers may indicate that some cheques have been deliberately kept aside for some other motives which certainly is a concern | The "IF" function in Excel along with its derivative usage with "And/or" can be useful for detecting gaps, finding duplicates and locating multiple records. |
| Cash withdrawals or other transactions as per bank statement accounted differently in the bank book | Obtain a list of bank accounts held and ascertain the purpose for which each bank account is used. On a sample basis, select one month each for each of the bank accounts, obtain bank statements directly from the bank and re-perform bank reconciliation statements. |

Possible Other Audit Procedures – Test of Details

| Tests | Purpose | Procedures |
|---|--|---|
| Physical voucher consistency test in a series | <ul style="list-style-type: none"> Helps identify replacement or insertion of a new voucher. Can be applied for cash and bank payments, supplier invoices from the | a) Is the paper relatively new or has it yellowed less in comparison with other vouchers around the |

Appendices

| | | |
|---|--|---|
| | same supplier, purchase vouchers, journal vouchers etc. | same date. b) Are the routine ticks missing. c) Is the paid stamp missing. |
| Specimen signatures comparison test | Helps to identify simple forgeries or fictitious transactions. | To obtain specimen signatures of all signatories and keep them for comparison during vouching. |
| Chronological test of supporting vouchers | Helps in identifying fraudulent/fictitious bills when huge bunches of supporting vouchers are attached to a single voucher. | Check if the supporting vouchers are dated subsequent to the payment voucher date or the date relates to earlier periods? |
| Chronological test of approvals | Helps to identify if any vouchers were approved by the resigned/newly joined employee after the resignation date or before the joining date. | If any of the authorised signatories had resigned or newly joined during the year, along with the specimen signatures also obtain their date of resignation or joining. |

Guidance Note on Reporting on Fraud

Possible Other Audit Procedures – Management Override of Controls

- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and verifying any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, verifying the possibility of related parties and the sources of financial resources supporting the transactions.
- Use of statistical tool for sample selection.
- Reviewing large and unusual expenses.
- Reviewing the authorisation and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

Possible Other Audit Procedures – Revenue Recognition

- Comparing revenue reported by month/product line/remote locations during the current reporting period with comparable prior periods.
- Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel to corroborate information relating to sales returns, discounts, shipments near the end of the period etc.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment
- Risk of understating/not accounting scrap sales.

Possible Other Audit Procedures – Inventory

Appendices

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Analysing inventory shortages by location or product type.
- Performing additional procedures during the observation of the count, for example:
 - more rigorously examining the contents of boxed items,
 - the manner in which the goods are stacked (for example, hollow squares) or labeled,
 - the quality (that is, purity, grade, or concentration) of liquid substances such as oil or specialty chemicals.
 - take the help of technical experts to weigh/measure inventory.

Possible Other Audit Procedures – Vendor and Customer

- Check for duplicate vendor IDs, contact number, bank account number.
- Obtaining back dated cheques from customers and credit to customer based on instrument date and not the deposit date to reduce the outstanding debtors and also to reduce the penal interest.
- Unidentified credit balances have possibility of being misused by way of wrong credits to suppliers, customers, accomplices and could also facilitate teeming and lading of collections.
- Analysing recoveries of written-off accounts.
- Receivables growing faster than revenues.

Guidance Note on Reporting on Fraud

Possible Other Audit Procedures – Employees

- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.

Appendices

Appendix 5

(Refer paragraph 87)

**Illustrative Format for Reporting to Board or the
Audit Committee on Fraud**

(As required by Rule 13 of the Companies (Audit and Auditors)
Rules, 2014

Date:

Subject: Report under Sub-section (12) of Section 143 of the Companies Act, 2013 on suspected offence involving fraud being committed or having been committed against the company by its officers or employees.

| S.No | Particulars | Details |
|-------------|--|----------------|
| 1(a) | Name of the Company ⁸ | |
| 1(b) | CIN | |
| 1(c) | Address of the Registered Office | |
| 2(a) | Name of the auditor or auditor's Firm ⁹ | |
| 2(b) | Membership number | |
| 2(c) | Address | |
| 3 | Date of the annual general meeting when the auditor was appointed or reappointed | |
| 4 | SRN and date of filing | |
| 5 | Address of the office or location where the suspected offence is believed to | |

⁸ Where the suspected offence relates to any component (subsidiary, associate, joint venture) forming part of the consolidated financial statements, to include and specify accordingly.

⁹ Where the period of offence dates back to an earlier time period, where the current auditor was different, to indicate the name of the predecessor auditor.

Guidance Note on Reporting on Fraud

| S.No | Particulars | Details |
|------|---|---------|
| | have been or is being committed | |
| 6 | Full details of the suspected offence involving fraud (attach documents in support) ¹⁰ (Refer Note 1) | |
| 7 | Particulars of the officers or employees who are suspected to be involved in the commission of the offence, if any: | |
| 7(a) | Name (s) | |
| 7(b) | Designation | |
| 7(c) | If Director, his DIN | |
| 7(d) | PAN | |
| 8 | Basis on which fraud is suspected ¹¹ | |
| 9 | Period during which the suspected fraud has occurred | |
| 10 | Date of sending report to the Board or Audit Committee as per rule 13(1) | |
| 11 | Estimated amount involved in the suspected fraud (Refer Note 2) | |
| 12 | Any other relevant information | |

Notes:

1. The details of suspected offence involving fraud are those that have arisen during the course of performance of duties by the auditor and hence the auditors do not offer

¹⁰ Supports would relate to the convincing evidence that supported the suspicion of the auditor.

¹¹ With respect to the suspected fraud, briefly state procedures performed, the audit evidence obtained and the conclusions on evaluation of the audit evidence.

Appendices

any assurance on completeness of the said matter or any other matter that may not be knowledgeable to the auditor.

2. The estimated amount indicated in Point No. 11 in the table above is based on the available information and evidence relating to the suspected fraud that supports the suspicion of the auditor. It is expected that based on this reporting by the auditors, Those Charged with Governance would initiate an investigation/forensic audit and provide complete details to the auditor to enable him to report to the Central Government and also to assess the impact of the same on the financial statements.

APPENDIX 6

(Refer paragraphs 3 and 103)

| | |
|--|---|
| Form No. ADT-4 | |
| REPORT TO THE CENTRAL GOVERNMENT | |
| (See rule 13(4) of the Companies (Audit and Auditors) Rules, 2014) | |
| Date: | |
| Subject: Report under sub- section (12) of section 143 of the Companies Act, 2013 on suspected offence involving fraud being committed or having been committed | |
| 1) | (a) Name of the Company (b) CIN: (c) Address of the Registered Office: |
| 2) | (a) Name of the auditor or auditor's Firm (b) Membership Number (c) Address |
| 3) | Date of the annual general meeting when the Auditor was appointed or reappointed |
| 4) | SRN and date of filing |
| 5) | Address of the office or location where the suspected offence is believed to have been or is being committed |
| 6) | Full details of the suspected offence involving fraud (attach documents in support) |
| 7) | Particulars of the officers or employees who are suspected to be involved in the commission of the offence, if any: a) Name(s) : b) Designation |

Appendices

| |
|--|
| <p>c) If Director, his DIN</p> <p>d) PAN</p> <p>8) Basis on which fraud is suspected:</p> <p>9) Period during which the suspected fraud has occurred</p> <p>10) Date of sending report to the Board or Audit committee as per rule 13(1)</p> <p>11) Date of reply received from Board or Audit committee, if any and if so received, attach copy thereof and give gist of the reply</p> <p>12) Whether the auditor is satisfied with the reply of the Board or Audit committee. Yes _____ No _____.</p> <p>13) Estimated amount involved in the suspected fraud;</p> <p>14) Details of steps, if any, taken by the company in this regard; (Furnish full details with references)</p> <p>15) Any other relevant information.</p> |
| <p style="text-align: center;">VERIFICATION</p> <p>I,, Proprietor/Partner of, Chartered Accountants do hereby declare that the information furnished above is true, correct and complete in all respects including the attachments to this form.</p> <p style="text-align: right;">(Name, Signature and Seal of the Auditor)</p> |
| <p>Attachments:</p> <p>1. Optional attachments</p> |

APPENDIX 7

(Refer paragraph 105)

Illustrative Management Representation Letter

**(for the reply of the Board or the Audit Committee on
fraud reported by the auditor under Rule 13(1) of
Companies (Audit and Auditors) Rules, 2014)**

[Letterhead of the Entity]

Messrs. *Name of the Audit Firm*

Chartered Accountants

Dear Sirs,

This representation letter is provided in connection with our reply dated ___ to you pursuant to your letter dated ____ on fraud suspected by you and reported to us under Rule 13(1) of the Companies (Audit and Auditors) Rules, 2014.

We understand that the fraud reported by you is as follows:

(Details of fraud reported by the Auditors)

We acknowledge that because of the inherent limitations of an audit, together with the inherent limitations of internal controls, there is an unavoidable risk that material misstatements due to fraud or error may occur and not be detected, even though the audit is properly planned and performed by the auditor in accordance with the Standards on Auditing and that the matter reported by you in your letter dated ____ is not exhaustive or complete list of frauds against the Company that may exist.

We acknowledge our responsibility for the prevention and detection of fraud. Our responsibility also includes informing you about any fraud detected and remedied by the management, any incidence of fraud reported through the vigil mechanism or through any other internal or external sources. We acknowledge that we are also responsible to take appropriate action when a fraud is detected or reported through any of the sources.

Appendices

In particular we confirm that we are responsible for the following:

- a) Designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of the financial statements which are free from material misstatements, whether due to fraud or error.
- b) To set up a vigil mechanism for reporting suspected fraud and administer the mechanism effectively.
- c) Take appropriate action to detect the fraud and wrongful gain or loss, if any, incurred on account of the fraud.
- d) Take appropriate action against the fraudsters.
- e) Address the control weaknesses which were the root cause for fraud and strengthen the internal control system.

We confirm the following representations in respect of fraud noted and reported during the year/period, other than for the matters reported by you:

- 1. There have been no communications from regulatory agencies concerning non-compliance with or deficiencies in financial reporting practices [except for (*insert appropriate description*)].
- 2. We have disclosed to you all changes/deficiencies in the design or operation of internal controls over financial reporting identified as part of our assessment, including separately disclosing to you all such deficiencies that we believe to be significant deficiencies or material weaknesses in internal controls over financial reporting.
- 3. We acknowledge our responsibilities for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error. We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

Guidance Note on Reporting on Fraud

4. We are not aware of any/We have disclosed to you all significant facts relating to any frauds or suspected frauds known that may have involved (i) Management; (ii) Employees who have significant roles in accounting and internal control; or (iii) Others.
5. To the best of our knowledge and belief, the Company has not made any improper payments or payments which are illegal or against public policy.
6. The Company has complied with all aspects of contractual agreements which could have a material effect on the financial statements in the event of non-compliance. There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
7. We have no plans or intentions which may materially affect the carrying value or classification of assets and liabilities reflected in the financial statements.
8. We have made available to you all books of account, supporting documentation and minutes of all meetings of the shareholders and the Board of Directors and Committees of the Board and all other details with regard to action taken by the management to evaluate the fraud reported by you.
9. We have acted in good faith and in the best interests of the Company regarding the action taken by the management to evaluate the fraud reported by you.
10. We have not withheld from you any relevant information that we are aware of and would have an implication on the process of your responsibilities to report fraud under the statute.
11. The conclusions reached by us are based on the rationale of facts and data that were identified during the investigation/other action taken by us to evaluate the fraud reported by you.

Appendices

12. We believe that appropriate action has been taken against employees/officers involved in the fraud and we confirm that appropriate controls have been put in place to ensure that such incidences are avoided in the future.

With effect from 1st April 2014, the provisions of the Companies Act, 2013 ('the Act') have become applicable to the Company. We understand that Section 143(12) of the said Act read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014 requires the auditors to report on fraud to the Board or the Audit Committee prior to reporting the same to the Central Government. We are aware that the Board or the Audit Committee is required to consider the report of the auditor and respond on the matter reported within 45 days of the date of the report of the auditor.

Insofar as the matter reported by you in your letter dated ___ and our reply thereto dated ____, we confirm the following:

1. We have carried out an investigation into the matter reported by you towards which ____, an independent agency/the Company's internal auditor/Senior Management of the Company were engaged to investigate the matter.
2. Status of the investigation commissioned by the Board or the Audit Committee.

1. Investigation complete and Board or the Audit Committee concurs with the auditor on the suspected fraud

1. We concur with your assessment of suspected fraud based on the following: (State details and the reasons for occurrence).
2. The persons allegedly involved in the matter are: (list names and designations, DIN (if a Director is involved) and PAN of the person).
3. Based on the investigation carried out, we confirm that the period to which the fraud relates is _____.

Guidance Note on Reporting on Fraud

4. The estimate of amounts involved in the fraud as determined by the investigation is Rs. _____.
5. We have initiated the following steps with immediate effect to mitigate the recurrence of such fraud. (State steps taken to mitigate such risk in future).
6. We have initiated the following actions on the persons involved in the fraud (List action taken on the concerned persons.) [or] Pending closure of the internal hearings of the Committee of Ethics of the Company, no action has been taken on the persons involved.

II. Investigation complete and Board or the Audit Committee does not concur with the auditor on the suspected fraud

1. State reasons for not concurring with the auditor's assessment of suspected fraud with persuasive evidence supporting the Board or the Audit Committee conclusion.
2. We believe that the investigation commissioned by us was independent, comprehensive, objective, unbiased and did not involve any scope limitations. Specifically, the investigation focused on the following areas that are impacted by the suspected fraud reported by you: (list areas)
3. We confirm that no fraud has been or is being committed against the Company by its officers or employees as reported by you.

III. Investigation is in progress

1. As on date of this letter, the investigation commissioned by the Board or the Audit Committee is in progress.

Appendices

2. Management to state items in I.3 to I.8 to the extent applicable.

We acknowledge that your report on suspected fraud under Section 143(12) of the Act is made in good faith to comply with the requirements of the law and, therefore, cannot be considered as breach of maintenance of client confidentiality requirements or be subject to any suit, prosecution or other legal proceeding since it is done in pursuance of the Act or of any rules or orders made thereunder.

Yours faithfully,

Chairman of the Audit Committee/Board