

# Fraud auditing and reporting

15 April 2018



# Fraud auditing

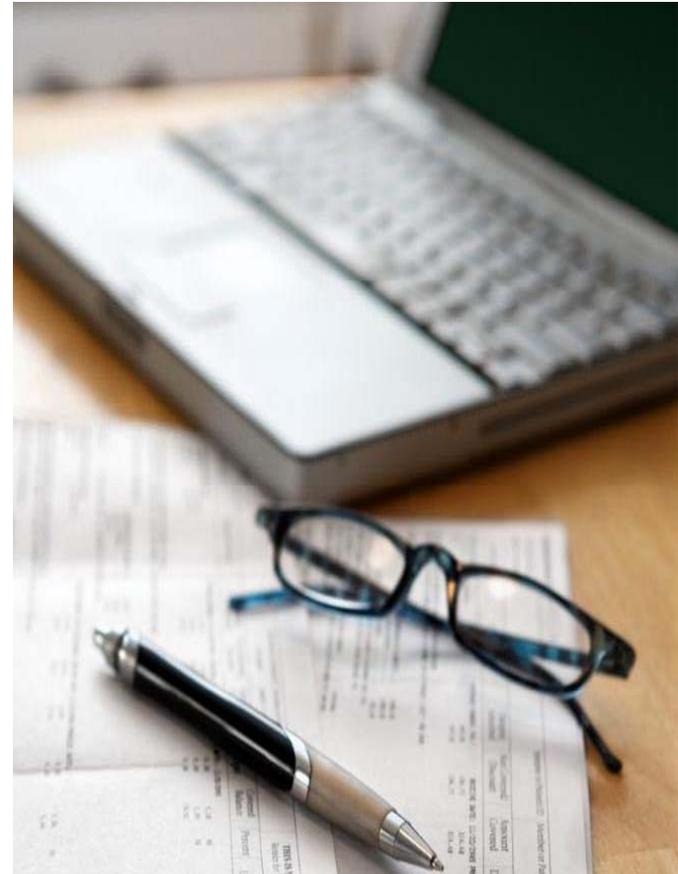


# What do we understand by 'Fraud' ?

## What is Fraud ?

ISA 240 defines fraud as :

- An intentional act
- By one or more individuals among management, those charged with governance, employees or third parties
- Involving the use of deception
- To obtain an unjust or illegal advantage.



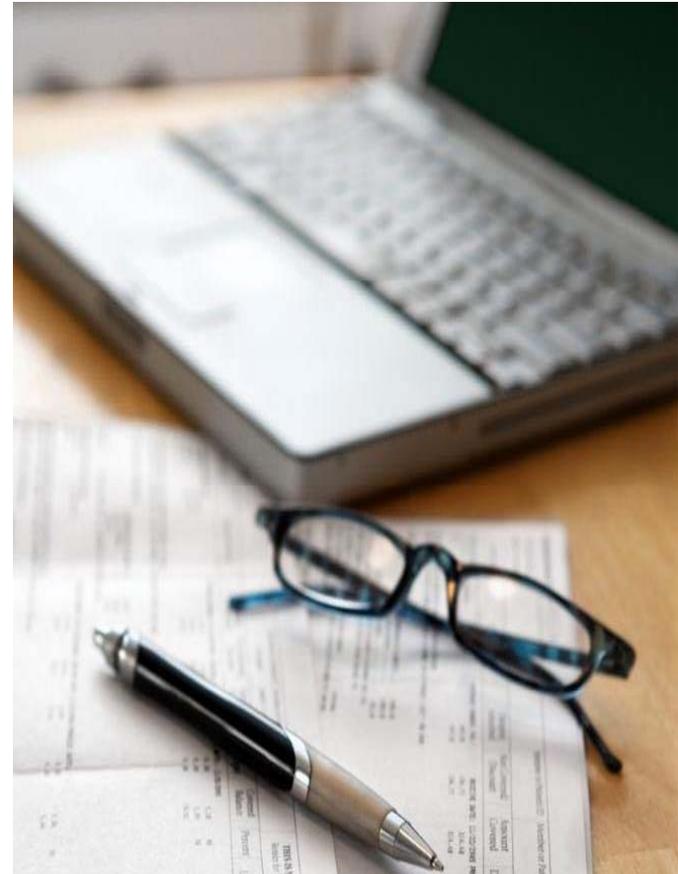
# Why is understanding fraud important ?

## Why is consideration of Fraud important?

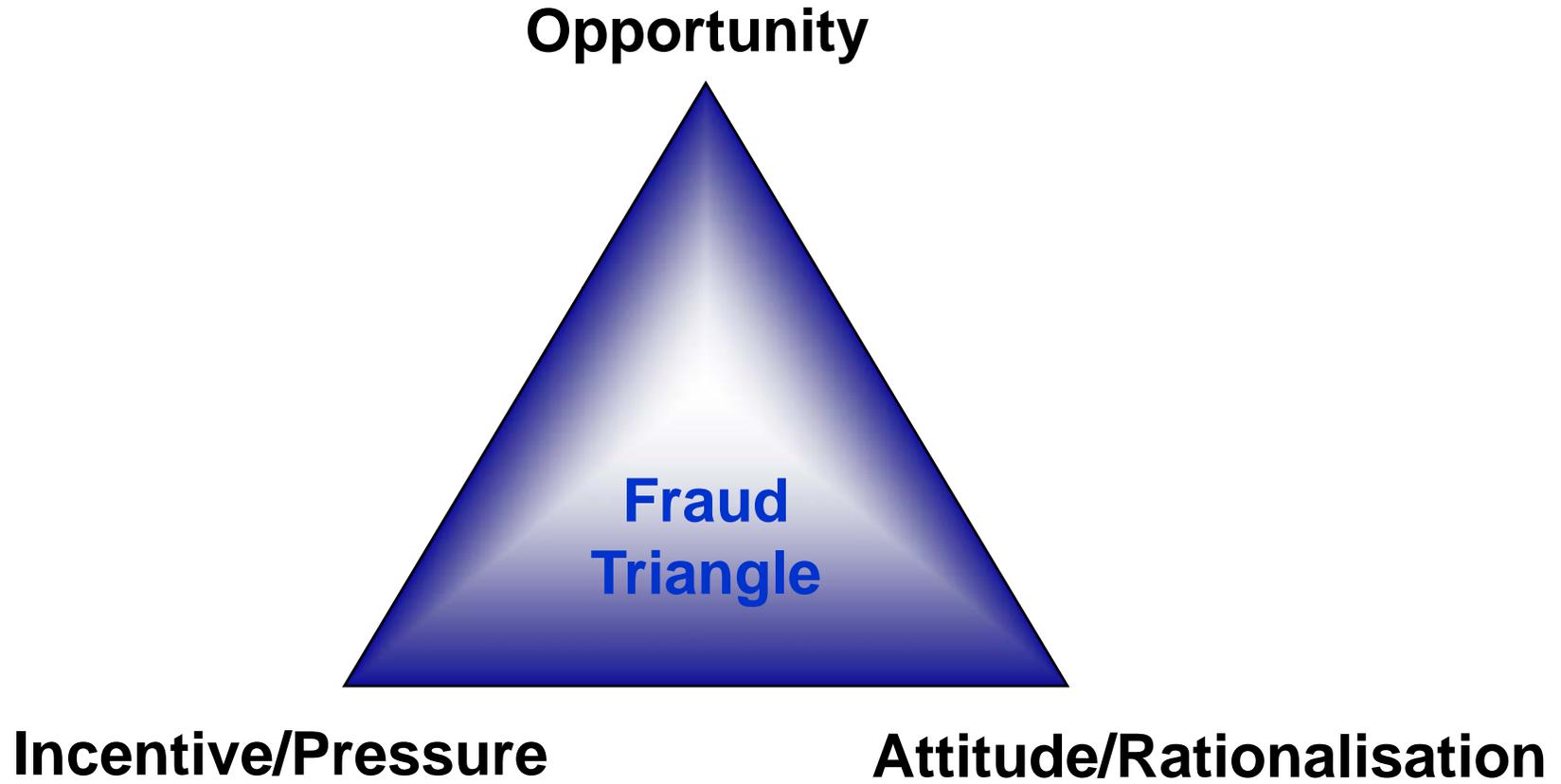
- A fraud may result in material misstatement of financial statements.
- We could give the wrong audit opinion if we failed to detect a material misstatement in the financial statements

Therefore, we have to recognise that undetected material misstatements due to fraud pose a significant threat to the validity of an audit opinion.

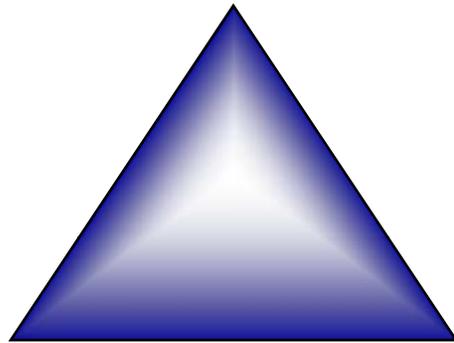
And hence this is a major source of ***audit risk***



# Fraud triangle



# Fraud triangle

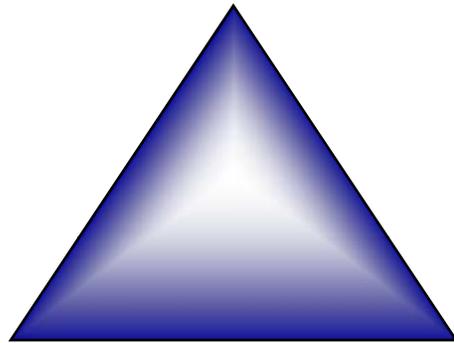


**Incentive/Pressure**

## Incentive / pressure

- Pressure to achieve an expected (and perhaps unrealistic) earnings target or financial outcome
- Consequences to management for failing to meet financial targets/goals can be significant
- Individuals living an extravagant lifestyle
- Critical need for funding
- New accounting or regulatory requirements

# Fraud triangle

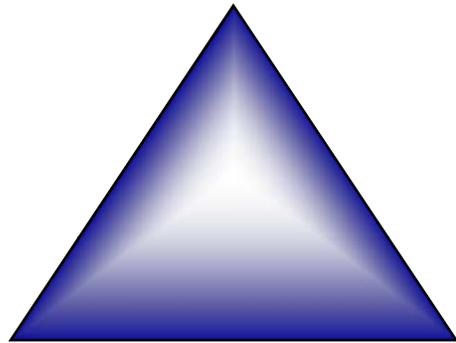


**Opportunity**

## Opportunity

- Ineffective monitoring of management
- Internal control components are deficient
- Ability to override internal controls
- Ineffective internal audit
- Overly complex banking arrangements
- Significant related party transactions

# Fraud triangle



**Attitude/rationalisation**

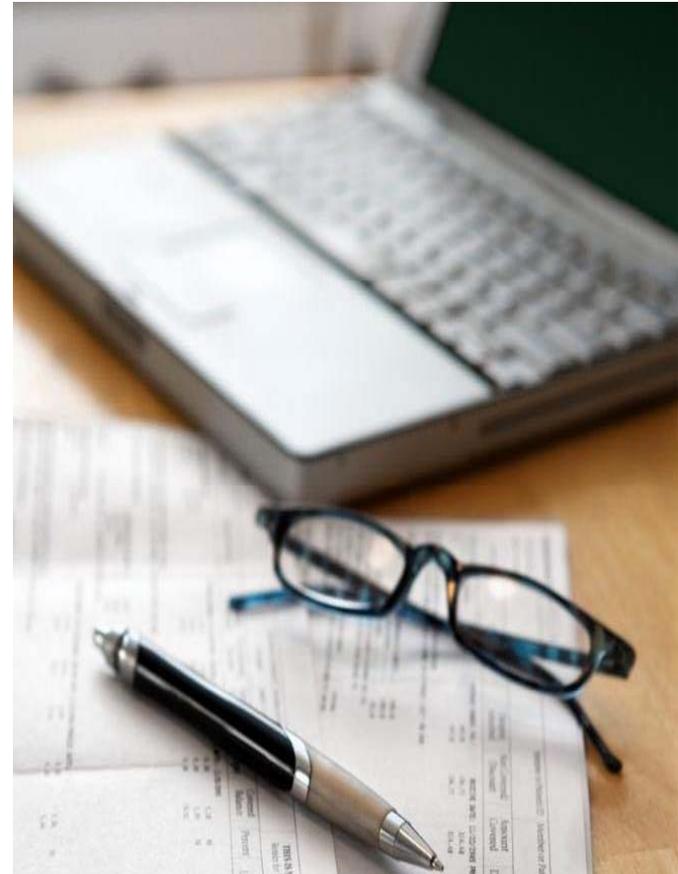
## Attitude / rationalisation

- Ethical values not embedded
- Shareholders disputes
- Minimising reported earnings for tax reasons
- Inappropriate accounting and restatements

# Two types of intention misstatement

## Misappropriation of assets

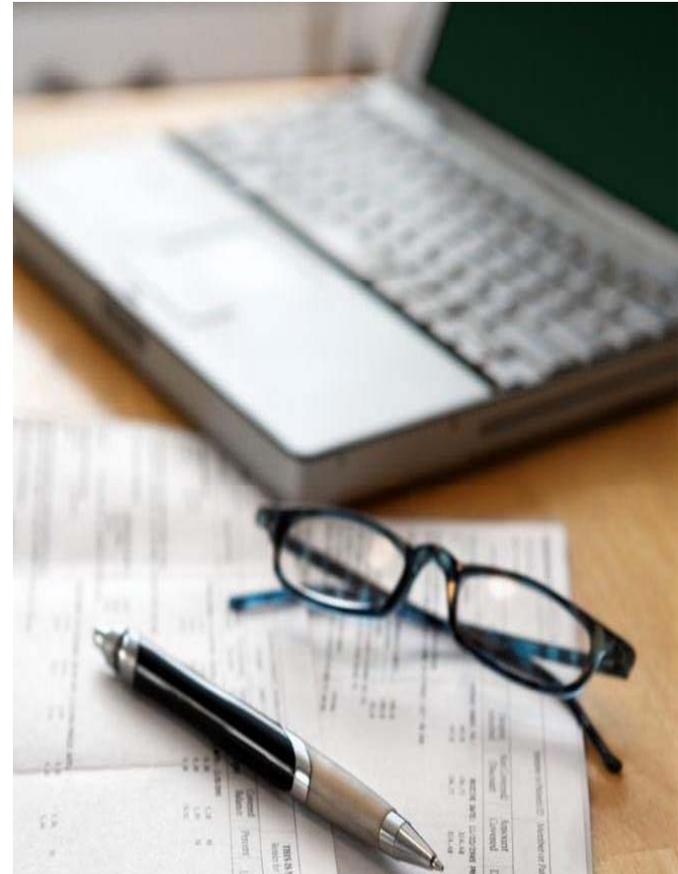
- Embezzling of receipts
- Stealing physical assets or intellectual property
- Causing entity to pay for goods/services not received
- Using assets for personal use



# Two types of intention misstatement

## Fraudulent financial reporting

- Intentional manipulation, falsification
- Intentional omission of amounts or disclosures
- Intentional misapplication of accounting principles
- Management override of controls



# Responsibilities of an auditor per ISA 240

## Auditors' responsibilities

- Reasonable assurance that financial statements are free from material misstatement, ***whether caused by fraud or error***
- To maintain professional skepticism
- To consider potential for management override of controls
- For fraud risk, perform procedures that are responsive to that fraud risk



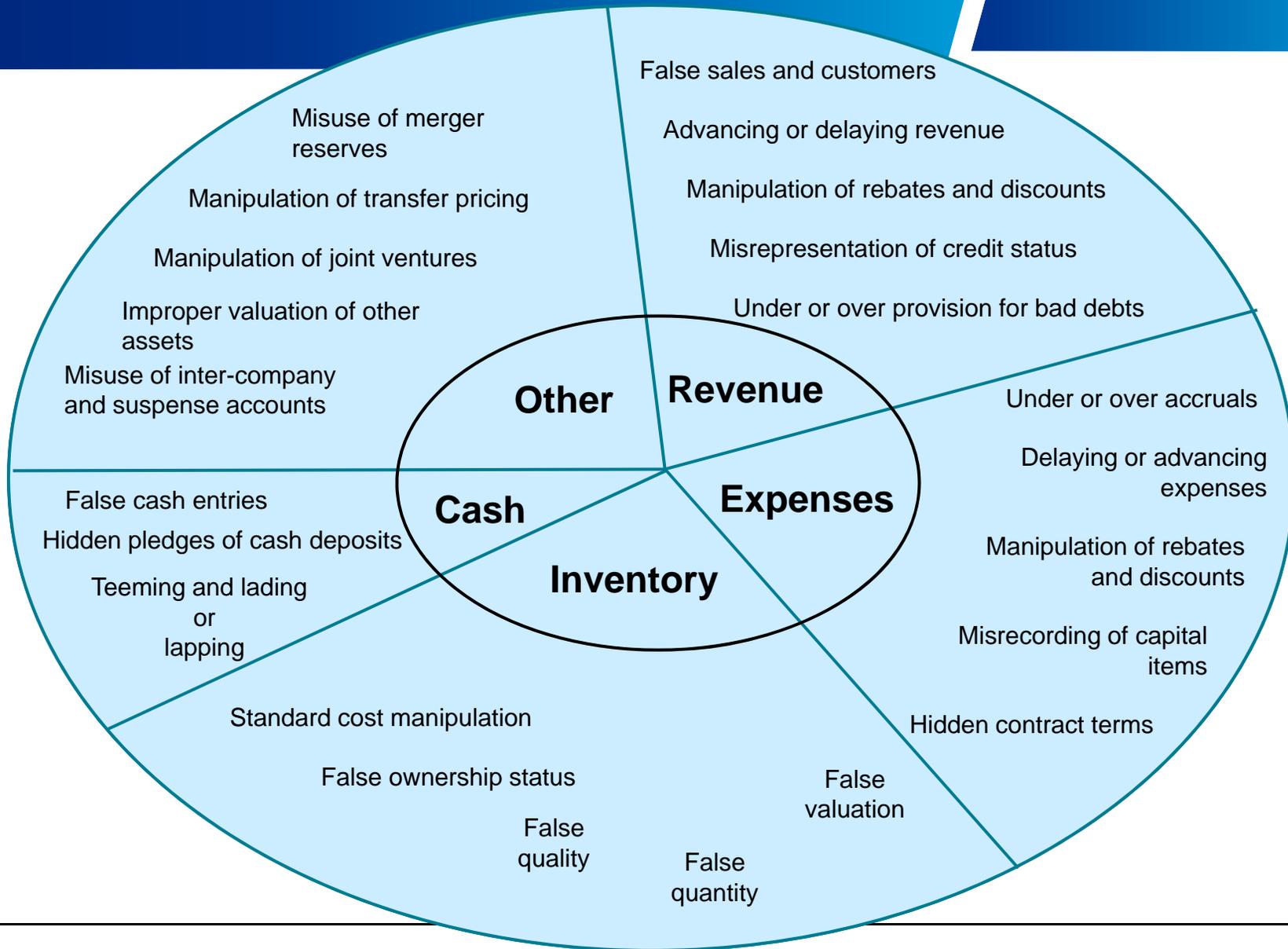
# Auditors' response to fraud risk

## Pervasive financial statement fraud risks

- Excessive pressure to meet third party expectations / financial targets
- Nature of industry / entity's operations
- Complex / unstable organisation
- Ineffective monitoring by management
- Threats to personal financial position of management



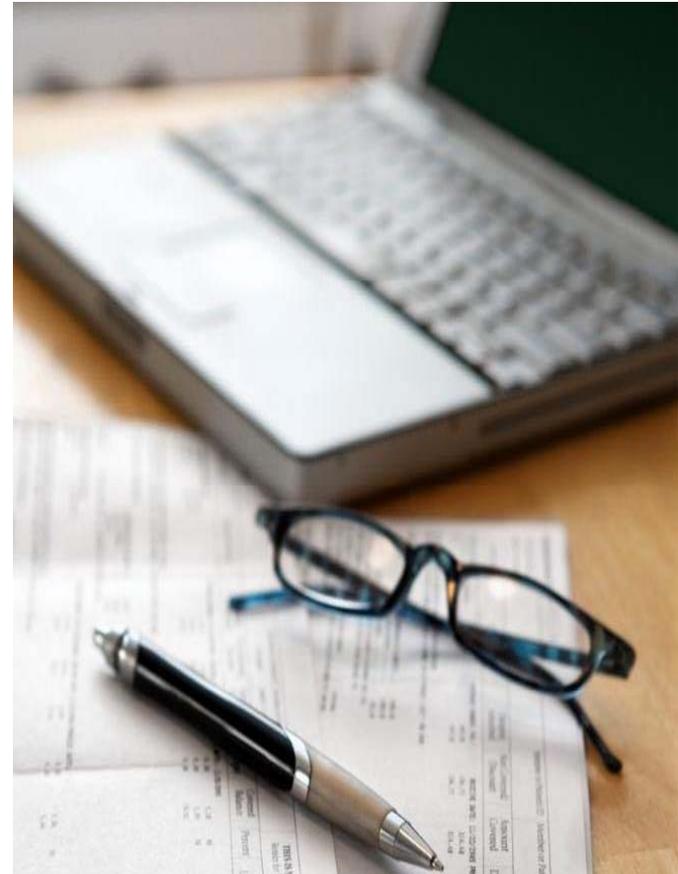
# Specific financial statement fraud risk



# Auditors' response to fraud risk

## Types of audit responses

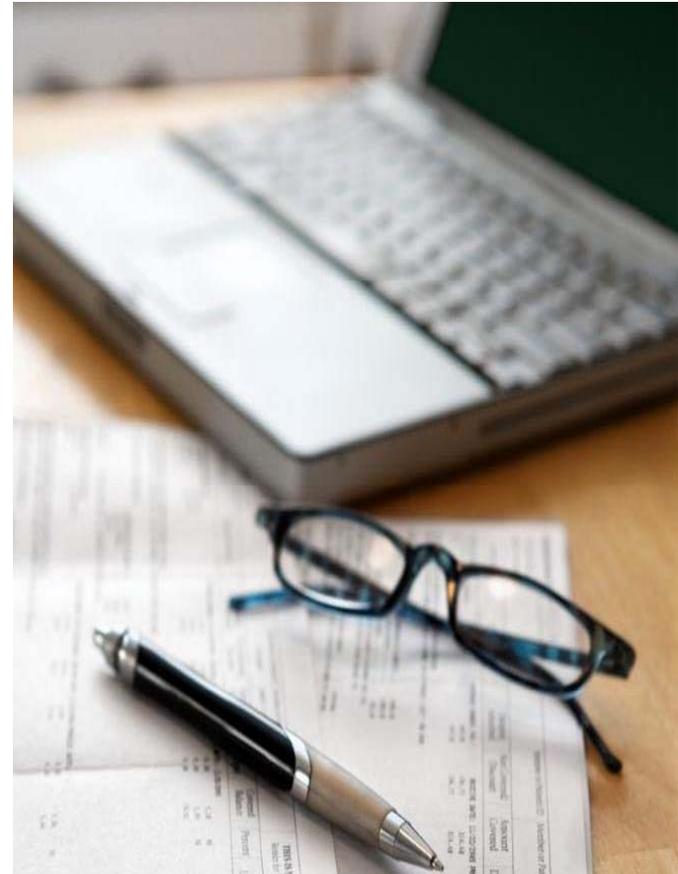
- Overall response on how audit is conducted
- Response to identified risks at assertion level (nature, timing and extent of procedures)
- Response to performance of certain procedures to address the risks arising from management override of controls



# Auditors' response to fraud risk

## Overall response

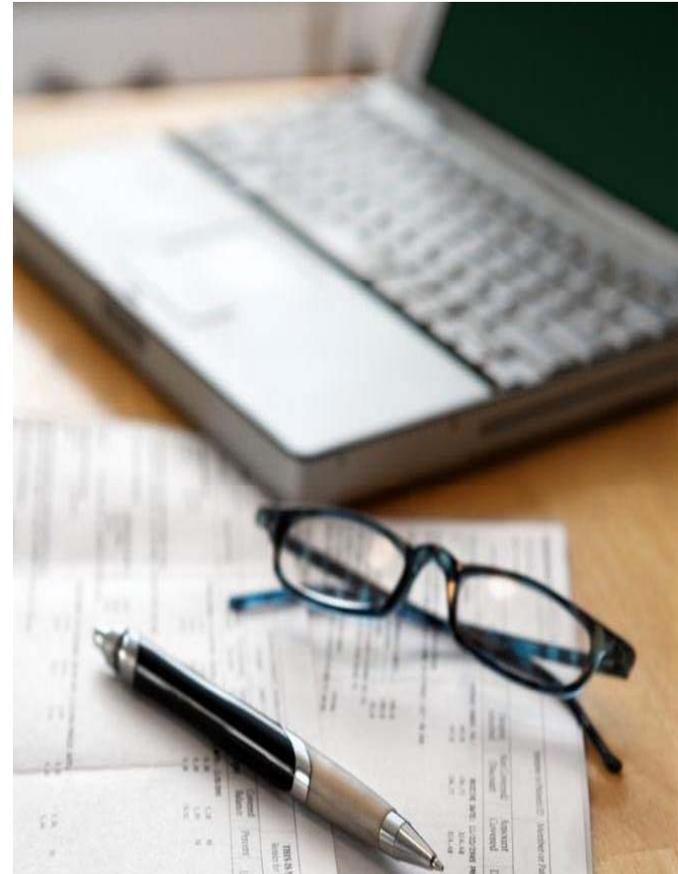
- Reliability and sufficiency of procedures
- Assignment and supervision of personnel
- Consider inappropriate selection or application of accounting policies (subjective measurements and complex transactions)
- Incorporate an element of unpredictability in the nature, timing and extent of procedures



# Auditors' response to fraud risk

## Financial statement fraud risk

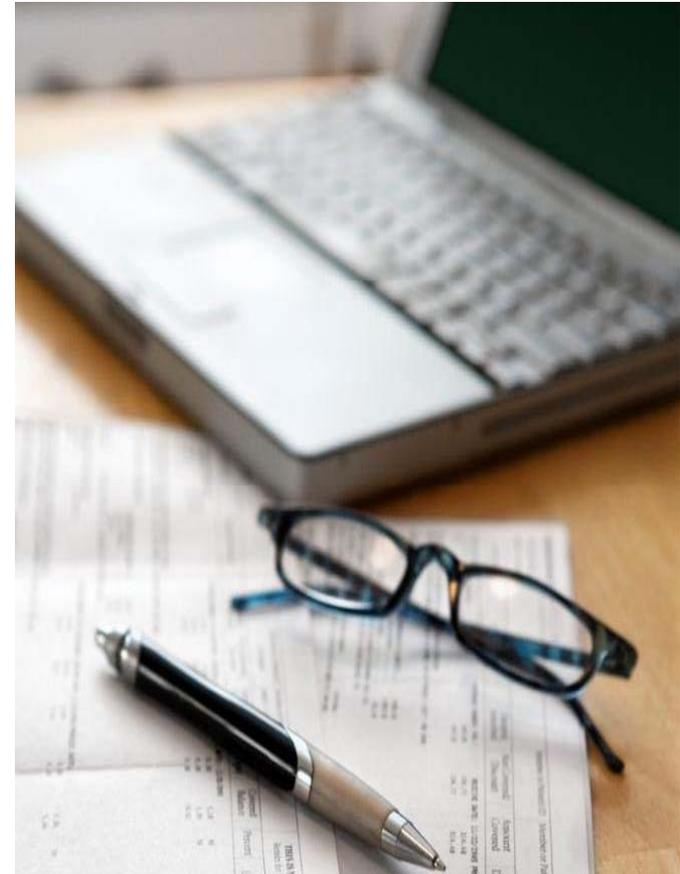
- Understand and document the relevant process activities and controls (including IT controls)
- Evaluate the design of such controls
- Test the operating effectiveness of such controls designed to mitigate the fraud risk
- Perform substantive procedures



# Auditors' response to fraud risk

## Management override of controls

- Assess completeness of journal entries
- Test the design and operating effectiveness of controls over journal entries
- Perform substantive testing of journal entries
- Review significant estimates for bias
- Perform retrospective review of prior year estimates



**Report identified frauds to Those Charged With Governance (‘TCWG’)**

**Reporting on Fraud  
by the Auditors u/s  
143(12) of the  
Companies Act, 2013**



# Agenda

1

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

2

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

3

Reporting on frauds in various scenarios

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

## Background

Section 143 of the Companies Act, 2013 (2013 Act) has been effective from 1 April 2014.

The Central Government seeks the support of auditors in bringing:

- transparency and
- discipline

in the corporate world to protect the interests of the shareholders and public at large.



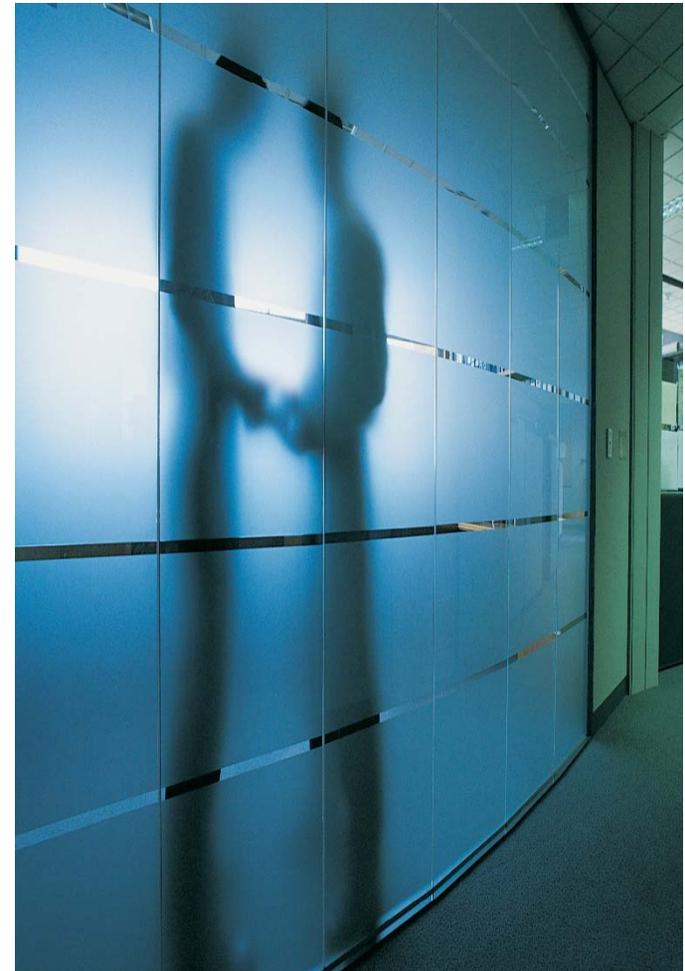
# Defining Fraud

## Fraud

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

- Any act, omission, concealment of any fact or abuse of position ,
- Committed by any person or any other person with the connivance in any manner,
- With intent to deceive, to gain undue advantage from or to injure the interests of,
- The company or its shareholders or its creditors or any other person,
- whether or not there is any wrongful gain or wrongful loss.

As per SA 240 : An intentional act by one or more individuals among management , those charged with governance, employees , or third parties , involving the use of deception to obtain an unjust or illegal advantage.



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

## Section 143(12) requires that:

If an auditor of a company

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



# When does an auditor commence reporting under section 143(12) of the Companies Act, 2013

Based on Suspicion?

Reasons to believe?

**Reasons to believe and knowledge**

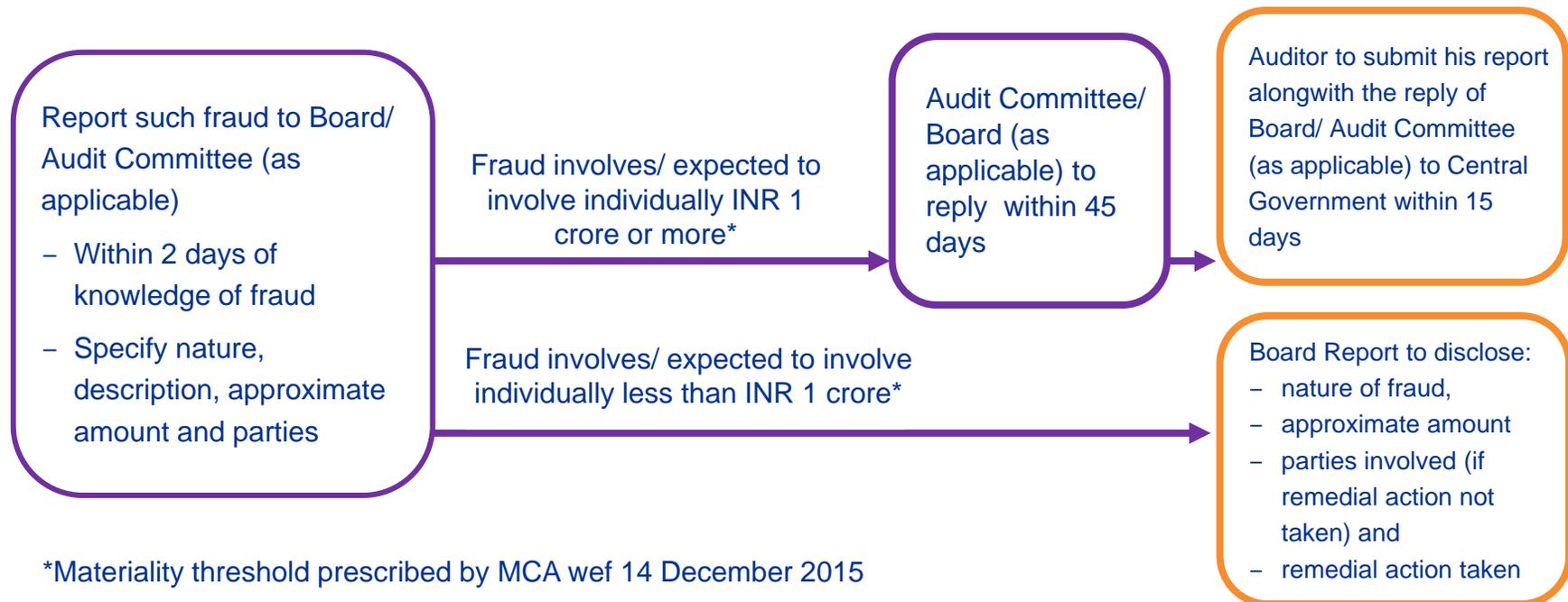
Knowledge?

Determination of offence?

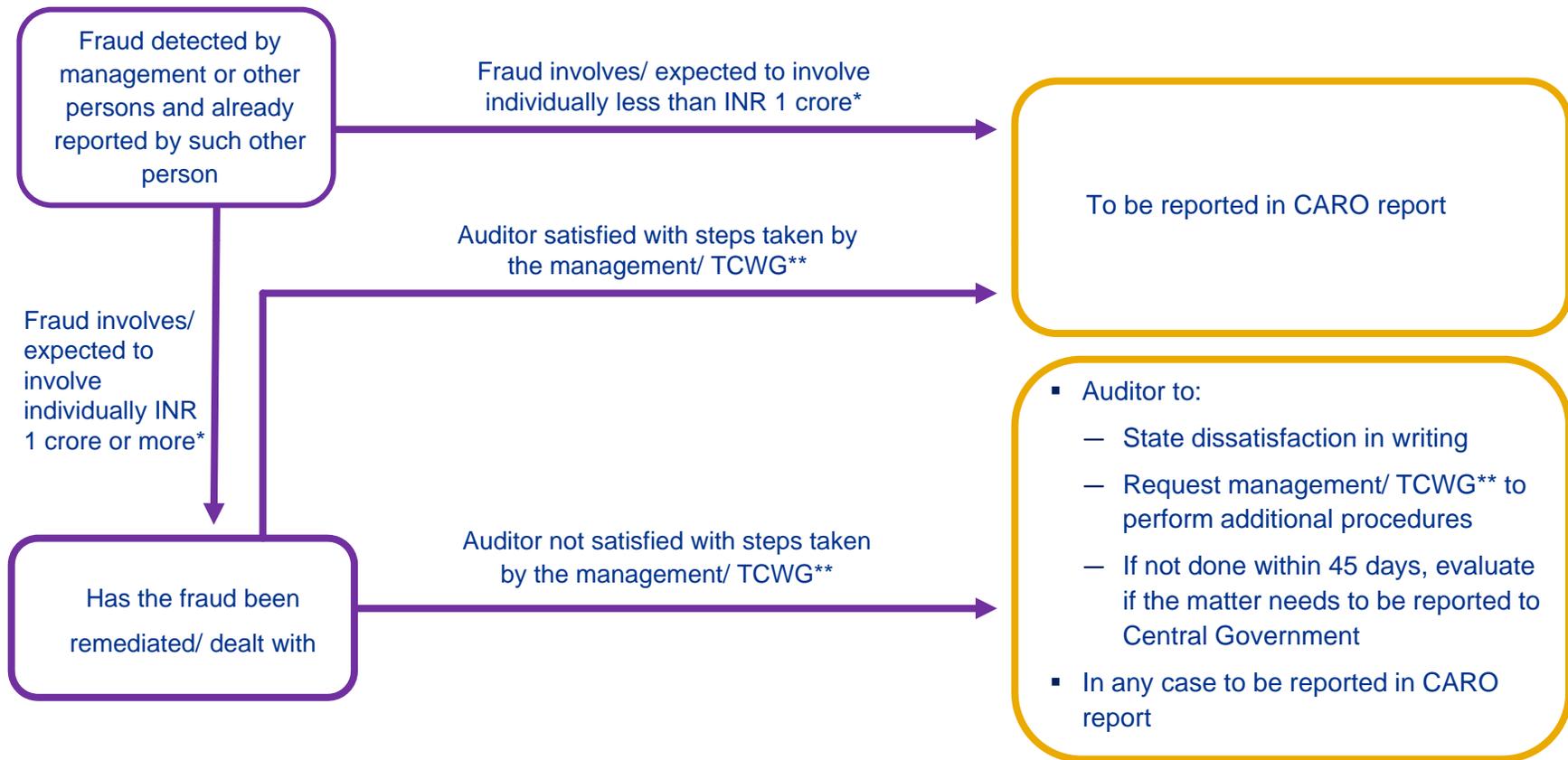
# Reporting of fraud (by officers or employees) identified by Auditor – ICAI Guidance

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

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



# Reporting of fraud not identified by auditor – ICAI Guidance



\*Materiality threshold prescribed by MCA wef 14 December 2015

\*\*TCWG: Those charged with governance

# Responsibility of the management for prevention and detection of fraud

**As per section 134(5) (c) of the 2013 Act, directors responsibilities include safeguarding of the assets of the Company and preventing and detecting fraud and other irregularities.**

- Primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management
- Board's report to include a responsibility statement, *inter alia*, that the directors had taken proper and sufficient care for safeguarding the assets of the company and preventing and detecting fraud and other irregularities.



# Auditor responsibility for consideration of fraud in an audit of financial statements

## Scope of the guidance note is as follows:

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



# Agenda

1

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

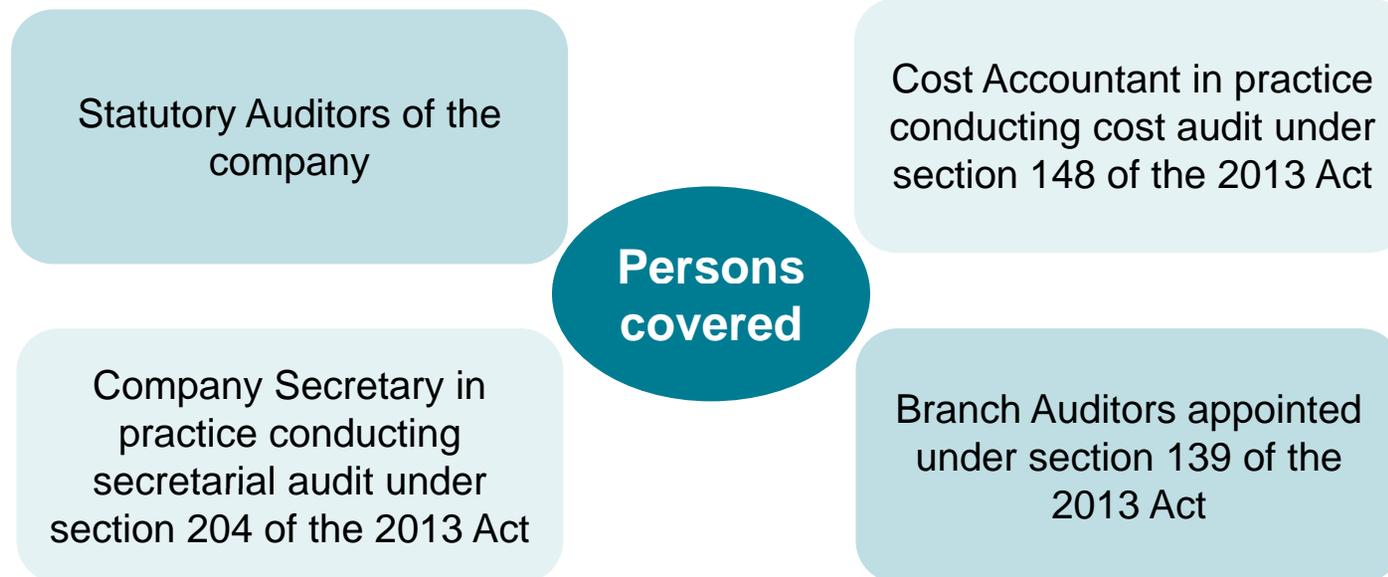
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**Persons covered for reporting under section 143(12) of the Companies Act, 2013**

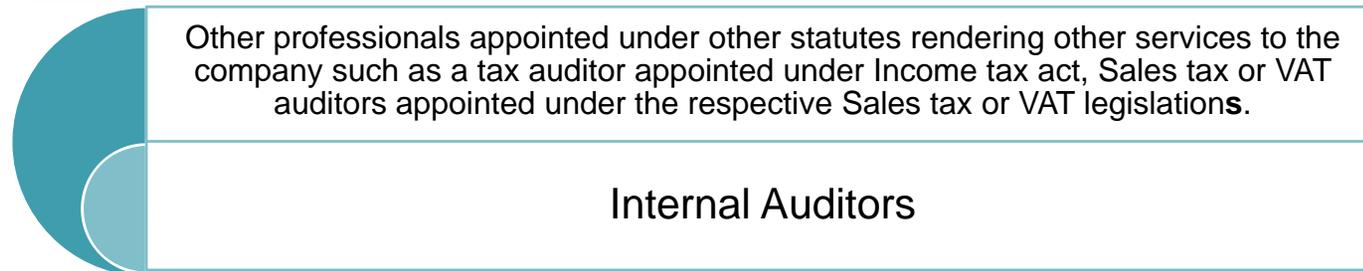
3

Reporting on frauds in various scenarios

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



## Persons not covered



# Agenda

1

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

2

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

3

**Reporting on frauds in various scenarios**

# Reporting on frauds in various scenarios

**It would be an auditor's responsibility to report about frauds in the following scenarios:**

**Fraud noted by an auditor first before the management**

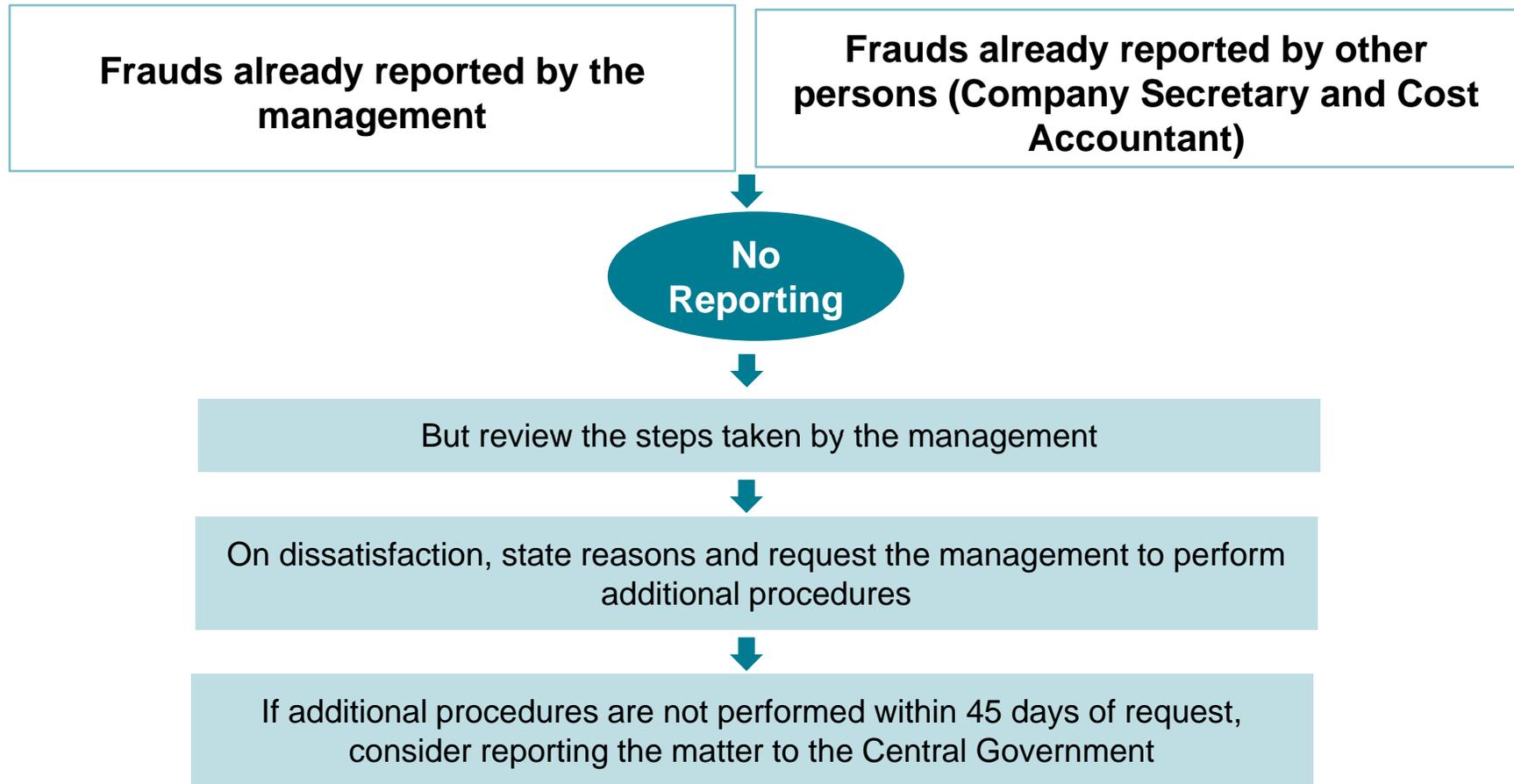
- Report to the management first and then the Central Government.

**While providing attest or non-attest services, audit/limited review of interim period financial statements/results**

- Exercise professional judgement to evaluate materiality of the information
- Uses or intends to use the information obtained in the course of attest or non-attest services when performing an audit under the 2013 Act.



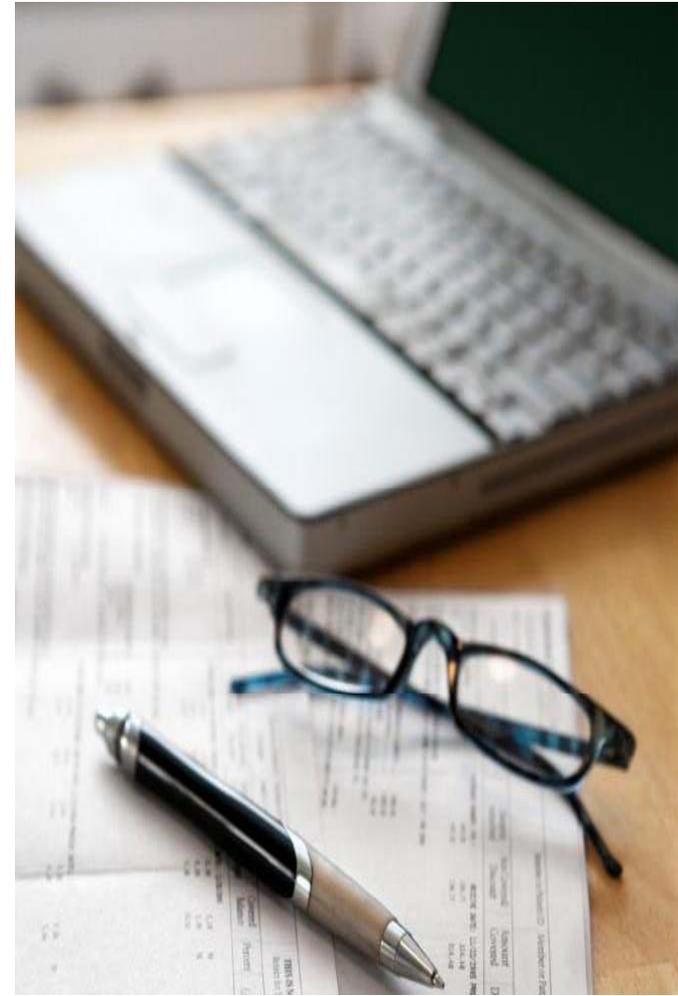
# Reporting on frauds in various scenarios



# Reporting on frauds in various scenarios

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

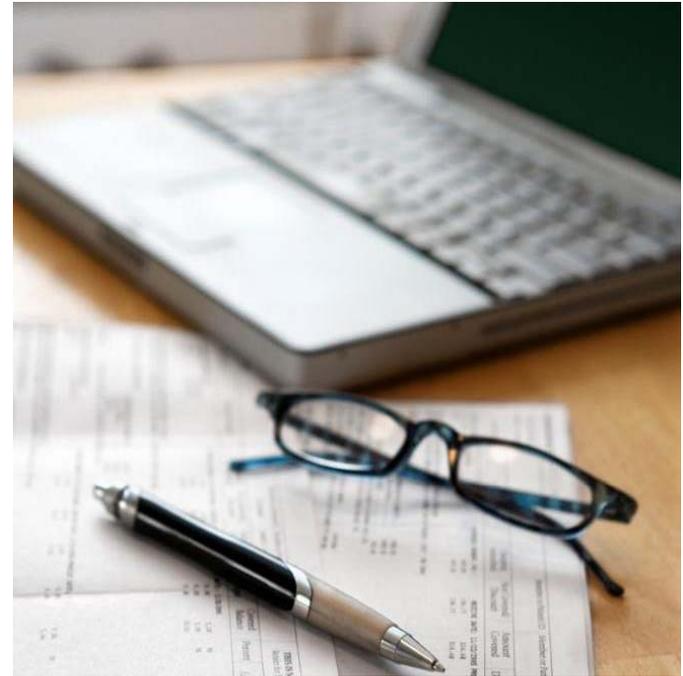
- An auditor of the parent company is not required to report on frauds under section 143(12) if frauds are not being or have not been committed against the parent company by the officers or employees of the parent company but relate to frauds in:
  - a component which is an Indian company as the auditor of that Indian company has the responsibility
  - a foreign corporate component that is not a company.
- An auditor of the parent company to report frauds in a component of the parent company only if:
  - fraud has been committed by employees or officers of the parent company and
  - such fraud is against the parent company.



# Reporting on frauds in various scenarios

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

- An auditor would report on fraud relating to earlier years under section 143(12) of the 2013 Act only if:
  - The suspected offence involving fraud is identified by the auditor in the course of performance of his duties as an auditor during the financial years beginning on or after 1 April 2014, and
  - To the extent that the same was not dealt with in the prior financial years either in the financial statements or in the audit report.



# Reporting on frauds in various scenarios

## Reporting when fraud relates to Corruption, Bribery, Money Laundering and Non-compliance with other laws and regulations

- An auditor would report on fraud on the above matters under section 143(12) of the 2013 Act only if:
  - Such acts have been carried out by officers or employees of the company, and
  - Also take into account guidance in para 28 of SA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*.



# Reporting on frauds in various scenarios

## Reporting in case of fraud noted in an audit of a bank

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



## Certain other considerations for fraud reporting

Consider the following scenarios:

A purchase manager receiving a pay-off to favour a specific vendor

An employee carries on business parallel to and in competition with the company's business

The managing director's password is misused by the IT Administrator to leak certain critical information of the company's business to its competitors.

All the above acts '**injure the interests of the company or its shareholders whether or not there is a wrongful gain or wrongful loss**'. Is the auditor expected to detect all such acts? It is pertinent to note that the financial effects of such acts are not reflected in the books of account?

## Certain other considerations for fraud reporting

How does the auditor determine whether the value of individual fraud exceeds rupees one crore?

Can auditor apply concept of materiality? What if materiality for a particular audit exceeds rupees one crore?

Can a range of estimates be applied in arriving at the value of fraud where a definite amount determination is difficult?

Is the auditor expected to perform a 'forensic audit'?

## Certain other considerations for fraud reporting

Where an auditor reports a fraud under Section 143(12), he would need to evaluate whether there is any reportable matter under Section 143(1) to Section 143(3) as also his report on IFC.

How would reporting under Section 143(12) work for joint audits?

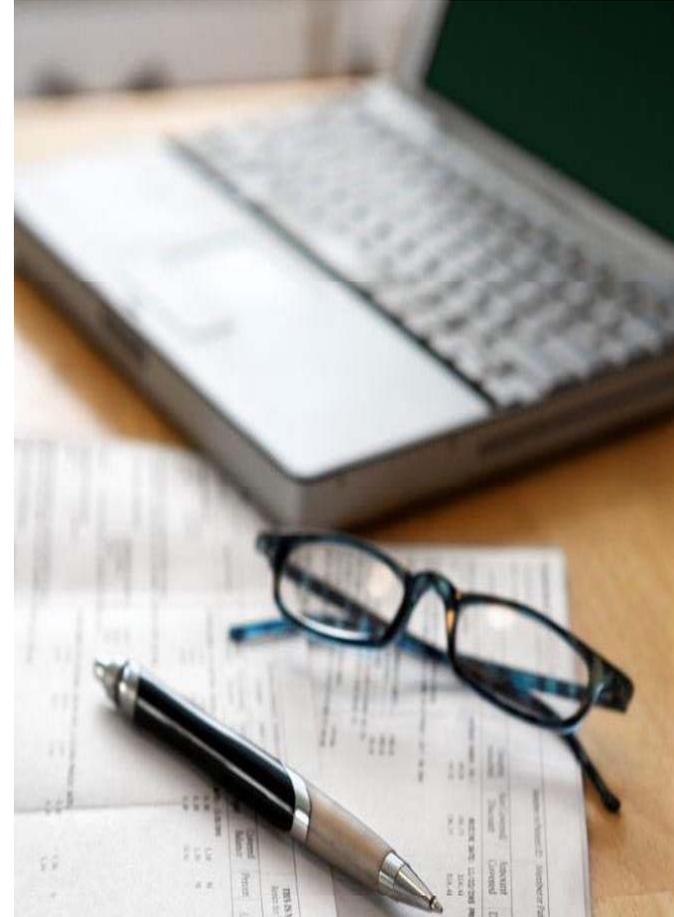
On receiving response from the company disagreeing with the initial belief of the auditor that a suspected offence involving fraud is being or has been committed, if the auditor is convinced that his initial suspicion was incorrect, does the auditor still need to report the matter to the Central Government?

Does the auditor have any responsibility of verifying Board's disclosures around fraud in the Board Report?

# CARO 2016 versus CARO 2015 in Respect of Fraud

## Comparison between CARO 2016 vs CARO 2015

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





**Q&A**

## Source

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

# Thank you

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