KPMG

First Notes

Mandatory reporting of fraud by an auditor

22 August 2023

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All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Introduction

The management of a company has the primary responsibility to establish adequate internal control systems to prevent and detect frauds and errors in a company. Auditors have a reporting obligation in relation to a fraud and/or suspected fraud in a company. This obligation is laid down under the Companies Act, 2013 (2013 Act), its rules and the Standard on Auditing (SA).

Auditor's mandatory reporting obligation is explained below:

Mandatory reporting obligations on auditors to report fraud and/or suspected fraud

The Companies Act, 2013

- Section 143 read with Rule 13 of the Companies (Audit and Auditors) Rules, 2014 lays down the reporting obligation on the auditor and the detailed steps that need to be followed.
- Matter should be reported to the Board/Audit Committee within two days of the auditor's knowledge of the fraud.
- In the case of reporting of a fraud involving or expected to involve individually an amount INR1 crore or above and the Statutory Auditor fails to get any reply/observations from the Board/Audit Committee within 45 days, then the Auditor shall forward a report in the specified form - ADT-4 to the Secretary, Ministry of Corporate Affairs, Government of India.

The Companies (Auditor's Report) Order, 2020

Clause (xi) of CARO requires auditors to make statements relating to reporting of fraud in his/her report.

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

- Deals with the auditor's responsibilities relating to a fraud in an audit of financial statements.
- Auditor should maintain professional skepticism throughout the audit
- SA 240 provides details regarding communications to management, Those Charged with Governance (TCWG) and regulatory and enforcement authorities regarding reporting of the fraud/suspected fraud.

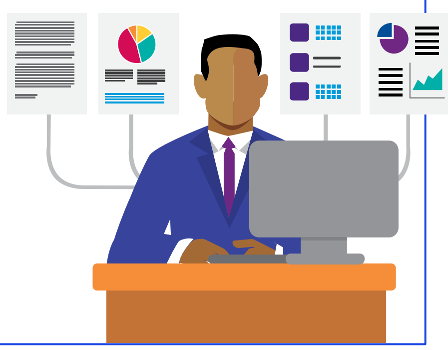
(Source: KPMG in India's analysis, August 2023)

New development

On 26 June 2023, the National Financial Reporting Authority[1] (NFRA) issued a circular (the Circular) to clarify the responsibility of statutory auditors in relation to reporting of a fraud in a company.

In this issue of First Notes, we aim to provide an overview of the important clarifications from the circular which are as follows:

- **Mandatory obligation to report fraud by an auditor:** Statutory auditors are under a mandatory obligation to report fraud or suspected fraud if they observe suspicious activities, transactions or operating circumstances in a company that indicates *reasons to believe that an offence of fraud is being or has been committed against the company by its officers or employees*. In such a case, an auditor should initiate the steps prescribed under Rule 13 of the Companies (Audit and Auditors) Rules 2014 (Audit Rules).
- **Procedure to report fraud by an auditor:** If an event of fraud is identified, the statutory auditor should initiate the procedure prescribed under Rule 13 of Audit Rules. Reporting to the Board, Audit Committee, and the Central Government (as the case may be) will be done as per below procedures:
  - **Report within two days to the Board/Audit Committees:** A statutory auditor is required to report a fraud/suspected fraud to the Board/Audit Committee immediately but not later than two days of his/her knowledge of the fraud and seek their reply within 45 days.
  - **Report to the Central Government:** On receipt of such reply or observations, the auditor should forward his/her report and the reply or observations of the Board or the Audit Committee along with his/her comments (on such reply or observations of the Board or the Audit Committee) to the Central Government (only if the amount exceeds INR1 crore) within 15 days from the date of receipt of such reply or observations.
  - **Amount involved is INR1 crore or more:** If the individual amount involved or expected to be involved in the fraud is INR1 crore or above, the statutory auditor fails to get any reply/observations from the Board/Audit Committee within 45 days, the auditor should forward a report in the specified form i.e. ADT- 4 to the Central Government. The form will be submitted along with a note containing the details of his/her report that was earlier forwarded to the Board or the audit committee for which he/she has not received any reply or observations.
  - **Mode of communication to the Central Government:** The report should 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.
  - **Details of the auditor:** The report should be on the letterhead of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his/her seal and should indicate his/her membership number.
- **Auditor not being the first person to identify the fraud:** The statutory auditor is duty bound to submit Form ADT-4 to the Central Government under Section 143(12) of the 2013 Act even in cases where the statutory auditor is not the first person to identify the fraud/suspected fraud.
- **Resignation by an auditor:** Resignation by an auditor does not absolve the auditor of his/her responsibility to report suspected fraud or fraud as mandated by the law.
- **Professional skepticism:** The statutory auditor should exercise his/her own professional skepticism while evaluating fraud and need not be influenced by legal opinion provided by the company or its management.



[1] NFRA is a statutory authority set up under section 132 of the Companies Act 2013 to monitor implementation and enforce compliance of the auditing and accounting standards and to oversee the quality of service of the professions associated with ensuring compliance with such standards.

Our comments

The circular issued by NFRA is in the form of a clarification. It clarifies the requirement regarding a statutory auditor's responsibility about reporting requirements in relation to a fraud in a company.

The primary responsibility for prevention and detection of frauds rests with the management and TCWG of the company. As per the provisions of Section 134(5) of the 2013 Act, the Board of Directors are required to, *inter alia*, state as a part of the directors' responsibility statement in the Board's 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. Under Section 143(12) of the 2013 Act, the companies, whose auditors have reported frauds under that 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.

It is important to note that with regard to the requirements of the 2013 Act about fraud/suspected fraud committed against the company by officers or employees of the company, in 2016, the Institute of Chartered Accountants of India had issued a Guidance Note on Reporting on Fraud under Section 143(12) of the Companies Act, 2013 (Guidance Note) to provide guidance to the members on this reporting requirement.

A combined reading of the NFRA circular and the Guidance gives rise to few practical challenges for auditors and companies. These have been discussed below:

- **Fraud/suspected fraud is identified by the company/other person:** As per the Guidance Note, a statutory auditor would report a fraud when he/she is the first person to identify an instance of fraud/suspected fraud in the course of performance of his/her duties as an auditor. Further, in case a fraud is detected by the cost auditor or secretarial auditor and the same has been reported under Section 143(12) by the 2013 Act by such other person, then the auditor is not required to report the same under Section 143(12) since he/she has not identified the fraud.

  It should be noted that the NFRA's circular extends the reporting requirement for the statutory auditor in the instance where a fraud has been identified by the company or other person. It mentions that a statutory auditor of a company is duty bound to report to the Central Government even in cases where the statutory auditor is not the first person to identify the fraud/suspected fraud.

- **Indications of reasons to believe a fraud may exist:** As per the provisions of the Section 143(12) of the 2013 Act, a statutory auditor is required to report a fraud when he/she has reason to believe that an offence of fraud is being or has been committed. Whereas, as per NFRA's circular the auditor's reporting responsibilities are triggered when there are **indicators** of reasons to believe that an offence of fraud is being or has been committed.

  The Guidance Note mentions that the condition of '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.

  The Guidance Note further mentions that 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.

  The combined reading of the Guidance Note and NFRA's circular highlights that the scope of evaluation, assessment and reporting of fraud/suspected fraud has been widened.

- **Fraud by third parties:** While the circular emphasises on the auditor's responsibilities with respect to reporting of fraud or suspected fraud that is being or has been committed against the company by its officers or employees, there may be instances where a fraud is committed on the company by a third party such as a vendor or customer. In such cases, the statutory auditors should evaluate their responsibility, if any and exercise professional judgement to determine reporting such instances as fraud to the Central Government.

- **Whistle blower complaints:** The 2013 Act and the SEBI's Listing Regulations[2] require companies to establish whistle blowing mechanism and provide sufficient safeguard to whistle blowers. Furthermore, the 2013 Act requires, every listed company and prescribed class or classes of companies to establish a vigil mechanism for their directors and employees to report genuine concerns or grievances. Additionally, CARO 2020 articulates reporting requirements for statutory auditors relating to whistle blowers. Companies and auditors should consider and review such whistle blower complaints on a regular basis to evaluate if such instances can be a triggering event for a fraud instance in the company.

- **Resignation by the statutory auditor:** The circular emphasises that the auditor cannot avoid any statutory consequences by resigning from the audit engagement and is duty bound to report frauds even on resignation. The circular clarifies that mere resignation by an auditor does not absolve him of his responsibility to report suspected fraud or fraud as mandated by the law.

[2] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015

Our comments (contd.)

- **Effective date for application:** The circular does not specify an effective date for implementation. Statutory auditors would need to consider the effect of this circular on frauds identified by the company that are under investigation that relate to previous years. The auditors need to evaluate whether they would need to be reported to the Central Government. This area would require further deliberation by the statutory auditors and companies.

Next steps

NFRA circular raises a number of challenges for the statutory auditors and the companies. It is important to note that this is an emerging area and will require further deliberation and discussion to clarify the challenges highlighted in this note. Companies should closely monitor developments in this area and engage with their statutory auditors to understand the implications of this circular.

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Missed an issue of Accounting and Auditing Update or First Notes?

Issue no. 84 – July 2023

The topics covered in this issue are:

- Effects of climate related matters on financial statements
- Sustainable finance
- Regulatory updates

To access the publication, please click here

SEBI amends disclosure requirements of material events or information

11 August 2023

Regulation 30 of the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) requires a listed entity that has listed specified securities, to provide disclosure of material events or information to the stock exchange in accordance with Part A of Schedule III of the Listing Regulations.

SEBI, through a notification dated 14 June 2023, issued various amendments with respect to disclosure of material events or information by issuing the SEBI (Listing Obligations and Disclosure Requirements) (Second Amendment) Regulations, 2023 (the amendment. Subsequently, SEBI issued a Circular (the circular) on 13 July 2023 which explains the following:

- The events that should be disclosed as per Para A and Para B of Part A of Schedule III
- The timeline for disclosure of materiality events and guidance on when an event / information can be said to have occurred and
- Manner of determination of materiality for events covered in Para B. `

In this issue of First Notes, we aim to provide an overview of the key amendments made by SEBI related to disclosure of material events or information.

To access the First Note, please click here.

Voices on Reporting - Quarterly updates publication

On 28 July 2023, KPMG in India released its VOR – Quarterly updates publication which provides a summary of the of key updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Reserve Bank of India (RBI), the National Financial Reporting Authority (NFRA), the Institute of Chartered Accountants of India (ICAI) and the Insurance Regulatory and Development Authority of India (IRDAI).

To access the publication, please click here.

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