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HALF-YEARLY JOURNAL OF  
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# CORPORATE FRAUDS AND THE AUDITOR'S RESPONSIBILITY

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## Abstract

**Purpose:** The study is intended to examine the concept and types of fraud, as given in the new Companies Act and to identify the types and victims of corporate frauds, with reference to the infamous corporate frauds in India, and the existing legal provisions intended to prevent, curb and regulate corporate frauds in India.

**Design/methodology/approach:** The study is mainly based on the secondary data. Some data was also collected from the corporate executives' investors and government officers.

**Limitations:** The study is confined to the corporate sectors. However, similar type of frauds might be indulged in other sectors also.

**Findings:** The study has emphasised the need for strengthening of internal control system, auditing, timely reporting of fraud by auditors and companies, effective 'due diligence' by banks and financial institutions and more professionalism on the Board of Directors and strong internal control system.

**Policy Implications:** The prevention of corporate fraud reduces the anxiety and improves the stakeholders' confidence which affect resources and reputation of the company.

**Contribution/Value:** The findings of the study will be helpful to the policy-makers and regulatory bodies to curb corporate frauds.

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**Key words:** Corporate frauds, Regulatory provisions, Auditor's responsibility, Punishments

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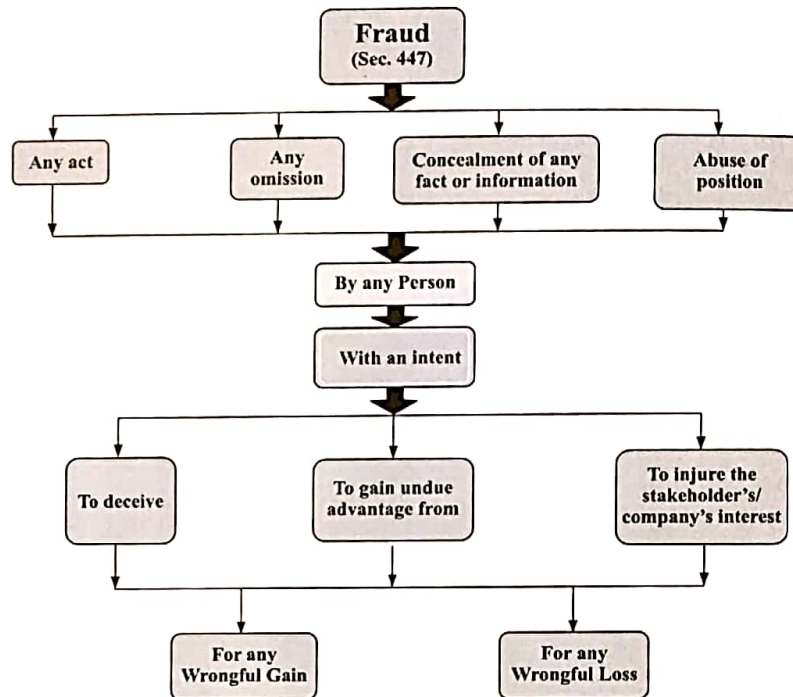


## THE CONCEPT AND COMPONENTS OF FRAUD

A fraud committed by or against a company is often referred to as a corporate fraud. The corporate sector is mainly regulated by a comprehensive company law. Presently, the Companies Act, 2013

contains the legal measure for regulating the corporate sector in India. The said Act has, for the first time, introduced the concept of 'fraud', under section 447, which is depicted in the Figure 1.

Figure 1: Components of Fraud under the Companies Act, 2013



The concept of fraud, as given in the new Companies Act is inclusive, not comprehensive, and pertains only to the affairs of a company or body corporate. Certain terms used in the definition need elaboration.

**Act/ Omission to Act:** While an act of omission is the failure to perform an act expected to be done by a person, an act of commission is doing an act that causes harm.

There is *actus rea* (conduct of the accused), also called the act of the offender, which is related to doing or performing of a particular act. As far as the omission is concerned, it is omitting of an act which a person was bound to do or act.

**Fraudulent Concealment:** The word 'concealment', as per *Shorter Oxford English*

*Dictionary* (3rd Edition), means 'the intentional suppression of truth or fact known, to the injury or prejudice of another'.

The word 'fraudulently', appearing in section 206 of the Indian Penal Code, 1860 (IPC) cannot be interpreted as meaning nothing more than 'dishonestly'. The two words do not mean exactly the same thing. A dishonest act is not necessarily a fraudulent act. The elements which make an act fraudulent are, first deceit or an intention to deceive and in some cases mere secrecy. Where there is neither an intention to deceive, nor secrecy, the act, though dishonest, is not fraudulent [1937 MWN 462; 46 LW 139; AIR 1937 Mad 713(1937) 2 MLJ 802.].

'Fraudulent concealment' means the deliberate hiding or suppression, with an intention to deceive



or defraud other persons of a material fact or circumstances, by a person which he is legally bound to disclose. Any fraudulent failure to reveal the information which some one knows and is aware that he should, in good faith, communicate to another, such as the failure to disclose a defect in a product or omitting one's assets from a bankruptcy scheme to keep them from being available for distribution to creditors.

**Fraud by Abuse of Position:** Many cases of the most serious frauds and corruption are committed by the people at the top who have the power to conduct fraudulent transactions and cover them up. There are several things which suggest someone is abusing his position and could actually be committing fraud.

**By any Person:** While the Companies Act, 2013, does not define the concept of a 'person', its meaning is given under Section 11 of the IPC. Every person who has been charged for committing a crime in India is liable for punishment without distinction of caste, religion, creed, sex, or colour. However, the Criminal Courts are barred from initiating any proceeding against certain persons, which include:

1. Acting President and Governors;
2. Foreign Sovereigns; and
3. Ambassadors, companies and corporations.

Companies and corporations are excluded since these entities are artificial juridical persons and the acts of these are performed by an individual or a group of individuals. Therefore, the criminal courts are exempted to award any punishment of imprisonment to a company, but a fine can be imposed on a company or corporation. Further, under different enactments, like the Food Safety and Standards Act, 2006, and the Essential Commodities Act, 1955, a company can be prosecuted and convicted. But a company or corporation cannot be prosecuted for offence, which is committed by an individual alone, such as, murder and dacoity. These entities cannot be indicted for offences which are compulsorily punishable with imprisonment. Except this, they can be held liable for the criminal acts or omission of its directors, employees or authorized persons.

**Intent:** An act of fraud, omission or concealment must have been done with intent:

- (a) To deceive;
- (b) To gain undue advantage from someone; or
- (c) To injure the interest of (i) the company, (ii) a shareholder, (iii) a creditor, or (iv) any other person.

The emphasis of this definition is on intent. In fact, the legal system in India is replete with concepts, like 'intent', 'public interest' and 'principles of natural justice'. This is particularly true about the Indian Penal Code and certain other legislations. The term intent is of paramount importance. It is the 'intent' of a person which determines whether his action, omission, concealment of facts, or abuse of position amounts to a fraud or not.

The intent of a person must be to deceive, to gain undue advantage, or to injure the interest of the other party. The other party can be a company, or its shareholder, creditor or 'any other person' (associated with the company concerned). In a majority of criminal cases, the main element involved is *mens rea* (criminal intent), which is an intention to commit offence and pertains to the mind of the offender.

**Injury:** The word 'injury' denotes any harm whatever illegally caused to any person in body, mind, reputation or property. The word 'injury' has been given a wide meaning, which will include every tortuous act. An unlawful detention of a cart at a toll gate, caused due to demand for an illegal payment, amounts to injury. Threat of a decree which can never be executed is a threat of harm to an individual in his person, reputation or property. Threat to use the process of law for the purpose of enforcing payment of more than is due is illegal and such an object is a threat of injury.

**Deceit:** To deceive is to induce someone to believe that a false thing is true, and which the person indulging in the deceit knows or believe to be false. Deceit is the state that prompts intentional concealment or perversion of truth for the purpose of misleading. Deceit is the behaviour that is deliberately intended to make people believe



something which are not true.

As per section 415 of the IPC, a dishonest concealment of facts, or where there is a legal duty to disclose particular facts, a dishonest omission to disclose those facts, is a deception.

**Wrongful Gain:** The word 'wrongful' means prejudicially affecting a party in some legal right. Section 23 of the IPC defines 'wrongful gain' as a gain by unlawful means of property to which the person gaining is not legally entitled. A person is said to gain wrongfully when such person retains something wrongfully, as also when he acquires it wrongfully. Wrongful gain includes a short-lived gain.

**Wrongful Loss:** As defined in Section 23 of the IPC, 'wrongful loss' is the loss by unlawful means of property to which the person using it is legally entitled. A person is said to lost wrongfully, when such person is wrongfully kept out of any property as well as when such person is wrongfully deprived of the property. As in the case of a wrongful gain, wrongful loss also includes a short-lived loss.

Therefore, the fraud may be considered as funds generation, by an intentional act of person, through abusive of position and with rapture of regulations for unfair or unlawful gains through undisclosed sources by deliberately adopting the ways of deception.

### Why is a Fraud Committed?

Motivation, opportunity and rationalisation are three important factors which are connected with the committing of a fraud. Motive comes from financial pressure; opportunity occurs through weakness in internal control and rationalisation is the fraudsters' internal justification for his or her act. Competitive and economic survival can be a motive to commit a fraud.

### Who can Commit a Fraud?

Anyone can commit fraud and fraudsters cannot be distinguished from other people by their characteristics. From the ingredients, one may conclude that fraud is caused mainly by factors

external to the individual: economic, competitive, social and political issues, and poor control mechanism.

## TYPES AND VICTIMS OF CORPORATE FRAUDS

### Types

While an illegal act in service is corruption, an illegal act in business is bribery, manipulation of financial statements, mis-appropriation of assets, infringement of intellectual property rights of a person and procedure lapses in doing business. Bribery/ Corruption may be either in cash or in kind. Bribery refers to offering, giving, receiving or soliciting anything of value to influence an 'official act' while corruption is dishonest or illegal behaviour of powerful people; Misappropriation of Assets involves taking away cash and other assets in an organisation and it includes those frauds in which a perpetrator employs tricks to steal the assets of an organisation; Manipulation of Financial Statements is manipulation of balance sheet, profit & loss Account, cash flow statements to increase in financial health of a company ; procedure-related frauds are those frauds which are committed by over-ruling or bye-passing the procedures ; and corporate espionage refers to all the undercover activities that are performed by businessmen for acquiring information of intellectual property rights of their rivals.

### Victims of Corporate Fraud

The most trusting people are also the most gullible and victims of fraud. The frauds are often committed by owners, employees and by even by outsiders. People, become the victim of corporate frauds outside or inside the company. The insiders, including the directors, managers, and the employees, would suffer a loss of position, reputation or standing. The outside victims would include the investors, creditors, partners, customers, suppliers, underwriters, attorneys, and the independent auditors. The list of fraud perpetrators, victims and their types are summarised in Table 1.



**Table 1: Victims and Types of Corporate Fraud**

S. No.	Victims	Type of Fraud	Fraud Perpetrator
1	Bankers	False applications for credit, false financial statements for working capital arrangements.	Companies and their Directors
2	Competitors	Predatory/ exploitative pricing, selling below cost to eliminate or prevent competition, Information piracy, Infringement of patents/ copyrights, Theft of trade secrets.	Companies and their Directors, and competitors
3	Customers	False advertising, false weights, false representations, Price fixing, Defective products, Short shipment, Overbilling, Double billing, Substitution of inferior goods, Corruption of employees.	Companies and their Directors, and vendors
4	Employers	Expense account padding, fake performance, overstating revenue and assets, overstating profits, understating expenses and liabilities, Theft of assets, embezzlement, commercial bribery, insider trading, related party transactions, manipulation/ destruction of records.	Vendors, suppliers and Contractors, Employees
5	Employees	False employment applications, false benefit claims, false expense claims, theft and pilferage, fake performance, embezzlement, corruption.	Employees and Employers
6	Government Agencies	False reports/returns, false claims, contract padding, willful failure to file reports/returns.	Companies and their Directors
7	Insurance Agencies	Fraudulent loss claims, arson for profit, false insurance claims.	Companies and their Directors
8	Stakeholders (Shareholder/ Creditors/ Investors)	False financial statements, false financial forecasts, false representations, false applications for credit.	Companies and their Directors

### Infamous Corporate Frauds in India

Corporate frauds have shown an unprecedented increase in India in recent years and have posed serious questions before managers, regulators and professionals, on the effectiveness of corporate governance mechanism, regulatory mechanism, and the role of corporate and individual ethics.

Probably the first major corporate scam in the Independent India was what is commonly referred to as the Mundhra scam. Hari Das Mundhra, an industrialist and stock speculator, sold fictitious shares to the Life Insurance Corporation of India (LIC) and thereby defrauded the corporation by Rs. 1.25 crore, in 1957. He was found guilty and was

sentenced to imprisonment for 22 years. The then Union Finance Minister, T.T. Krishnamachary, had to resign from his prestigious post in the face of scathing criticism within and outside Parliament. After the Haridas Mundra case of 1957, another major scam in the mid-sixties and early-seventies, was associated with Jayanti Dharma Teja. He took loans from banks and financial institutions and

used this easy money to establish a shipping empire, in the name of Jayanti Shipping Company Limited. While he had set up this company with a paid-up capital of a mere Rs. 200/- and took government loans amounting to Rs. 22 crore. The infamous cases are summarised in **Table 2**.

**Table 2: Infamous Corporate Frauds in India**

S. No.	Name of Fraud/ Scam	Year/ Period	Nature of Industry	Fraud Perpetrators	Modus Operandi	Amount Involved (Rs. crore)
1.	Harshad Mehta	1992	Capital Market	Managing Director	Trading in shares at premium in stock market.	4000
2.	C.R Bhansali	1992-1996	Capital Market	Managing Director	Collecting money from public and transfer the same to non-existent companies.	1200
3.	Ketan Parekh	2001	Capital Market	Managing Director	Availing loan with the help of bankers, above the maximum banking limits.	1500
4.	Dinesh Dalmia	2001	Information Technology	Managing Director	Trading in shares which were not listed in Stock Exchange.	595
5.	Satyam	2009	Information Technology	Auditor, Director	Hugely inflated accounting entries	8000
6.	NSEL	2013	Exchange	Promoters, Auditors and Members	Fake certificates about availability of goods meant for sale	5600
7.	Saradha Group	2013	Chit Fund	Promoters	Fake Collective Investment Schemes	4000
8.	Bank of Baroda	2015	Money Laundering	General Manager, Foreign Exchange Officer	Created a fraudulent trade circuit, where exports claim duty drawback on inflated export bills and creation of shell Companies to make payment for non-existent imports.	6172

Contd..



9.	PACL	2015	CIS including Ponzi Scheme	Founder and KMP	Lure investors by raising money against bogus land allotment letters.	47000
10.	Vijay Mallya	2016	Airlines	Promoters	By criminal conspiracy cheated the consortium of banks by way of over invoicing, misrepresentation in diverting the outward remittances, layering and integration through a complex web of financial transaction.	9990
11	Rotomac	2018	Manufacturer of Pen	Promoters	Cheated consortium of 7 banks by siphoning of bank loan as diverted the sanctioned loan to another fake company from where the money was routed back to Rotomac.	3695
12.	Nirav Modi	2018	Diamond & Jewellery	Promoters & PNB executives	Core banking system of the bank was bypassed as the PNB employees issued fake LoUs to overseas branches of other Indian bank by using the International Financial Common System, SWIFT.	14356

### Consequences of Corporate Frauds

Corporate frauds can have a devastating effect on the business firms where the fraud has occurred. The loss in the organisation can also have an impact on the local, state and national economic conditions based on the size of the business affected by the

fraud.

The consequences of frauds on company's stakeholders; for the organisation, and for the economy are summarised in **Table 3**.

**Table 3: Consequences of Fraud**

S. No.	For the Stakeholders	For the Organisation	For the Economy
1	Loss of confidence of investors in the organisation	Adverse effect on banker's attitude in respect of granting of loans and other credit facilities	Loss of confidence of foreign investors

Contd.



2	Loss of credibility of the organisation	Loss of Net worth	Adverse effect on overall growth
3	Loss of employees due to switching over	Loss of Reputation/Goodwill of the company	Higher cost of projects
4	Non-payment to creditors	Loss of dedicated and experienced employees	Imposition of more government controls
5	Non-payment to bankers against working capital facilities availed leads to NPA which damages bankers	More government regulations	Reduction in employment
6	Non-receiving of dividend for long period	Decrease in value of shares	Negative impact on the investment climate in the country
7	Loss of capital invested by investors (Indian and Foreign investors)	Loss of confidence of investors (Indian and Foreign)	Loss of Revenue due to stripping of large taxes
8	Decrease in value of investment	Bound to set unrealistic corporate targets	Negative plunge on national wealth
9	Employees losses their savings and pension	Lowering of employee's morale	Adverse effect on the Foreign Exchange
10		Loss of customers (existing and future) due to negative publicity by media	Inadequate or false returns affects policy decisions

## REGULATION OF CORPORATE FRAUDS IN INDIA

The government, as provided in the Preamble to the Constitution in India, must secure to all its citizens social, economic, or political justice. The Directive Principles of State Policy are fundamental in the governance of the country and enjoin upon the state to apply these to direct its policy to sub serve the 'common good' and to see to it that the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment. The main effects of the banking frauds are the loss of money by the government and huge embezzlement of funds out of the nation. Now, it is the duty of the government to make good the loss and recapitalise the bank out of tax payer's money. The government must perform its constitutional obligation to uphold the

law of the land and it is important that the faith of the public in the banks is restored through stringent punishment and confiscation of property of culprits who have or are looting the funds of the nation.

### Major Legislations for Preventing and Control Corporate Frauds in India

A summary of the major enactments dealing with the prevention and regulation of corporate frauds in India is given in **Table 4**

**Table 4:** Major Legislations for preventing and control Corporate Frauds in India

S. No.	Name of the Act	Relevant Sections	Enforcement Authority	Appellate Authority/Court
1.	The Companies Act, 2013	Sections 7 (5), 7 (6), 8 (11), 34, 36, 38 (1), 46(5), 56 (7), 66 (10), 75 (1), 132, 139, 140 (5), 206, 207, 208, 209, 210, 211, 212, 213, 216, 217, 219, 220, 221, 222, 223, 224, 229, 241, 244, 251 (1), 266 (1), 339 (3), 447, and 448	(i) National Company Law Tribunal (ii) Relevant department under the Ministry of Corporate Affairs (ii) Regional Director (iv) Registrar of Companies (v) Central Government	(i) National Company Law Appellate Tribunal (ii) High Courts
2. (i)  (ii)	The Securities and Exchange Board of India Act, 1992  The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003	Sections 11, 11C, 11D, 12, 12A, 15A, 15B, 15C, 15D, 15E, 15F, 15G, 15H, 15HA, 15HB, 15K, 15L, 15R, 15T, 15V, 15Y, 15Z, 20, 23, 24, 24A, and 27. Regulation - 2(1)(c)	The Securities and Exchange Board of India	Securities Appellate Tribunal followed by Supreme Court

Contd..



3.	The Benami Transactions (Prohibition) Act, 1988	Sections 3,4, 5, 6, 7, and 8	Civil Courts	(i) High Courts (ii) Supreme Court
4.	The Money Laundering Act, 2002	Sections 4, 12, 13, 14, and 66	Adjudicating Authority set up under the Act	Appellate Tribunal, followed by High Court, and finally by the Supreme Court
5.	The Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974	Sections 3,4, 5, 5A, 7, 8, 9,10, 11, 12, and 12A	Central Government	High Courts
6.	The Indian Penal Code, 1860	Sections 11, 23, 25, 33, 53, 120A, 264, 403, 405, 408, 409, 410, 415, 416, 417, 418, 419, 420, 421, 463, 464, 465, 468, 470, 471,477, 477A, 481, 482, 486, 487, 489, and 511	District & Sessions Court	High Courts
7.	The Fugitive Economic Offenders Act,2018	Section 12	Adjudicating Authority set up under the Act	Appellate Tribunal, High Court, and finally by the Supreme Court

## AUDITOR'S RESPONSIBILITY TOWARDS CURBING OF CORPORATE FRAUDS

The auditor plays an important role in any organisation in curbing corporate fraud. He has been given responsibilities with liabilities and duties under the Companies Act, 2013. On the basis of provisions related to auditors, the function of an auditor can be classified as follows:

### Duties of an Auditor

The major duties of an auditor are:

1. To complete audit work papers;
2. To update professional and technical knowledge;
3. To ensure adequate disclosures;
4. To attend general meetings;
5. To communicate audit findings;
6. To give reasons for qualifications;
7. To sign the audit report; and
8. To ensure compliances of the audit report.

The auditor is bound to fulfil certain duties under the Companies Act, 2013. The followings are the

duties of an Auditor while auditing the Financial Statements of an organisation:

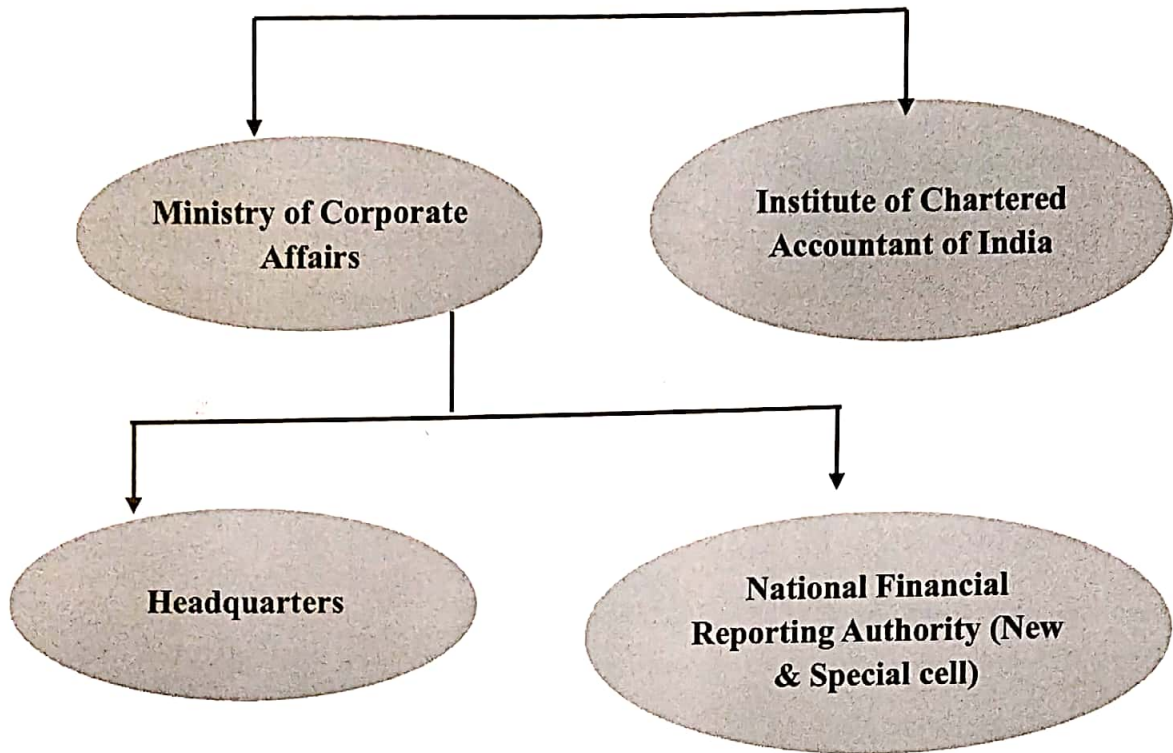
1. To ensure compliances with establish internal control procedure by examining records; reports, operating practices and documentation;
2. To verify assets and liabilities with documents;
3. To employ reasonable skills and care;
4. To complete audit work papers by documenting audit tests and findings;
5. To communicate audit findings by preparing a final report and discussing findings with the auditee;
6. To give reasons for qualifications or obligations;
7. To sign the audit report;
8. To attend the general meeting or meeting of audit committees of Directors etc;
9. To make adequate disclosures in the audit report; and
10. To update professional and technical knowledge by attending educational workshops, Seminars, lectures through reading of various publications

### Auditor Liabilities, Responsibilities and Punishment (Relevant Statutory Provisions under the Companies Act, 2013)

S. No.	Prevailing Sections	Particulars
<b>LIABILITIES</b>		
1.	Section 35	Misleading contents in Prospectus
2.	Section 129	Financial Statements
3.	Section 209	Search and Seizure of Books and Papers of Auditor
4.	Section 245	Class Action Suit against Auditors
<b>RESPONSIBILITY</b>		
1.	Section 143(2)	Audit Report and Auditing Standards
2.	Section 143 (12)	Reporting of Frauds by Auditor
<b>PUNISHMENT</b>		
1.	Section 147	Imprisonment / Fine



### Authorities regulating the profession of Chartered Accountants working as an company Auditor



#### The National Financial Reporting Authority

In most of the cases during the last 5 years, it was noticed that inadequate disclosure and inadequate audits were the factors for committing a fraud. In order to regulate and penalise the auditors, a provision of setting-up of the NFRA was introduced in the Companies Act, 2013. Before the existence of the National Financial Reporting Authority (NFRA), the Institute of Chartered Accountants of India (ICAI) was empowered to punish partners of a Chartered Accountants firm while no action was taken by the Institute of Chartered Accountants of India against the firm for their wrong doings. But now, the Authority has been empowered to take action and penalise firm of Chartered Accountants also. The MCA and the ICAI are old authorities while the NFRA is a new one under the Companies Act, 2013, so the brief provisions of the same are discussed below:

Section 132 of the 2013 Companies Act lays down the provisions regarding setting up of a NFRA. Besides, the ICAI, the NFRA will also look after the

performance of those Chartered Accountants who are associated with ensuring compliance with accounting standards and policies.

The objectives of setting-up of the NFRA are:

- (i) To make recommendations to the Central Government on accounting policies and standards for adoption by certain companies or their auditors;
- (ii) To monitor and enforce the compliance of these policies and standards, to oversee the quality of the professionals associated with ensuring compliance; and
- (iii) To suggest measures for improvement in quality of professional services.

It has the power to investigate the matters of professional misconduct committed by any member of the Institute of Chartered Accountants of India. This investigation can be done either *suo motu* or on a reference by the Central Government. Once the investigation is started by the Authority, then no other institute or body can initiate any proceedings against such members. The Authority

has the power of a civil court under the Code of Civil Procedure. It has been empowered to pass an order to impose a penalty in the following manner:

- (a) In case of an individual: Rs. 1 lakh to 5 times of professional fees received.
- (b) In case of a firm: Rs. 10 lakhs to 10 times of the fees received.

Besides imposing a penalty, it can debar the member or firm from engaging in practice as the member of Institute of Chartered Accountants of India for a minimum period of six months. It can debar the member up to a maximum period of 10 years. The Central Government is also empowered to constitute an Appellate Authority consisting of Chairperson and not more than two members. Any person aggrieved by any order of the National Financial Reporting Authority can file an appeal before the Appellate Authority by depositing a prescribed fee.

#### **Auditor's Advice and Disclosures in Case of Fraud**

If the fraud relates to past years when an auditor did not represent the client, the new auditor has to advise its clients to make disclosures of fraud. An auditor, after examining the accounts, if found any fraud, should advise the client to make a complete disclosure. If client refuses, the auditor would make a report to the authorities that the accounts prepared and examined by him are unreliable on account of certain information obtained later.

#### **CONCLUSION**

In India, corporate sector corporate governance and regulatory mechanism are weak, and need amendment in the existing regulatory framework. There is a time lag between the actual occurrence of a fraud and the information reaching the public domain, and the public interest is adversely affected by such delay. Moreover, the appointment of qualified and independent directors in the audit committees might help in preventing and minimising frauds. Furthermore, the rotation of statutory auditors and compulsory appointment of qualified internal auditors would also tend to prevent frauds. The auditors also need to be trained

in order to equip them with the changed regulatory measures and technological advancements.

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