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Companies Act, 2013

– A big leap to prevent and punish fraud

- Although the Companies Act, 1956 did contain provisions to deal with fraud by corporates, the measures were felt insufficient in the light of Satyam like frauds unearthed in recent years and accordingly opportunity has been taken to make the provisions of the Companies Act, 2013 more stringent with regard to frauds. A brief comparative analysis of the old and new Acts is presented here.

Introduction

The financial and corporate frauds and scams in recent years in India have rekindled the thought on the need for high standards of corporate governance and stringent provisions to tackle fraud. This prompted our lawmakers to statutorily address the growing problem of corporate frauds by introducing stringent provisions in the new Companies Act, 2013 (New Act), ranging from increasing the role and duties of independent directors and that of the auditors. The new Act's focus on the issue of tackling fraud is an indication of the trend in this direction which is likely to continue in the future. Not only by means of regulations, there is also a realization in the minds of corporate India to adhere to strict standards and they are becoming cautious and serious about the problems of fraud.

What is new now?

Quite obviously with the introduction of the new Act, much has been discussed and spoken about the concept of 'fraud' as a

new concept. But is it really true? Has the concept of fraud not at all been dealt with in the Companies Act, 1956? The Companies Act, 1956 too has provisions relating to fraud and hence it is not really correct to say that the concept is new. It provides for

* Views expressed herein are the personal views of the author.



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The definition of the term fraud uses the term 'person' which gives it a very wide coverage. Thus, it just doesn't only mean and cover certain officers, directors or employees of the company, instead it covers any person in relation to the affairs of the company. So irrespective who that person is, as long as that person in the context of the affairs of the company falls within the ambit of the definition of fraud, he will be guilty of committing fraud.

punishments for fraud in various sections. Take for instance, the Act of 1956 provides for an imprisonment of 5 years or fine or both when a person fraudulently induces persons to invest money in a company. It also provides that no compensation to managing/whole time director will be provided if he loses his office because of being guilty of fraud or breach of trust. Then, there is an imprisonment of 7 years if a person is found falsifying books during the course of winding up. Further, penalty for frauds by officers attracts 2 years of imprisonment and fine. Fraudulent conduct of business in the course of winding up attracts an imprisonment of 2 years or with fine or both. The Act also provides that when the Central Government is of the opinion that any person connected to conduct and manage the company is guilty of fraud, it can file reference with the court to seek directions against such person(s). There are many more instances under the Companies Act, 1956 where provisions regarding "fraud" are provided. So the question is then why is there so much discussion regarding "fraud" under the Companies Act, 2013. Is there anything different in the new law as compared to what is provided in the Companies Act, 1956? What really is the change now? Surely, there is a lot more in the New Act with respect to tackling the problem of fraud as compared to the Companies Act, 1956. The new Act provides for a couple of important changes regarding fraud as compared to the Companies Act, 1956. First and foremost is the definition of "fraud". It is noteworthy that although the Companies Act, 1956 dealt with fraud it did not have a meaning and definition given to it. Now under the new Act, there is a very clear definition of the term fraud.

Meaning of fraud

Section 447 of the new Act provides for the definition of fraud and also the punishment for committing fraud. Fraud is defined inclusively as under:

"Fraud in relation to affairs of a company or any body corporate

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."

It is clear from the definition that not all acts, omissions, concealment of fact or abuse of position will lead to fraud. In order to fall within the meaning of 'fraud' these actions, omissions, concealment of fact or abuse should be done with an intent to deceive or to gain undue advantage or to injure the interest of the company or its shareholders or creditors or any other person. Therefore, this brings in the concept of *mensrea*. Further, it would still constitute fraud whether or not such acts, omissions, concealment of fact or abuse of position results in 'wrongful gain' or 'wrongful loss' i.e. commission of crime with that intent is important not the results thereof.

'Wrongful gain' has been defined to mean gain by unlawful means of property to which the person gaining is not legally entitled. Similarly, "wrongful loss" has been defined to mean loss by unlawful means of property to which the person losing is legally entitled. Therefore, to fall within the meaning of fraud, the following should have happened:

- acts, omissions, concealment of fact or abuse of position should have taken place;
- such acts, omissions, concealment of fact or abuse of position should have essence of *mensrea* in them; and
- irrespective of the fact whether or not they resulted in 'wrongful gain' or 'wrongful loss'.

The definition of the term fraud uses the term 'person' which gives it a very wide coverage. Thus, it just doesn't only mean and cover certain officers, directors or employees of the company, instead it covers any person in relation to the affairs of the company. So irrespective who that person is, as long as that person in the context of the affairs of the company falls within the ambit of the definition of fraud, he will be guilty of committing fraud.

Punishment for fraud

Another major difference between the new Act and the Companies Act, 1956 is that the punishment prescribed for fraud under the new Act is similar for all the cases of 'fraud' unlike in the Companies Act, 1956 where different punishments are provided for different actions leading to fraud. For example, as described above, an imprisonment of 5 years or fine or both is provided when a person fraudulently induced persons to invest money in a company, whereas an imprisonment of 7 years is provided if a person is found falsifying books during the course of winding up or an imprisonment of 2 years and fine is provided when fraud by an officer commits fraud. However, under the new Act, for all cases of fraud, the punishment provided is the same which is an imprisonment of 6



months to 10 years. However, there is more stringent punishment provided when the fraud committed involves public interest. In that case, the minimum punishment prescribed is 3 years, (and not 6 months), the maximum being the same for 10 years.

Take for instance, if fraud is committed by way of concealment of fact in the prospectus in an initial public offer with an intent to deceive the public shareholders, the minimum punishment will be 3 years as this is a case where public interest is involved. Similarly, take a case where a private limited company raises bank financing on the basis of falsified financial statements, it can be argued that public interest is involved since the lending bank had taken public deposit. Therefore, in this case also the private limited company and the persons responsible would be guilty of fraud attracting minimum punishment of 3 years.

In addition to imprisonment, there is also a fine equivalent to the amount involved in fraud and which can extend upto 3 times of the amount involved in fraud.

Punishment to be in addition to any other liability provided

It is noteworthy that the punishment of fraud is in addition to any other liability provided under the new Act including the repayment of debt wherever the new Act requires repayment of debt. This means that the person guilty of fraud has to suffer that other liability in addition to the punishment provided for fraud under Section 447. For example, Section 75 which provides for the repayment of deposits to the public, also provides that if the company fails to repay the deposit or any part thereof within the time provided and that such deposits were accepted with an intent to defraud the depositors or for any fraudulent purpose, then every officer of the company who was responsible for the acceptance of such deposit shall in addition to the liability under Section 447 will be personally liable, without any limitation of liability, for all or any of the loses or damages that may have been incurred by the depositors. Therefore, such officers will be liable for both the personal liability and the liability under Section 447. This is what Section 447 provides that the punishment of fraud provided under Section 447 is in addition to any other liability provided under the new Act.

Punishment for false statement or omission of material facts

Section 448 deals with the cases of making false statement (knowing it be false) or omission of materials facts (knowing it to be material) in –

- (i) Return
- (ii) Report
- (iii) Certificate

➤ There are around seventeen provisions scattered all over the new Act wherein the punishment provided is as in Section 447. But that doesn't mean that only those cases would be considered as "fraud" and punished as fraud. Undoubtedly those would be punished as fraud but other cases which fall within the meaning of the definition of fraud under Section 447 will also attract the punishment as provided in Section 447.

- (iv) Financial statement
- (v) Prospectus
- (vi) Statement
- (vii) Other document required for any provision of the new Act.

and provides for the same punishment as provided in Section 447.

Sections 447 and 448 have already been notified effective September 12, 2013 and are in force and therefore, it is very important that the provisions of these sections are well understood. Owing to the very stringent punishment, these will go a long way to prevent frauds in the company.

Offence of fraud - non-compoundable

As the punishment for fraud is both imprisonment *and* fine, it will be a non-compoundable offence, which makes the commission of fraud a more serious affair.

Whether cases of fraud only restricted to provisions as mentioned in the new Act?

One interesting question that arises is whether the provisions of punishment only apply to those cases of fraud which are specifically covered under various provisions of the new Act i.e. the punishment for fraud as provided in Section 447 is only applicable to cases of fraud as mentioned in other provisions of the new Act or to any other case of fraud. There are around seventeen provisions scattered all over the new Act wherein the punishment provided is as in Section 447. But that doesn't mean that only those cases would be considered as "fraud" and punished as fraud. Undoubtedly those would be punished as fraud but other cases which fall within the meaning of the definition of fraud under Section



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447 will also attract the punishment as provided in Section 447.

Some instances as provided in the new Act which will attract punishment as provided in Section 447.

- (a) incorporation of a company based on false or incorrect information, the first directors, first subscriber and the professional who made declaration will be liable
- (b) for untrue, misleading statement in prospectus or inclusion or omission of any matter
- (c) for fraudulently inducing persons to invest money
- (d) for personation for acquisition of securities, etc.
- (e) acceptance of deposits with intent to defraud depositors or for any fraudulent purpose
- (f) cases where auditor acts in a fraudulent manner or abets or colludes in any fraud
- (g) when business of a company is carried on for a fraudulent or unlawful purposes or with intent to defraud creditors, members or any other persons
- (h) for making fraudulent application for removal of name
- (i) for furnishing of false statement, mutilation, destruction of documents during inspection, inquiry or investigation.

Serious Fraud Investigation Office

In order to investigate frauds in companies, it is proposed to set up Serious Fraud Investigation Office (“SFIO”). This office already exists but there are no detailed provisions that exist in respect of SFIO, and now SFIO will have more teeth as compared to the existing powers that it has. This body will consist of experts from banking, corporate affairs, taxation, forensic audit, capital market, information technology, law. The powers given to SFIO can be examined from the fact that when SFIO investigates, then no other investigating agency will proceed with the investigation and concerned agency is already investigating the matter it will have to transfer all the relevant documents and records to SFIO. In cases SFIO investigates, then all other investigating agencies, state Government, police authority, income tax authorities having any information or documents in respect of such offence shall provide all such information or documents available with it to the SFIO. Similarly, SFIO will share any information or documents available with it, with any investigating agency, State government, police authority or income tax authorities which may be relevant or useful for such investigating agency, state government, police authority or income tax authorities in respect of any offence or matter being investigated or examined by it under any other law. The SFIO will submit its report to the Central Government.

Other aspects of fraud under the New Act

There are some other aspects that are provided in the new Act in order to unearth fraud and stringent punishment, such aspects include:



- (a) The auditor has to report offence involving fraud to the Central Government;
- (b) The auditor guilty of fraud or abets or colludes in any fraud, then both the partner and firm shall be jointly and severally liable;
- (c) Recovery back from MD/WTD/Manager/CEO excess remuneration, if any, which is revealed upon the re-statement of financial statements which is required to be done on account of fraud in the company;
- (d) Disgorgement of asset, property or cash if any Director, KMP or other officer has derived any undue advantage or benefit when fraud takes place in a company.

Are government companies exempted from the provisions of fraud?

Although government companies enjoy a lot of exemptions under the Companies Act, 1956, they are not eligible for exemption with respect to any provision applicable to fraud under the Companies Act, 1956. Similarly, going by the same logic it does not appear that these companies will be eligible for exemption with respect to the provisions and punishment of fraud as provided under the new Act.

Conclusion

The introduction of very stringent provisions regarding fraud shows the seriousness to tackle this problem and these provisions of the new Act will be tested if any corporate fraud and scams are unearthed now in India Inc., although one wishes none happens but if it does, there are enough legal weapons to deal and counter them. cs



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Demystifying Corporate Fraud

- Fraud is the biggest challenge before the national and global economy. Concerted efforts are required on the part of corporates and Regulators to tackle this menace.

“Corporate India Largely Sees Fraud as an Inevitable Cost of Doing Business, and not as a Strategic Risk.”

Preface

Companies worldwide are battling to survive and grow in what have continued to be highly adverse economic conditions. In this environment, growth and ethical business conduct can sometimes appear to be competing priorities. India is an emerging country with a plethora of opportunities. As a potential market, it is in the blueprint of many global giants who are planning to expand business. But these *opportunities are fraught with numerous risks and challenges like fraud, bribery and corruption*. These risks are growing concerns for Indian companies. A major challenge faced by the senior management of a company in addressing these risks is the lack of awareness.

India has evolved into an attractive investment destination as both foreign and domestic companies are increasingly making their presence felt in one of the largest markets in the world. Traditionally, important parameters that attract investment into a country have been profitability, cost, infrastructure, etc. The factor of risk has evolved as one of the parameters impacting investment and decision making in business. These risks always have a latent bearing on investment and operations. The possible consequences can be in the form of loss of time, infrastructure, inventory, manpower and also opportunity to invest in some other



economies that are more rewarding. These risks sometimes not only affect an organization in the form of loss of infrastructure, manpower etc. but also adversely affects the economy at large.

Organisations Overwhelmed Tackling Fraud

The acuity of corruption in India – as measured by Transparency International ('TI') (global civil society organisation leading the fight





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against corruption) – has worsened. According to TI's 2012 study, India was ranked 94th(out of 176 countries) with a score of 36 on an overall score of 100. This is a low score indicating, high perception of public sector corruption in India. This suggests that the cases of corruption and fraud in the country i.e. the Commonwealth Games, Adarsh Housing Society case, the August a Westland helicopter deal etc., amongst others, have had a severe impact on how the world perceives India.

However, despite several emerging issues, India, has responded back by enacting several pieces of Legislations. One piece of Legislation that stood out recently is the Companies Act, 2013 (the 'Act'). The Act has raised the bar of how Indian companies need to evaluate themselves and aims to increase corporate transparency. The other anti-fraud Legislations, Regulations, Guidance, include the following:

- (a) Prevention of Corruption Act(1988)
- (b) Whistle Blowers Protection Act
- (c) Prevention of Money Laundering Act, 2012
- (d) Central Vigilance Commission Act, 2003
- (e) Indian Contract Act, 1872
- (f) Indian Penal Code, 1860
- (g) Listing Agreements
- (h) CARO 2003
- (i) Income Tax Act, 1961
- (j) Right to Information Act, 2005

"Fraus Omnia Vitiate" - Fraud Vitiates Everything

All these legislations, force corporates to re-evaluate their controls and to implement fraud prevention, detection and response mechanisms accordingly.

Fraud is generally described as an intentional or deliberate act to deprive another of property or money by deception or other unfair means. It is further defined, with respect to financial reporting, as an intentional act that results in a material misstatement in the financial statements.

Fraud essentially involves using deception to make a personal gain for oneself dishonestly and/or create a loss for another. Although definitions vary, most are based around these general themes. The term 'fraud' commonly includes activities such as theft, corruption, conspiracy, embezzlement, money laundering, bribery and extortion.

The Law as it Stands - Regulatory Scenario

The recent scams in India have resulted in increased regulatory activism. Existing acts have been amended and updated to address

the new and complex threats. Regulators are proposing more stringent standards for *Fraud Prevention, Detection and Reporting*.

For instance, the Companies Act, 2013 which replaced the Companies Act 1956 has several measures to deal with corporate frauds. One of such measure is the formation of a financial reporting body called the "National Financial Reporting Authority (NFRA)" for better monitoring of Corporate Financial Management. This body will have quasi judicial powers to order investigation, levy penalty and bar professionals from practice in case of their indulgence in professional or other misconduct. Such authority has the mandate to ensure scrutiny and compliance of Accounting and Auditing Standards. It will also ascertain the quality of service of professionals associated with compliance.

The new Act provides more fangs to Serious Frauds Investigation office (SFIO). The SFIO is a multi-disciplinary organization under the Ministry of Corporate Affairs, consisting of experts in the field of accountancy, forensic auditing, law, information technology, investigation, company law, capital market and taxation for detecting and prosecuting or recommending for prosecution of frauds, and has enforcement powers, including arrests; focus on protection of investors with recognition of class action suits and provision for nomination of Directors by small shareholders and stricter role for auditors including rotation. The major gridlock of occurrence of regulatory overlap with more than one agency entitled to investigate an event of corporate crime has been overcome with the Companies Act, 2013 and designating SFIO as the agency to investigate corporate fraud.

Currently under various regulations like Clause 49 of the Listing Agreement, the CEO and CFO of a company, in their certification have to confirm that there are, to the best of their knowledge and belief, no fraudulent /illegal transactions entered into by the company during the year. Also, as per Companies (Auditor's Report) Order (CARO) 2003, the auditor has to report whether any fraud by or on the company was noticed or reported along with its nature and amount.

Modern Conceptualization of Corporate





Fraud



Types of Fraud Heard / Read / Experienced

There are many types of corporate frauds, including the following common frauds:

- Bribery and corruption including kickbacks
- e-Commerce, internet and Cyber related fraud
- Diversion/theft of funds or goods through false invoicing, fake claims, pilferage etc.
- Financial Statements Fraud
- Regulatory non-compliances
- Money Laundering
- Internal Reporting (e.g.: MIS reports related fraud)

Businesses are also susceptible to fraud committed by outsiders, such as

- Intellectual Property Fraud (counterfeiting, piracy)
- Corporate Identity Thefts
- Cyber Crimes

Why Fraud is committed

One of the basic concepts in the field of fraud examination originated from the famous criminologist, Donald R. Cressey. The hypothesis is referred to as “The Fraud Triangle” which relates to three key elements that are present in every fraud viz., Pressure, Opportunity and Rationalisation. The occurrence of fraud, therefore, is typically a result of these three factors:

Pressure / Motivation / Incentive [Need or Perceived Need]

Pressure to commit fraud can be attributed to factors like, sustaining growth or profitability in a volatile economic environment, increasing competition, financial need, job performance, etc.

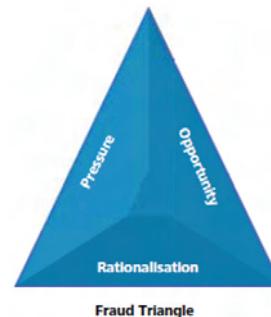
Opportunity [access to assets, information, people]

Circumstances exist – for instance, the absence of controls,

ineffective controls, or the ability of management to override controls – that provide an opportunity for fraud to be perpetrated.

Rationalisation / Justification / Attitude [justification for action]

Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act.



A Strategic Move: Proactive Fraud Risk Management

The first step a company should take in its quest to address fraud risk is to do a Fraud Risk Assessment. This helps in identifying the vulnerable areas and indicates the key red flags. There is considerable increase in the number of companies opting to undertake proactive fraud risk management in recent years. This is an encouraging sign which indicates a better future for Corporate Governance in India. A fraud risk assessment generally includes 3 key elements:



- Identify fraud risks
- Assess likelihood and significance of fraud risks
- Respond to significant and those frauds likely to occur

A fraud risk assessment should be performed periodically to identify potential schemes and events that need to be mitigated. An effective fraud risk assessment should identify where fraud may occur and



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who the perpetrators might be. The fraud risk assessment should also anticipate the behaviour of a potential fraud perpetrator. It is important to design fraud detection procedures that a perpetrator may not expect. The challenge for companies is to develop a comprehensive effort to prevent fraud by-

- (1) Understanding all of the various control frameworks and criteria that apply to them.
- (2) Categorizing risk assessments, codes of conduct, and whistleblower mechanisms into corporate objectives.
- (3) Creating a broad ranging program that manages and integrates fraud prevention, detection, and response efforts.

An effective Fraud Risk Management approach or Anti-Fraud Strategy has four main components:

- Prevention
- Detection
- Deterrence
- Response

Fraud Prevention

There are two main elements to fraud prevention-

- (a) sound ethical culture
- (b) sound internal control systems.

There are a number of preventive strategies, ranging from enterprise wide, non-fraud-specific strategies, such as starting with corporate ethics policies, to highly targeted controls designed to prevent specific fraud schemes. Organisations should have their own code of business conduct and ethics policy. This should be further supported with a detailed guidance to employees, through the Fraud control policy and Anti-bribery and corruption policy, in order to prevent fraud, bribery and corruption. These policies should be approved by the Board of Directors and the Audit Committee, which should be implemented by the management, along with its compliance status being monitored regularly.



A sample list of steps for fraud prevention by applying Fraud Triangle concept is listed below:

Reduce Pressures	Reduce Opportunities	Reduce Rationalisation
<ul style="list-style-type: none"> - Set realistic strategies - Set Fair pay systems - Set Performance systems 	<ul style="list-style-type: none"> - Background checks for prospective employees - Proper System Internal Controls / monitoring controls - Protect whistleblowers 	<ul style="list-style-type: none"> - Clear communication of Code of conduct - Promotion of integrity throughout the organisation - Proper & effective Trainings

Fraud Detection

Detection strategies are meant both to deter frauds, due to employees knowing they are in place, and to uncover those that occur. It will never be possible to eliminate all frauds. No system is completely 'fraud proof'. However, if an organisation pays greater attention to the most common indicators, this can provide early warning that something is wrong and increase the probability of discovering the fraudster.



One of the effective ways for detecting fraud and corruption can be implementing a robust *Whistle blowing mechanism* within the organisation. A whistle blowing system is also recommended under Clause 49 of the Listing Agreement. A vigil mechanism (Whistleblowing mechanism) has been made mandatory in the Companies Act, 2013 for listed companies and such class or classes of companies, as would be prescribed in the rules.

Fraud Response

An organisation's approach to dealing with fraud should be clearly described in its fraud policy and fraud response plan. The fraud response plan should reiterate the organisation's commitment to high legal, ethical and moral standards in all its activities, and its approach to dealing with those who fail to meet those standards. A fraud response management programme, when effectively



designed and implemented, can become one of the most critical elements of an organisation's anti-fraud program.

Fraud Deterrence

Fraud detection acts as a deterrent by sending a message to likely fraudsters that the organisation is actively fighting fraud and that procedures are in place to identify any illegal activity. The possibility of being caught will often persuade a potential perpetrator not to commit a fraud.

Deploying all the four elements of fraud and corruption risk management collectively, that is, **Assessment, Prevention, Detection, and Response** can put companies on the path of being resilient to the threat of fraud and corruption.

Emerging Fraud Risks

Even though there has been sufficient increase in awareness about fraud after the recent scandals, corporate India is still hesitant to accept it as a strategic risk. It is still viewed as an operational or occupational risk and hence the mitigation strategies inclined to be more generic rather specialist. In today's world organisations are faced not only with the risk of traditional frauds but also substantial risks from emerging frauds viz.,

- * Cyber Crime
- * IP Counterfeiting and Piracy
- * Identity Theft and more

Thus, organisations are necessitated to adopt and implement more robust fraud risk management measures in order to mitigate the rising risk of emerging frauds. Some of the ways in which organisations can mitigate such emerging risk are.

- Strong and up to date technology enabled platform to provide early warning signs
- Adoption of ethical code of conduct amongst employees and stakeholders
- Latest technology driven controls
- Effective risk assessment strategies
- Endeavor to carry out proactive rather than reactive checks; and
- Robust whistleblower mechanisms.

Concluding Thoughts

Policy makers have taken their first step to increase corporate transparency by writing several pieces of legislations, including the Companies Act, 2013 and many other proposed revision(s), amongst others, which has brought about more stringent measures to fight corporate frauds, with greater accountability being placed on Independent Directors and Auditors. However, regulators may still need to act as a tipping point and compel laggards to create a transparent and proactive corporate culture.

The need of the hour for corporate organisations is thus to invest in right anti-fraud measures, such as, employee background screening, business partner or third party due diligence, effective and well-understood whistleblowing systems and well-tested fraud risk management systems, which would help reduce losses on account of fraud and corruption. The combination of effective fraud risk governance, a thorough fraud risk assessment, strong fraud prevention and detection (including specific anti-fraud control processes), as well as co-ordinated and timely investigations and corrective actions, can significantly mitigate fraud risks.

Better technology and methods are similarly available to counter fraud, provided the first step of seeing fraud as *strategic risk* is taken, so that internal control measures can be built. People will volunteer information only when there is adequate protection to the whistleblower. Companies can have codes of conduct and ethics policies, but more important is the need to create a culture of prompt compliance.

"To Think, We Know And Understand All Risks Around Us Is Misleading, To Think We Can Manage All Of Them, If They Hit Us, Is An Illusion, And To Turn A Blind Eye To Them Is Sheer Foolishness." Fraud Prevention Is To Be Treated Like A Journey And Not A Destination.

Disclaimer

The information shared in this article is provided in good faith by the author with the view to enhancing member's knowledge and understanding of the subject matter, with references stated therein.

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