Revisiting the FCPA’s Internal Accounting Controls Provision: Addressing Common Misconceptions and Challenges
Introduction

When drafted in 1977, the internal accounting provision of the Foreign Corrupt Practices Act (FCPA) was designed to increase public confidence in securities markets by requiring corporations to make assurances that their recordkeeping was kept honest. Despite this desire for greater clarity, the internal controls provision of the FCPA remains among the most misunderstood and contentious areas of U.S. anti-bribery law. In this White Paper, TRACE addresses what are some of the common misconceptions and challenges that persist in our understanding of this provision, and explains what companies are doing to respond to those challenges.

The language of the provision, found in section 13(b)(2)(B) of the Securities & Exchange Act, is short and deceptively straight-forward (see figure 1, below). Companies that are regulated by the Securities & Exchange Commission (SEC) are required to devise and maintain a system of internal accounting controls. Those controls must provide “reasonable assurances” that the company’s management is properly overseeing authorization for transactions and access to assets, and that the company’s financial statements are in conformity with generally accepted accounting principles (GAAP).

Section 13(2)(b) of the Securities Exchange Act of 1934

§ 13. Periodical and Other Reports

(2) Every issuer which has a class of securities registered pursuant to section 78l of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall—

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that— (i) transactions are executed in accordance with management’s general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management’s general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Figure 1

Over the past four decades, the SEC has used the internal controls provision of the FCPA as a crucial instrument in regulating issuers’ bookkeeping. Of the nine cases brought by the SEC under the FCPA in 2015, all nine included charges under section 13(b)(2)(B) – a trend that seems to have continued into 2016 (see figure 2, below). In fact, of all 71 FCPA cases brought by the SEC since 2010, 99% have involved charges pursuant to the internal controls provision.
Despite the provision’s overwhelming use, its application remains controversial. Questions surrounding the SEC’s application of section 13(b)(2)(B) include whether violations of the internal controls provision must entail actual corruption, as the FCPA’s name implies; whether mere control failures – in the absence of any actual harm – violate the FPCA; and to what standard a company’s accounting controls are measured under the provision. To understand these concerns, TRACE has conducted a holistic review of the cases brought under the internal controls provision, revisiting the assumptions underlying the SEC’s application of the statute in light of the FCPA’s legislative history. Our aim is to provide clarity, where we can, for companies seeking to comply with the FCPA and to shine a light on those issues that still require more guidance from the SEC in better clarifying the requirements under the law.

**Covered Activity Under the Internal Controls Provision**

For a company to be found guilty under the internal accounting control provision, must the SEC show the occurrence of some underlying wrongful activity? In typical cases, a company’s internal controls violation naturally stems from some attendant bribery activity involving a foreign government official. The criminal charge and the civil charge go hand-in-hand: one punishes the improper act, the other punishes the company’s weak system of internal controls that allowed the act to occur in the first place.

Take, for example, the $45 million settlement between the SEC and Alcatel Lucent in 2010. The SEC alleged that the company made millions of dollars in payments through its subsidiaries to government officials throughout the world. According to the SEC’s complaint, the company’s subsidiaries falsified books and records, entered into agreements retroactively, used false invoices and payment documentation under business consulting agreements, and allowed manual cash disbursements without documentation, among other things. In Alcatel’s case, the internal controls violation was fairly straight-forward: had the company’s compliance and accounting teams put in place an adequate control system, the bribes could have been detected earlier-on and maybe even prevented altogether.

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What has caused so much controversy among the FCPA bar is the SEC’s increasing activity against companies under the internal controls provision even where no actual bribe has occurred. Much of the commentary has surrounded the 2012 case brought against Oracle Corp., in which distributors of Oracle’s Indian subsidiary set aside over $2.2 million from sales of software to the Indian government into an off-the-books account (see figure 3, below). Notably, Oracle’s distributors never actually used the funds to pay bribes, although the SEC’s complaint alleged that the parked funds “created a risk that they potentially could be used for illicit means, such as bribery or embezzlement.”

It is certainly more difficult to see what harm, if any, could have been prevented in such a scenario.

**SEC v. Oracle Corp**

The SEC filed a complaint against Oracle Corporation in the U.S. District Court for the Northern District of California on 16 August 2012. The SEC complaint alleged that between 2005 and 2007, employees of Oracle India Private Limited (“Oracle India”), Oracle’s Indian subsidiary, set aside part of the proceeds from sales of software to the government of India, allowing the money to be used for bribery or embezzlement. Over a dozen transactions were structured in this way, and USD $2.2 million were set aside.

Specific allegations contained in the SEC’s complaint claim that Oracle India negotiated contracts with entities of the Indian government for the purchase of software licenses and services. Oracle India then employed local distributors with whom the government entities would place their orders pursuant to the negotiations. The distributors would buy the licenses directly from Oracle and then resell them to the government customers at the higher prices that had been negotiated through Oracle India. On 14 occasions, Oracle India employees, and set aside the margin. Oracle India employees would then instruct the distributors to use the set aside funds to pay third parties, some of whom were not on Oracle’s approved vendor list, and some of which did not exist as legitimate businesses.

The Company discovered irregularities in India while conducting routine audits of its Asia division. Once the problem of the “parked funds” was discovered by Oracle, the Company conducted additional due diligence on its partner transactions in India, terminated its relationship with the suspect distributor, and instructed other distributors not to allow funds to be set aside. Oracle also enhanced its anti-corruption training programs.

The senior Channel Sales Manager for Oracle India resigned in November 2007. Following an audit by Oracle’s Asia Division, four other Oracle India employees were dismissed for allowing or actively participating in Oracle India to set aside funds through its distributors.

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FCPA commentators have variously attacked the reasoning in Oracle, saying that it presents “a very dangerous slippery slope,” offers “a stunning result” and effectively turns the FCPA into “a strict liability statute.” The government can rely on the Oracle precedent as a backstop for every investigation – if the government cannot prove bribery then they need only show that there is a ‘risk’ of bribery,” writes FCPA commentator Michael Volkov. “The case sets a dangerous precedent and a real stretch of the FCPA statute.”

For its part, however, the SEC has consistently viewed the purview of the FCPA as broader than corruption, and even the potential for corruption. The history behind how the accounting provision came to be included within the FCPA is instructive here. Prior to passage of the FCPA in the early 1970s, there was an initiative within the accounting industry to standardize accounting controls to insure public confidence in the ways in which financial information was being reported. At the time, publicly-traded companies were using various accounting methods that made it more difficult for investors to rely on financial statements on their face. With the support of the SEC, the Financial Accounting Standards Board (FASB) was established in 1973, and shortly thereafter the FASB began publishing standards to be observed in the presentation of audited accounts and financial statements. A year later, the SEC began investigating a large number of bribery scandals revealing how off-the-books accounts were being used to funnel bribes to foreign government officials.

When Congress invited the SEC to suggest language for inclusion in early versions of FCPA, the Commission sought to use the Act as a mechanism for furthering ideals of assuring corporate accountability which, up until that time, had been attempted primarily through voluntary cooperation. As Lloyd Feller, former counsel at the SEC and now a partner at the law firm of Morgan & Lewis wrote in 1982, “the [FCPA], as it is applied through the accounting provisions, has absolutely nothing to do with foreign corrupt practices; it has to with accounting, including the maintenance of books and records, and the establishment and maintenance of a system of internal accounting controls.” Establishing a base level for corporate accounting controls was therefore seen as an important precedent to confidence in financial reporting.

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6 See, A Closer Look at Internal Controls Enforcement, supra note 3.

As a result, many of the SEC’s early cases brought under the internal accounting provisions of the FCPA had nothing to do with foreign bribery. Instead, they were primarily intended to penalize companies that had failed to put in place the most basic of accounting controls. In one early case involving a company in the wholesale dealing of rare coins, the company was found guilty under section 13(b)(2)(B) where it failed to safeguard the physical inventory of its coins, maintain adequate purchase orders as documentation to determine correct costs, require employees to keep receipts, and generally maintain adequate supporting documentation sufficient to keep reasonably accurate books and records.

“The establishment and maintenance of a system of internal controls is an important management obligation. A fundamental aspect of management’s stewardship responsibility is to provide shareholders with reasonable assurances that the business is adequately controlled. Additionally, management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis. An adequate system of internal accounting controls is necessary to management’s discharge of these obligations.”

– Senate Report No. 95-114, 1977

Far from being an outlier case, as some have suggested, Oracle conforms to this longstanding tradition within the SEC of using the FCPA to set a standard for corporate accounting systems. Slush funds, like the one that the Oracle’s Indian subsidiary put in place, fall squarely within the type of accounting failures that the provision was intended to prevent. Oracle also serves as a reminder of the broad reach of the internal control requirements under the FCPA. The provision operates similarly to a strict liability requirement insofar as any issuer subject to regulation by the SEC is expected to provide reasonable assurances that its system of internal accounting controls is working. That the issuer conducts business abroad or even with foreign government officials is ultimately irrelevant.

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Establishing “Reasonable Assurances” Under the Act

To what standard are a company’s accounting controls measured under section 13(b)(2)(B)? While the SEC must show that a company’s internal controls system is inadequate, there are no specific standards by which to evaluate the sufficiency of those controls. The Act simply states that a company’s system of internal accounting controls must provide “reasonable assurances” that transactions are recorded accurately. What “reasonable assurances” must be met is left open to interpretation.

Again, the history behind the statute is instructive here. As designed, section 13(b)(2)(B) was intended to ensure that companies put controls in place that would safeguard the accuracy of their financial statements. By including the internal accounting controls provision in the FCPA, the SEC wished to supplement those efforts by the FASB to standardize the way in which public companies were already beginning to put accounting controls in place. In drafting the provision, Congress borrowed directly from the accounting literature and intentionally referenced generally accepted accounting principles (GAAP) in the statute so that people would interpret the language in the same way that accountants had already been doing for years.11 Far from establishing any new requirements or expectations for companies, the provision largely sought to bring companies more in conformity with one another.

Many in the FCPA community have been alarmed, therefore, by the SEC’s increasingly aggressive and prescriptive approach in this area. In 2012, the SEC and the Department of Justice published a joint guide to the FCPA which stated that “[a]n effective compliance program is a critical component of an issuer’s internal controls.”12 In the same document, the two enforcement agencies listed ten “Hallmarks of an Effective Compliance Program,” touching on such areas as training, third party due diligence, and disciplinary measures. This policy position presents a significant departure from the statute’s original language, which discusses “accounting controls” in terms more closely tied to effective bookkeeping. GAAP, for example, does not impose any requirements for employee anti-bribery training or third party due diligence.

The SEC’s case-record shows its willingness to enforce compliance measures under section 13(b)(2)(B). See Watts Water (charges under section 13(b)(2)(B) for failure to implement FCPA training for employees);13 Titan Corp (failure to implement an anti-bribery policy);14 and Smith & Wesson (failure to conduct due diligence on third parties).15 Unsurprisingly, many have viewed the SEC’s application of the internal controls provision as a misapplication of the statute. William Stuckwisch, former prosecutor at the Department of Justice and now a partner at Kirkland & Ellis LLP writes that the SEC’s application of the internal accounting controls “conflates the provision’s requirements for sufficient ‘internal accounting controls’ with the continually evolving elements of an ‘effective’ compliance program.”16 This conflation has only led to more confusion under the statute, re-enforcing the misconception that the internal controls provision of the FCPA is primarily aimed at curbing foreign corruption – something the SEC has repeatedly shown to be untrue.

In the Matter of BHP Billiton Ltd. and BHP Billiton Plc

The effects of the SEC’s aggressive application of section 13(b)(2)(B) were felt most recently in the civil action brought by the Commission against BHP Billiton Ltd. (“BHP Billiton”) in May 2015. Under investigation by the Department of Justice and SEC since 2013, BHP Billiton eventually agreed to pay USD $25 million to resolve allegations that the company violated the books and records and internal controls provisions of the FCPA by providing extravagant hospitality to government officials as part of the company’s sponsorship of the 2008 Olympics in Beijing. In 2007 and 2008, BHP Billiton allegedly offered three to four day stays at luxury hotels, tickets to Olympic events, meals, and other items to government officials. Each hospitality package was valued at approximately USD $12,000 to USD $16,000, and some government officials also allegedly received business-class airfare.

Interestingly, BHP Billiton designed a system of controls meant to address the exact bribery risk posed by inviting government officials to the Olympics, developing a specific internal approval process for hospitality surrounding the games. Business managers were required to complete a hospitality form for any individuals, including government officials, whom they wished to invite, and a cover sheet that accompanied the blank forms included a short description of BHP Billiton’s anti-bribery policy and urged employees to re-read the section concerning travel, entertainment, and gifts before completing the form. Each completed form then needed to be approved by the country president of the various business units. Finally, a supervisory Ethics Panel was established to provide advice on ethical and compliance matters, including those related to the hospitality program.

Despite putting these measures in place, the company’s internal controls were ultimately determined to be insufficient by the SEC. Among the reasons why, the SEC noted that the hospitality forms were not subject to any independent legal or compliance review, that some were inaccurate or incomplete, that employees did not receive any specific training on how to complete the forms, and that employees were not required to update the forms based on new information. To many, the BHP Billiton case establishes an alarmingly high threshold for how the SEC measures the sufficiency of a company’s internal controls. While perhaps not perfect, BHP Billiton clearly demonstrated numerous efforts to mitigate against its corruption risks. Given that no two company’s internal controls are the same and the SEC is always able to engage in after-the-fact analysis relating to financial irregularities, many compliance officers have been left to wonder whether their company’s internal controls could similarly be deemed insufficient.

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Complying with the Internal Controls Provision of the FCPA

Companies subject to the internal controls provision of the Foreign Corrupt Practices Act must operate in an increasingly difficult regulatory landscape. The combination of the SEC’s willingness to apply section 13(b)(2)(B) to non-bribery cases with the fact that companies are ever more held to a compliance “best practices” standard has created an especially high bar for companies. And until cases like BHP Billiton are challenged in court, the SEC is likely to continue to push for this more expansive reading of the provision.

Given these challenges, companies need to ensure that their internal controls systems are sufficiently robust to meet the SEC’s heightened scrutiny. Below are some of the ways companies are meeting this challenge:

- Establishing a clear anti-bribery policy and related procedures;
- Implementing a third party due diligence program that adequately vets and monitors third party business partners;
- Conducting third party audits and reviewing third party outlays that may create bribery risks (e.g. excessive commissions to third parties);
- Ensuring that audits are conducted in accordance with Generally Accepted Auditing Standards and embedding compliance checks into periodic internal audits;
- Cross-training compliance and accounting teams on bribery-related issues;
- Conducting company-wide risk assessments, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.
- The risk assessment should produce insight as to the likelihood of bribery risks occurring, the strength of the company’s internal controls, and any residual risk that may remain;
- Reviewing procedures related to transfer of funds, such as approvals, authorizations, reconciliations, and segregation of duties;
- Reviewing procedures regarding opening of bank accounts and maintaining up-to-date records of all company ledger accounts;
- Reviewing invoices for irregularities, falsehoods, misstatements or other potential fraudulent activities;
- Reviewing procedures for proper recording of all payments – including facilitation payments - on company books; and
- Review of procedures related to journal entries and adjustments made in the period-end financial reporting process.

Many companies are already adopting these internal accounting controls; others will need to catch up. But companies are better off dealing with problems in-house than having them disclosed to the SEC. For each of the above recommendations, companies must show that these controls have not only been adequately set up, but also that they’ve been implemented and revised over time. Compliance officers should vigilantly document their efforts to evidence that these controls are working. So long as the SEC’s application of the internal control provision remains unchallenged, it will likely continue to adopt an expansive interpretation of the statute. In this environment, taking a pro-active approach early-on is a company’s best and only defense.
About TRACE

TRACE International and TRACE Incorporated are two distinct entities with a common mission to advance commercial transparency worldwide by supporting the compliance efforts of multinational companies and their third party intermediaries. TRACE International is a non-profit business association that pools resources to provide members with anti-bribery compliance support while TRACE Incorporated offers both members and non-members customizable risk based due diligence, anti-bribery training and advisory services. Working alongside one another, TRACE International and TRACE Incorporated offer an end-to-end, cost-effective and innovative solution for anti-bribery and third party compliance.

For more information, visit www.TRACEinternational.org.

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