

RESPONSES TO THE CONSULTATION PAPER ON THE REVIEW OF THE OECD ANTI-BRIBERY INSTRUMENTS

Comments from Ernst & Young Global Limited

Ernst & Young welcomes the opportunity to comment to the OECD's Working Group on Bribery on the external audit aspects of its Consultation Paper -Review of the OECD Instruments on Combating Bribery of Foreign Public Officials in International Business Transactions Ten Years After Adoption (January 2008) ("Cons. Paper"). As a global network of member audit firms in more than 130 countries, the fight against foreign bribery and corruption is of keen interest to Ernst & Young. We believe the consultation process will significantly advance that effort by focusing all interested stakeholders on areas and issues of further improvement and will strengthen the global efforts to eliminate corrupt business practices and transactions.

I. Overview of the Differing Roles of Company Management and External Auditors in Combating Bribery

Preparatory to addressing the three external audit issues specifically identified in the paper, Cons. Paper para. 106, it is helpful to compare the role of an external auditor with that of a company and its management regarding the prevention and detection of foreign bribery.

The OECD's 1997 Revised Recommendation of the Council on Combating Bribery in International Business Transactions was intended to address, inter alia, issues of accounting and auditing not fully detailed by the OECD Convention itself. The 1997 Recommendation urged that companies in international business transactions and their management be required to meet adequate accounting requirements, make adequate disclosure in their financial statements, adopt adequate internal controls and take other anti-bribery measures. 1997 Recommendations, para. V.

The international auditing standards of the accounting profession align with this view. "[T]he responsibility for the preparation and presentation of the financial statements...is that of the management of the entity, with oversight from those charged with governance. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities." International Standard on Auditing ("IS A") issued by the International Auditing and Standards Assurance Board ("IAASB") 200.33. "Management is also responsible for [d]esigning, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error." ISA 200.36.

Other global anti-bribery initiatives concur on the primacy of management's responsibility to prevent bribery and maintain adequate controls, books and records and internal audit and whistleblower functions. E.g., International Chamber of Commerce, "Combating Extortion and Bribery: ICC Rules and Recommendations" (2005) (effective anti bribery compliance cannot be achieved without the proper management "tone at the top"); World Economic Forum, "Partnering Against Corruption -Principles for Countering Bribery" (2005).

As will be elaborated below, the external auditor has a supplementary and secondary role regarding detecting and preventing bribery, one that must be viewed through the prism of the auditor's annual audit of a company's financial statements for the stated purpose of expressing an opinion on whether they are free from material misstatement.

II. Comment on the Working Group's Three Stated External Audit Issues

The Working Group's Mid-Term Study caused it to identify the following three issues in relation to independent external audits and auditors:

- a. whether the requirement of an external audit applies to an adequate spectrum of companies;
- b. whether there is an adequate obligation for reporting actual or potential bribery to the competent authorities; and
- c. whether the standard is adequate for triggering a report of foreign bribery either internally or externally to the competent authorities.

A. Expanding the External Audit Requirement Beyond Public Listed Companies Requires a Public Policy Analysis That Weighs the Costs vs. the Benefits

The Consultation Paper expresses concern that very large unlisted privately held or family owned companies are presently exempt from the external audits required of public, listed companies. Cons. Paper, paras. 67 and 107. Presumably the point is that without such an external audit requirement private companies are more likely and able to engage in bribery since the likelihood of detection and deterrence is reduced.

Ernst & Young has the following observations:

First, policymakers requiring external audits of all companies should consider the costs and administrative burdens imposed on small and medium private companies if external audits are required. See, for example, Communication from the European Commission, "Simplified business environment for companies in the area of company law, accounting and auditing" (COM(2007)394 final, pp. 2 and 7-8. Such an analysis of external audits for unlisted companies should assess whether the benefits outweigh such costs. Second, one must recognize that the very objective of an audit is to enable the auditor to express an opinion, to give reasonable assurance if you will, whether the financial statements, taken as a whole and in all material respects, are presented fairly in all material respects/give a fair and true view in accordance with the applicable financial reporting framework. ISA 200.2 and 700.6. As such the auditor is concerned with risks that result in material misstatements in the financial statements, not risks of misstatements that are not material to the financial statements themselves taken as a whole. ISA 200.26.

The last point is not intended to assert that an external audit does not often uncover acts of bribery nor that an auditor does not have a responsibility to consider the possibility of fraud when conducting an audit. ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements." It simply means that third parties should appreciate that by undertaking to do an audit of financial statements in accordance with international auditing standards an auditor is not undertaking to discover all acts of bribery that may exist nor is the auditor providing reasonable assurance via the audit opinion that there are no such acts of bribery which remain undetected. After all, foreign bribery "is inherently difficult to detect because it is committed in secret and involves two satisfied parties." Cons. Pap. para. 64. To provide affirmative assurance regarding the absence of such bribery would require a "fraud audit" -a very different and more costly task than an audit of financial statements.

Therefore, public policymakers might consider whether other more effective prevention and detection measures should be adopted regarding certain non-public companies, such as requiring them to adopt adequate internal controls or to maintain accurate books and records to the extent the law does not already require them to do so.

B. Adequate Auditor Reporting Obligations Exist

The Working Group expressed concern that there are uneven or no requirements in many countries that auditors report actual or potential instances of bribery should they discover them during an audit. Cons. Paper paras. 108-110. Ernst & Young believes there are international professional standards and

laws that address the issue in a manner consistent with the non-managerial role of an external auditor and protecting the public interest. The Working Group should actively encourage countries to adopt such requirements if they have not done so.

The relevant professional standard is ISA 250 and it governs the audits of both public and private companies. Entitled "Consideration of Laws and Regulations in an Audit of Financial Statements," it sets forth an ordered process by which an auditor is to proceed when conduct is uncovered which might violate anti-bribery laws. ISA 250.32-37. This measured response is appropriate because whether certain conduct constitutes or is likely to constitute a violation of law is within the professional competence of legal experts and is ordinarily outside the professional skills of an auditor. ISA 250.4. The guidance also recognizes that the further removed the conduct is from the subject matter of the financial statements which are the focus of the audit, the less likely it is that the auditor will learn of it or recognize it as a possible instance of non-compliance with law. ISA 250.5.

If potential violations of anti-bribery laws are discovered the auditor is required to bring them to the attention of the company's senior management or, if senior management is involved, to the next highest level of authority such as the audit committee or the supervisory board. ISA 250.32-34. The auditor then assesses the remedial actions taken by the company, which could include the company having to notify outside authorities such as securities regulators. If the company's actions are deemed inadequate the auditor, depending on the circumstances and materiality, may have to qualify or disclaim an audit report or resign. ISA 250.35-37 and .39. In such circumstances any usual duty of confidentiality that otherwise might preclude the auditor from reporting the potential bribery to competent authorities or other third parties can be overridden by local laws or statutes if a country has determined that such outside disclosure is appropriate. ISA 250.38.

ISA 250 was crafted by the International Auditing Practice Committee, the predecessor body to the IAASB whose members were from national standard setting bodies around the world. Significantly, IAASB pronouncements like ISA 250 are adopted and issued after a careful public consultation process that includes advice and input from a select group of 12 National Audit Standard Setters, 10 of whom are from countries that are signatories to the OECD treaty.

ISA 250 recognizes that it is the company, its management and its audit committee or supervisory board which have, and must continue to have, the primary duty to disclose relevant information, including acts of actual or potential bribery. Should an auditor encounter questionable activity and bring the matter to their attention as required by ISA 250, the company and management have the responsibility to take the appropriate and responsible action, including any necessary disclosure to competent authorities. We would support reasonable efforts to strengthen any company disclosure obligations that the Working Group may feel are warranted. We do not support, however, diluting or transferring that disclosure duty to external auditors given their lack of expertise regarding legal matters like violations of law, their non-managerial role and the specific nature of the audit engagement which focuses on issues as they affect the financial statements under audit. (In the United States the issue of a listed company auditor disclosing to the securities regulator arises only if the illegal conduct has a material effect on the financial statements and the company and its management fail to take timely and appropriate remedial action and the board of directors has failed to cause management to so act after being notified by the auditor. 15 U.S.C. sec. 78j -1 (e)).

Ernst & Young has some further observations about the Working Group's sense that auditors are sometimes reluctant to report potential bribery to competent authorities outside the company. In our experience, auditor caution about outside reporting is not attributable to a hesitance to "do the right thing." Rather it follows from the fact that almost always the certainty of a violation of anti-bribery law is an open question. Determining non-compliance with a law is always difficult for people not trained in the law.

Further, the facts surrounding a potential violation are often murky and open to interpretation. Was the absence of adequate documentation of a payment to a third party intermediary in a foreign country an act of intentional deception by a company's internal accounting staff to cover up a surreptitious payment by the intermediary to a foreign official or just administrative sloppiness and lack of detail about an otherwise valid transaction? Was a contribution made to a foreign charity not really an act of good corporate social responsibility but an implied quid pro quo because the charity was a personal avocation of the foreign official in charge of purchasing goods such as those offered by the company? Seldom are the facts clear and distinct as to not be susceptible of an interpretation of non-criminal conduct.

A reasonable auditor will always ask "what are the consequences if I am wrong" in reporting something that seems suspicious but, in the end, is not an act of bribery. At a minimum the company will be required to pay often substantial sums for legal and other fees in connection with any investigation. Experience has shown that these can often run into hundreds of thousands of dollars or euros even if the investigation is closed without any action being taken. Corporate or individual reputations will have been called into question and perhaps never completely cleared of suspicion by the mere fact of an allegation of wrongdoing. Companies or even individuals may conclude that they have a legal claim against the auditor for making a report which, in the end, is not substantiated as an act of bribery.

For these reasons we believe that it is appropriate to afford external auditors a legal "safe harbour" regarding any reporting which the auditor makes reasonably and in good faith. The United States, for example, has done so. 15 U.S.c. sec. 78j -1 (c).

C. Financial Statement Materiality is the Reasonable and Workable Standard for an External Auditor Regarding Outside Competent Authorities

Apparently based on a perceived ambiguity in the concept of financial statement materiality, the Working Group seeks input on whether it is an adequate standard to trigger reporting potential bribery "either internally or externally." Cons. Paper paras. 66,106 and III.

As to "internal reporting" to company management or an audit committee or supervisory board, financial statement materiality is not considered. An auditor is not required to report internally to the company those potential violations of anti-bribery laws which are "clearly inconsequential or trivial." ISA 250.32. This is a much lower threshold than the level of materiality which will be used by the auditor to draw conclusions on which to base the opinion on the financial statements. Moreover, even immaterial bribery violations often still result in the entity reporting the matter to external authorities. *In the Matter of Westinghouse Air Brake Technologies Corp.*, Securities Exchange Act Release No. 57333 (Feb. 14, 2008) listed company self reported \$137,000 of improper payments at a 4th level subsidiary).

Regarding any external reporting obligation, financial statement materiality is the only reasonable standard for an outside auditor since that is what governs the auditor's undertaking of an audit and the form of the eventual audit report. Supra at 4 and 15 U.S.C. sec. 78j -1 (b) (2) (A).

The definition of materiality is:

Information is material if its omission or misstatement could influence the economic decisions of users on the basis of the financial statements. Materiality depends on the size of the item or the error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-offpoint...." ISA 320.3.

There is no doubt that determination of what is material is a matter of professional judgment and involves "both the amount (quantity) and nature (quality)" of the misstatement caused in the financial

statements. ISA 320.4 and 5. Yet merely because materiality is judgmental does not mean it is vague or unworkable; indeed, auditors make such determination in each and every audit on a daily basis. Therefore, when an outside auditor is expected to report matters externally which come to his/her attention during an audit it is illogical to impose a standard other than that which governs the engagement being performed. Nor does use of that threshold present a genuine hazard of non-trivial and consequential bribery acts going unreported externally due to materiality's qualitative component. For example, a \$25,000 bribe paid by a low level salesman in an obscure and minor foreign location is qualitatively different than a bribe of the same amount paid by the company's CEO. The amount may be the same but the significance of the direct involvement of senior management, a qualitative distinction, puts the matter in a wholly different light as a user of the financial statements presumably would like to know such facts about the conduct of the person who heads up the company's entire operations and establishes the "tone at the top."

Finally, the concept of materiality with regard to bribery conduct is not per se anathema to the OECD treaty as "facilitating payments" are not an offence. Commentaries on the Convention on Combating Bribery, etc. para. 9. Thus, the issue is simply where does one draw the line between what is material or immaterial in the context of external reporting of bribes. For an auditor the existing professional standard applied in good faith is fair, adequate and logical.

III. Other Comments

Ernst & Young also wishes to express its agreement with, and endorsement of, the Working Group's comments and observations about a company's internal controls. Cons. Paper paras. 97-104. The four 1997 Recommendations regarding internal controls are sound statements of "best practices" which any company operating in cross-border business transactions should adopt and follow. Cons. Paper para. 97. Adequate internal controls, corporate standards of conduct and management statements in annual reports are sound tools to establish prevention and detection mechanisms as well as demonstrate the right "tone at the top." Monitoring bodies like audit committees are part of proper corporate governance. "Whistleblower" mechanisms and protections are essential to encouraging and enabling individuals most likely to have knowledge of questionable bribery behaviour to report it without fear of retribution.

We concur that more Parties should encourage their companies to adopt anti-bribery controls in the manner described in para. 99 and that SMEs should not be excluded from this effort simply because they are smaller compared to large multinational companies. Their smaller size and closer connectivity between senior management and "on the ground" personnel often makes conveying the anti-bribery message easier and the internal control environment not quite as complex. Even accounting for more limited resources, SMEs in international business transactions can and should do more.

As signatories of the World Economic Forum's "Partnering Against Corruption Principles for Countering Bribery" we support the goal of establishing effective antibribery compliance programs, management expression of commitment and effective reporting of suspicious activity. Cons. Paper para. 101. As noted above we agree that more companies need to offer adequate "whistleblower" measure. Cons. Paper para. 102.

Last, but surely not least, Ernst & Young applauds the Working Group's recognition of the important role of a company's internal auditors in preventing and detecting bribery. Cons. Paper 103 and 104. We concur that a strong and effective internal audit function can "positively influence" a company, its management and corporate governance bodies, like an audit committee, to fight bribery and can provide a "safety-net for preventing, detecting and reporting" bribery. Cons. Paper para. 104. Internal audit's activities can include key anti-bribery activities such as monitoring internal control, examining financial and operating information, reviewing the economy, efficiency, and effectiveness of operations and reviewing compliance with laws and regulations like anti-bribery statutes. ISA 610.5. Together with

management and the company's corporate governance bodies, internal audit is part of a company's primary bulwark against illegal bribery conduct. We look forward to reviewing the submission from the Institute of Internal Auditors as solicited by the Working Group.