Journal of Forensic & Investigative Accounting
Vol. 7, Issue 2, July - December 2015

Independent Auditors' Responsibilities for Violations of Anti-bribery Provisions Under the U.S. Foreign Corrupt Practices Act: Auditing for Bribes

Ricardo Colon*

The anti-bribery provisions of the Foreign Corrupt Practices Act (FCPA) subjects companies traded in U.S. exchange markets and individuals to criminal and civil liability for paying bribes to foreign government officials in exchange for obtaining or retaining business or securing any improper advantage.[1] Although the FCPA primarily targets companies and their executives, independent auditors are not free from FCPA related-liability.[2] Public perceptions of the role of independent auditors coupled with rigorous enforcement of the FCPA have resulted in heightened scrutiny of the independent auditors' responsibility to detect bribes.

According to the Association of Certified Fraud Examiners (ACFE), most fraud and bribery are uncovered through tips, management reviews, internal audits, account reconciliations, or merely by accident.[3] Recent high profile bribery investigations and enforcement actions support these findings. To illustrate, tips given by Argentinean employees alerted Ralph Lauren Corporation that its subsidiary in Argentina paid bribes totaling $593,000 to government officials from 2005 to 2009 in order to import products into the country.[4] In another high profile case, an employee alerted Orthofix International N.V. (Orthofix) that its subsidiary in Mexico paid bribes totaling approximately $5 million to government officials to obtain lucrative sales contracts with state owned hospitals.[5] The bribes, colloquially referred to as "chocolates," were detected by an executive employee at the Mexican subsidiary who reported them to Orthofix. More recently, Wal-Mart reportedly first learned about a bribery scheme at its Mexican subsidiary, Wal-Mart de México, through an email sent by a whistleblower.[6] Interestingly, the whistleblower was a Mexican attorney who was responsible for obtaining construction permits for Wal-Mart de México prior to resigning from the company. The email described how Wal-Mart de México

---

*The author is an Assistant Professor of Accounting at Lamar University.

[1] Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78dd-1(a) (2014).
[2] An accounting firm that pays a bribe to a foreign government official on behalf of a client is liable under the FCPA. For example, an affiliate firm of KPMG International was charged with FCPA violations for bribing Indonesian tax officials to reduce a client's tax assessment. *See SEC v. KPMG Siddharta*, SEC Litigation Release No. 17127 (Sept. 12, 2001).
[3] ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE, 2014 GLOBAL FRAUD STUDY 19 (2014) [hereinafter REPORT TO THE NATIONS].
[4] Press Release, SEC Announces Non-Prosecution Agreement With Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013).
[5] Press Release, SEC Charges Orthofix International with FCPA Violations (July 10, 2012).
[6] David Barstow, *Vast Mexico bribery case hushed up by Wal-Mart after top-level struggle*, N.Y. TIMES, Apr. 21, 2012, http://www.nytimes.com/2012/04/22/business/at-wal-mart-in-mexico-a-bribe-inquiry-silenced.html?_r=2&.

paid bribes in excess of $24 million to government officials to expedite the approval of new store permits, obtain confidential information about competitors, and seek a reduction or elimination of fines imposed by government agencies.

Contrary to public perception, only 3 to 4 percent of all fraudulent acts are detected by independent auditors.[7] This data suggests that the ability of independent auditors to detect fraud is surprisingly low, especially considering that approximately 7 percent of all fraudulent acts are detected by accident.[8] Ultimately, given the vital role that audits of financial statements play in corporate governance, can auditors ignore the possibility of bribes to foreign government officials when auditing financial statements? The answer to this question is "No." As this study explains, auditors have a responsibility under the Securities Exchange Act of 1934 (Exchange Act) and the standards issued by the Public Company Accounting Oversight Board (PCAOB) to design and implement audit procedures that provide reasonable assurance of detecting violations of the FCPA's anti-bribery provisions and, in some instances, must report these violations to U.S. authorities.[9]

1. Independent auditors' responsibility with respect to bribery

Pursuant to Section 10A of the Exchange Act and AU section 317, *Illegal Acts by Clients*, auditors have a responsibility to design procedures that provide reasonable assurance of detecting illegal acts that have a direct and material effect on the financial statements.[10] Bribing a foreign government official is illegal and has a direct and material effect on a company's financial statements. Companies that pay bribes generally record the underlying transactions in their accounting books as legitimate operating expenses in an effort to avoid detection. Since bribes often involve disbursements of cash, recording a bribe as a legitimate operating expense results in false reporting of expenses on the income statement. Although such amounts paid may not be monetarily substantial, determining whether these have a material effect on the financial statements does not necessarily depend on a numerical threshold. In Staff Accounting Bulletin No. 99, *Materiality*, the Securities and Exchange Commission (SEC) stated that a quantitatively small misstatement will likely be considered material when "the misstatement involves concealment of an unlawful transaction.''[11] This situation is exactly what occurs when a company conceals a bribe by recording it as a legitimate business expense.[12]

---

[7] REPORT TO THE NATIONS, *supra* note 3 at 19.
[8] *Id.*
[9] Foreign public accounting firms that conduct audits of companies traded in U.S. exchange markets must observe the same standards as U.S. public accounting firms. *See* Sarbanes-Oxley Act of 2002 § 106(a), 15 U.S.C. § 7216(a) (2014).
[10] Securities Exchange Act of 1934 § 10A(a)(1), 15 U.S.C. § 78j-1(a)(1) (2014)); AU sec. 317. References to AU sections ("AU sec.") throughout this study correspond to PCAOB interim auditing standards.
[11] SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 19, 1999).
[12] Bribery may also subject companies to liability for keeping inaccurate books and records and for failing to maintain an effective system of internal controls pursuant to the FCPA's accounting and internal control provisions. *See* Staff Audit Practice Alert No. 8, *Audit Risks in Certain*

Under AU section 317, the auditor's responsibility with respect to bribery is the same as that for misstatements caused by error or fraud. First, the auditor is required to follow Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* and perform "risk assessment procedures" that provide a reasonable basis for identifying and assessing the risks of material misstatements in the financial statements.[13] If the auditor identifies such risks, the auditor is required to design and implement audit responses specifically aimed at addressing the particular risks identified.[14] For instance, if the preliminary risk assessment procedures identify a high risk of bribery of foreign government officials, then the auditor must design and implement audit tests and procedures that respond to the assessed bribery risk.[15]

2. Bribery Detection

i. Performing Risk Assessment Procedures

An audit of financial statements requires auditors to perform risk assessment procedures and evaluate the existence of risk factors that may have an effect on the financial statements.[16] To comply with auditing standards, the auditor is required to understand the company and its environment and internal controls over financial reporting. This includes, for example, understanding the following: the relevant industry and regulatory and external factors affecting it; the company's objectives, strategies and business risks; its organizational structure; its sources of funding for operations; significant investments, including via equity, joint ventures, and variable interest entities; sources of earnings, including the relative profitability of key products and services; key supplier and customer relationships; management's philosophy and operating style; and the policies and actions of management, the board of directors, and the audit committee regarding internal controls.[17]

Since the early 2000s, a wave of bribery scandals has emerged spanning a broad range of industries, affecting reputable companies such as Wal-Mart, Hewlett-Packard, Alcoa, Total, Eli Lilly, Tyco, Siemens, and Halliburton.[18] These cases highlight the need to evaluate corruption and bribery risks when auditing companies with significant foreign operations, especially in the

---

Emerging Markets, p. 20 n. 61 [hereinafter *Staff Practice Alert No. 8*] (stating that the accounting provisions of the FCPA require issuers with securities registered under section 12 of the Exchange Act or required to file reports under section 15(d) of the Exchange Act, among other things, to make and keep books and records that fairly reflect the transactions and assets of the issuer and to devise and maintain internal accounting controls sufficient to permit the preparation of financial statements in conformity with the applicable financial reporting framework).

[13] *See* paragraphs 4-6 of Auditing Standard No. 12.

[14] *See* paragraph 3 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement.*

[15] *See* paragraphs 3 and 4 of Auditing Standard No. 13.

[16] *See* Auditing Standard No. 12.

[17] *Id.* ¶¶ 7 – 10.

[18] SEC ENFORCEMENT ACTIONS: FCPA CASES, http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml (last visited June 25, 2014).

eight countries that represent the highest bribery risk: Nigeria, Iraq, China, Azerbaijan, Kazakhstan, Mexico, Thailand, and Saudi Arabia.[19]

Specifically, auditors should consider events, conditions, and activities that may indicate a heightened risk of illegal payments to foreign government officials. The accounting literature has identified numerous factors that raise red flags indicating a heightened risk of fraud.[20] Table 1 summarizes the most relevant risk factors.

Table 1
Risk Factors Indicative of Bribes

Prior history of FCPA violations perpetrated by the company, its subsidiaries, or in the industry.	Geographic location of the company's operations and the relevant corruption rating from Transparency International.
The operating countries' anti-corruption enforcement levels and ongoing investigations or schemes.	Susceptibility to pay bribes using third parties.
Knowledge of corporate anti-bribery policies and procedures by employees, vendors and agents.	Findings from previous testing, audits, surveys and hotlines.
Internal control deficiencies and material weaknesses.	Recent changes in management and reporting lines.
The dollar amount and percentage of transactions with the government.	Payments to third parties including sales agents and commercial agents.
Material budget to actual variances.	Payments for professional services and discretionary non-inventory spending.
The nature and timing of expense reporting.	Corporate gift and travel policies.
Manipulation of accounting records to conceal or mischaracterize payments.	Corporate cash management and disbursement policies.
Unusual delay by management in the	Policies related to incident reporting and

[19] Brittany Zeske and Michael D. Ackers, *The Foreign Corrupt Practices Act An Examination of Cases and Enforcement Actions*, 82 THE CPA JOURNAL 60, 64 (2012).
[20] *See* Matt Birk, *Prescription for FCPA Compliance*, 67 INTERNAL AUDITOR 53, 55 (2010); *Staff Practice Alert No. 8*, *supra* note 12; THE INSTITUTE OF INTERNAL AUDITORS, INTERNAL AUDITING AND THE FOREIGN CORRUPT PRACTICES ACT 8, 20 (2010) [hereinafter INTERNAL AUDITING AND THE FCPA]; Mitchell S. Ettinger, *Auditing FCPA Compliance Risk*, 67 INTERNAL AUDITOR 46, 48-50 (2010); Albert G. Holzinger, *Countering Corruption*, 69 INTERNAL AUDITOR 47, 49 (2012); Marks, *infra* note 30, at 12.

production of routine documents requested by auditors.	investigations.
Existence of uncorroborated expenses for which the business purpose is unclear.	Unexplained discrepancies between amounts reported in SEC filings and amounts included in the financial reports filed with local authorities.
Use of personal-type bank accounts held in the name of corporate officers or employees instead of corporate bank accounts.	Irregularities in sales contracts, such as a company specific seal affixed on the sales contract that does not belong to the purported customer in the contract.
The company's significance in the regional or local economy and its level of influence over its industry, and regional or local government.	Local business practices and the cultural norms in the business and regulatory environments.
The possibility that employees may not be willing to report bribes and fraud for cultural reasons or fear of retribution from management.	Management's ability to pressure employees or third parties to provide false information to the auditors.
Management ties with the local government.	

These factors offer a baseline to assist auditors in identifying the financial statement accounts that require analytical procedures to address bribery risk. A logical starting point for analytical procedures is to review the company's chart of accounts and financial statements to select for testing those accounts where the bribery risk has been historically high, including commissions, consulting fees, royalties, other expenses, legal fees, customs fees, duties, miscellaneous expenses, interest expense, travel, meals and entertainment, agency services, training expenses, promotional expenses, and payroll.[21] For example, if the auditor analyses the expense accounts and management reports a significant unexpected increase in commissions resulting from increased sales, the auditor should obtain evidence to corroborate this representation and critically evaluate whether the representation is reasonable based on the evidence obtained, such as whether the sales or services giving rise to the commissions actually occurred.

Auditors should perform other procedures to identify and assess bribery risk, including evaluating information obtained from the client acceptance and retention analysis, audit planning activities, past audits, and other engagements performed for the company; discussing among the

[21] *See* Benjamin A. Cohen & Kiersten S. Archer, *Putting the CPA in FCPA Investigations*, 81 PENNSYLVANIA CPA JOURNAL (2011), *available at* http://www.picpa.org/Content/41950.aspx. *See also* Ricardo Colón & Héctor G. Bladuell, *Auditors and the Foreign Corrupt Practices Act: Lessons from Latin America*, 14 JOURNAL OF RESEARCH IN ACCOUNTING IN EMERGING ECONOMIES (SPECIAL ISSUE) (forthcoming 2014).

engagement team members the bribery risks; asking the audit committee, management and others within the company about bribery; and evaluating the design of the company's internal controls that are intended to address bribery and fraud risks and determining whether those controls have been implemented.[22]

ii. Performing Substantive Procedures

Auditors are required to design and implement audit responses to address risks identified during the risk assessment phase of the audit. Specifically, if risk assessment procedures reveal a bribery risk, the auditor must respond in two ways: first, by designing and implementing responses that have an overall effect on the manner in which the audit is performed (known as overall responses) and, second, by changing the nature, timing, and extent of audit procedures.[23]

Overall responses to address the risk of bribery include staffing the audit with supervisors and team members with specialized knowledge, skills, and abilities related to the detection of bribes and maintaining professional skepticism with respect to the possibility of bribery when gathering and evaluating audit evidence.[24] While auditors are not expected to be experts at detecting bribes, exercising professional skepticism requires auditors to obtain reliable evidence that corroborates the management's explanations or representations. In addition to exercising professional skepticism, two required overall audit responses are especially relevant for addressing fraud and bribery risks. First, the auditor must incorporate an element of unpredictability in the selection of audit procedures to be performed, for example, by selecting items for testing beyond the customary selection parameters or performing unannounced procedures.[25] Second, the auditor must evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions, indicate bias that could lead to material misstatements in the financial statements.[26]

The assessed risk of bribery also affects the nature, timing, and extent of audit procedures. For instance, the timing of audit procedures may be modified to take place when bribes are more likely to occur.[27] Similarly, the extent of audit procedures may be modified to obtain more evidence by increasing sample sizes and using computer assisted tools capable of detecting bribes based on techniques such as statistical analysis, anomaly detection, data visualization, and text mining.[28] Lastly, the auditor may modify the nature of audit procedures to perform substantive tests specifically tailored to the assessed bribery risk and the risk that management may override internal controls designed to prevent bribery.[29]

---

[22] *See* paragraphs 41-45, 49-58 and 72 of Auditing Standard No. 12.
[23] *See* paragraphs 3 and 4 of Auditing Standard No. 13.
[24] *Id.* ¶¶ 5-7.
[25] *Id.* ¶ 5.
[26] *Id.*
[27] *Id.* ¶ 14.
[28] *Id.*
[29] *Id.* ¶¶ 13, 15.

To properly respond to bribery risks, auditors must modify traditional audit programs to include substantive tests and procedures specifically designed to detect bribes. Table 2 illustrates some of these substantive tests and procedures.[30]

Table 2
Tests and Procedures to Detect Bribes

Examine transactions with customers, suppliers, and distributors that are government entities or that involve a one-time payment.	Review discounts, rebates, promotional programs or adjustments to invoices.
Audit key agents, distributors and government contracts.	Examine commission and finder's fee payments.
Review provisions in contracts and agreements for compliance with corporate policies and FCPA requirements.	Evaluate favorable or abnormal credit terms or below-market prices.
Identify unusual duty tax payments and excessive processing or shipping charges.	Examine payments made to consultants, sales representatives, agents, attorneys, and lobbyists.
Evaluate payments for commissions and bonuses and ascertain their reasonableness and business purpose.	Test expense accounts most at risk for bribery and FCPA violations including gifts and entertainment, hospitality, travel, commissions, donations, professional fees, event expenses, and bonuses.
Query transactions for keywords that may refer to bribes in the local language (*e.g.*, the word "chocolates" referring to bribes in Mexico).	Identify payments involving offshore holding companies or payments to suppliers and agents located in countries where the company does not operate.
Examine political contributions and charitable donations.	Examine payments to detect fines and penalties and violations of laws and regulations.

Additionally, auditors often test the petty cash account to search for bribes. Most petty cash payments are nominal, and hence, a large volume of unsupported petty cash payments is a

[30] *See, e.g.*, *Staff Practice Alert No. 8*, *supra* note 12; Birk, *supra* note 20, at 55-56; INTERNAL AUDITING AND THE FCPA, *supra* note 20, at 9-10, 19; Hernan Huwyler, *Audit Procedures for FCPA Testing*, DAILY EXEC. BLOG, http://mydailyexecutive.blogspot.com/search/label/fcpa; Jonathan T. Marks, *Thirteen Steps to FCPA Compliance*, 81 THE CPA JOURNAL 11, 11-13 (2011).

red flag.[31] In some countries, it is harder for U.S. companies to obtain bank accounts in the corporation's name, and thus, petty cash payments are often made in amounts more sizeable than the threshold usually expected from a petty cash account.[32] The SEC enforcement actions against Willbros Group, Inc. and Dow Chemical Co. illustrate bribery payments via petty cash. For instance, Willbros Group, Inc. paid approximately $6 million in bribes to Nigerian court and tax officials out of its petty cash fund supported by fictitious invoices for fuel, freight, and catering expenses.[33] Similarly, a subsidiary of Dow Chemical Co. paid bribes to state inspectors and state officials in India to facilitate distribution of agro-chemical products. The subsidiary routinely disbursed money out of its petty cash, generally in amounts under $100, to bribe government officials.[34] These small petty cash disbursements amounted to $87,400 in bribes over a five-year period.

iii. Engaging forensic accountants

The role of forensic accountants has become more prominent given the public demand for transparency and honesty following numerous corporate accounting scandals and reports of white-collar crime.[35] Forensic refers to materials "used in or suitable to courts of law."[36] Forensic accounting generally involves the application of special skills in accounting, auditing, finance, quantitative methods, specific legal and research areas, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings.[37] Because of their expertise, practitioners and professionals who have knowledge and skills related to fraud and forensic accounting are in high demand.[38]

The increasing popularity of forensic accounting has coincided with a growing expectations gap among various stakeholders affecting their beliefs of the actions that auditors take or should take in detecting fraud and the actions that auditors are capable of doing.[39] The primary responsibility of financial statement auditors is not to detect fraud, but to obtain

---

[31] *See* Cohen & Archer, *supra* note 21.
[32] *Id.*
[33] Complaint at 11-12, SEC v. Willbros Group, Inc., No. 4:08-cv-01494 (S.D. Tex. May 14, 2008).
[34] The Dow Chemical Co., Exchange Act Release No. 55281, 2007 WL 460872 (Feb. 13, 2007).
[35] Madan Lal Bhasin, *Corporate Governance and Forensic Accountants' Role: Global Regulatory Action Scenario*, 1 INTERNATIONAL JOURNAL OF ACCOUNTING RESEARCH 1,1 (2013).
[36] BLACK'S LAW DICTIONARY 676 (8 th ed. 2004).
[37] This definition was adopted by the AICPA Business Valuation/Forensic and Litigation Services Executive Committee and included in the AICPA Professional Ethics Executive Committee (PEEC) Exposure Draft; Proposed Interpretation 101-17: *Performance of Client Advocacy Services, Fact Witness Testimony, and Forensic Accounting Services,* Under Rule 101, Independence; September 15, 2005.
[38] U.S. DEPARTMENT OF JUSTICE, EDUCATION AND TRAINING IN FRAUD AND FORENSIC ACCOUNTING: A GUIDE FOR EDUCATIONAL INSTITUTIONS, STAKEHOLDER ORGANIZATIONS, FACULTY, AND STUDENTS 3 (2007).
[39] GLOBAL PUBLIC POLICY SYMPOSIUM, GLOBAL CAPITAL MARKETS AND THE GLOBAL ECONOMY: A VISION FROM THE CEOS OF THE INTERNATIONAL AUDIT NETWORKS 12-13 (2006).

reasonable assurance about whether the financial statements are free of material misstatements.[40] Existing PCAOB auditing standards require auditors to consider fraud by, among other things, performing audit procedures to identify fraud risks; planning and performing procedures to address those risks, including specified procedures to address the risk of management override of controls; and considering fraud when evaluating the results of the audit.[41] To fulfill these standards, auditors already perform procedures that can be considered investigative, or forensic, in nature.[42] Examples of forensic procedures traditionally used in the audit environment to detect fraudulent misstatements include testing journal entries, retrospective review of significant accounting estimates, evaluation of the business rationale for significant unusual transactions, and other procedures that involve performing substantive tests or applying methods of collecting evidence that presume the possibility of dishonesty, including the override of internal controls, falsification of documents, and collusion.[43]

PCAOB Quality Control Standards require firms to establish policies and procedures that allow auditors to consult with individuals within or outside the firm, especially when dealing with "complex, unusual, or unfamiliar issues."[44] While the risk or actual occurrence of bribery is a complex issue that likely warrants consultation with a forensic accountant, there is no mandate to engage a forensic accountant in a financial statement audit.[45] If auditors employ a forensic accountant, the nature and scope of the consultation may vary depending on factors such as the size of the audit firm and the levels of knowledge, competence, and judgment possessed by the auditors.[46]

In the present audit environment, independent auditors use forensic accounting procedures more routinely. Consequently, forensic accountants may assist auditors during an audit of financial statements in numerous areas such as participating in discussions among audit personnel regarding the risks of material misstatement due to fraud during the planning phase of the audit; reviewing information needed to identify the risks of material misstatements due to fraud and identifying methods to obtain information; conducting interviews with and making inquiries of the client; assessing fraud and bribery risks in internal controls; and implementing training programs to develop auditors' forensic skills and techniques.[47] This list is not

---

[40] *See* paragraph 2 of AU sec. 110.
[41] *See generally* Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, Auditing Standard No. 14, *Evaluating Audit Results*, and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.
[42] PCAOB STANDING ADVISORY GROUP MEETING, PANEL DISCUSSION – FORENSIC ACCOUNTING PROCEDURES 5-6 (2007).
[43] *See* AU sec. 316.
[44] *See* Paragraph 19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. *See also* Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions*.
[45] PCAOB STANDING ADVISORY GROUP MEETING, *supra* note 42, at 5.
[46] *See* Paragraph 19 of QC sec. 20.
[47] *See* AICPA FORENSIC AND LITIGATION SERVICES COMMITTEE, DISCUSSION PAPER: USING FORENSIC PROCEDURES AND SPECIALISTS IN FINANCIAL STATEMENT AUDITS 17-24.

comprehensive and merely illustrates some of the areas in which forensic accountants may bring expertise during the audit process.

The accounting literature has observed that "today's technologies allow for cost effective means to continuously monitor (not spot check) corporate activities under forensic audit practices."[48] Ordinarily, forensic accountants may be engaged to assist auditors proactively, but in practice, forensic accountants are more commonly employed after an allegation of fraud arises or a bribe is discovered. Forensic accountants bring in-depth knowledge of financial statement analysis, allowing them to identify abnormal patterns in accounting information; specialized knowledge of fraud schemes including asset misappropriations, money laundering, bribery, and corruption; proficiency in conducting investigations in computerized accounting systems and electronic evidence techniques designed to detect fraudulent transactions and bribes; knowledge of psychology that enables them to understand impulses behind criminal behavior and facilitates the design of programs that deter fraudulent behavior; interview skills that allow for detection of specific verbal and non-verbal cues of deception; and communication skills that aid in disseminating corporate policies and procedures to fraud and bribery investigations.[49] Often, forensic accountants possess specialized knowledge about regulatory issues and fraud and bribery risks affecting particular industries such as healthcare, pharmaceuticals, oil and gas, utilities, telecommunications, and entertainment.[50] Forensic accountants also have knowledge of the legal system, rules of evidence, and the potential pitfalls in a case; therefore, they are better equipped to properly document the results of investigations and handle evidence, including maintaining the appropriate chain of custody, to avoid spoliation.[51]

Auditors must understand the breadth, depth, and scope of the procedures performed by forensic accountants. If fraud or bribery is detected by forensic accountants, the auditor must consider whether additional investigative procedures are needed, assess materiality, determine whether the fraud or bribery result in a material misstatement in the financial statements and consider the need to withdraw from the engagement.[52] The auditor must also consider the effect of the forensic accountant's findings on independence. While auditors are allowed to expand the scope of an audit upon the detection of fraud and bribery to determine their impact on the financial statements, SEC independence rules prohibit auditors from providing opinions or other litigation support services to audit clients or their legal representatives for the purpose of advocating the client's interest in litigation or in regulatory and administrative investigations or proceedings.[53] Specifically, independence is considered impaired if the auditor is engaged to provide forensic accounting services to an audit client's legal representative in connection with

---

[48] Stevenson Smith & Larry Crumbley, *Defining a Forensic Audit*, 4 JOURNAL OF DIGITAL FORENSICS, SECURITY AND LAW 61, 65-66 (2009).
[49] Bhasin, *supra* note 35, at 7.
[50] AICPA FORENSIC AND LITIGATION SERVICES COMMITTEE, *supra* note 47, at 18.
[51] *Id.* Generally, spoliation is a tort that consists of an intentional or negligent interference with a prospective civil action by destruction of evidence. S. Nolte, *The Spoliation Tort: An Approach to Underlying Principles*, 26 ST. MARY'S L.J. 351, 360 (1995).
[52] *See generally* Auditing Standard No. 14, Audit Evidence.
[53] Qualifications of Accountants, 17 C.F.R § 210.2-01 (2014).

defense of an investigation by the SEC.[54] Likewise, auditor independence is impaired if an audit client's legal counsel engages the auditor to provide forensic accounting services in connection with any litigation, proceeding, or investigation.[55]

In 2000, *The Panel on Audit Effectiveness Report and Recommendations* concluded that auditing standards should require a "forensic-type fieldwork phase" for all audits.[56] This fieldwork phase, which could be integrated throughout the audit, would require "[p]erformance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management (recognizing that management includes many levels of personnel in an entity, including personnel outside of the United States, and not just top corporate-level management."[57] In response to corporate scandals involving companies such as Enron, Adelphia, HealthSouth, Tyco, and Xerox, large audit firms used to assign staff from their forensic accounting practices to assist auditors in identifying fraud risks and bribery.[58] For the most part, this practice has now been discontinued.

Recently, a PCAOB Advisory Group concluded: "[c]onsistent with the Panel on Audit Effectiveness, we recommend the PCAOB revise its standards to require forensic auditing procedures and include greater guidance on the forensic audit procedures that should be performed."[59] Currently, the PCAOB is conducting research to determine whether improvements are needed to auditing standards regarding the auditor's approach to the detection of fraud and, more specifically, discussing whether to expand audit requirements to require additional forensic procedures or other types of procedures for detecting financial statement fraud.[60]

3. Auditors' responsibility to report FCPA violations

The auditor's response upon detecting a bribe is a controversial issue, subject to much debate. The following hypothetical case illustrates the controversy:

> ABC Auditors is hired to perform an external audit of the financial statements of XYZ Co., a publicly traded U.S. company. Based on information obtained during

---

[54] Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 33-8183 (Jan 28, 2003).
[55] *Id.*
[56] PUBLIC OVERSIGHT BOARD, THE PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS (2000).
[57] *Id.* at 88-89.
[58] MEMORANDUM FROM THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD INVESTOR ADVISORY GROUP, SUBCOMMITTEE ON GLOBAL NETWORKS AND AUDIT FIRM GOVERNANCE 12 (2011), http://pcaobus.org/News/Events/Documents/03162011_IAGMeeting/Subcommittee_Memo.pdf
[59] *Id.* at 13.
[60] *See* PCAOB STANDING ADVISORY GROUP MEETING, CONSIDERATION OF OUTREACH AND RESEARCH REGARDING THE AUDITOR'S APPROACH TO DETECTING FRAUD 6-8 (2012), http://pcaobus.org/News/Events/Documents/11152012_SAGMeeting/2012_11_15_%20SAG_BP_%20Fraud.pdf

> the audit and through consultation with legal counsel, ABC concludes that XYZ has violated the FCPA. In response to the detected illegal act, ABC should do all of the following EXCEPT:
> **a.** Consider the illegal act's effect on the amounts presented in XYZ's financial statements
> **b.** Evaluate the adequacy of disclosure in the financial statements of the illegal act's potential effects on XYZ's operations
> c. Consider the implications of the illegal act in relation to other aspects of the audit
> **d.** Disclose the illegal act to the SEC

This hypothetical was published in an article entitled *What is Your Fraud IQ* published in *Journal of Accountancy.*[61] The correct answer, according to the authors is "d" because "[i]t ordinarily is not the auditor's responsibility to disclose an illegal act to parties other than the client's senior management and its audit committee and board of directors, and such disclosure would be precluded by the auditor's ethical and legal obligations." However, the Chief Accountant of the SEC's Division of Enforcement and the Chief of the SEC's FCPA Unit subsequently published a letter in the *Journal of Accountancy* arguing that the answer "d" was incomplete and misleading because it created a false impression that auditors never have a duty to report a client's illegal act to the SEC.[62] Clearly, "d" is not correct.

The Exchange Act imposes two basic responsibilities upon auditors that discover an illegal act or information that suggests that an illegal act may have occurred, regardless of whether or not the illegal act is perceived to have a material effect on the financial statements. First, the auditor must determine whether an illegal act has in fact occurred and must consider the effect of the illegal act on the financial statements, including any contingent monetary effects such as fines, penalties, and damages.[63] Second, the auditor must inform the appropriate level of management and the audit committee, or the board of directors in the absence of an audit committee, unless the illegal act is "clearly inconsequential."[64] It is highly unlikely that a violation of the anti-bribery provisions of the FCPA will be considered clearly inconsequential given the active enforcement of this law by the SEC and the U.S. Department of Justice (DOJ). If management fails to take timely and appropriate remedial action, and this failure is reasonably expected to warrant a departure from an unqualified report or cause the auditor to resign, then the auditor is required to provide a written report to the board of directors, who must inform the SEC of the auditor's report within one business day and provide a copy of that notification to the auditor.[65] If the board of directors fails to do so, then the auditor must either resign and provide

---

[61] Andi McNeal & Dawn Taylor, *What's Your Fraud IQ?*, JOURNAL OF ACCOUNTANCY , Feb. 2012, at 36, 37.

[62] **Howard A. Scheck & Kara Novaco Brockmeyer, *More on auditors' reporting duties to the SEC* JOURNAL OF ACCOUNTANCY, May 2012.**

[63] Securities Exchange Act of 1934 § 10A(b)(1)(A)(i)-(ii), 15 U.S.C. § 78j-1(b)(1)(A)(i)-(ii) (2014).

[64] Securities Exchange Act of 1934 § 10A(b)(1)(B), 15 U.S.C. § 78j-1(b)(1)(B) (2014).

[65] Securities Exchange Act of 1934 § 10A(b)(2)-(3), 15 U.S.C. § 78j-1(b)(2)-(3) (2014).

a copy of its report to the SEC, or provide a copy of the report to the SEC within one business day of the board's failure to inform the SEC. [66]

Recently, the SEC and the DOJ issued joint guidance addressing the auditor's responsibilities with respect to client violations of the FCPA's anti-bribery provisions in a publication entitled *A Resource Guide to the U.S. Foreign Corrupt Practices Act*. The guidance makes clear that "independent auditors who discover an illegal act, such as the payment of bribes to domestic or foreign government officials, have obligations in connection with their audits of public companies" and reiterates that "auditors who become aware of illegal acts [are required] to report such acts to appropriate levels within the company and, if the company fails to take appropriate action, to notify the SEC."[67]

4. Independent auditors' opinion

Auditors are required to issue an opinion regarding whether the financial statements taken as a whole, present fairly, in all material respects, the financial position of the client, and the results of its operations and its cash flows, in accordance with Generally Accepted Accounting Principles.[68] An auditor usually issues an unqualified audit opinion when the financial statements are free of material misstatements. However, when a client violates the anti-bribery provisions of the FCPA, the violation also may result in a material error in the financial statements. If the material error is not properly accounted for or disclosed, the auditor should issue a qualified or adverse opinion on the financial statements.[69] If the client prevents the auditor from obtaining information to evaluate the effect of the FCPA violation, then a scope limitation occurs which generally causes the auditor to disclaim the opinion on the financial statements.[70] If the client refuses to accept a qualified opinion, an adverse opinion, or a disclaimer of opinion, then the auditor must withdraw and inform the client's audit committee or board of directors of the reasons for withdrawing in writing.[71]

The Sarbanes-Oxley Act imposed an additional responsibility on auditors to issue an opinion on the effectiveness of internal controls over financial reporting based on control criteria such as published in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.[72] Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with An Audit of Financial Statements*, requires independent auditors to understand internal controls over financial reporting, assess the risk of material weakness in internal controls, and test and evaluate the design and operating effectiveness of internal controls.[73] Auditors must inform management and

---

[66] Securities Exchange Act of 1934 § 10A(b)(3)-(4), 15 U.S.C. § 78j-1(b)(3)-(4) (2014).
[67] U.S. DEPARTMENT OF Justice AND US SECURITIES AND EXCHANGE COMMISSION, A RESOURCE GUIDE TO THE US FOREIGN CORRUPT PRACTICES ACT 2 (2012), p. 45 http://www.justice.gov/criminal/fraud/fcpa/guide.pdf.
[68] Securities Exchange Act of 1934 § 13(a)(2), 15 U.S.C. § 78m(a)(2) (2014).
[69] *See* paragraph .18 of AU sec. 317.
[70] *See* paragraph .19 of AU sec. 317.
[71] *See* paragraph .20 of AU sec. 317.
[72] Sarbanes-Oxley Act of 2002 § 404(b), 15 U.S.C. § 7262(b) (2014).
[73] *See* paragraphs 1-61 of Auditing Standard No. 5.

the audit committee in writing of all material weaknesses in internal controls.[74] Additionally, auditors must inform management, in writing, of all internal control deficiencies over financial reporting, regardless of materiality, and notify the audit committee when the communication takes place.[75] If the auditor discovers one or more material weaknesses over internal controls, the auditor must issue an adverse opinion.[76]

An FCPA violation or an inadequate FCPA compliance program constitutes a material weakness in internal controls over financial reporting. To illustrate, Ernst & Young issued an adverse opinion on Bio-Rad Laboratories Inc.'s 2010 report over internal controls due, in part, to an inadequate FCPA compliance program, as the company lacked policies related to doing business in high-risk emerging markets and failed to require background checks on contractors and subcontractors.[77] Similarly, KPMG issued an adverse opinion on NATCO Group's 2007 report over internal controls because corporate policies and procedures were not sufficient to identify, report, and evaluate potential violations of the FCPA.[78]

5. Auditors' liability

Auditors who fail to fulfill their obligations are subject to civil and criminal liability. First, the SEC may initiate administrative cease-and-desist proceedings to require auditors to stop violating the securities laws, to undertake remedial action to prevent future violations, and to disgorge ill-gotten gains pursuant to Section 21C of the Exchange Act,[79] one of the SEC's most powerful enforcement tools. Second, the SEC has the authority to censure any auditor and to revoke the auditor's ability to appear or practice before the SEC,[80] disqualifying the auditor from conducting audits of U.S. public companies or companies listed on U.S. exchange markets. Third, the SEC may impose civil penalties if it finds that the auditor discovered an illegal act, that the company failed to take remedial action to correct it, and that the auditor willfully failed to disclose the illegal act to the SEC.[81] The penalties are imposed based on the facts and circumstances of the auditor's conduct and generally range in amounts from $5,000 to $100,000 in the case of individual auditors, and from $50,000 to $500,000 in the case of audit firms.[82] In addition, the DOJ may seek to punish willful violations of the Exchange Act, or any rule or regulation promulgated by the SEC, with criminal sanctions consisting of fines up to $5 million and imprisonment up to 20 years for individuals and fines up to $25 million for legal entities.[83]

---

[74] *Id*. ¶ 78.
[75] *Id.* ¶ 81.
[76] *Id.* ¶¶ 90-92.
[77] Bio-Rad Laboratories, 2010 Annual Report (Form 10-K) (Feb. 28, 2011).
[78] NATCO Group, 2007 Annual Report (Form 10-K) (March 17, 2008).
[79] Securities Exchange Act of 1934 § 21C(a), 15 U.S.C. § 77h-1(a) (2014).
[80] **Securities Exchange Act of 1934 § 4C, 15 U.S.C. § 78d-3(a) (2014); *see also* SEC Rules of Practice No. 102(e).**
[81] Securities Exchange Act of 1934 § 10A(d), 15 U.S.C. § 78j-1(d) (2014).
[82] Securities Exchange Act of 1934 §§ 21(d)(3)(B)(i)-(iii), 21B(b)(1)-(3);
15 U.S.C. §§ 78-u(d)(3)(B)(i)-(iii), 78u-2(b)(1)-(3) (2014).
[83] *See* Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (2014).

The PCAOB may also impose sanctions such as suspending or prohibiting auditors from practicing before the PCAOB, limiting the auditor's ability to perform audit work, and imposing civil penalties for each violation up to $100,000 for individuals and $2,000,000 for firms.[84] In cases of intentional, knowing, or reckless conduct, or where there have been repeated instances of negligent conduct, the penalties increase to $750,000 for individuals and $15,000,000 for firms.[85] Indeed, the PCAOB has brought enforcement actions predicated on the auditor's failure to employ audit procedures designed to provide reasonable assurance of detecting illegal acts.

One of such enforcement actions is *In re Price Waterhouse, Bangalore, Lovelock, & Lewes*, where the PCAOB imposed a $1.5 million fine on several Indian audit firms, members of PricewaterhouseCoopers International Limited, for violating auditing standards in connection with the audit of Satyam Computer Services, Limited (Satyam).[86] Satyam perpetrated a massive fraud in which it overstated its cash balance by $1 billion, overstated profits for several years, overstated accounts receivable, and understated liabilities. The auditors used a deficient confirmation procedure that prevented detection of the fraud by allowing Satyam's management to handle the process of sending and receiving confirmations of cash and accounts receivable. The auditors also ignored significant deficiencies in Satyam's internal controls that indicated a heighted risk of fraud. Despite these warning signs, the auditors failed to perform audit procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the financial statements, in violation of Section 10A(a) of the Exchange Act.

In another enforcement action, *In re Kantor, Geisler, & Oppenheimer, P.A.*, the PCAOB revoked the registration of an audit firm that failed to perform additional audit procedures on becoming aware of a possible illegal act.[87] Specifically, the auditor discovered suspicious payments to a limited liability company and payments out of the limited liability company for executives' personal expenses. In response, the auditor made inquiries of the management, whose explanations did not satisfy the auditor that an illegal act had not occurred. However, the auditor did not perform any other tests or procedures. The PCAOB found that the auditor violated Section 10A(b) of the Exchange Act and PCAOB standards because it failed to perform additional audit procedures to determine whether it was likely that an illegal act had occurred.

Lastly, in *In re Reuben E. Price & Co.*, the PCAOB brought an enforcement action against an audit firm for failing to inform the client's Board of Directors about the occurrence of an illegal act.[88] While auditing the financial statements of Universal Communication Systems Inc. (Universal), the auditors became aware that Universal had filed a document with the SEC that purportedly contained Universal's audited financial statements. At the time of the SEC filing, the auditors had not completed the audit nor issued an audit report. The auditors informed

---

[84] *See* Sarbanes-Oxley Act of 2002 § 105(c)(4)(D)(i), 15 U.S.C. § 7215(c)(4)(D)(i); *see also* PCAOB Rule 5300(a)(4).
[85] Sarbanes-Oxley Act of 2002 § 105(c)(4)(D)(ii), 15 U.S.C. § 7215(c)(4)(D)(ii); *see also* PCAOB Rule 5300(a)(4).
[86] *See* PCAOB Release No. 105-2011-002, ¶¶ 11, 39-40 (Apr. 5, 2011).
[87] *See* PCAOB Release No. 105-2007-009, ¶¶ 25-26 (Dec. 14, 2007).
[88] *See* PCAOB Release No. 2006-002, ¶ 9 (Apr. 18, 2006).

management and a member of the board of directors that Universal had filed an unauthorized report falsely representing that its financial statements had been audited. For a 15-week period, Universal's management and the board member failed to take appropriate remedial actions. The PCAOB found that the auditors violated Section 10A(b)(2) of the Exchange Act because they failed to inform all members of Universal's Board of Directors that the illegal act had a material effect on its financial statements in a timely manner and that management had failed to implement appropriate remedial actions.

Conclusion

Rigorous enforcement of the FCPA coupled with the possibility of criminal and civil liability highlights the need for heighted awareness of bribery among auditors. Paradoxically, the accounting literature does not address this topic adequately. This study fills this gap through three significant contributions. First, this study discussed the independent auditor's responsibility with respect to violations of the FCPA's anti-bribery provisions. Second, this study identified numerous audit procedures and tests that are not ordinarily performed in an audit of financial statements but are specifically tailored to assist auditors in assessing bribery risk and to detect bribes. Third, this study addressed the role of forensic accounting procedures and forensic accountants in audits of financial statements, particularly where there is a high risk of bribery.

The main limitation of this study is that because it is based on secondary data (*i.e.* analysis of documents), it fails to address whether independent auditors are, in fact, performing the procedures discussed herein to assess and respond to bribery risk. Future research in this area could focus on interviewing independent auditors and forensic accountants to identify the procedures they actually perform to assess and respond to bribery risk and evaluate their effectiveness and cost-benefit.

Finally, this study calls for additional guidance. The publication of the *Resource Guide to the U.S. Foreign Corrupt Practices Act* by the SEC and the DOJ in 2012 has already raised awareness among auditors of their legal and professional obligations, but more is needed. In the short term, the PCAOB should revisit AU Section 317 to clarify the scope of the auditor's professional responsibilities when clients engage in illegal acts. In the long term, the PCAOB should follow up on the recommendations of *The Panel on Audit Effectiveness Report and Recommendations* and clarify the role of forensic accountants and the use of forensic accounting procedures in audits of financial statements, particularly with respect to fraud, bribery, and other illegal acts that have a direct and material effect on financial statements.