Understanding the effects and challenges of Section 1504
The oil and gas industry has been keeping a close eye on a challenging element of the Dodd-Frank Wall Street Reform and Consumer Protection Act, designed to enhance transparency around payments to foreign governments.

Known as Section 1504, the provision requires companies engaged in the commercial development of oil, natural gas or minerals to track and report — by project and by government — all payments that equal or exceed US$100,000, individually or in aggregate. Despite protests and legal challenges from industry and business groups over the rule's complexity, cost and competitive implications, most experts believe that Section 1504 — in some form — will be implemented.

Companies involved in the global energy business are already familiar with the Foreign Corrupt Practices Act (FCPA) and other similar country-specific anti-bribery and corruption laws, as well as their similar focus on payments to government officials and entities. In recent years, FCPA compliance has been a major focus for US energy companies engaged in international activity, and many have robust compliance programs that include considerable internal enforcement.
Overlap – and beyond

Certainly there is overlap between FCPA and Section 1504. Enacted in 1977, the FCPA governs actions taken by US-based companies, and companies traded on US exchanges, in markets overseas. The FCPA prohibits these companies from paying foreign government officials in order to attract or retain business; in other words, it prohibits bribery. The FCPA, with its provision that accounting records must be maintained accurately to ensure compliance, has led companies to much more closely watch over interaction with government entities and officials. Given the wide range of vendors, suppliers, contractors and government entities involved in a typical overseas oil and gas project, companies usually devote their focus to select categories of their employees’ or agents’ activities where the opportunity (or even the appearance) for bribery is heightened. However, most companies have not invested significant time analyzing transactional detail as part of their compliance programs.

Under Section 1504, that focus will necessarily broaden. The rule requires that oil and gas companies disclose all payments to government entities (including US federal agencies), regardless of the potential for illegality, related to commercial development activities, including:

- Taxes
- Royalties
- Fees (including license fees)
- Production entitlements
- Bonuses
- Dividends
- Infrastructure improvements

Further, Section 1504 requires oil and gas companies to provide detailed information regarding the above types of payments, specifically:

- The type and total amount of payments made for each project
- The type and total amount of payments made to each government
- The total amounts of payments, by category
- The currency used to make payments
- The financial period in which the payments were made
- The business segment of the company that made the payments
- The government that received the payments, and the country in which the government is located
- The specific project to which the payments relate

This required increase in tracking and reporting of payments, with the specification that spending be broken down into such concrete categories, will require companies with even the most stringent compliance programs to enhance their data collection systems and processes.

Defining ‘government’

In Section 1504, the Securities and Exchange Commission (SEC) has defined “foreign government” as “a foreign government, a department, agency or instrumentality of a foreign government, or a company owned by a foreign government, as determined by the Commission.” 1 The SEC further added an ownership threshold to the equation stating that “a company owned by a foreign government is a company that is at least majority-owned by a foreign government.” 2 In other words, according to the SEC, to be considered a company owned by a foreign government, a foreign government must have an ownership share in the company of over 50%.

This sounds simple enough, but the definition may create confusion in corporate compliance.

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departments as it appears to run contrary to what has previously been considered a government entity or government official during certain FCPA enforcements and contrary to recent guidance proffered by the SEC and Department of Justice (DOJ).

The FCPA defines a “foreign official” as “any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization.”

Certain previous FCPA enforcements have determined that government ownership as low as 43% in an entity was enough for employees of the entity to be considered government officials. Furthermore, recent guidance by the SEC and DOJ states that the term “instrumentality” is “broad and can include state-owned or state-controlled entities. Whether a particular entity constitutes an ‘instrumentality’ under the FCPA requires a fact-specific analysis of an entity’s ownership, control, status, and function.”

Without further explanation as to which guidance is appropriate for determining what exactly is a government company or official, oil and gas companies working overseas need to take due care in becoming informed and tracking the different levels of government “ownership, control, status, and function” of companies with which they do business.

More oversight of expenses

During a typical FCPA compliance review or audit, certain categories of expenses with potentially greater exposure to FCPA-sensitive areas (such as commissions, gifts, meals and entertainment, and travel) may be reviewed on a sample basis to understand potential FCPA red flags. With the passing of Section 1504, the SEC has directed that all (excluding de minimis) payments to government-controlled companies in certain categories, regardless of the potential for illegality or non-compliance with the FCPA, are to be disclosed. The volume and size of payments for compliance programs to provide oversight will be greatly increased, thus affecting normal compliance operations.

Further, the disclosure requirements being placed on companies that may have – under FCPA requirements – decided not to self-report certain foreign payments to the SEC will change based on Section 1504. Payments that fall under the purview of Section 1504 would be required to be disclosed, rendering the decision of whether or not to self-report moot. This could have far-reaching implications on how aggressively companies need to monitor payments as part of their compliance programs and procedures.

Companies may decide to incorporate the identification and disclosure of these payments into existing compliance programs, as those programs may already contain considerations for tracking and recording government-related payments. Existing compliance personnel may also be more aware of the dynamics of payments to third parties that are to be paid to a foreign government on the company’s behalf, which are also required to be disclosed under Section 1504.

Some companies in the energy industry have already been disclosing payments to foreign governments annually. However, the information disclosed by these companies may not be to the level of detail as required by Section 1504, including information at the project level. Here, the SEC leaves it up to each company to appropriately determine the definition of “project” for disclosure purposes. Based on the operations of each company, the definition of “project” may vary widely. If they have not already done so, companies will now need to consider how to track costs on a project level.

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Proper classification of expenses

The Books and Records Provision of the FCPA mandates that companies “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of ... assets.” In other words, companies are to classify expenses appropriately in accounting records, regardless of the nature of the expenses.

Companies can spend a significant amount of time and effort verifying that FCPA-sensitive payments are given due consideration and are properly classified in the accounting records for FCPA compliance.

Companies may have similar difficulties considering and classifying payments to government companies under Section 1504, with the added burden that payments falling under Section 1504 could be far greater in frequency and amount than FCPA-sensitive payments. The SEC stated that companies “must consider the aggregate amount of the related periodic payments or installments of the related payments” that meet the $100,000 threshold in relation to taxes, royalties, fees, production entitlements, bonuses, dividends and infrastructure improvements.

The issue of aggregating payments requires attention to the proper classification of expenses, since one inadvertent misclassification could potentially result in certain payments remaining under the threshold and not being required to be disclosed. The SEC addresses this in an anti-evasion provision by stating that a company “that typically makes payments of the type that would otherwise be covered under the final rules and that changes the way it categorizes or makes payments after issuance of the final rules so that the payments are not technically required to be disclosed may be viewed as seeking to evade the disclosure requirements.”

Payment misclassifications, even if inadvertent, may cause headaches for companies under Section 1504. Companies may have to invest in additional resources, especially in foreign locations, to ensure that all payments to government entities are properly recorded in accounting records so as to be disclosed to the satisfaction of the SEC.

Costs of compliance

With additional disclosure requirements, companies may need to invest in additional resources such as personnel, training, hardware and software to develop the systems and procedures necessary to comply with Section 1504. The SEC estimated that the initial cost for all applicable companies to comply with this new set of regulations is approximately $1 billion, with ongoing compliance costs of $200 million to $400 million.

Companies will need to determine how to identify and gather information relevant to Section 1504 disclosures. Experience in designing and implementing such programs will be key. Once the proper systems and procedures are in place, company personnel will need to be trained with ongoing compliance procedures and reporting requirements.

Section 1504 does not require that the disclosed payment information be audited or reported on an accrual basis. However, companies may choose to audit the results in order to gauge compliance and avoid potential disputes (and penalties) with the SEC. These additional auditing procedures may require the hiring and training of new personnel, thus increasing cost and altering the company’s compliance landscape.

Increased complexity

According to the SEC, simply disclosing the lump-sum amounts paid to government companies would fall short in adequately complying with Section 1504 disclosure requirements. Companies are required to disclose payments to government entities based on a number of metrics; the metric that seems likely to add the most complexity to disclosure requirements is that the payments must be organized by the project of the company to which the payments relate.

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6 Anti-Bribery and Books and Records Provisions of The Foreign Corrupt Practices Act, §78m (b)(2)(A)
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The SEC did not define “project” in the final rules but left it up to each company to determine what a project is in terms of the company’s operations. Once the definition of “project” is established, companies will need to develop methods to track and report all project-level costs meeting the disclosure criteria. As with the correct categorization of expenses, assigning costs to the appropriate project(s) will affect disclosure reporting significantly. Further, entity-level costs that are allocated across different projects do not require disclosure. Additional steps will need to be taken to ensure that these allocated costs are not included in the filings.

Next steps
The SEC has stated that companies subject to Section 1504 must begin disclosing payments, on an annual basis, for fiscal years ending after 30 September 2013, and no longer than 150 days after the end of each fiscal year. The disclosures are to be filed on a Form SD and must be included in an exhibit to annual filings and electronically tagged using a specific format.

As mentioned earlier, industry groups such as the American Petroleum Institute, the Independent Petroleum Association of America, US Chamber of Commerce and National Foreign Trade Council have been vocal in their opposition to Section 1504, going so far as to file suit in US District Court seeking to halt its implementation. In addition to the new rule’s cost and complexity, the industry is concerned that required disclosures will put US companies at a disadvantage to foreign competitors that do not have to make such payments public.

The SEC recently denied a request to stay the rule pending the result in US District Court, and there is little reason to believe that implementation will not continue as expected. Thus, companies must begin making preparations now.

This effort should entail:

- Reviewing and understanding all existing contracts and payments made to government entities as defined by Section 1504
- Developing systems to effectively track and categorize associated payments
- Changing nomenclature and how payments are booked to facilitate tracking
- Identifying software and hardware needs to handle increased complexity of reporting
- Identifying staffing needs
- Developing and implementing appropriate policies and procedures, both in the field and in accounting/compliance, and training all relevant employees

It appears that Section 1504 – while complex – may also offer a unique opportunity to companies that take a strategic approach to the challenge. The data identified during Section 1504 tracking and reporting can be used to more fully understand a company’s activity in certain countries, helping management understand who exactly is getting paid, what they are doing to earn those payments and who is approving the activity. Section 1504 will deliver a level of detail most companies don’t currently have regarding their own business practices in countries around the world. How your company uses that data to improve your business strategy going forward is up to you.

For more information about the Dodd-Frank Wall Street Reform and Consumer Protection Act visit www.ey.com/oilandgas/doddfrank
How Ernst & Young can help

Issuers will need to address the following key steps:

- Consider the risk of noncompliance with country laws or confidentiality agreements and steps to mitigate those risks
- Determine whether entities meet the definition of foreign government
- Identify payments to foreign governments, government equivalents and state-owned entities
- Evaluate which activities meet the definition of commercial development
- Determine the project level for reporting
- Develop management-level and government reporting structures
- Identify differences between the cash basis and accrual reporting and create processes to compile information

Ernst & Young can help companies with:

- **Our multidisciplinary network:** Our network includes dedicated forensic, assurance and tax policy professionals who assist energy clients from across industries and in countries around the world. As needed, our teams access the deep knowledge and resources of Ernst & Young, tapping into professionals with core competencies in information technology, environmental health and safety (EHS), internal audit, supply chain risk management, sustainability reporting and a range of other key areas.

- **Our data management:** At Ernst & Young, our forensic data analytics approach can be utilized to capture, track and report on payments as required under Section 1504. Our unique methodology groups related data and builds models of relationships among and between people, documents and events, giving clear visibility into high volumes of disparate data through visual analytics and customized reporting dashboards. Our forensic data analytics leverage proprietary Ernst & Young technology, which are supported by subject matter resources in both model-based data mining and in the different global payments required by Section 1504. The data captured by using these forensic data analytics can be used to complete the Form SD exhibit detailing payment information in XBRL tags.