

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 272-2650



THE ACCOUNTING PROVISIONS OF THE
FOREIGN CORRUPT PRACTICES ACT: AN ANALYSIS

An Address by

Harold M. Williams, Chairman
Securities and Exchange Commission

SEC Developments Conference
American Institute of
Certified Public Accountants
Washington, D.C.

January 13, 1981

It is a pleasure to again address the AICPA's SEC Developments Conference. In a departure from my talks of prior years -- in which I generally surveyed a broad spectrum of current developments -- today I will devote my remarks solely to one major auditing development of recent years: the accounting provisions of the Foreign Corrupt Practices Act of 1977. The Act last month had its third anniversary. The time has come to apply the experience we now have in administering, and complying with, the Act to resolving the issues it has raised.

When viewed from an abstract perspective, the Act's accounting provisions seem merely to codify a basic and uncontroversial management principle: No enterprise of any size can operate successfully without maintaining effective controls over its transactions and the disposition of its assets. Perhaps in part because these provisions were considered truisms, the Act was passed without Congressional dissent.

However, practical experience with new legislation -- even a law thought to be noncontroversial -- often will reveal unanticipated problems. Newly enacted standards, for example, may be subject to differing constructions or raise compliance difficulties and ambiguities unforeseen by their draftsmen. And, until these problems are resolved by an agency, the courts or the Congress, those who are subject to these laws are often faced, unfortunately, with some disquieting circumstances.

The anxieties created by the Foreign Corrupt Practices Act -- among men and women of utmost good faith -- have been, in my experience, without equal. This consternation can be attributed, in significant part, to the spectre which some commentators have raised of exposure to Commission enforcement action, and perhaps criminal liability, as a result of technical and insignificant errors in corporate records or weaknesses in corporate internal accounting controls. In fact, some commentators claim that, because of the broad strokes with which the accounting provisions are fashioned, no corporate executive can ever feel fully confident that his corporation is in compliance with the law. And, other commentators have expressed fear that this lack of concrete statutory parameters evidences a meaning to the Act which is far beyond its Congressional intent.

Such uncertainty can have a debilitating effect on the activities of those who seek to comply with the law. My sense is that, as a consequence, many businesses have been very cautious -- sometimes overly so -- in assuring at least technical compliance with the Act. And, therefore, business resources may have been diverted from more productive uses to overly-burdensome compliance systems which extend beyond the requirements of sound management or the policies embodied in the Act. The public, of course, is not well served by such reactions.

The Commission is sensitive to these concerns and considerations. The goal is to allow a business, acting in good faith, to comply with the Act's accounting provisions in an innovative and cost-effective way and with a better sense of its legal responsibilities. I have conferred, accordingly, with my colleagues before presenting these remarks, and they have authorized me to advise you that these remarks constitute a statement of the Commission's policy.

I will begin with a summary of the Commission's analysis.

-- Recordkeeping. The Act's recordkeeping provision requires that a company maintain records which reasonably and fairly reflect the transactions and dispositions of the company's assets. This provision is intimately related to the requirement for a system of internal accounting controls, and we believe that records which are not relevant to accomplishing the objectives specified in the statute for the system of internal controls are not within the purview of the recordkeeping provision. Moreover, inadvertent recordkeeping mistakes will not give rise to Commission enforcement proceedings; nor could a company be enjoined for a falsification of which its management, broadly defined, was not aware and reasonably should not have known.

-- Internal accounting controls system. The Act does not mandate any particular kind of internal controls system. The test is whether a system, taken as a whole, reasonably meets the

statute's specified objectives. "Reasonableness," a familiar legal concept, depends on an evaluation of all the facts and circumstances.

-- Deference. Private sector decisions implementing these statutory objectives are business decisions. And, reasonable business decisions should be afforded deference. This means that the issuer need not always select the best or the most effective control measure. However, the one selected must be reasonable under all the circumstances.

-- State of mind. The accounting provisions principal objective is to reach knowing or reckless conduct. Moreover, we would expect that the courts will issue injunctions only when there is a reasonable likelihood that the misconduct would be repeated. In the context of the accounting provisions, that showing is not likely to be possible when the conduct in question is inadvertent.

-- Status of subsidiaries. The issuer's responsibility for the compliance of its subsidiaries varies according to the issuer's control of the subsidiary. The Commission has established percentage of ownership tests to afford guidance in this area.

-- Enforcement policy. These views reflect Commission policy and practice in implementing and enforcing the accounting provisions and are consistent with the cases brought by the

Commission over the last three years. During this period, the Commission has addressed these areas prudently and with common sense. Similarly, the Commission has not sought out violations of the accounting provisions for their own sake; indeed, we have not chosen to bring a single case under these provisions that did not also involve other violations of law. The Commission, instead, places its greatest emphasis on encouraging an environment in which the private sector can meet its responsibilities in complying with the Act meaningfully and creatively. In that connection, the Commission has adopted enforcement policies in furtherance of this policy that I will discuss in a few moments.

I will now amplify on each of these thoughts.

PURPOSES OF THE ACT

At the outset of this analysis, it is worthwhile to consider briefly the events which led to the Foreign Corrupt Practices Act -- not because the abuses which led to its enactment were representative of the entire business community, but rather to put the Act in the proper context. As most will recall, during the mid-1970s the existence of a pattern of questionable payments to foreign government officers by prominent American corporations became public knowledge. These disclosures -- often in bold headlines -- shook faith and trust in the integrity of our corporate sector. This reaction became part of a rising

tide of public skepticism and served further to undermine the traditional American consensus that business conducts itself and reasonably pursues its own economic interests in a manner consistent with the standards and expectations of the larger society. In this climate, Congress felt compelled to act. And, after nearly three years of hearings and debate, the Foreign Corrupt Practices Act became law.

New Section 13(b)(2) of the Securities Exchange Act of 1934 is a product of this legislative process. It establishes two interrelated accounting requirements: First, public companies are required to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions" of their assets. Second, corporations are also required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that certain specified objectives are attained. In essence, these objectives are that assets be safeguarded from unauthorized use, that corporate transactions conform to managerial authorizations, and that records be accurate.

Some commentators have argued that the Act's title is a misnomer. Clearly, Congress went further than determining whether the payments which gave the new law its name were ethically and commercially justifiable. It also chose to consider the corporate accounting and control deficiencies which had been breeding

grounds for these practices. And, by doing so, it addressed the far more serious issues raised by these disclosures.

As the Commission's 1976 report to Congress on questionable payments stated:

"The most devastating disclosure that we have uncovered in our recent experience with illegal or questionable payments has been the fact that, and the extent to which, some companies have falsified entries in their own books and records."

These payments and falsifications were not only previously unknown to public investors and independent auditors, but many were also unknown to the payor's board and, in numerous examples, even to its senior management. In some of these instances, internal controls existed, but they were shown to be ineffective or easily subverted. Unauthorized payments and related falsifications of corporate records seemed to evidence -- indeed, were fostered by -- a lack of adequate accounting records and controls. Consequently, in the legislation which ultimately emerged from Congress, prohibiting questionable payments and mandating control and recordkeeping were inexorably interconnected.

In enacting these accounting provisions, Congress did not change the government's role with respect to accounting or auditing matters -- nor was the Commission authorized to prescribe corporate records such as it may for such regulated entities as broker-dealers and investment companies. Instead,

Congress determined that the federal interest in corporate recordkeeping is satisfied if it assures that corporate transactions are recorded -- in the words of the Act's Conference Report -- "in conformity with accepted methods of recording economic events." Such procedures, the Conference Report declared, "should effectively prevent off-the-books slush funds and payments of bribes." Meaningful accounting controls, the Committee added, "provide reasonable assurances, among other things, that transactions are recorded as necessary to maintain accountability for assets."

Statute or no, these are, of course, inherent obligations of the stewardship of a public corporation. The standards embodied in the Act's accounting provisions are, in effect, the cardinal principles of managing a business enterprise. Among members of the business community, few would dispute that acceptable management cannot be achieved absent such records and controls.

In that sense, this is hardly the stuff of radical legislation. The Act's accounting provisions endorsed and incorporated accepted private-sector standards; such an approach does not suggest an intent to markedly affect the operations of the great number of companies which already had such procedures in effect.

The primary thrust of the Act's accounting provisions, in short, was to require those public companies which lacked

effective internal controls or tolerated unreliable recordkeeping to comply with the standards of their better managed peers. That is the context in which these provisions should be construed.

THE ACT'S ACCOUNTING REQUIREMENTS

With this in mind, it is possible to resolve many of the interpretative questions concerning the accounting provisions which commentators and practitioners have raised in recent years. I will now address four of the most important: first, the degree of exactitude in recordkeeping mandated by the Act; second, the deference it affords business decisions concerning internal controls; third, whether a particular state of mind is necessary for a violation to exist; and, finally, liability for compliance by subsidiaries.

Degree of Exactitude

I turn first to the question of whether the Act's text or purpose mandates that business records and controls conform to a standard of absolute exactitude or that a company's control system meet some absolute ideal. The answer is "no." Both of the Act's accounting provisions, it should be noted, are modified by the key term "reasonable." That is, a public company's records must, "in reasonable detail, accurately and fairly reflect" disbursements of its assets. And, its internal accounting controls must be "sufficient to provide reasonable assurances" that the

provision's objectives will be satisfied. In essence, therefore, the Act does provide a de minimus exemption, though not in absolute, quantitative terms.

Many persons, however, have not been comfortable with such a fluid legal standard. Indeed, it is the lack of more specific guidelines which, since the Act became law, seems to have generated the greatest concern. Some commentators regard the Act's accounting provisions as excessively vague. And, to resolve this perceived problem, suggestions have been made to qualify these provisions by superimposing a "materiality" test on the requirement that corporate records be accurate and on the scope of the internal controls provision.

Such a test, in fact, was advocated by a number of persons when Congress was deliberating the Act. Despite these suggestions, however, Congress determined not to incorporate such a limitation. It was correct in doing so. Internal accounting controls are not only concerned with misconduct that is material to investors, but also with a great deal of misconduct which is not.

True, materiality is a concept with which managers of public companies, accountants, and lawyers are experienced and feel relatively comfortable. For almost 50 years, it has served as the standard for determining whether, under the federal

securities laws, a particular matter must be disclosed to the investing public.

But, materiality, while appropriate as a threshold standard to determine the necessity for disclosure to investors, is totally inadequate as a standard for an internal control system. It is too narrow -- and thus too insensitive -- an index. For a particular expenditure to be material in the context of a public corporation's financial statements -- and therefore in the context of the size of the company -- it would need to be, in many instances, in the millions of dollars. Such a threshold, of course, would not be a realistic standard. Procedures designed only to uncover deficiencies in amounts material for financial statement purposes would be useless for internal control purposes. Systems which tolerated omissions or errors of many thousands or even millions of dollars would not represent, by any accepted standard, adequate records and controls. The off-book expenditures, slush funds, and questionable payments that alarmed the public and caused Congress to act, it should be remembered, were in most instances of far lesser magnitude than that which would constitute financial statement materiality.

Reasonableness, rather than materiality, is the appropriate test. Reasonableness, as a standard, allows flexibility in responding to particular facts and circumstances. Inherent in

this concept is a toleration of deviations from the absolute. One measure of the reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars ordinarily should not be spent conserving hundreds. Further, not every procedure which may be individually cost-justifiable need be implemented; the Act allows a range of reasonable judgments.

The touchstone of this analysis is the judgment of company management. Many managerial requirements are common to all companies. The most obvious illustration of this principle is that every public company needs to establish and maintain records of sufficient accuracy to meet adequately four interrelated objectives: appropriate reflection of corporate transactions and the disposition of assets; effective administration of other facets of the issuer's internal controls system; preparation of its financial statements in accordance with generally accepted accounting principles; and proper auditing. Thus, for all practical purposes, the adequacy of a company's control system is bounded by the adequacy of its underlying books and records.

In fact, because accurate records are so crucial to these objectives, Congress chose to incorporate a specific recordkeeping requirement into the Act. But, this provision is not an

independent and unrestrained mandate to the Commission to establish novel or unprecedented corporate recordkeeping standards; it is, rather, an integral part of Congress' efforts to assure that the business community records transactions and assets in such a way as to maintain adequate control over them. And, this leads to two important conclusions: First, the Act does not establish any absolute standard of exactitude for corporate records. And, second, records which are not related to internal or external audits or to the four internal control objectives set forth in the Act are not within the purview of the Act's accounting provisions.

More specific managerial objectives, of course, will vary from company to company. Some companies, by their very nature, have unusual control needs. A company's management requirements may be influenced by such factors as its line of business and prior control problems. A company whose inventory consists of precious metals or jewels would require more sophisticated inventory records and controls than, for example, a dealer in cement. And, in other companies, the frequency with which relatively small losses occur from a common source may require that these losses be considered, in the aggregate, as a significant managerial problem.

Deference

This, in turn, raises questions regarding the extent to which there should be issuer liability for false books and records and the measure of deference the courts and the Commission should afford to management decisions concerning the structure of the company's internal accounting controls. With respect to issuer liability for recordkeeping violations, we will look to the adequacy of the internal control system of the issuer, the involvement of top management in the violation, and the corrective actions taken once the violation was uncovered. If a violation was committed by a low level employee, without the knowledge of top management, with an adequate system of internal control, and with appropriate corrective action taken by the issuer, we do not believe that any action against the company would be called for.

Turning to the controls question, there is an almost infinite variety of control devices which could be utilized in a particular business environment. Thus, considerable deference properly should be afforded to the company's reasonable business judgments in this area. The purpose of the internal accounting control provisions, after all, is to assure that a public company adopts accepted methods of recording economic events, safe-guarding assets, and conforming transactions to management's authorization.

Importantly, the selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management prerogatives and responsibilities.

In this vein, the law long ago determined that it should avoid interfering in reasonable corporate decisionmaking which entails the exercise of good faith judgment concerning routine matters. High societal costs -- including lost innovation and vexatious litigation -- would result if courts could substitute their judgments for those of business executives concerning such matters. Provided that the reasonable assurances requirement set forth in the statute is met, the Act's accounting provisions, relating as they do to matters of internal corporate conduct and management, justify such deference to decisions regarding corporate records and control mechanisms; certainly nothing in the Act mandates a different standard of review.

This concept is not a mandate for board -- or even most senior management -- involvement in the minutia of recording and accounting for every transaction which the company may make. But, it does mean that both management and the board have important roles to play in monitoring and evaluating the adequacy of the company's records and controls systems.

This standard is not satisfied if a company's leadership, while making nominal gestures of compliance, abdicates its responsibilities to foster integrity among those who operate

the system. Regardless of how technically sound an issuer's controls are, or how impressive they appear on paper, it is unlikely that control objectives will be met in the absence of a supportive environment. In the last analysis, the key to an adequate "control environment" is an approach on the part of the board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished.

State of Mind

Now let us turn to the question of the state of mind needed to violate the Act's accounting provisions. It is, first of all, important to recognize that nothing in the Congressional objectives of the accounting provisions requires that inadvertent recordkeeping inaccuracies be treated as violations of the Act's recordkeeping provision. The Act's principal purpose is to reach knowing or reckless misconduct. It is probable that an injunction will be issued by a court only upon a showing of some likelihood of repetition of misconduct; this remedy would not be expected to be available upon a showing of only past inadvertent conduct. Moreover, depending on the circumstances, intentional circumventions of a company's system of records and of accounting controls by a low-level employee would not always be considered violations of the Act by the issuer. No system of adequate records and controls -- no matter how effectively devised

or conscientiously applied -- could be expected to prevent all mistaken and improper transactions and dispositions of assets. Given human nature, regardless of the adequacy of the system, a bookkeeper may still erroneously post entries, an overzealous agent may make unauthorized payments, or an unscrupulous employee may falsify records for his own purposes.

The Act recognizes each of these limitations. Neither its text and legislative history nor its purposes suggest that occasional, inadvertent errors were the kind of problem that Congress sought to remedy in passing the Act. No rational federal interest in punishing insignificant mistakes has been articulated. And, the Act's accounting provisions do not require a company or its senior officials to be the guarantors of all conduct of company employees.

A failure to correct a known falsification -- or a falsification that reasonably should be known -- or any attempt to cover-up a falsification -- is, of course, prohibited. But, this responsibility arises only when the individual in question is in some respect responsible for the records or controls, or otherwise supervises the activity giving rise to the violation. Similarly, there can be no relaxation of the proscription against the creation or maintenance of any fund that is designed to be used for "off-books" payments outside the issuer's system of internal accounting control, or against obstructing or circumventing

in any significant respect the issuer's system of internal controls by misstatement to auditors or related means.

The test of a company's control system is not whether occasional failings can occur. Those will happen in the most ideally managed company. But, an adequate system of internal controls means that, when such breaches do arise, they will be isolated rather than systemic, and they will be subject to a reasonable likelihood of being uncovered in a timely manner and then remedied promptly. Barring, of course, the participation or complicity of senior company officials in the deed, when discovery and correction expeditiously follow, no failing in the company's internal accounting system would have existed. To the contrary, routine discovery and correction would evidence its effectiveness.

SUBSIDIARIES

Finally, much concern has been raised about the issuer's liability for compliance with the accounting provisions by its subsidiaries. Where the issuer controls more than 50 percent of the voting securities of the subsidiary, compliance is expected. So, too, would it be expected if there is between 20 percent and 50 percent ownership, subject to some demonstration by the issuer that this does not amount to control. If there is less than 20 percent ownership, we will shoulder the burden to affirmatively demonstrate control.

RESPONDING TO CURRENT DEVELOPMENTS

While analyses of this sort can diminish the Act's ambiguities, merely making the requirements of the accounting provisions somewhat more concrete should not end our inquiry. The Commission has not ignored meaningful developments within the private sector itself in the area of corporate accountability. Indeed, it is these developments, rather than the Act, that are the most effective antidotes to the conditions which fostered questionable payments. Let me briefly recount some of these developments:

-- Independent directors. The years since the questionable payments disclosures began have witnessed a significant increase in the numbers and responsibilities of directors who are not also part of the company's management. This development is important because independent directors do not face the same short-term performance pressures as do management personnel. They are more likely, therefore, to be sensitive to the negative impact which questionable expediencies have on a company and, indeed, the entire business community. And, independent directors, particularly through the committee system, are playing an increasingly responsible role. The Commission's most recent survey found that 65 percent of directors of public companies are not part of the management of the companies they direct.

-- Audit committees. Effective audit committees composed of independent directors are a significant assurance that meaningful internal controls will be established and enforced. In the mid-1970's, few such committees existed. In contrast, the Commission's most recent survey found that 85 percent of public companies now have audit committees, a number that is even higher among major companies.

-- Internal auditors. The increasing acceptance of the internal auditor as an important management professional has been yet another major contributor to the quality and credibility of internal accounting control systems. And, while traditionally, internal auditors reported exclusively to more senior management, a recent study indicates that one-third of internal auditors now report directly to the board or the audit committee and that many others have direct access.

-- The experience factor. Any new legislation precipitates a learning period among those it affects and a period in which business operations are brought into compliance. In substance, these are a law's start-up costs. During the three years since the enactment of the Foreign Corrupt Practices Act, major efforts have been made by the AICPA and by accounting firms to develop materials and provide guidance to assist managers and directors in establishing, evaluating, and monitoring internal accounting control systems. Many companies have reexamined

their internal controls and reevaluated their review programs. It appears that this start-up investment in implementing the Foreign Corrupt Practices Act has been, for most practical purposes, substantially completed; that is, most public companies have now made the adjustments necessary for them to operate within a reasonable reading of the Act.

THE COMMISSION'S ENFORCEMENT POLICY

The Commission's overriding policy, in recent years, has been to allow these private-sector initiatives to flower. And, it has administered and enforced the Act's accounting provisions -- which share a common accountability purpose with those initiatives -- in accordance with this policy.

The genius -- and challenge -- of these provisions, it should be remembered, is their reliance on private sector decisionmaking -- rather than specific federal edicts -- to address an area of public concern. The Act's eventual success or failure will, therefore, depend primarily upon business's response. The Commission's obligation, in turn, is to provide a regulatory environment in which the private sector can address these issues meaningfully and creatively. In this regard, we must encourage public companies to develop innovative records and control systems, to modify and improve them as circumstances

change, and to correct recordkeeping errors when they occur without a chilling fear of penalty or inference that a violation of the Act is involved.

All new legislation has rough edges that can be polished only by the forces of time and practical experience. To foster the innovative environment which would best effect the Act's purposes, the Commission has addressed these areas through monitoring, constructive criticism, maintaining open lines of communication, and a substantial measure of understanding. The very limited number of enforcement actions which the Commission has undertaken reflect those policies. As I noted earlier, in each of the cases which the Commission has brought under the accounting provisions, these requirements were breached as part of violations of other provisions of the federal securities laws.

Despite these considerations, I recognize, of course, that there is some sentiment that the accounting provisions should be amended. The Commission has not, thus far, taken any position on legislation of that nature. As part of the Commission's own institutional accountability, we would welcome a dialogue with Congress, if it is concerned that our actions or policies do not best serve the public interest or that the reach of the Act should be further clarified.

CONCLUSION

In conclusion, the Commission is meeting its difficult mandate of administering the accounting provisions of the Foreign Corrupt Practices Act in what we believe is a constructive and pragmatic manner. We have been receptive to -- and responsive to -- the comments and criticisms of the public, the business community, and the legal and accounting professions. Indeed, we continue to welcome such comments and discussions in light of the private sector's on-going voluntary initiatives in corporate accountability and specifically welcome reactions to this statement of Commission policy. As a consequence, I believe progress has been made -- and will continue -- in assuring that public companies meet the statutory mandate for accurate records and meaningful internal accounting controls, without inflicting unreasonable costs on the business community and with only minimal federal intrusion upon internal corporate decisionmaking.