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**THE ACCOUNTING PROVISIONS OF THE FOREIGN
CORRUPT PRACTICES ACT**

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Since its enactment in 1977, the Foreign Corrupt Practices Act has engendered a fire storm of debate. Discussions of the accounting provisions of the Act have unfortunately generated more heat and smoke than light. While much of the fear about the difficulty and expense of compliance is truly illfounded, there is a degree of uncertainty that inevitably attends that easy but momentous step that transforms a generally accepted practice into a legally enforceable duty. Moreover, since people act on their perceptions of the truth, we risk, through misunderstanding and overreaction, losing the fine balance which was drawn between the significant public and private interests involved.

I am here this afternoon to narrow that credibility gap. It has been a source of deep concern to the Commission. For that reason, about a month ago we took the highly unusual step of formally adopting a policy statement that will govern our administration of the accounting provisions. It was first released in Chairman Williams' January 13 address to the AICPA. To the extent that I reiterate some elements of that policy statement, it is to emphasize its central importance. Some people have expressed concern about whether the policy statement will be enduring. I fully understand the position of those who doubt the enduring ability of regulators to regulate themselves. Nevertheless, established notions of equity and due process require that we act in accordance with that policy statement until we announce otherwise.

Beyond the policy statement, I would like to address some of the underlying reasons for the discomfort about the Act and my views about the proper role to be played by the accounting profession in this process of mutual education on which we are all embarked.

My theme is that the Act's accounting provisions are a logical and temperate response to a valid concern felt by Congress; they neither require accounting perfection nor establish the Commission as an unchecked force, roving the business landscape to avenge real and imagined ills. Compliance with these provisions is no different from compliance with any of the flexible standards which cover a wide variety of conduct, such as the concepts of fiduciary obligations or materiality.

The Accounting Provisions: Metamorphosis
of the Accounting Literature

The Act's accounting provisions embody the entirely unremarkable conclusions that companies having public reporting obligations under the Securities Exchange Act should

- (1) maintain books and records, in reasonable detail, that accurately and fairly reflect the company's activities; and

- (2) devise and implement a system of internal accounting controls which provides reasonable assurances about the control and recording of business transactions and safeguarding of assets from unauthorized access.

As you know, the Act's formulation of these obligations was taken from the accounting literature. I dare say that if the Act had never been passed, my restatement of these general principles would be nothing so much as boring to you. Indeed, one might well argue that these obligations are no more than the legal duties owed by corporate managers under established fiduciary principles to their stockholders. Moreover, they have been recognized as a necessary precondition to the preparation of financial statements in compliance with generally accepted accounting principles.

If these principles are so well-recognized, what was all the fuss about? Let me suggest three reasons. The first is historical. The accounting provisions grew out of our experience with financial pathology. Revelations about the practice of some multinational companies in competing for business abroad through corporate bribery provoked widespread condemnation in the Congress. Integral to these practices was the improper manipulation of a company's accounting systems and records to place large sums of cash outside the normal accounting controls and at the disposal of small numbers of executives not required to account formally for expenditures. In these circumstances, Congress viewed the misuse of accounting and accountability systems as an intolerable step not only toward the ultimate improper payments themselves, but also, in the words of the Commission's 1976 Report, as a practice which:

"casts doubt on the integrity and reliability of the corporate books and records which are the very foundation of the disclosure system established by the federal securities laws."

Thus, the mandate of good accounting practices became associated with foreign corrupt practices, and a primary concern of the SEC's Division of Enforcement and the Justice Department's Criminal Division. That is enough to make anyone concerned with financial accounting uncomfortable.

The second reason grows out of the dominance of independent auditors in the theory and literature of accounting. Like all of us, independent auditors view the world through the screen of their special responsibilities. In this case it is to insure that financial statements fairly present a company's financial condition and results of operations. That objective gives form and content to all of the uncertainties and ambiguities of the accountant's profession.

Yet the experience of the 1970's, with accounting practices associated with "sensitive" payments, clearly went a step beyond concerns about fair presentation. Indeed, it would be fair to say that the accounting provisions of the Act were adopted precisely because of concern that traditional concepts of materiality -- that is, impact on the fairness of the presentation -- left open a range of conduct that the Congress thought was improper. That further step was legitimate and important. But it seemed to cut the accounting profession loose from its traditional moorings. Nevertheless, there are general practices that meet the objectives of the Act. Moreover, in testing the adequacy of a system of internal controls (or indeed, the accuracy of books), the auditor does not use a screen that detects only gross inadequacies. The materiality standard governs whether the report is to be qualified, not the auditor's ability to give useful advice to management.

The third cause of discomfort is an amalgam of the first two and the difficulties that come with reducing accepted nonlegal principles to precise written rules, putting civil and, in some cases, criminal teeth in those rules and hanging them in front of lawyers and accountants to shoot at. It's one thing to say "be reasonable;" it's quite another to say "I'll put you in jail if you are not." In the words of Samuel Johnson, "When a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully."

Popular Criticism -- and Response The results of this sharpened thinking have been a series of criticisms which may be outlined as follows:

- The recordkeeping provisions can be read to require perfect books, records and accounts, with liability attaching to even the smallest mistaken entry on any piece of paper.
- The internal controls provisions require universal compliance with a perfect system which meets the unstated specifications of the Commission and the Justice Department, without regard for the good faith business judgments of management.
- The Act can be violated by inadvertent action, taken in good faith, perhaps even without the knowledge of the members of corporate management who are responsible for these matters.

- Liability may arise under the Act by reason of the conduct of subsidiaries of an issuer which may not be under the control of the issuer.

I will briefly summarize the way in which our policy statement responds to these concerns:

- Recordkeeping. The Act's recordkeeping provision requires that a company maintain records which reasonably and fairly reflect the transaction 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 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.

More generally, however, those criticisms reflect what appears to be a deep-seated misunderstanding and distrust - and I would like to address that issue more directly. The

common thread running through responsible criticism of the Act's accounting provisions is their lack of precision. Truly, they are fairly general statements. There are no safe harbors or precise guidelines. I submit, however, that this generality is not the Act's weakness, but its strength -- in the circumstances the only practicable means of achieving its goals.

Today there are over 9,000 public companies subject to the Act. They range from firms with assets of approximately \$1 million to behemoths with billions of dollars in assets. Each is different. Yet the Act must apply to them all -- with as much fairness and equity as we can muster. In my view, fixing precise guidelines applicable to all issuers with equal force would put these companies into straight jackets without any hope of realizing the Act's goals. It would, in fact, do precisely what the Act's critics fear: put the SEC directly into the business of setting accounting principles and practices.

This difficulty is well illustrated by concerns about the need for a materiality qualification in the Act. For the reasons I discussed earlier, the Congress not only rejected materiality, but its explicit intention was to reach practices that are not so significant that they would distort a company's financial statements. Of course, it does not follow that Congress intended every failure to be a violation of Federal law. All agree that transactions or errors beneath a certain level should not be caught up in the regulatory sweep of the Act. But the range of issuers and transactions makes it difficult at this stage to establish a percentage or absolute dollar test.

There is nothing revolutionary about this approach. Like the anti-trust laws, state corporate laws, the Federal securities laws and many other statutes, the Act applies general standards of conduct to an infinite variety of factual situations. There will always be a degree of uncertainty involved, just as in other areas of the law. But this uncertainty need not be viewed with such alarm if one keeps in mind several important factors. First, while the uncertainty complicates the task of an adviser, it does not, as a practical matter, give the Commission free rein. To the contrary, it means that the courts will tend to validate the mainstream of good accounting practice.

Second, the Act's internal controls provisions are intended to be largely self-executing. Congress clearly intended to leave to management and the board of directors the initial judgments of how a company's accounting systems should reflect the characteristics of that company and the business environment in which it operates. It is only when the decisions of management and the board deviate from the norms of reasonable and prudent conduct that outside intervention is contemplated.

Third, the Act itself contains qualifications which limit the exposure of issuers. The recordkeeping provision requires not perfect books, but books, records and accounts which "in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." The legislative history of this part of the Act makes it clear that Congress intended to defer to existing, accepted accounting conventions governing the recording of economic events, and had no intention of granting the Commission the power to second-guess those conventions.

Concededly, there may be a technical interpretive problem with the accuracy requirements, particularly as they apply to inadvertent or insignificant errors. For that reason, our policy statement emphasizes the importance of state of mind as a touchstone of our enforcement program in this area. A knowing or reckless falsification or failure to maintain adequate books is a clear signal of a transaction that deserves careful scrutiny.

Similarly, the Act's internal accounting controls provision states that, in devising and maintaining the required system of controls, the goal is to provide "reasonable assurances" that the stated aims will be met. Again, what is required is not perfection, with the open jailhouse door waiting for each slip of the pen, but merely the creation of a reasonable system. Congress intended that management was entitled to make a judgment as to whether existing or potential controls were cost-justified, in light of the expected benefits.

Fourth, for my own part, I would expect time to bring an evolving standard of transactions that are significant enough to be an appropriate object of the Act. That -- and not a self-serving statement of the SEC's good sense and benevolence -- is what underlies our consistent appeals to look at how we have administered the Act. Of the half-dozen or so cases brought by the Commission for alleged recordkeeping violations, not one could even arguably be called insignificant or inadvertent. Moreover, an insignificant or technical violation of the accuracy requirement would not present the factors necessary for us to obtain an injunction. Even more clearly, the state of mind necessary for a criminal conviction would not be present. In that sense, the remedy begins to define the wrong.

The Role of the Accounting Profession Finally, I would like to devote a few minutes to the role of the accounting profession in this process. It is a dual role: as adviser to your clients, and as the principal crucible in which these provisions are given meaning. I was amused to read in SAS 30 that compliance with the accounting provisions of the Act is a "legal" matter. I fully understand why, at this stage, an accountant would be reluctant to opine upon compliance with

those provisions. Nevertheless, it is very plain that it is the accounting profession to which companies must look for the design of their accounting and internal control systems, and that one of the crucial legal issues will always be the extent to which a company's systems deviate from general practice for similar companies.

Moreover, SAS 30 clings to the teddy bear of financial statement materiality. It provides a source of comfort for a profession with financial statements as its focus. But that is a source of comfort your clients no longer have in the internal controls area. In the end, they will ask more of you as well.

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Those of you here today and your colleagues in the accounting profession will write the conclusion to my remarks this afternoon. If the profession continues to recoil from the Act's accounting provisions because this is purely a "legal" question, the inevitable result will be that your clients will look elsewhere for guidance and comfort. Even more important, what you decide not to do will be left to the SEC to complete.

If the profession elects to assume a positive role -to ask "how can we help", -- the burden of external regulation will be lightened, and the profession and its clients will maximize their independence and flexibility.