

AN EXAMINATION OF THE ACCOUNTING PROVISIONS OF THE FCPA

Lloyd H. Feller*

I. INTRODUCTION

Before I discuss the accounting provisions of the FCPA, I would like to make a few random observations about the earlier discussions. Judging from the tenor of the first speaker, one might wonder why there has been such a great controversy over the Foreign Corrupt Practices Act (FCPA),¹ an Act which actually has very little to do with foreign corrupt practices, at least in some of its applications.

I disagree, in some respects, with what I have heard about the impact of the FCPA regarding the antibribery provisions.² It may be that, in some countries, bribes are the rule rather than the exception. Every country in which there were payoffs, I believe, had strict laws against taking such payments. Nevertheless, businessmen and lawyers who practice in the international area have suggested to me that there continue to be problems in countries throughout the world. The Carter Administration argued that the Foreign Corrupt Practices Act, by prohibiting types of payments which arguably may not violate the intent of the Act, operates as an export disincentive. I do not know whether that is true or not. I would note, however, that President Carter was of the view that the lack of guidance on the antibribery provisions was itself an export disincentive, and that Justice Department guidance was necessary.

II. THE ACCOUNTING PROVISIONS

Let me try to put into context the controversy surrounding the accounting provisions. First, it is important to understand that

* Partner, Morgan, Lewis & Boekius, Washington, D.C.; Co-Chairman, ABA Ad Hoc Comm. on Revision of the FCPA, Section of Corporation, Banking and Business Law.

1. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, §§ 102-104, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78a, 78m, 78dd-1, 78dd-2, 78ff (Supp. V 1981)), *reprinted in Appendix I, infra*.

2. 15 U.S.C. §§ 78dd-1 and -2 (Supp. V 1981).

the accounting provisions are part of the Securities Exchange Act of 1934, and apply to all issuers which register securities with the SEC.³ The provisions apply to all such issuers, whether or not they do business overseas. The Act, as it is applied through the accounting provisions, has absolutely nothing to do with foreign corrupt practices; it has to do with accounting, including the maintenance of books and records, and the establishment and maintenance of a system of internal accounting controls.

I think it is important to start with an understanding of how the Act was presented to the corporate community at the time it was passed, because the context in which the words were used and the purpose for which the accounting provisions were intended created the great controversy. It is important to understand that people who never heard of the bribery of foreign officials woke up one day and found that an Act had just been passed which applied to them in very significant ways. This was an Act which they had never heard of, had never thought involved them, had never paid any attention to, and had never understood. They listened to the lawyers and accountants explain it to them and still did not understand. Alan Levenson, a former director of the Division of Corporate Finance, said that it was the most extensive application of federal securities law to internal corporate affairs since the passage of the Acts in 1933 and 1934.⁴

An American Bar Association Committee issued a guide to the new provision⁵ which declared that, because the 1934 Act was concerned about financial disclosure which would assist investors in making investment decisions, the new accounting provisions were also directed at financial disclosure to investors. It is important to understand what people were saying about the accounting provisions at the time. Daniel L. Goelzer, who is now General Counsel of the SEC, said:

Finally the [Foreign Corrupt Practices] Act has important implications for the Securities and Exchange Commission. The incorporation of the accounting provisions into the federal

3. 15 U.S.C. § 78m(b)(2) (Supp. V 1981). The accounting provisions are *reprinted in* Appendix I *infra*.

4. *Accounting Provisions of the Foreign Corrupt Practices Act Discussed at New York Law Journal Seminar*, [1978] 451 SEC. REG. & L. REP. (BNA) D-1, D-1, quoting Alan B. Levenson, formerly Director of the Commission's Division of Corporate Finance, cited in Goelzer, *Accounting Provisions of the Foreign Corrupt Practices Act—the Federalization of Corporate Recordkeeping and Internal Control*, 5 J. CORP. L. 1, 4 (1979).

securities laws confers on the Commission new rulemaking and enforcement authority over the control and recordkeeping mechanisms of its registrants. Broadly speaking, the Foreign Corrupt Practices Act reflects a Congressional determination that the scope of the federal securities laws and the Commission's authority should be expanded beyond the traditional ambit of disclosure requirements. Accordingly, the Commission's General Counsel, Ralph C. Ferrara, has noted that the scope and impact of the accounting provisions may be analagous to that of the antifraud sections of the federal securities laws. In any event, the consequences of adding substantive requirements governing accounting control to the federal securities laws may significantly augment the degree of federal involvement in the internal management of public corporations.⁶

Mr. Goelzer's position is made clearer by the following statement: "While reporting issuers are already subject to the Commission's jurisdiction, the accounting provisions expand the Commission's authority over the issuer's information systems, analagous to that which it exercises over securities professionals."⁷ This refers to the authority that the SEC has over broker dealers who are registered with it under section 17 of the Securities Exchange Act, which gives the SEC authority to define the records which the broker must keep and maintain.⁸ Section 17 does not have an explicit rulemaking provision in it, but the SEC argued that its general rulemaking grant was sufficient to give it this authority with respect to all issuers.

I think it is fair to say that the first message that came from the SEC was that the Foreign Corrupt Practices Act was a way of assuring corporate accountability. It was viewed by some as a mechanism for furthering ideals of corporate governance which, up until that time, had been attempted primarily through jawboning by various Commissioners or by hoping that people would voluntarily cooperate. It was not then clear, nor is it now clear, that the SEC has the authority to do many of the things that it sought to do under the Act. For example, Harold M. Williams, former Chair-

5. ABA Comm. on Corp. Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934*, 34 BUS. LAW. 307 (1978).

6. Goelzer, *Accounting Provisions of the Foreign Corrupt Practices Act—The Federalization of Corporate Recordkeeping and Internal Control*, 5 J. CORP. L. 1, 5 (1979).

7. *Id.* at 20.

8. 15 U.S.C. § 78q (Supp. II 1978).

man of the Commission, asked then General Counsel Harvey L. Pitt what authority there might be to require companies to have audit committees comprised of independent directors. One of the sources of authority which General Counsel Pitt came up with was the Foreign Corrupt Practices Act. It is hard to understand how the requirements of internal controls and accurate books and records can be interpreted to also require outside directors. State laws have no such requirements. Nor do state laws require that outside directors be put on audit committees, or that the audit committees be given the responsibility of making sure that the systems of internal control function properly. Nevertheless, the SEC asserts such authority.

Business people were concerned about how far the SEC would push its authority. They became even more concerned when the SEC proposed a requirement that management report on internal controls. The fear was that people would be singled out. For example, some staff members suggested that if someone put in an expense voucher for twenty dollars for a taxicab, and actually that person drove to the airport that day, or if someone put in a voucher for a meal and actually had gone out to eat with his girlfriend, then those people had violated the Act. There was no materiality threshold with respect to what violated the accurate books and records provision, section 13(b)(2)(A).

In addition, corporations which discovered they had an internal accounting control which was not working properly were automatically in violation of the law and subject to criminal penalties. It was hard to tell the business community that the SEC would be reasonable in its administration of the Act when it had staff members at conferences telling people that this Act meant exactly what it said. Even a mistake transposing figures would be a violation. Without a materiality standard, some people thought perfection was required. Of course, perfection is not possible. Any internal accounting control system is imperfect. You have to be able to review your systems of internal control; you have to have the ability to change it. Indeed, a system of internal controls which does not have the capability to undergo regular review and monitoring may not be a good system of internal accounting control. Part of the problem was that no one really knew.

I think that, to date, fourteen cases have been brought by the SEC under the accounting provisions. There were, however, many more investigations, many involving assertions that the Act reach-

ed conduct which was clearly not material in any sense. I can say that because I was involved in some of them. It is only fair to say that the Commission did not pursue most of these situations beyond the investigative stage. Nevertheless, the companies had to pay considerable legal fees to defend themselves. Word spread among the corporate community that certain types of behavior were being looked at by the SEC. This was troublesome to the corporate community because the companies did not know what was expected of them. They would hear one thing from their lawyers, another thing from their accountants, and still another from the SEC.

Partly as a result of this uncertainty, there was a movement which resulted in S. 708 being passed in the Senate. This Bill reworks the Foreign Corrupt Practices Act.⁹ It is true that the momentum for amending the Foreign Corrupt Practices Act is also attributable to its antibribery provisions and their effect on trade. But there was also the concern that corporations had overreacted, spending enormous amounts of money to change their systems of internal accounting control—sums which were not cost-justified. Corporations still did not understand what was intended and what was meant, so there was pressure on both sides to try to change the provision.

Let me describe briefly certain problems which occurred with the very simple language of the accounting provisions. The first is the lack of any materiality standard in the Foreign Corrupt Practices Act. In addition, there is the problem of deciding what "reasonable detail" means. These words were added at the last moment when Congress enacted the Foreign Corrupt Practices Act, and it was done out of a concern that an unqualified standard might connote an unrealistic degree of precision. The addition of the words "in reasonable detail" makes clear that the records should conform to accepted methods of accounting which would prevent off-the-book slush funds and the payment of bribes.

What does that language mean in the context of regular transactions, putting aside illegal payments, slush funds and bribes? As an example, suppose an invoice is sent to a customer and the invoice reflects that the sale amount is one hundred dollars. One hundred dollars is then owed and the payment is due.

9. S. 708, 97th Cong., 1st Sess. (1981), 127 CONG. REC. 13,983-85 (1981). These proposed changes to the FCPA are *reprinted in* Appendix II, *infra*.

The terms of the payment may or may not be included. Now assume that a separate document reflects an agreement with the purchaser that a purchase of fifty million dollars during a six-month period will qualify him for a ten percent volume discount. If that agreement does not show up on the face of the original invoice, is there a violation? Taken in isolation, does the absence of the terms of the agreement constitute a violation? Some said that it did, and there was debate on this question.

There is a problem of what to do when you have to take a group of documents to piece together what happened in some transaction. Part of the answer may depend upon whether the auditors have been given access to all the documents, so they have the opportunity to know what is going on. If a second set of books exists, then we have a different type of problem, because that seemingly constitutes false entries. I am speaking of an incomplete document which is accurate on its face, unless you take the position that it is inaccurate because it fails to reflect the discount which was made available in a separate arrangement.

There is another problem which stems from the use of the word "records" in the Act. On the implications of the use of the word "records," Dan Goelzer said:

The scope of the accuracy requirement is not, however, limited to records which are a part of the accounting system or incident to the preparation of financial statements. Section 3(a)(37) of the Securities Exchange Act defines "records" to mean, "accounts, correspondence, memoranda, tapes, disk, paper, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language." Thus, Congress's use of the term "records" suggests that virtually any tangible embodiment of information made or kept by an issuer is within the scope of section 102 of the Foreign Corrupt Practices Act, at least if it pertains to the recording of "economic events."¹⁰

Goelzer's comments show what I believe to have been an unintended meaning applied to the word "records" by the SEC. The word "records" does appear in the Act, but the language does not limit the definition to "accounting records." The SEC's definition of the word is broader than was intended when the Act was written. Nevertheless, the SEC asserts the broadest possible meaning. Therefore, if someone keeps notes which do not ac-

10. Goelzer, *supra* note 6, at 23-24.

curately reflect what he wanted to say, he may be in trouble, even if the notes are not going anywhere.

The four objectives of internal accounting control set forth in the statute come directly out of the accounting literature. They were deliberately taken from the accounting literature so that they would be understood by accountants. It was expected that people would interpret the language in the same way that accountants had been doing it for years. I would add, however, that the accountants said that non-accountants would not understand the language, which was only intended for special accounting purposes, and opposed incorporating accounting language into the Act.¹¹

The auditing literature does contain a definition of "reasonable assurances:" it is basically a cost-benefit analysis. Every business decision must balance the cost of a perfect system against the cost of any other system or control. If the benefits of a system do not outweigh the costs, one would not implement those particular controls. That language, however, was not explicitly incorporated as part of the statute, and there continues to be debate and uncertainty about exactly what "reasonable assurances" mean, how much latitude a board of directors has to make business judgments, and whether the SEC would defer to those business judgments.

There is also a question regarding state of mind (scienter), which relates to enforcement proceedings. In order for the SEC to bring an action, does the offender have to violate the Act knowingly? If you scribbled something down without any thought that you were doing anything wrong, would that be enough to constitute a violation? The SEC took the position that there was no scienter requirement: Congress intended to reach all types of conduct, whether negligent, willful, or knowing. Consequently, there was disagreement between the ABA, the SEC, and the corporate community.

A further issue which needed clarification deals with subsidiaries. The statute expressly addresses issuers, but it does not mention the subsidiaries of issuers. A question was raised at almost the first conference that was held on the Foreign Corrupt Practices Act about whether the scope of the Act extended to subsidiaries. Speaking for myself, I think it is fairly clear that if the

11. AICPA STATEMENT ON AUDITING STANDARDS No. 1 (Nov. 1972).

Act does not include the subsidiaries, its intended purposes would be defeated. Nevertheless, the debate about subsidiaries continues. It becomes especially important when corporations own less than fifty percent of their subsidiaries, and consequently do not really control them. There may be subsidiaries where the corporation owns fifty percent because it is required by the laws of the foreign country, but there is no operating control over that subsidiary. There are also companies which own even less of the subsidiary. Under the equity method of accounting, one is deemed to have significant influence if one owns between twenty and fifty percent of the subsidiary. Does that mean that the company can dictate how the subsidiary maintains its books and records? It was not always clear to a U.S. company which owned twenty-five percent of a foreign company that it could go in and tell the company how to maintain its books and records. Many of the foreign companies did not appreciate the U.S. companies instructing them about the SEC's new record-keeping requirements.

III. RESPONSES TO THE PROBLEM

Legislative interest in amending the FCPA was first expressed by Senator Chafee of Rhode Island. At about the same time, there was a fair amount of debate within the SEC concerning the proper interpretation of the Foreign Corrupt Practices Act. The Commission itself was not of one mind on many issues, and there were extensive debates within the Commission. Decisions were not lightly reached. In January of 1981, the SEC issued a policy statement which, in an effort to blunt the proposed legislation, significantly restated the SEC's prior position. In that statement, the SEC said that the reasonableness standard did not mandate exactness in record-keeping, and the reasonable assurances standard did not require the achievement of an ideal system. The Commission stated that it recognized that the concept of reasonable-ness tolerated certain deviations and encompassed cost-benefit analysis. It indicated its willingness to be deferential, stating that it would only bring actions when there was knowing or reckless conduct. This was a significant change from what the SEC had said in the past.

On the question of subsidiaries, the SEC set forth the rebuttable presumption of responsibility for subsidiaries between twenty and fifty percent. The important thing was that with respect to scienter, the SEC would bring actions only for knowing or reck-

less conduct. That was, in a sense, a scienter standard: the SEC was not looking for inadvertent errors, but would instead look to top management's degree of involvement as one of its tests to see whether it would bring enforcement actions.

If the SEC had come out with its policy statement earlier, it might have greatly reduced the uncertainty and the pressure which occurred. At this point in time, however, the legislation had moved forward. Senate Bill 708, as passed by the Senate, made some significant changes in the accounting provision. The first change was that the books and records provision, section 13(b)(2)(A), was changed to reflect a new objective of internal accounting control. The purpose of this move was to remove the books and records provision as an independent basis for enforcement actions by the SEC, but to leave the provision as a component of a system of internal accounting control. I am not convinced that this is consistent with traditional notions of internal accounting control. It probably belongs more in a criminal provision if it is intended to facilitate the prosecution of bribes or illegal payments. Senate Bill 708 represents a compromise as it now stands, and I am not sure that it accomplishes its purpose.

In addition, the legislation has decriminalized the accounting sanction for issuers who do not maintain a system of internal accounting controls which meets the objectives set forth in the FCPA. That should be contrasted to circumvention of a system of internal accounting controls which is established. In that situation, a person may be either civilly or criminally liable for deliberate circumvention of a system established by an issuer. There are new scienter provisions put into the Act with respect to the company: if a good faith defense is made, the individual must be shown to have knowingly caused the issuer to fail to devise or maintain a system of internal accounting controls.

There is also a definition of "reasonable assurances" in the legislation which has an interesting provision. It says:

[F]or the purpose of this section the term "reasonable assurances" and "reasonable detail" mean such level of detail and degree of assurances that would satisfy prudent individuals in the conduct of their own affairs, having in mind a comparison between benefits to be obtained and costs to be incurred in obtaining such benefits.¹²

12. S. 708, 97th Cong., 1st Sess., 127 CONG. REC. 13,983-85 (1981), *reprinted in* Appendix II, *infra*.

The prudent person language comes from testimony by the SEC. My problem with it is that it talks about a prudent individual in the conduct of his own affairs. I think everyone intended to talk about the prudent *businessman* in the conduct of affairs similar to the affairs about which the judgment is being made. I think this needs clarification in the hearings that are going on in the House at this time.

IV. FUTURE CHANGES

The House is continuing to meander through hearings on the accounting provisions and they will conduct further hearings this term. Whether they actually consider a bill is a question which other members of the panel can discuss later this session. The Administration has supported S. 708 essentially as it was enacted by the Senate, with certain technical changes.

As a final thought, let me point out that there are different views about why the accounting provisions were included in the Act. Let me give one reason that may not be immediately apparent, because it is totally unrelated to foreign payments and corrupt practices. Some people believe that auditing in the future will move towards auditing systems of internal control, rather than auditing the books and records of a corporation, and that this movement has been engendered by the internal controls provisions of the Foreign Corrupt Practices Act. Its controls force companies to make the initial expenditure to get their systems in good shape, and this will produce long-term cost-savings benefits as well as changes in the method of accounting. I think that these benefits, although in many ways unrelated to the FCPA, have been very beneficial.