Washington and Lee Law Review

Volume 36 | Issue 3 Article 7

Summer 6-1-1979

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Recommended Citation

Thomas E. Baker, *Accounting And Accountability: Overview Of The Accounting Provisions Of The Foreign Corrupt Practices Act Of 1977*, 36 Wash. & Lee L. Rev. 809 (1979).
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ACCOUNTING AND ACCOUNTABILITY: OVERVIEW OF THE ACCOUNTING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT OF 1977

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Corporate accounting techniques and practices for publicly held companies[1] have been the focus of increased scrutiny and debate. The accounting provisions of the Foreign Corrupt Practices Act of 1977[2] (FCPA) have focused attention on technical matters and procedures, as well as certain broader issues regarding the role of accounting and accountants, and the manner in which corporate management itself is responsible for preventing wrongdoing. The accounting provisions of the FCPA generally require publicly held corporations to keep books, records and accounts and to maintain a system of internal accounting controls meeting specified objectives.[3] The impact and reach of these provisions has raised far broader questions of corporate accountability. These questions relate to the evaluation, by

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[1] A publicly held company is a corporation that has a class of securities registered pursuant to § 12 of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78*l*, and must file reports pursuant to § 15(d) of the 1934 Act, 15 U.S.C. § 78o(d) (1976).

[2] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1794 (codified in scattered sections of 15 U.S.C.) [hereinafter cited as FCPA]. The FCPA's accounting provisions were codified as an amendment to § 13(b) of the 1934 Act, 15 U.S.C. § 78m(b)(2) (Supp. I 1976). *See* note 3 *infra*. The FCPA also contains prohibitions on foreign bribery. This article discusses only the accounting provisions.

[3] The FCPA's accounting provisions provide that:

> every issuer which has a class of securities registered pursuant to section 12 of [the 1934 Act] and every issuer which is required to file reports pursuant to section 15(d) of [the 1934 Act] shall:
>
> (A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
>
> (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that-
>
> (i) transactions are executed in accordance with management's general or specific authorization;
>
> (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
>
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
>
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

15 U.S.C. § 78m(b)(2) (Supp. I 1976).

means of accounting techniques, of management's performance of its stewardship responsibilities, and the accountability of management for allocation of, and financial reporting for corporate assets. The FCPA is one example of legislation that turns increased scrutiny on management and, to some extent, the internal affairs of the corporation. Improvements in the process of corporate governance, including refinements in accounting procedures and increased accountability to shareholders, should be accomplished without seriously inhibiting the ability of corporate management to manage efficiently and achieve the corporation's principal objectives.

This article is an overview and summary of the accounting provisions of the FCPA. However, the terms and requirements of the FCPA reflect developing views and opinions regarding proper means and degrees of accountability for corporate actions, the role of accounting principles therein, and the standard of duty and responsibility of corporate management. Therefore, these general issues will be highlighted when appropriate in the course of the analysis of the FCPA's provisions.

I. Accountability In General

The Honorable Harold M. Williams has defined corporate accountability as simply "the process by which managers are held responsible for the result of their stewardship."[4] Corporate financial performance is an obvious component of corporate accountability. The sentiment has been expressed, however, that corporate accountability also includes meeting the company's social responsibilities, complying with laws, and supervising carefully the internal conduct of business and affairs. The goal of corporate accountability in this expanded sense can be reached by implementing a system that includes internal controls, effective accounting and auditing, careful structuring, responsibilities of management, oversight by boards of directors and their committees, and public disclosures.[5] Corporate codes of business ethics and conduct, legal compliance programs and formal policy and control procedures may be considered parts of corporate accountability systems. While codes of conduct may be appropriate, it is improper and counterproductive to apply the label "ethical business" or "unethical conduct" in the absence of a clearly drawn requirement for conduct which is based on a general consensus, tempered by deliberation, and properly defined. A distinction should be clearly drawn in any case, between performance in the sense of corporate financial reporting, and accountability according to expanded social standards. Legislative monitoring and regulation of accounting practice to achieve goals of substantive regulation of corporate conduct raises serious questions on both practical and theoretical levels. Additional accounting procedures and standards

[4] Address by Harold M. Williams, Chairman, Securities and Exchange Commission, Sixth Annual Securities Regulation Institute, San Diego, California (January 18, 1979).

[5] *See generally* Moss, *The Crisis of Corporate Accountability: A Legislator's View*, J. Corp. L. 251 (1978).

may become excessively burdensome, and raise difficulties regarding the nature, extent and source of some legal duties.

The functions corporate accounting serves as part of a trend toward greater accountability are rapidly developing due to the influence of legislation such as the FCPA and refinements introduced by the Securities and Exchange Commission (Commission) and self-governance bodies in the accounting profession. Like any science or art, however, corporate accounting has limitations. Its primary purpose is to record clearly and accurately financial data and information, and compile the same into usable statements of financial condition. To the extent corporate accounting is assigned the primary role in auditing and monitoring to ensure overall corporate accountability, corporations will incur unreasonable burdens and expenses and the public will develop expectations that probably will remain unfulfilled. Some goals cannot be attained by reliance on corporate accounting techniques, however expanded and refined those techniques may become.

II. CORPORATE ACCOUNTING GENERALLY

While the accounting provisions of the FCPA do not specifically refer to or define generally accepted accounting principles, the statutory terms should be read in light of the established and accepted practices of the accounting profession.

Basically, accounting may be defined as "[t]he recording and reporting of transactions."[6] This function involves techniques for recognition of a corporate transaction, including the appropriate timing and quantification of a transaction, the processing of transactions, recording and grouping of transactions, internal checking of transactions, and reporting, both internally and externally to others, such as in financial statements.[7] From a practical point of view, accounting is "the science and art of systematically recording, presenting, and interpreting the financial facts of an . . . enterprise."[8] Accounting practices are always carried out with the goal of providing management with the financial information necessary to discharge responsibilities, including those of a fiduciary nature, and to apprise investors and others of the financial condition of an enterprise.[9] An

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[6] E. KOHLER, A DICTIONARY FOR ACCOUNTANTS (4th ed. 1970) [hereinafter cited as A DICTIONARY FOR ACCOUNTANTS].

[7] *Id.* Although authorities differ on the terminology used to define accounting, the concepts underlying the definitions are generally similar. *Compare* G. MACFARLAND & R. AYARS, ACCOUNTING FUNDAMENTALS 1 (1947) *with* P. GRADY, AMERICAN INSTUTITE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) ACCOUNTING RESEARCH STUDY NO. 7; INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES, 2-4 (1965) [hereinafter cited as RESEARCH STUDY NO. 7].

[8] G. MACFARLAND & R. AYARS, ACCOUNTING FUNDAMENTALS 1 (1947).

[9] Accounting is the body of knowledge and functions concerned with systematic originating, authenicating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character,

accounting system can only provide the information and disclosure data necessary to the discharge of managerial duties; it can not ensure that those duties will in fact be performed. Neither will an auditing system of reasonable cost ensure that all those duties will in fact be performed properly.

While the Commission has the authority to establish accounting standards,[10] this function has traditionally been relegated by the Commission[11] to the private sector, now through the Financial Accounting Standards Board (FASB). The Commission, of course, retains oversight responsibility and from time to time makes known its opinion both on matters of professional concern and the performance of the FASB itself. The Commission is not bound to accept traditional views on the formulations of accounting principles devised by the FASB or its predecessor organizations.[12] While the FASB undertakes numerous projects of significance to financial reporting generally, a current study project most germane to the issues of accounting and accountability is one entitled "Conceptual Framework for Financial Accounting and Reporting."[13] The project addresses matters such as the objectives of a financial statement, the qualitative characteristics of the information contained therein, and the basic measuring devices to be employed in compiling the pertinent information. Recently, in its first pronouncement[14] relating to the objectives of financial reporting, the

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> required for the management and operation of an entity and for the reports that have to be submitted thereon to meet fiduciary and other responsibilities.

RESEARCH STUDY No. 7, *supra* note 7, at 4.

[10] 15 U.S.C. §§ 77s, 78w (1976).

[11] *See* SEC Accounting Release No. 4, (April 25, 1938), *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,005. The Commission will assume that financial statements are misleading unless there is support for the accounting principles upon which the statements are based. *Id.* Recently the Commission has taken the position that official Financial Accounting Standards Board (FASB) Statements and Interpretations will provide the requisite support for the use of accounting principles in preparing financial statements. SEC Accounting Release No. 150 (December 20, 1973), *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,172.

[12] For example, the Commission is presently developing accounting standards, with respect to oil and gas producing activities, that are not consistent with past practices. The Commission's concern for the adequacy of corporate accountability in the oil and gas producing market stems from a perceived failure of traditional accounting methods to reflect properly companies' operational results and financial position. SEC Securities Act Release No. 5966, (August 31, 1978), *reprinted in* 6 FED. SEC. L. REP. (CCH) § 72,275. Most significantly, the Commission indicated that traditional accounting for gas and oil reserves was no longer satisfactory. *Id.* Pending an investigation to establish a uniform accounting system, the Commission promulgated rules requiring oil and gas producers to issue supplemental earnings summaries in connection with their financial reporting. 17 C.F.R. § 210.3-18 (1977). *See* SEC Securities Act Release No. 6006 and 6007, (December 19, 1978), *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶¶ 72,279-280.

[13] FASB, DISCUSSION MEMORANDUM, CONCEPTUAL FRAMEWORK FOR FINANCIAL ACCOUNTING AND REPORTING: ELEMENTS OF FINANCIAL STATEMENTS AND THEIR MEASUREMENTS (1976); FASB, TENTATIVE CONCLUSIONS ON OBJECTIVES OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISE (1976); FASB, SCOPE AND IMPLICATIONS OF THE CONCEPTUAL FRAMEWORK PROJECT (1976).

[14] FASB, STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1 OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES (November 1978).

FASB indicated that the objectives pertain to financial reporting generally, and are not limited to communicating information through financial statements.[15] From a practical standpoint, "[f]inancial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions."[16] Moreover, the statement indicates that financial reporting should show how management has discharged its stewardship responsibilities to shareholders in the use of the enterprise's resources, with particular focus on the earnings information. The statement emphasizes, however, that financial reporting, and especially financial statements, normally do not offer a basis for assessing management performance apart from the enterprise financial performance.[17]

Traditionally, corporate management and not the board of directors or independent accountants has taken the primary responsibility for financial reporting of accounting results for publicly held corporations. The Commission forty years ago stated its view on the assignment of primary responsibility for the reporting of financial information:

> [t]he fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by employment of independent public accountants, however reputable .... [An independent accountant's opinion is not a] substitute for management's accounting of its stewardship, but as a check upon that accounting.[18]

This principle has been reaffirmed by the American Institute of Certified Public Accountants' (AICPA) "Cohen Commission Report."[19] The Report differentiated management's direct responsibility for financial statements from the independent accountant's audit responsibility. Internal audit responsibility is also distinguished.

III. DEFINITIONS

The legislative history of the FCPA indicates that the meaning of terms used in the statutory language should be obtained from generally accepted accounting principles.[20] Presumably these definitions will change as accounting terms develop and become more sophisticated.

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[15] *Id.* at 3.

[16] *Id.* at 16.

[17] *Id.* at 25-26.

[18] *In re* Interstate Hosiery Mills, Inc., 4 S.E.C. 706, 721 (1939). *See also* SEC Accounting Release No. 62, (June 27, 1947), *reprinted in* FED. SEC. L. REP. (CCH) ¶ 72,081.

[19] AICPA, THE COMMISSION ON AUDITORS' RESPONSIBILITIES REPORT, CONCLUSION, AND RECOMMENDATIONS 8-9 (1978).

[20] The legislative history contains numerous references to authoritative accounting literature or specific references therein. *See Report of the Securities and Exchange Commission on Questionable and Illegal Payments and Practices,* Submitted to the U.S. Senate Committee on Banking, Housing and Urban Affairs on May 12, 1976, at 59, 67 [hereinafter cited as

A. Assets

The term "assets" has been defined as representing "expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."[21] In terms of ownership, an asset "represents either a property right or value acquired, or an expenditure made which has created a property right or is properly applicable to the future."[22] These definitions normally look to the tangible nature of the item, and involve an assessment that the item will endure for some period into the future. Intangible values generated in the ordinary course of business rather than purchased, such as research results, advertising promotion and special technical competence are not normally recognized as assets.[23] Research activities, for example, are normally expensed.[24] The cost of intangibles purchased from others to be used in conjunction with research activities, however, is to be capitalized and amortized.[25]

Past definitions have not always reflected the practices under generally accepted accounting principles.[26] The definition of assets within the context of authoritative accounting literature is, in fact, currently undergoing review.[27] Moreover, courts in the past have questioned whether the accounting definition is dispositive on all issues. In *United States v. Simon,*[28]

SEC May 12 Report]; SEN. REP. No. 114, 95th Cong., 1st Sess. 8, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4098, 4106 [hereinafter cited as SENATE REPORT].

[21] AICPA ACCOUNTING RESEARCH STUDY NO. 3, A TENTATIVE SET OF BROAD ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 8 (1962) [hereinafter cited as RESEARCH STUDY NO. 3]. Assets also represent property rights, value acquired and expenditures that either create property rights or are properly applicable to the future. RESEARCH STUDY NO. 7, *supra* note 7, at 227.

[22] RESEARCH STUDY NO. 7, *supra* note 7, at 227.

[23] FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 2, ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS (October 1974).

[24] *Id.*

[25] *Id.* at 5.

[26] *See* RESEARCH STUDY NO. 3, *supra* note 21, at 60, 80.

[27] The FASB recognizes, for instance, that not all items includable as assets in financial reports according to its definitions of assets will necessarily be recognized as assets.

> Present practice for recognizing assets is determined by conventions and rules that have developed over many years and generally are beyond the scope of this Discussion Memorandum (paragraph 11-22). Thus, definitions discussed determine the items that are eligible to be included in assets and combine with decisions about recognition and measurement to determine the assets that should be included in the financial statements of a particular enterprise at a particular time.

FASB DISCUSSION MEMORANDUM, *supra* note 13, at 75.

[28] 425 F.2d 796 (2d Cir. 1969). In *Simon,* the government claimed that Continental Vending Machine Corporation's accountants had inadequately disclosed the nature of the company's accounts receivable. *Id.* at 801. The trial court had instructed the jury that if the financial statements did not fairly represent the company's financial position the dispositive issue was whether the accountants had acted in good faith. *Id.* at 805. The defendants had produced accounting experts who testified that the accounting procedures used conformed with generally accepted accounting principles and auditing standards. *Id.* However, the court charged the jury that conformity with profession-wide standards were merely evidence of good faith conduct. *Id.* at 805-06. The Second Circuit agreed, noting that generally accepted

the Second Circuit held that the definition of an "asset" under generally accepted accounting principles merited substantial consideration but was not dispositive in deciding whether accountants had adequately fulfilled their duties. At issue was the nature of a receivable which the auditing accountants had allowed to be carried as an asset with only footnote disclosure. While expert testimony and authoritative literature demonstrated that the receivable was an "asset," the court would apply that evidence only to the issue of good faith, and not to exonerate the accountants as a matter of law. Further disclosure may therefore be mandated in order to make the financial statement not misleading under the securities laws, even if the item clearly has the characteristics of an asset. The Commission's standards for disclosure at times may reach beyond definitional matters as expressed in accounting literature.

While statutory terms and regulatory guides are helpful in determining whether certain items fit the category of "assets" in discrete fact situations, these provisions and legal concepts are not determinative.[29] Often the ultimate determining factor should be sound judgment based on relevant facts. Regulation S-X,[30] concerning the form and content of financial statements, deals with specific categories of assets to be set forth in the financial statements, and the proper aggregation and segregation of the assets. Those items deemed "assets" under authoritative accounting literature should be segregated in accordance with generally accepted accounting principles as separate stated amounts in the financial reports of a business enterprise. For reporting purposes, however, assets may sometimes be aggregated or excluded under the test of materiality. For instance, Rule 3.02 of Regulation S-X provides, "[i]f the amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth."[31] Thus, the accounting definition of "assets" is the touchstone for the interpretation of statutory and regulatory terms in general, though the general definition can be overridden or superseded by express language establishing a separate rule in a given context. The accounting provisions of the FCPA, however, do not evidence any intent to establish a separate definition of assets. Consequently, as the definition of assets is developed and refined under generally accepted ac-

accounting principles do not establish accountants' disclosure responsibilities when the auditor has reason to believe that the company's affairs are not conducted honestly. The court stated that "[p]roof of compliance with generally accepted standards was 'evidence which may be very persuasive but not necessarily conclusive that he acted in good faith, and the facts as certified were not materially false or misleading.'" *Id.* at 805-06. *Simon* thus indicates that adherence to generally accepted accounting principles in reporting the nature of assets will not automatically insulate an auditor from liability for acting in bad faith.

[29] *See* note 27 *supra.*

[30] *See* 17 C.F.R. § 210.3-02 (1978). Regulation S-X establishes the requisite form and contents of financial statements. 17 C.F.R. § 210.1-01 (1978). Section 210.3-03 states that if amounts required to be shown under the regulation are immaterial, they need not be separately set forth in the reporting company's financial statement.

[31] 17 C.F.R. § 210.3-02 (1978).

counting concepts and authoritative accounting literature, such concepts should apply to the accounting provisions of the FCPA.

B. Transaction

Similarly, the term "transaction" should be defined according to generally accepted accounting principles and authoritative accounting literature. "Transaction" has been defined as "an economic event that has been recognized as having such an effect, rendered in a form that can be processed, and accepted for processing by one or more of the entity's accounting systems."[32] As used in the accounting context, a transaction relates to changes in assets, that is their receipt, expenditure or conversion. Changes in assets may occur in an exchange of assets, increase or decrease of an asset for a corresponding change in a liability or obligation, acquisition of an asset in exchange for performance of services, or a decrease of an asset with a corresponding decrease in a liability or obligation or an increase in assets due to receipt of services rendered. Transactions also include the internal transfer or conversion of an asset from one form to another, or consumption within the entity to generate revenue.

Since the time period in which changes and occurences are recognized is crucial to proper accounting procedures,[33] the timing of transaction recording and recognition must be consistent with generally accepted accounting principles. A transaction is in effect, an economic event that, under generally accepted accounting principles, has the status that requires recognition.[34] For example, accounting convention does not require under all circumstances the recordation of executory contracts, except in appropriate form as commitments or contingent liabilities, until such contracts can be considered "firm commitments for the acquisition of permanent or long-term investments and property, plant and equipment and for the purchase, repurchase, construction or rental of assets under material leases."[35] When items are treated as expenses rather than assets, as is the case for costs for research, proper recordation of the expenses is necessary in order that they be reflected fairly in financial statements in all material respects.[36]

The internal accounting control provisions of the FCPA require that transactions be authorized by management. Prior to such authorization and approval, a corporate transaction should not be executed, nor should access to assets be permitted. When a properly executed transaction

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[32] ARTHUR ANDERSEN & CO., A GUIDE FOR STUDYING AND EVALUATING INTERNAL ACCOUNTING CONTROLS 11 (1978).

[33] *See* RESEARCH STUDY NO. 3, *supra* note 21, at 6-7 (describing the term "time period" as a "basic postulate" and stating that a function of accounting is "to assign the changes to specified periods of time.")

[34] *See* INTERNAL ACCOUNTING CONTROLS, *supra* note 32, at 11. *See also* A DICTIONARY FOR ACCOUNTANTS, *supra* note 6, at 430-31.

[35] 17 C.F.R. § 210.3-16(i) (1978).

[36] *Id.* §§ 210.1-01, 5-02 (1978).

should be recorded in the accounting records depends in part upon the nature and timing of the transaction. The term "transaction" has a specific accounting meaning to which reference must be made in making such decisions.[37]

C. Books, Records and Accounts

While the scope of the term "books, records and accounts" as used in the FCPA[38] may seem self-evident, the Commission has suggested that it embraces various sorts of underlying data and information. This is of some concern because it constitutes an extension of the reach of the FCPA.

Section 3(a)(37) of the Securities Exchange Act of 1934 (the 1934 Act), defines the term "records" to mean "accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language."[39] Arguably, new section 13(b)(2) rejects the section 3(a)(37) definition, since, if the definition had been intended, the terms "books" and "accounts" would not have been needed in the FCPA provision, and specific reference would have been made in the legislative history to section 3(a)(37). Notably, in its SEC May 12 Report[40] the Commission used the term "books, records and accounts" without a specific explanation. The use of the term in section 13(b)(2) implies an adoption of the accounting definition, rather than the strict section 3(a)(37) definition. The reasonable conclusion is that the term "books, records and accounts" relates to the accounting journals, ledgers and other accounting papers required with respect to the art of accounting; which art may be described as the "classifying [recognizing] and recording, presenting, and interpreting of the financial facts [transactions]" after they have been authorized.[41]

References to "underlying data," according to authoritative accounting literature,[42] are not necessarily references to "books and accounts" in the securities laws sense. Discussions of the term "evidential matter," which is a general designation referring to various types of data used by the auditor, distinguish "underlying accounting data" from "all corroborating information available to the auditor." "The books of original entry, the

[37] AICPA STATEMENT ON AUDITING STANDARDS No. 1, ¶ 320.42 (November 1972)[hereinafter cited as AICPA STATEMENT No. 1]. *See* A DICTIONARY FOR ACCOUNTANTS, *supra* note 6 at 430-31; P. MASON, FUNDAMENTALS OF ACCOUNTING, 21-28 (2d ed. 1947).

[38] 15 U.S.C. § 78m(b)(2)(A) (Supp. I 1976); *see* note 3 *supra*.

[39] 15 U.S.C. § 78c(a)(37) (Supp. I 1976).

[40] SEC May 12 Report, *supra* note 20, at 63.

[41] G. MACFARLAND & R. AYARS, *supra* note 8, at 1. The distinction that the AICPA draws between "underlying accounting data" and "all corroborating information available to the auditor" can serve to delineate the scope of the term "books, records and accounts" in the FCPA. Underlying accounting data is the term most analogous to the FCPA's phrase. It includes "[t]he books of original entry, the general and subsidiary ledgers, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations. AICPA STATEMENT No. 1, *supra* note 37, ¶ 330.03-07.

[42] See AICPA STATEMENT No. 1, *supra* note 37, ¶ 330.03-07.

general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of financial statements" and are "underlying accounting data."[43] Any materials beyond those directly affecting the reliability of the financial statements and the accountability for assets, while important to the auditor's job, should not be encompassed within the term "books, records and accounts" in the FCPA.

In all cases, definitions of these terms should be drawn from authoritative accounting literature. This is demonstrated by the legislative history. In the SEC May 12 Report, the Commission stated its belief "that any legislation in this area should embody a prohibition against the falsification of corporate accounting records."[44] Senator Proxmire had previously in S. 3133 proposed to give the Commission by rule or regulation the authority to define the form of the information that books, records and accounts should contain.[45] Since the legislation was directed at certain shortcomings of corporate accounting records, and since the Commission was not given explicit authority to define form and content, the term "books, records and accounts" should be understood to be limited to those documents which reflect the accounting for transactions and for the dispositions of assets by the corporation. This may include the underlying accounting data and documents evidencing or supporting such transactions or dispositions of assets,[46] but the phrase should be construed in accordance with accounting princples, and not extended indiscriminately.

IV. BOOKKEEPING PROVISIONS

Subsection A of the FCPA (Subsection A) imposes upon publicly held corporations the obligation to "make and keep books, records and accounts, which in reasonable detail, accurately and fairly reflect the transactions."[47] The existing sanctions of general application in the 1934 Act[48] may be imposed for violations of the FCPA accounting provisions. While corporate management has a clear obligation to implement and maintain proper bookkeeping procedures that meet the statutory requirements, management should not be saddled with an absolute obligation to insure or guarantee against any insignificant, unintentional errors or isolated irregularities.

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[43] *Id.* ¶ 330.03-04.

[44] SEC May 12 Report, *supra* note 20, at 58.

[45] 122 CONG. REC. S3,279 (daily ed. March 11, 1976) (remarks of Sen. Proxmire).

[46] *See* AICPA STATEMENT No. 1, *supra* note 37, ¶ 330.01-05.

[47] 15 U.S.C. § 78m(b)(2)(A) (Supp. I 1976); *see* note 3 *supra*.

[48] *See* Report by the Committee on Corporate 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, 320-22 (1978) [hereinafter cited as *Guide*]. The Commission has made clear that the FCPA's bookkeeping provisions supplement rather than displace, the 1933 and 1934 Act's general disclosure requirements. See SEC Exchange Act Release No. 14478, (February 16, 1978), *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 72,264.

Further, this limited reading of subsection A is particularly justified when management has no active and deliberate role in the errors, or when the errors or irregularities are detected in a timely manner by employees or auditors in the normal course of performing their assigned functions. Subsection A should not be read to impose substantive requirements and duties beyond those already found in generally accepted accounting principles. For instance, the FCPA should not increase the number of accounts maintained in the corporate books according to generally accepted principles and practices.

A. Adequacy

While Subsection A was based on similar language in the SEC May 12 Report,[49] there is a notable difference in that the statutory language inserts the phrase "in reasonable detail." The Conference Report indicated in relevant part that:

> [t]he conference committee adopted the 'in reasonable detail' qualification to the accurate and fair requirement in light of the concern that such a standard, if unqualified, might connote a degree of exactitude and precision which is unrealistic. The amendment makes clear that the issuer's records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes.[50]

The question of whether books and records are adequate is closely related to the definition of that term. The broader the definition, the greater the standard of accuracy will be. While one goal of the FCPA is to prohibit the falsification of records necessary to disguise illicit activities, the definition of "books, records and accounts" should be drawn from authoritative accounting literature, as evidenced by the legislative history. Indiscriminate extension of the definition that disregards accounting principles would conflict with the requirement of "reasonable detail," and disturb what would seem to be an appropriate understanding of "adequacy."

The system of "books, records and accounts" maintained by a corporation must be adequate to meet the internal auditing control requirements of the FCPA.[51] The two provisions are related in that inadequate or incomplete books of account raise serious questions about whether an effective audit is possible. The internal auditing control requirements state generally that transactions must be executed according to authorization from management, that transactions must be recorded properly, that access to

[49] SEC May 12 Report, *supra* note 20.

[50] H.R. CONF. REP. No. 831, 95th Cong., 1st Sess. 10, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4121, 4122 [hereinafter cited as CONFERENCE REPORT].

[51] 15 U.S.C. § 78m(b)(2)(B) (Supp. I 1976) [hereinafter cited as Subsection B]; *see* note 3 *supra*; text accompanying notes 74-97 *infra*.

assets must be limited and that the records periodically be compared with reality.[52] The reliability of the books and records is a fundamental part of an effective system of internal accounting controls. The corporate books, records and accounts must therefore be sufficient to permit preparation of financial statements in conformity with generally accepted accounting principles and to maintain proper accountability for assets. This should be possible, however, without requiring the extensive use of additional books, records or accounts. Neither is there any suggestion of a need for providing substantial additional underlying data.

B. Role of State Law

The FCPA does not set forth criteria for determining when a transaction is executed, or access to assets is permitted, according to "authorization" by management. The question of proper authorization should be determined with reference to state corporate and agency law and to authoritative accounting literature. The authorization may be general or specific and may be granted directly by management or the board of directors or by delegation of authority from either, in keeping with the relevant provisions of state law.

Most state corporation laws impose requirements pertaining to the maintenance of books and records by corporations incorporated under their laws.[53] The Model Business Corporation Act provides that "each corporation shall keep correct and complete books and records of account . . . ."[54] Publicly held corporations have traditionally maintained financial books, records and accounts for practical reasons, in order to enable them to furnish financial reports to investors and file financial reports under various statutes and regulations. A variety of state and federal statutes establish standards of conduct for recordkeeping functions and prescribe administrative, civil and criminal sanctions for violations thereof.[55]

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[52] 15 U.S.C. § 78m(b)(2)(B) (Supp. I 1976).

[53] *See* MODEL BUSINESS CORPORATION ACT ANNOTATED 2d § 52, ¶ 6 (1971) (citing various state statutes requiring corporations to keep accounting records).

[54] *Id.* § 52.

[55] *See* 18 U.S.C. § 1001 (1976) (up to $10,000 fine and 5 year prison sentence for willful fraud in matters within jurisdiction of federal department or agency); 15 U.S.C. § 78ff(a) (1976) (penalties for willful violation of 1934 Act include imprisonment for up to 5 years). State law sanction provisions include DEL. CODE tit. 11, §§ 871, 4206 (1974) (falsification of business records punishable by up to 2 years imprisonment). The Delaware provision defines the conduct to which the sanctions apply as follows:

> [a] person is guilty of falisifying business records when, with intent to defraud, he:
>
> (1) Makes or causes a false entry in the business records of an enterprise; or
>
> (2) Alters, erases, obliterates, deletes, removes, or destroys a true entry in the business records of an enterprise; or
>
> (3) Omits to make a true entry in the business records of an enterprise in violation of a duty to do so which he knows to be imposed upon him by law or by the nature of his position; or
>
> (4) Prevents the making of a true entry or causes the omission thereof in the

Congress gave no specific indication in the FCPA of an intent to federalize applicable law on the issue of proper authorization. The guiding principle, then, as set forth in *Santa Fe Industries, Inc. v. Green,* is that state law controls.

> Absent a clear indication of Congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the court stated in *Cort v. Ash,* '[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly requires* certain responsibilities . . . , of directors with respect to stockholders, state law will govern the internal affairs of the corporation.' 422 U.S. at 84.[56]

The requirement of proper authorization must therefore be construed in light of applicable principles of state law, since those principles traditionally govern questions of authorization and are well established.[57] The duties of management implied by the FCPA must likewise be integrated with state corporate law principles.

C. Standard of Precision

Duly authorized corporate transactions are generally required to be recorded in a manner which permits them to be stated in the proper amounts, at the proper times, and classified in the proper accounts.[58] Oth-

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business records of an enterprise.

DEL. CODE tit. 11, § 871 (1974).

[56] 430 U.S. 462, 479 (1977). In *Green,* the Court cited the leading case of Cort v. Ash, 422 U.S. 66, 84 (1975). In *Ash,* a shareholder brought a derivative action alleging violations of 18 U.S.C. § 610 (1976) which prohibits certain corporate campaign contributions. 422 U.S. at 67. The Court held that § 610 did not create a private remedy in addition to its criminal sanctions. Aside from the fact that state law generally governs shareholders' relations with their corporation, the Court based its holding on three factors. Legislative history of the Federal Election Campaign Act indicated that § 610 did not create a substantive right in shareholders. *Id.* at 80-82. There was no indication that Congress implicitly recognized the existence of a federal right by creating a shareholder right to damages for violation of § 610. *Id.* at 82-84. Moreover, implying a shareholder right under § 610 would not effectuate Congress's intent to minimize corporate influence on the outcome of elections. *Id.* at 84.

[57] *See also* Burks v. Lasker, 99 S. Ct. 1831 (1979) (state law applies to determine whether independent directors may discuss a derivative action charging violations of the Investment Company Act of 1940 and Investment Advisers Act of 1940).

[58] For the proposition that financial statements do not reflect all events potentially affecting the nature and value of a company's assets, because some corporate transactions are not of such nature, or do not rise to a level of importance, sufficient to require recording, see ARTHUR ANDERSEN & CO., A GUIDE FOR STUDYING AND EVALUATING INTERNAL ACCOUNTING CONTROLS 11 (1978):

> It is a postulate of accounting that all economic events that involve the entity in exchnages with outsiders should be reflected in its financial statements. In addition, generally accepted accounting principles require that certain economic events

erwise, it would not be possible to meet the objectives of permitting "preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to such statements" and maintaining "accountability for assets." The AICPA in its *Statement on Auditing Standards No. 1* states, "[r]ecording of transactions comprehends all records maintained with respect to the transactions and the resulting assets or services and all functions performed with respect to such records."[59] In a larger sense, however, "[t]he accountability function follows assets from the time of their acquisition in one transaction until their disposition or use in another . . . [requiring] the maintenance of records of accountability for assets and periodic comparison of these records with the related assets."[60] Proper authorization therefore does not complete management's obligation. There is also a duty to follow through and see that the records kept are complete and consistent.

Since the legislation relies heavily upon authoritative accounting literature, the bookkeeping requirements should be construed consistently therewith. While accuracy and clarity are to be pursued, "[t]he term 'accurately' . . . does not mean exact precision as measured by some abstract principle. Rather, it means that an issuer's records should reflect transactions in conformity with accepted methods of recording economic events."[61] Insignificant errors, defined in authoritative accounting literature in part as "unintentional mistakes in financial statements and includ[ing] mathematical or clerical mistakes in the underlying records and accounting data . . . ,"[62] should not be actionable under the 1934 Act's sanction provisions. The same analysis has been offered with respect to occasional errors which do not establish a pattern.[63] While the Commission has refused to adopt any materiality test to limit the types of errors deemed actionable, the Commission has stated, "[t]he statute does not require perfection . . . the legislative history reflects that 'standards of reasonableness' are to be used . . . ."[64] A limitation of reasonableness eliminates concern for errors of a minor nature and impact. Where an error or irregularity is material but is detected within a timely period by employees in the normal course of performing their assigned functions, and prior

involving external forces or entities and certain internal economic events also should be reflected in the financial statements. Thus, some, but not all, economic events that potentially affect the nature and value of an entity's resources are reflected in its financial statements. The economic events that are to be reflected in the financial statements must, therefore, first be selected, or recognized. It is desirable that, once recognized, they be approved, or authorized.

[59] AICPA STATEMENT No. 1, *supra* note 37, ¶ 320.24.

[60] *Id.* ¶ 320.25.

[61] S. REP. No. 1031, 94th Cong., 2d Sess. 11 (1976).

[62] AICPA AUDITING STANDARDS EXECUTIVE COMMITTEE, STATEMENT ON AUDITING STANDARDS No. 16, THE INDEPENDENT AUDITOR'S RESPONSIBILITY FOR THE DETECTION OF ERRORS AND IRREGULARITIES ¶ 2 (1977).

[63] *Guide, supra* note 45.

[64] SEC Exchange Act Release No. 15570 (February 23, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959.

to the publication of financial statements, the corporation should not be in violation of the FCPA. The purpose of internal accounting controls is to establish controls that avoid errors and irregularities and, where necessary, find and correct errors and irregularities in a timely manner. The correction of *de minimis* errors, when not justified on a cost-benefit determination, should not be required provided the lack of correction does not cause any other misstatements or errors in the related internal or external financial reports.

D. Irregularities

Occasional errors should be distinguished from irregularities of a recurring or deliberate nature, which raise a different and more difficult set of problems. Such irregularities include "intentional distortions of financial statements, such as deliberate misrepresentations by management . . . or misappropriations of assets . . . , omission of significant information from records or documents; recording of transactions without substance . . . or misappropriation of assets for the benefit of management . . . ."[65] A clear distinction should be made between direct and indirect managerial involvement in this type of irregularity. An irregularity attributable to one or more employees without any general or specific authorization or knowledge by management, in circumvention of a system of internal accounting controls which is otherwise sufficient, should not subject the corporation or management to liability under the Securities Exchange Act of 1934, as long as the irregularity neither materially affects the corporation's financial statements nor impairs accountability for assets. Persistent irregularities at lower levels, however, raise serious questions regarding the sufficiency of the internal accounting controls. By contrast, in isolated situations involving only one member of management acting contrary to corporate policy and outside the system of internal accounting controls, neither other members of management nor the corporation should be held accountable absent other facts.

E. Liabilities

As discussed above, some questions arising under the FCPA, such as the authorization of transactions and the adequacy of books and records, may be resolved by reference to state law. Similarly, the management of a corporation must discharge a duty of care owed under state law regarding the maintenance of books and records and the safeguarding of assets.

The responsibilities pertaining to proper maintenance of financial books, records and accounts should be considered from the separate viewpoints of the corporation as an entity, of the directors, of management, and of the employees directly responsible. In his role of overseeing and directing the business and affairs of a corporation, a director performing his duties

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[65] *See* STATEMENT No. 16, *supra* note 62, ¶ 3.

"in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances," should be afforded the right to rely on the books, records and accounts and have no liability with respect thereto.[66] In making a judgment as to the reliability or completeness of such books, records and accounts, however, a director must exercise proper care.[67]

The duties of management[68] in charge of the daily conduct of the business and affairs of a corporation are more exacting and constant than those of a board of directors. In performing their duties, members of management should also have the right to rely on the books, records and accounts, so long as they act in good faith and exercise proper care.[69] Under normal conditions, members of management having direct control over the books, records and accounts should have greater responsibility and higher duties of care. A particular member of management having specific authority over and responsibility for a particular transaction would possess greater accountability for that transaction.

The requirement that management maintain proper accounting books, records and accounts[70] does not make management a guarantor of the completeness, veracity and reliability of all accounting books, records and accounts. Conscientious compliance with the bookkeeping provisions of the FCPA will not eradicate the inadvertent errors that occur from time to time. Non-management employees may deliberately falsify the recording of some transactions. Under some circumstances, mistakes or fraud would be neither material to the corporate enterprise nor result in distorted reporting of financial information. In some cases management will not be involved in any deliberate action or collusion, and the decision-making process of management will not be adversely affected. In any event, it should be recognized that not all illegal acts are recorded in the books, records and accounts of a corporation. In some instances non-management employees may deliberately circumvent the internal controls of a corporation. While such employees should be punished, neither management nor

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[66] Where directors are statutorily authorized to rely on the corporate officer's accounts and reports, there is usually a requirement that the reliance be in good faith. *See* DEL. CODE, tit. 8, § 141(e) (1974). Section 35 of the Model Business Corporation Act further qualifies a director's right of reliance by requiring a director to act "in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." MODEL BUSINESS CORPORATION ACT ANNOTATED 2d § 35 (Supp. 1974).

[67] *See* Report of Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAW. 947, 954-55 (1974).

[68] There is a distinction between corporate management and boards of directors. While management conducts the company's daily business and affairs, directors oversee the company's operation.

[69] *See* H. BALLANTINE, CORPORATIONS §§ 62-64 at 157-58, 165-66 (1946); W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 991, 1031-32, 2203 (rev. perm. ed. 1975) [hereinafter cited as W. FLETCHER].

[70] W. FLETCHER, *supra* note 69, §§ 2187-88.

the corporation itself should be subject to sanctions, so long as management acted in good faith, the corporation had a sufficient system of internal accounting controls under the circumstances, the corporation's financial reporting was not materially affected, and the corporation's accountability for assets was not significantly affected.

Subsection A of the FCPA must be construed in context and in light of its purpose as a part of the Securities Exchange Act of 1934, in order to avoid incorrect and troubling implications regarding its breadth and coverage. For example, Subsection A requires keeping books, records and accounts sufficient to enable reporting in compliance with the federal securities laws. Subsection A, however, was not intended to require that such books, records and accounts be sufficient to prepare reports for other federal or state agencies or regulatory bodies. Reporting requirements under other laws may differ in scope or objective from the FCPA. The records the FCPA requires must be sufficient to determine the amounts of assets, liabilities, revenues and expenses to be reflected in the financial statements of a publicly held corporation and adequate also to maintain control over and accountability for assets. The FCPA does not apply, however, to all other sorts of books, records and accounts of a corporation that might be kept in order to report or file with any other agency or body, or that might be maintained for internal administrative purposes. Consequently, reports, filings and information which are outside the requirements of the 1934 Act, such as reports filed with other governmental bodies or agencies, should not be covered by the terms of the FCPA.

The impact of the bookkeeping and internal accounting control provisions upon the liabilities and responsibilities of management, directors and the corporation itself will become apparent only with the passage of time and as a result of litigation. The reasonable anticipation is that the courts on balance will apply the provisions with care and deliberation in a manner which will not be overexacting, counterproductive and costly.[71] This is especially necessary in light of the extent and power of various enforcement paths and liability provisions. The Commission's enforcement responsibilities "extend to conducting investigations, bringing civil injunction actions, commencing administrative proceedings if appropriate . . . and referring cases to Justice Department for criminal prosecution where warranted . . . ."[72] The Guide points out clearly that any person engaging in irregularities is in "jeopardy under the penalty provisions of section 32(a) of the 1934 Act."[73] For these reasons, legal jeopardy under the FCPA should extend only to members of management deliberately or knowingly contravening the statutory duty.

[71] *Cf. Guide, supra* note 45, at 311-12 (suggesting that the FCPA's legislative history dictates standard of reasonableness be used to assess compliance with new § 13(b) accounting requirements).

[72] SEC Exchange Act Release No. 14478 (February 16, 1978), *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 72,264.

[73] *Guide, supra* note 45, at 311.

In summary, management should have no obligation to ensure against all errors in the bookkeeping system. Liability should be based only on a clear breach of duty, or of course, deliberate and willful wrongdoing. The line drawn between liability and exoneration must depend on the degree of direct management involvement, materiality of the error and harm to any person as a result of false reporting.

V. INTERNAL ACCOUNTING CONTROLS

The second part of the accounting provisions of the FCPA (Subsection B) deals with internal accounting controls. Subsection B requires the establishment of "a system of internal accounting controls sufficient to provide reasonable assurances"[74] that transactions are executed in accordance with management's authorization and properly recorded for purposes of financial presentation and accountability for assets. In addition, it mandates that assets be acquired or disposed of in accordance with management's authorization and requires that recorded assets be periodically reconciled with existing assets. The standard of "reasonable assurances" of reliability recognizes that no system can be flawless. This implies that considerations of flexibility, cost-benefit analysis and allowing management latitude to make prudent business judgments and take appropriate remedial steps will be afforded weight in determining the sufficiency of a program of internal accounting controls. Failure to consider these factors in evaluating a program would unreasonably restrict management, impair efficient corporate functioning and impose unnecessary or unreasonable costs on reporting companies.

The two-fold objectives of reasonable internal accounting controls regarding the accounting books, records and accounts are the safeguarding of accountability of assets, and assuring the reliability of financial reports of a corporate enterprise.[75] The terms "safeguarding" and "reliability" are not used in the absolute sense, but rather consistently with common sense and good accounting practice. Authoritative accounting literature suggests that the term, "safeguarding of assets" implies a system that must account for the assets by a maintenance of records of accountability for assets and a periodic reconciliation of such records with the related assets.[76] While accounting controls cannot insure that the stated objectives in every instance will be attained, an adequate system includes both complete record input and an effective double-check feature.

The details of a program of controls, the amount of time and energy spent devising and implementing, and the depth and frequency of the checking and verifying functions must be decided on the basis of reasonableness. Part of this standard is an assessment of the costs as offset against the benefits. To account properly and effectively for assets, of course, a

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[74] Subsection B, *supra* notes 3, 51.

[75] *See* AICPA STATEMENT NO. 1, *supra* note 37, ¶ 320.28.

[76] *Id.* ¶ 320.48.

system should determine that actual assets, as defined in authoritative accounting literature, agree with those reflected in the accounting books, records and accounts of a corporation, and that acquisitions and dispositions of assets are recorded consistently with corporate authorizations and executions of such transactions. The question of authorization, in the context of the mechanics of the system, does not refer to the exercise of business judgment in the transaction but rather to the proper reflection of the transaction in the accounting books and records in accordance with management's authorization. Further, proper internal accounting controls require the inventorying of assets. With respect to that inventory, "[t]he action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and cause of the discrepancy."[77] A system of controls should be capable of revealing material discrepancies in any event, and probably of revealing a lower threshold, particularly if the discrepancies are likely to be repetitious or particularly sensitive or significant to the corporate enterprise. The FCPA itself does not expressly provide for any test of materiality, but reference to accounting practices demonstrates a common sense approach. The standards set forth in authoritative accounting literature recognize that the costs may at some point exceed the benefits, and the reach of accounting controls should be limited accordingly.

> The definition of accounting control comprehends reasonable, but not absolute, assurance that the objectives expressed in it will be accomplished by the system. The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived. The benefits consist of reductions in the risk of failing to achieve the objectives in the definition of accounting control.[78]

The actual costs of any internal accounting control and the real benefits derived from its use may be somewhat indefinite, particularly in the absence of substantial previous experience. Accounting control procedures therefore may be applied on a test basis if this is an appropriate response to the cost-benefit analysis of a given situation.[79] The legislative history of the FCPA, in a similar vein, indicates that Congress recognized management's need for discretion to draw the line between worthwhile and excessively burdensome techniques, based on a standard of reasonableness, because management had the best practical grasp of the real impact of any accounting system.[80]

Deferring where appropriate to mangement's judgment and allowing some flexibility in implementation involve a realization that no account-

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[77] *Id.*
[78] *Id.* ¶ 320.32.
[79] *Id.*
[80] SENATE REPORT, *supra* note 20, at 4106.

ing system can be perfect. The Senate Committee recognized explicitly "that no system of internal accounting controls is perfect, and that there will always be room for improvement."[81] The Commission has taken a similar position:

> [s]ystems of controls will, of course, vary from company to company. The size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting controls system. The design of any such system necessarily involves exercise of management's judgment, and entails the balancing of the cost of implementing any given internal accounting control against the benefit to be derived.[82]

The meaning of the term "reasonable assurances" should be taken from accounting literature.[83] The Commission elaborated on this theme in the SEC May 12 Report, recognizing that the accounting profession had long considered internal accounting controls an important management function, and had developed a body of objectives and guides. The Commission stated that it was "satisfied that the specifications of the objectives of a system of internal accounting controls found in accounting literature can be readily understood by issuers and accountants."[84] The Commission further stated, "no system can insure or guarantee complete success, but the Commission believes its approach is the appropriate one to address the problems we have observed."[85] The Commission's position is particularly important in that (1) reliance is placed on accounting literature, and (2) the significant statement is made that "[n]o system can insure or guarantee success, but the Commission believes its approach is the appropriate one to address the problems we have observed." An appropriate approach, therefore, stresses not perfection but reasonable and efficient systems that provide adequate checking procedures without being impractical. In the words of the Senate Report on S. 3664:

> [r]equiring companies to devise, establish, and maintain an adequate system of internal accounting controls is not a panacea. Likewise it is not a requirement that is intended to be enforced without regard to the point at which the costs associated with a particular corporate system of internal accounting controls exceeds

[81] *Id.*

[82] SEC Exchange Act Release No. 13185, (January 19, 1977), *reprinted in* [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,896.

[83] *Id.*

[84] *See* SEC May 12 Report, *supra* note 20, at 59. The Commission has adopted the view that the structure of accounting systems will involve managerial judgments based upon cost benefit analysis. *See* SEC Release No. 13185, *supra* note 82.

[85] SEC Release No. 13185, *supra* note 82.

> the benefits that flow from the system . . . . The Committee recognizes that no system of internal controls is perfect and that there will always be room for improvement.[86]

The environmental setting in which an accounting system functions influences greatly the degree of accuracy and reliability attainable. Accounting literature on the subject highlights the concepts of management responsibility,[87] competence and integrity of personnel,[88] and segregation of functions.[89] Deliberate collusion, of course, is a different problem, since any internal accounting control system can be circumvented by design. Minor errors or insignificant irregularities may not be caught by an internal accounting control system designed on a reasonable cost-benefit basis.

The necessity for a proper control environment and the importance of accuracy and diligence should not prevent management from exercising prudent business judgment and taking proper business risks in accordance with corporate objectives, and the maximization of profit, nor should it adversely affect the procedures and conduct entering into management's rational decision-making process. Members of management should not be liable for an honest mistake of business judgment made within the scope of their responsibility. A stricter standard would freeze initiative and perhaps operate against the company's best interests. The requirements of the FCPA with respect to the recording of transactions demand, however, that management oversee authorization of transactions. Managerial overseeing must include general verifications in accordance with management's authorization, that transactions received proper initial authorizations that employees or agents executing transactions were properly authorized, that the transactions were executed within the terms of the authorizations, and that the transactions were duly recorded.[90]

While management bears a heavy responsibility for seeking reliable corporate financial records, the requirements of the FCPA should not be construed to infringe on the internal systems management adopts or its use of information solely for internal business purposes aside from those functions clearly subject to the internal accounting control system. Authoritative accounting literature points out that one interpretation of accounting controls with respect to the reliability of records could lead to the conclusion that they cover "such internal management purposes as establishing sales policies and prices, estimating future costs . . . or other lines of responsibility . . . greater than those required to provide reliability for external reporting purposes."[91] Information may be compiled and used by a corporation internally, in ways not comporting with the requirements of

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[86] SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, CORRUPT PRACTICES BY U.S. BUSINESS ENTERPRISES, S. REP. No. 1031, 94th Cong., 2d Sess. 11 (1976).

[87] AICPA STATEMENT No. 1, *supra* note 37, ¶ 320.31.

[88] *Id.* ¶ 320.35.

[89] *Id.* ¶ 320.36.

[90] *Id.* ¶ 320.19-25.

[91] *Id.* ¶ 320.18.

the FCPA for external reporting. Such internal use should be distinguished from external reporting and the necessity of compliance with the FCPA. Additional financial reporting safeguards are necessary, but the extent to which a control system must be detailed and thorough is limited by reasonability. Similarly, the cost of monitoring information used solely for some internal purposes by the corporation at some point exceeds the benefit of thoroughness and reliability of records.

The subsection B provisions require that management take steps to protect and safeguard assets. To achieve that objective, access to assets must be limited to authorized personnel[92] by implementing necessary procedures and practices with full explanation to employees. Reasonable access procedures coupled with a double-checking of records against the physical assets should be sufficient to discharge management's duty in this regard.

The objective of safeguarding assets, while important to the statutory scheme, is neither the primary function of management nor the central element in management decision-making. The FCPA may be broadly interpreted to state that the protection of existing assets and acquisition of additional assets is the primary function of management and, therefore, that any procedures or records entering into management's decision-making process are subject by this element of the definition of corporate records to the full structure of the FCPA.[93] Data may be used internally for the purpose of making business decisions. The result of business decisions is an impact on operations in terms of contracts entered into, sales made, net profit and other significant items and measures. These items go into the results of operations which are disseminated externally and accepted as an accurate record of corporate performance, documentation of existing assets and a reading of corporate financial health. At this point the general structure of internal controls interfaces with the reliability of financial statements. The *Report of the Special Advisory Committee on Internal Accounting Control* concludes "that an internal accounting control is one that is concerned with the reliability of financial statements and with the broad internal control objectives of authorization, accounting, and asset safeguarding and, further, that accounting controls should extend to all external reports of historical financial information."[94]

The definition of "material weaknesses" in an accounting system given in accounting literature[95] is in keeping with the criteria of reasonableness.

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[92] *Id.* ¶ 320.42.

[93] *Id.* ¶ 320.14.

[94] AICPA, REPORT OF THE SPECIAL ADVISORY COMMITTEE ON INTERNAL ACCOUNTING CONTROL, 11 (1979).

[95] *See* AICPA STATEMENT No. 1, *supra* note 37, ¶ 320.68, in which "material weakness" is defined as:

> a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the

While the FCPA itself does not say "material weakness," the term "weakness" is used. The definition of "weakness" should be taken from the concept of "material weakness" as defined in authoritative accounting literature. Basically, a weakness in internal accounting controls should be considered a condition in the procedures or the degree of compliance with them which prevents a reasonable assurance that errors or irregularities requiring correction could be prevented or timely detected. An adequate system must ensure that errors that lead to material misstatements or omissions in financial statements be detected. Once errors are detected, management of course has the obligation to correct the errors and revise the procedures.

Using a standard of reasonableness in construing the FCPA, the existence of material errors in a corporation's financial statements constitutes an indication of a violation of the Subsection B provisions. The persons involved in causing the irregularities in the accounting system or its implementation could be subject to the sanctions of the 1934 Act in accordance with the nature of the irregularities. A more troublesome problem for management is prospectively determining whether its internal accounting controls are sufficient. In fact, a continuing assessment is mandated because irregularities may develop in internal accounting controls that were sufficient in the past. Since such flaws could not reasonably have been anticipated, management must make periodic checks and examinations. Improvements to the system should always be encouraged.

A corporation could be subject to sanctions under the 1934 Act based on the development of reasonably foreseeable irregularities, if the relevant remedial internal accounting controls could be justified on a cost-benefit basis. Similarly, a member of management making a representation regarding the sufficiency of such controls might be subject to sanction, depending on the circumstances. As further developments better define proper internal accounting controls, obviously reasonable views will differ as to whether or not a weakness exists in internal accounting controls, even where no error or flaw has become apparent. There may be an obligation to correct a system containing a theoretical error, even though no actual fault has yet occurred. Nevertheless, the law must give fair and reasonable recognition to the efforts of management to review and improve its system of internal accounting controls and encourage the development and refinement of accounting control techniques and practices. An overly strict standard of liability is inappropriate and out of keeping with the criteria of reasonableness to be applied to the bookkeeping and internal accounting control provisions of the FCPA.

The Commission has actually noted that a negligence standard will govern civil injunctive actions brought to enforce the 1934 Act.[96] State

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normal course of performing their assigned functions.

This definition is repeated in AICPA STATEMENT ON AUDITING STANDARDS No. 20, REQUIRED COMMUNICATION OF MATERIAL WEAKNESSES IN INTERNAL ACCOUNTING CONTROL 11, 12 (1977).

[96] *See* SEC Exchange Act Release No. 14478, *supra* note 45.

corporate and agency law concepts, as affirmed in *Green*, should govern most internal affairs of a corporation. State law generally provides that management should exercise reasonable control and supervision of its employees. Under such concepts of corporate law, management may be chargeable where it has participated in fraudulent or wrongful acts of others, and may be chargeable with neglect of duty for failure to supervise employees. Ordinarily the harm suffered must be the result of a culpable failure of management with respect to the selection or supervision of employees. However, management should not be liable for losses due only to imprudence or honest errors of judgment[97] without some further shortcoming.

The possible liability of management, of course, depends on the extent of the scope and coverage of the FCPA. The weight of authority indicates that control procedures need not embrace everything the corporation does, nor extend to all paperwork its operations generate. As previously mentioned, accounting literature[98] distinguishes "administrative controls" from "accounting controls" and includes within administrative controls "the plan of organization and the procedures and records that are concerned with the decision processes leading to management's authorization of transactions . . . . [Such authorization] is the starting point for establishing accounting control of transactions." Examples of administrative controls might be records pertaining to customers contacted by salesmen and to employees' records relating to evaluation of performance.[99] Some controls, however, may be viewed as both accounting and administrative controls.

The Commission concurs in this distinction, as indicated by its statement that "[t]he term 'internal accounting controls' does not ordinarily encompass all corporate policies and procedures. Matters of efficiency, employee relations, and production quality control, for example, should not be confused with the accounting controls established to insure the reliability of financial information."[100] Internal accounting controls must cover those documents and materials directly affecting the reliability of financial statements, but need not extend to all corporate records and matters of any nature. Management's responsibility, and concomitant liability, is accordingly limited.

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[97] *See generally* H. BALLANTINE, CORPORATIONS 156-80 (rev. ed. 1946); H. HENN, LAW OF CORPORATIONS 453-57 (1970); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 109-21 (3d ed. 1978).

[98] AICPA STATEMENT NO. 1, *supra* note 37, ¶ 320.47. Administrative controls include recording such information as the customers contacted by salesmen and employee evaluation data. *Id.* ¶ 320.29.

[99] *Id.* ¶ 320.29.

[100] SEC Exchange Act Release No. 13185 (January 19, 1977), *reprinted in* [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,896.

VI. RECENT DEVELOPMENTS

A. Rules 13b2-1 and 13b2-2

Rule 13b2-1 issued by the Commission in February 1979,[101] makes it illegal for any person to directly or indirectly falsify, or cause to be falsified, any corporate books and records subject to the accounting provisions of the FCPA. Rule 13b2-2 prohibits any officer or director from making a materially false, misleading or incomplete statement to an accountant in connection with an audit or examination of financial statements, or the preparation or filing of any document or report with the Commission. The purpose of the Rules is to implement the substantive provisions of the FCPA, but their impact may extend further than implementation. Two prominent questions raised by these rules are whether a scienter test must be applied to determine violations and whether the rules extend to indirect representations of various sorts.

1. *Scienter*

Whether negligent conduct on the part of management can violate the FCPA's substantive provisions is unclear. Similar uncertainty adheres in the application of the new Rules. The Commission specifically rejected in the new Rules any scienter or knowingly test.[102] The Senate in S. 305,

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[101] *See* SEC Exchange Act Release No. 15570 (February 23, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959. These provisions were set forth in 17 C.F.R. § 240.13b-1, "Falsification of accounting records," and 17 C.F.R. § 240.13b2-2, "Issuer's representations in connection with the preparation of required reports and documents," with the additions underscored and deletions bracketed, and were modeled after proposed sections 13(b)3 and (b)4 of the SEC May 12 Report, and subsequently issued as proposed rules in SEC Exchange Act Release No. 13185 (January 19, 1979). The provisions read as follows:

> [(b)(3)] *No* [It shall be unlawful for any] person *shall* directly or indirectly, [to] falsify, or cause to be falsified, and book, record[,] *or* account [or document made or required to be made for any accounting purpose, of any issuer subject to section 12 of this title or which is required to file reports pursuant to Section 15(d) of this title.] *subject to Section 13(b)(2)(A) of the Securities Exchange Act.*
>
> [(b)(4)] *No director or officer of an issuer shall* [It shall be unlawful for any person], directly or indirectly,
>
> (a) [A to make] *Make*[,] or cause to be made[,] a materially false or misleading statement, or
>
> (b) [B to omit] *Omit to state*[,] or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances under which such statements were made, not misleading to an accountant in connection with *(1) any audit or examination* [any examination or audit of an issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports pursuant to Section 15(d) of this title, or in connection with any examination or audit of an issuer with respect to an offering registered or to be registered under the Securities Act of 1933.] *of the financial statements of the issuer required to be made pursuant to this subpart or (2) the preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.*

[102] *Id.* at 81,394.

however, had inserted "knowingly" in appropriate places in the statute to clarify that it did not intend to make unlawful "conduct which is merely negligent." The Senate Report stated that only deliberate conduct was unlawful:

> [a]s explained to the committee, the term 'knowingly' connotes a 'conscious undertaking.' Thus these paragraphs proscribe and make unlawful conduct which is rooted in a conscious undertaking to falsify records or mislead auditors through a statement or conscious omission of material facts.[103]

The Rules should follow the statutory standard if there is in fact no requirement of scienter. The question of whether scienter must be shown to establish a violation of the FCPA, and therefore of the rules promulgated thereunder, may be for the courts to answer. A scienter test must be applied in some contexts under the federal securities laws, as demonstrated by *Ernst & Ernst v. Hochfelder*.[104] Whether the *Hochfelder* requirements pertain to other statutory provisions is an open question. The legislative history did not resolve that issue, nor did Congress take a direct position as to whether the Commission has rulemaking authority to decide the standard of liability. The Conference Report, noting that the Senate's version of the statute was deleted in conference, indicated that Congress did not wish to raise the issue of whether the inclusion or deletion of "knowingly" would or would not "affirm, expand or overrule the decision of the Supreme Court in *Ernst & Ernst v. Hochfelder* (425 U.S. 185) . . . . [As regards the question of application of a scienter test] . . . the conferees intend that no inference should be drawn with respect to any rulemaking authority the SEC may or may not have under the securities laws."[105] The language used by the Commission in the rules, however, referring to "falsify or cause to be falsified" strongly implies that liability will turn on some degree of active conduct beyond negligence.

The history of Rule 13b2-1 indicates that unlawful conduct should be willful whether the violation arises by omission or commission. The objective of Rule 13b2-1 is to prevent false or misleading accounting reports. Individuals who are directly responsible for a falsification of accounting books and records are held accountable under the Rule. Speaking of an earlier version of Rule 13b2-1, the Commission in its May 12 Report[106] stated that the Rule "prohibits not only affirmative false statements but also the failure to make entries, or the failure to obtain or create documents, necessary for proper accounting records." In a Release under the 1934 Act, the Commission stated in part:

> [i]n many cases, instances of concealed corporate payments and off-book cash funds have resulted from the activities of particular

[103] SENATE REPORT, *supra* note 20, at 9.
[104] 425 U.S. 185 (1976).
[105] CONFERENCE REPORT, *supra* note 47, at 10-11.
[106] SEC May 12 Report, *supra* note 20, at 66.

individuals, acting with or without the knowledge or authorization of top management, to cause such transactions to be improperly reflected on the corporate records. Proposed Rule 13b-3 [predecessor rule] would permit the Commission to take action to preclude such individuals from further frustrating either the system of corporate recordkeeping *or the broader system of accountability by which management monitors the activities of the entire array of individuals entrusted with corporate assets.*[107]

Several general rationales may serve to mitigate the potentially severe results of enforcing the statute, and the Rules, in the absence of a scienter requirement. First, the Commission takes the position that the statutory requirements embody a standard of reasonableness, diminishing the impact of the lack of a scienter standard of liability. The Commission has pointed to the use of the phrase "in reasonable detail" in Subsection A of the FCPA as a basis for its interpretation and to alleviate much of the concern expressed in comments.[108] On this ground, the Commission dismissed as unwarranted the concern that inadvertent or inconsequential errors could lead to liability, and declined to make any specific changes in the rules. The Commission's rationale continues to be that "[t]he statute does not require perfection but only that books, records and accounts '*in reasonable detail,*' accurately and fairly reflect the transactions . . . [and] [i]n addition, the legislative history reflects that 'standards of reasonableness' are to be used in applying this provision."[109]

In this connection, it should be noted that the lack of an express materiality criteria for accounting errors or omissions arguably would lead to liability for minor errors without wilfullness. A standard of reasonableness may serve to mitigate this further problem.

Finally, as a general matter the lack of more specific statements or guidelines is based in part on a desire that the FCPA have a type of *in terrorem* effect. New Rule 13b2-2 is meant to "act as a deterrent to the falsification of corporate books, records and accounts and to the making of false, misleading or incomplete statements to an accountant or auditor that might conceal the falisification of such books and records by any officer or director of a publicly held corporation."[110] This enforcement posture is clear, and is not unique to the FCPA. Even so, this comfort is less than complete in that the Commission is free at any time to change its approach and prosecute for negligence without scienter.

[107] SEC Exchange Act Release No. 13185 (January 19, 1977), *reprinted in* [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,896 at 87,830 (emphasis added).

[108] SEC Exchange Act Release No. 15570 (February 23, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959.

[109] *Id.*

[110] *Id.*

2. *Scope*

The new Rules impose a standard of care that prohibits officers and directors from making false, incomplete or misleading statements to accountants in connection with audits. The Commission has stated that:

> the new rule encompass[es] the audit of financial statements by independent accountants, the preparation of any required reports, whether by independent or internal accountants, the preparation of special reports to be filed with the Commission, as for example, those filed pursuant to judicial orders incident to Commission enforcement proceedings, and any other work performed by an accountant that culminates in the filing of a document with the Commission.[111]

The Rule applies to oral statements as well as to written representations,[112] however, and care must be exercised to avoid any misunderstandings which could result in a possible violation.

Indirect representations to the Commission raise more difficult problems. These may be described generally as representations made between parties while preparing to file information with the Commission. These include written representations furnished by management to independent auditing firms often designated "Client Representations."[113] Material confirmations or representations made by officers or directors to other parties, such as attorneys and experts, stand on the same footing. Accountants, attorneys, experts and others rely on these statements in preparing the registration documents and rendering the opinions contained therein. Consequently, these representations might be deemed to be made indirectly to the Commission, and, in any case, could be covered by the provisions of the Rules.

In the course of preparing financial statements to be filed with the Commission, management may be asked by the auditing committee to give representations of compliance with the FCPA and the rules thereunder. Even if the accounting controls program is excellent, personnel in the operational departments of the corporation may nonetheless violate the law. Management may be unaware of such violations when called upon to make representations. For this reason, as a practical matter, "negative confirmations" may be desirable, stating generally that management has taken reasonable steps to institute an adequate system of internal accounting controls and is aware of no violations of the law.[114] Negative confirmations by management are indirect representations, subject to the same problems of compliance with the FCPA.

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[111] *Id.*

[112] *Id.*

[113] *See* AICPA STATEMENT ON AUDITING STANDARDS NO. 10, CLIENT REPRESENTATIONS (1977).

[114] Hinsey, *The Foreign Corrupt Practices Act - The Legislation As Enacted,* July 1979 FINANCIAL EXECUTIVE 12, 18.

Further, the indirect test arguably extends to cover negative confirmations given by officers and directors of a registrant in the context of an entirely different responsibility. If an individual occupies responsible positions in two entities, and one entity is required to make representations or negative confirmations to the other, then that individual could suffer liability arising from deficiencies in those confirmations. For example, an individual may be an officer or director of a publicly held corporation, and a director of a bank with which that corporation maintains an account. Upon request for confirmation of the account, or other asset, the bank may supply to the corporation a negative confirmation. If the bank is mistaken with respect to that confirmation, that mistake may be considered a "misrepresentation" under the Rules, subjecting the individual to liability. The Rules seem to allow this extension in scope, even though such extrapolation was uncontemplated by the FCPA. In this entire area of indirect representations, common sense and good judgment should be applied to avoid unreasonable standards or harsh results not anticipated by the terms of the FCPA.[115]

The desirability of a common sense approach is especially evident in light of the Commission's position that the record-keeping and internal accounting controls provisions of the FCPA provide additional grounds for enforcement. The Commission has stated that "[t]he new requirements may provide an independent basis for enforcement action by the Commission, whether or not violation of the provisions may lead, in a particular case, to the dissemination of materially false or misleading information to investors."[116] The Rules provide the Commission with the right to pursue corporation employees at any level for alleged violations of the accounting provisions of the FCPA. The farther down the ladder of responsibility the corporate employee is found, however, the weaker the deterrence rationale becomes. Whether the Rules themselves, without some knowing falsification in registration statements or reports, provide a basis for enforcement actions at all seems debatable. Any grounds on which the Commission proceeds must surely be tempered by a reasonable reading both of the statute and the Rules.

[115] The Commission has indicated that although its new rules do not expressly apply to persons who are unaffiliated with the reporting company, the 1934 Act's general antifraud provisions will continue to govern those persons' liability for misleading the issuer's accountants. Specific reference to those antifraud provisions is made following the statement that:

> [i]t must be stressed, however, that the exclusion from the express language of the new Rule of shareholders, low-level corporate employees of an issuer, and persons unaffiliated with the issuer does not indicate that those individuals may mislead the issuer's accountants with impunity.

SEC Exchange Act Release No. 15570 (February 15, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959, at 81,300.

[116] *Id.*

B. Proposed Rules

On April 30, 1979, the Commission issued proposed rules requiring management to make a statement regarding the adequacy of the corporation's internal accounting controls under the 1934 Act.[117] The proposed rules would require inclusion of the statement in Form 10-K and in annual reports to security holders. For accounting periods ending after December 15, 1980, management would be required to give an opinion as to whether during specified periods the system of internal accounting control provided reasonable assurances that specified objectives of internal accounting control were achieved. The statement of management would be required to be examined and reported on by an independent public accountant. Lesser requirements would be imposed for the period ending after December 15, 1979 and prior to December 16, 1980. The proposed rules in effect would require management of a reporting corporation to affirm compliance with the substantive internal accounting control provisions of the FCPA. In addition to any cause of action based on liability provisions of federal securities laws, or on the statutory terms of the FCPA itself, the Commission could be able to proceed against any individual on the basis of a false affirmation of compliance with the FCPA. Further, the proposed rules would have the effect of creating an express private remedy, in that a deficient certificate of management itself is a violation of section 13(a) of the Securities Exchange Act to which the liability provisions of section 18 apply.[118] The course the Commission has pursued in proposing this rule raises serious questions of statutory authorization, due process and the scope and extent of rule-making.[119] The comments submitted regarding this rule will no doubt reflect grave concern over the advisability of these requirements and significant doubt as to whether the Commission in fact has authority to promulgate such a standard.[120] In effect the Commission has set up an additional requirement that management must perform, and on which liability may be based. This is another indication that the Commission thinks the rules provide an independent basis for enforcement, but goes even farther in asserting liability based not on an administrative interpretation of statutory terms, but solely on failure to give a certificate not mentioned in the statute and required only by a Commission rule.

In addition, Release No. 34-15772,[121] in discussing the evaluation of internal accounting controls, focuses on the "overall control environment"

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[117] SEC Exchange Act Release No. 15772 (April 30, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,063.

[118] Letter dated July 31, 1979 from the American Bar Association to the Securities and Exchange Commission, in response to Securities Exchange Act Release No. 15772 (April 30, 1979) (copies on file with the Commission).

[119] *Id.*

[120] *See generally* Olsen, *Accounting Proposals: Negative Comments,* Legal Times of Wash., September 17, 1979, at 14.

[121] SEC Exchange Act Release No. 15772 (April 30, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,063.

as distinguished from the "internal accounting control environment."[122] The Release describes this "overall control environment," in part, as "careful exercise of management's judgment. . . communication of corporate procedures, policies and related codes of conduct; communication of authority and responsibility . . . [and] accountability for performance and for compliance with policies and procedures. . . ."[123] The propriety and legality of requiring a management compliance statement and expanding the scope of internal accounting controls are subject to serious questions. This language expands the content of "control environment" significantly beyond the analysis found in authoritative accounting literature. This article has contended that accounting documentation, the presence of checking procedures and an effort by management to examine and evaluate the accounting system and its result constitute the basic features of the "control environment." The Commission's approach, by contrast, includes elements of management discretion and corporate codes of conduct as part of an "overall control environment." Under the guise of accounting controls, the Commission would foster a system of business ethics and a substantive evaluation of management. This effort by the Commission exceeds the bounds of its statutory authority and effectively amends the provisions of the FCPA.

VII. CONCLUSION

The bookkeeping and internal accounting control provisions of the FCPA should be interpreted and construed in light of authoritative accounting literature. The legislative history indicates that Congress so intended. To be fair and just, the FCPA requirements should be based on authoritative criteria that are both well-established and widely known and accepted. Accounting literature forms a consistent and well-known set of principles to which affected accountants, attorneys and business people can refer for guidance.

Considerations of reasonableness and practicability are also central to an appropriate interpretation of the FCPA. No accounting system is perfect, and no individual performs duties flawlessly. While due diligence is called for, corporate functioning should not be impeded unnecessarily; and normal corporate operations should not be disrupted at all, absent substantive gains. While corporate accountability in a larger sense is certainly worthwhile, the objectives of an accounting system must be clarity and veracity. Substantive standards of corporate conduct and protections against mismanagement should not be confused with an accounting system.

The Commission has taken a different view, and the effect is clear on

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[122] *See* AICPA REPORT OF THE SPECIAL ADVISORY COMMITTEE ON INTERNAL ACCOUNTING CONTROL 12-19 (1979), which discusses "The Internal Accounting Control Environment."

[123] SEC Exchange Act Release No. 15772 (April 30, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,063, at 81,730.

certain points of interpretation of the FCPA discussed in this article. The Commission has stated that the FCPA is not exclusively concerned with the preparation of financial statements, but that "[a]n equally important objective of the law . . . is the goal of corporate accountability."[124] The Commission has also stated that the provisions of the FCPA have established "requirements concerning the internal activities of reporting companies . . . [and] may provide an independent basis for enforcement action by the Commission, whether or not violation of the provisions may lead, in a particular case, to the dissemination of materially false or misleading information to investors."[125] As mentioned at the beginning of this article, corporate accountability is much broader than the accounting provisions of the FCPA and its does not seem feasible or reasonable to expect that such provisions could be viewed as imposing recordkeeping and internal accounting controls with respect to all notions or concepts of corporate accountability. The legislative history and the SEC May 12 Report do not support a broad application of the accounting provisions of the FCPA to corporate accountability, nor to all of the internal affairs and business of a company.

Commission statements demonstrate a theoretical perception that the rules promulgated pursuant to the FCPA form a basis in and of themselves upon which to bring enforcement actions. Further, these rules could be construed to cover violations of corporate codes of conduct, failure to follow internal policies and procedures or carelessness and lack of management oversight. Actions may thus be instituted solely on the basis of insufficient management involvement, director oversight or lack of management integrity. The materiality of the error, the level of responsibility at which it occurred, the harm suffered by the the corporation or the public and even whether any misleading or erroneous statement resulted at all may be irrelevant. This position seems extreme, inflexible and impractical, and raises difficult and disturbing questions regarding the Commission's authority.

While the Commission has a responsible oversight role to be exercised in the public interest to see that the accounting provisions of the FCPA are fully complied with by all publicly held corporations, the power and prerogative of rule application urge restraint. The Commission has the power to exact consent decrees, including terms that affect the composition and duties of a corporation's board of directors and audit committee, the duties of officers, and procedures and policies followed within the conduct of the business and affairs of a corporation. Such far reaching authority should be exercised only when necessary.

Statements made by the Commission indicate that it may give weight to the good faith efforts of corporations which have adopted well articulated, consistent and adequate policies on these matters. Such policies

[124] SEC Exchange Act Release No. 15570 (February 15, 1979), *reprinted in* [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,959, at 81,395.

[125] *Id.*

should include procedures and guidelines concerning general corporate conduct, standards for corporate policies concerning management authorizations and delegations of authority and encouragement to conduct corporate operations and affairs in accordance with law. In such cases, the Commission would review the extent to which such policies, procedures and guidelines are adequately disseminated, administered, and monitored[126] as an element in assessing the corporation's performance.

In light of the differences of opinion among commentators and the severe position the Commission may take, the extent to which the provisions of the FCPA and the Commission's rules thereunder affect the internal affairs of corporations and impose an independent set of duties and liabilities on management will probably be left to judicial determination. Only by construing the FCPA with reference to the accounting literature and standards of reasonableness can the intent of Congress be realized without undue interference with corporate functioning. While accounting procedures can be one tool to achieve accountability, the overall goal is beyond the reach of mechanical requirements.

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[126] *See, e.g.*, SEC v. Killearn Properties [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,256 (N.D. Fla. 1977). In *Killearn*, the court charged the defendant company's board of directors' audit committee with the duties to monitor compliance with the company's code of conduct.

Washington and Lee Law Review

Member of the National Conference of Law Reviews

Volume XXXVI | Winter 1979 | Number 3

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