New management imperative: compliance with the accounting requirements of the Foreign Corrupt Practices Act;

Touche Ross & Co.;

Follow this and additional works at: https://egrove.olemiss.edu/dl_tr

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
https://egrove.olemiss.edu/dl_tr/776

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Touche Ross Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
The law’s title is a misnomer—it significantly impacts all companies, domestic as well as international, and especially public companies.

Compliance places added responsibilities on management, the board of directors and the audit committee.

Here’s a review of the law—and recommendations for obtaining effective compliance.
# Contents

<table>
<thead>
<tr>
<th>Part I—The Law and its Significance</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Synopsis of the Act</td>
<td>2</td>
</tr>
<tr>
<td>Record Keeping Requirements</td>
<td>2</td>
</tr>
<tr>
<td>Internal—and Internal Accounting—Control</td>
<td>3</td>
</tr>
<tr>
<td>The SEC View on Enforcement</td>
<td>4</td>
</tr>
<tr>
<td>Consequences</td>
<td>4</td>
</tr>
<tr>
<td>Uncertain Responsibilities</td>
<td>5</td>
</tr>
<tr>
<td>New Management Objectives</td>
<td>5</td>
</tr>
<tr>
<td>Can Internal Accounting Control be Reviewed? And How?</td>
<td>6</td>
</tr>
<tr>
<td>Identify Business Risks and Related Exposures</td>
<td>6</td>
</tr>
<tr>
<td>Describe and Understand the Systems Used to Process Transactions</td>
<td>7</td>
</tr>
<tr>
<td>Evaluate the Systems</td>
<td>7</td>
</tr>
<tr>
<td>Continued Review and Judgment</td>
<td>7</td>
</tr>
<tr>
<td>Where the Buck Stops</td>
<td>9</td>
</tr>
<tr>
<td>The Board of Directors</td>
<td>9</td>
</tr>
<tr>
<td>Operating Management</td>
<td>9</td>
</tr>
<tr>
<td>The Internal Auditor</td>
<td>10</td>
</tr>
<tr>
<td>The Independent Auditor</td>
<td>10</td>
</tr>
<tr>
<td>Conclusion</td>
<td>11</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part II—The Specifics of Compliance</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elements of Internal Accounting Control</td>
<td>12</td>
</tr>
<tr>
<td>Levels of Control</td>
<td>12</td>
</tr>
<tr>
<td>Approach to Evaluating Controls</td>
<td>17</td>
</tr>
<tr>
<td>Reviewing Controls</td>
<td>18</td>
</tr>
<tr>
<td>Limitations of Internal Controls</td>
<td>19</td>
</tr>
</tbody>
</table>

* * * *

## Appendices

A. Excerpts from Conference Report on the Foreign Corrupt Practices Act, including Title I of the law, P.L. 95-213 ... 24

B. Excerpts from Senate Report 114, Foreign Corrupt Practices and Foreign Investment Disclosure Acts of 1977 ... 34
Summary, and a Plan of Action

How a publicly-held business is controlled and keeps its records are now matters of legal compulsion, with fines and jail sentences for offenders. These are probably the most significant facts of the Foreign Corrupt Practices Act of 1977 (the Act)—yet most of its publicity has dealt with the penalties for bribes of foreign officials.

Perhaps more significant in the long run than possible fines and jail terms is the possibility of misguided and unintended use of the Act by regulatory agencies. A number of individual allegations could devolve to a set of requirements that would hamstring publicly-held businesses. Yet responsible and timely action by business, professional and regulatory leaders, in a cooperative effort, can attain the purposes of the Act without needlessly rigid rules.

The Act says, broadly:

- Bribes and questionable conduct must stop.
- Funds for bribes and questionable financial activities must be unavailable, and steps must be taken to assure that unavailability.
- The steps that constitute companies’ internal accounting and record keeping systems must be examined and almost invariably corrected where material weaknesses are found.

The Act applies* through two of its sections, Accounting Standards and Foreign Corrupt Practices by Issuers, to every company, domestic or foreign, subject to the Securities Exchange Act of 1934.

The Act expects management to be aware, to make judgments, to choose, and to take adequate steps to address deficiencies. Management can assume, if it wishes, that no action is required—that its responsibilities have not changed, that there are no new obligations. But wishes do not eliminate risks. And we see a new connection.

What was conceptual, ethereal, a tenet of faith, has been mandated by Congress and is now law—to be interpreted, perhaps misunderstood and definitely enforced.

Much of the interpretation and enforcement of the Act will deal not with its antibribery provisions (which are relatively specific) but with its “Accounting Standards Provisions” (which are not). These provisions were drawn from auditors’ pronouncements and will be quite difficult to apply. The writers of the Act recognized that judgments and estimates are needed to determine the degree of internal accounting control and record keeping that is appropriate for any company, and they put that burden on management.

A prudent course for management—given the regulatory authorities’ assigned responsibility, and mindful of the righteous, inquisitorial environment in which the law was adopted—involves action. Companies affected should make a systematic and documented effort to review the adequacy of record keeping and internal controls and should make any improvements that business judgment dictates are advisable.

If a company’s systems provide reasonable assurance of achieving the objectives of internal accounting control, and if a company’s systems have been modified to recognize the specifics and the intent of the Act, then we believe management has demonstrated compliance with the Act.

This is not to say that an actual violation of the Act will not be alleged, but rather that management has exercised due care in attempting to meet a responsibility amidst significant and valid differences of opinion as to how to comply.

Given very few authoritative regulatory guidelines, management will find that internal and outside auditors can be especially helpful. The board and the audit committee will find that in setting appropriate policy, as in monitoring progress, the independent accountant will be an indispensable aid. And we, as study of this booklet will confirm, stand ready and able to assist.

*And it applies to practically everybody else through a section labeled Foreign Corrupt Practices by Domestic Concerns, including

- any individual who is a citizen, national or resident of the U.S.
- any corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship that: a) has its principal place of business in the U.S., or b) is organized under the laws of a state, territory, possession or commonwealth of the U.S.
Part I

The Law and its Significance

The Foreign Corrupt Practices Act, signed in December, 1977, and reprinted in pertinent part within Appendix A, grew from fertile soil—including the following:

- The use of corporate resources for bribery of foreign officials and for domestic political contributions, as investigated by the Office of the Watergate Special Prosecutor and the Securities and Exchange Commission (SEC). Some of these payments were illegal at the time, others were at least questionable. Many were made through “off-the-books” bank accounts and other methods that circumvented internal accounting control systems.

- The findings and recommendations of the SEC’s “Report on Questionable and Illegal Corporate Payments and Practices,” issued to the Senate Banking, Housing and Urban Affairs Committee May 12, 1976. The SEC recommended that Congress enact legislation to improve the accuracy of corporate books and records.

- The hearings on illegal and questionable business payments conducted by the Senate Banking, Housing and Urban Affairs Committee. This committee also proposed legislation, part of which was incorporated in the Act.

SYNOPSIS OF THE ACT

The Act contains three sections relevant to this discussion:

- Accounting Standards
- Foreign Corrupt Practices by Issuers
- Foreign Corrupt Practices by Domestic Concerns

The Foreign Corrupt Practices sections deal primarily with bribes, questionable conduct, and stopping same. Much of what was questionable is now specifically illegal. While the antibribery provisions of the Act are relatively clear, the rest—most notably the “Accounting Standards” provisions—are cloudy, and will be difficult to interpret, apply, and comply with. Our interpretation of these provisions, and how to comply with them, are the ingredients of this booklet.

If your company is subject to the Securities Exchange Act of 1934, the Accounting Standards Provisions of the Act require that you keep, in reasonable detail, “books, records, and accounts” which accurately and fairly reflect the company’s transactions and dispositions of assets; your company must also maintain a system of internal accounting controls providing “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."

Record Keeping Requirements
The intent of the Act's record keeping systems requirement is to—

• Enable preparation of appropriate external financial statements, and

• Prevent or signal illegal payments so that senior management and the board of directors or its audit committee can take appropriate action.

This last requirement is clearly indicated in the Conference Report\(^1\) that says:

"... the issuer's records should reflect transactions in conformity with generally accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes."

The Conference Report also recognizes that significant amounts of judgment are required in attempts to comply, and that perfection is unattainable. For example, the same part of the Conference Report says:

"The House receded to the Senate with an amendment requiring such books, records and accounts to be made and maintained accurately and fairly 'in reasonable detail'. The 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."

In considering compliance with the Act, both Congress's intent and the concept of reasonableness should be applied in determining the action to be taken.\(^2\)

Despite the structure of the law, it is critical to recognize that financial record keeping is not truly separable from the internal accounting systems that generate the records. Therefore, a plan of action to demonstrate compliance with the record keeping requirements of the Act must consider a company's internal control system and especially internal accounting controls—acceptable record keeping is rarely attainable without acceptable internal accounting controls.

Internal—and Internal Accounting—Control

Internal control is essentially organization and procedures—the nervous system that activates overall operating policies and keeps a business within practical performance ranges. Every business has it, however unsophisticated. Each system of internal control, notwithstanding its superficial resemblance to common patterns of organization and management, is unique. It includes people with varying authorities and capacities of supervision and with varying abilities to delegate or assume authority.

"In a corporation, internal control commences with the . . . enforcement of top policies established by boards of directors and continues down through the organizational structure, taking form in the development and operation of management policies, administrative regulations, manuals, directives, and decisions; internal auditing; internal check; reporting; employee training and participation."\(^3\)

Internal accounting control must be defined more narrowly. Auditors, whose primary respon-
sibility is to examine and report on financial representations of others, have sought those aspects of a company's internal control system that could affect the auditor's examination (see (i)—(iv), on pages 2 and 3). This we define as the internal accounting control system. While inherently subjective, it is an improved formulation of objectives (for organizations and procedures) from the auditor's perspective. These objectives, as well as the manner in which they were developed and are used by the auditors, are described in pronouncements by the AICPA. They must be understood because the writers of the Act's Accounting Standards Provisions specifically selected the AICPA's language defining internal accounting control.

THE SEC VIEW ON ENFORCEMENT
Two months after adoption of the Act, the SEC explained its responsibilities for enforcement as follows:

"The legislative history of the Act reflects that the Commission's enforcement responsibilities extend to conducting investigations, bringing civil injunctive actions, commencing administrative proceedings if appropriate, including public or private disciplinary proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice, and referring cases to the Justice Department for criminal prosecution where warranted, just as the Commission currently does with respect to its existing responsibilities under the federal securities laws. In addition, as is true with respect to violations of other provisions of the Securities Exchange Act, controlling persons of an issuer may be liable for violations of the new requirements, and a negligence standard will govern civil injunctive actions brought to enforce the Act. The legislative history of the Act also contemplates that private rights of action properly could be implied under the Act on behalf of persons who suffer injury as a result of prohibited corporate bribery."

In a report to Congress on July 1, 1978 the SEC said—

"... Along with prohibiting companies from engaging in certain corrupt practices with respect to foreign officials, the Act . . . require[s] reporting companies to make and keep accurate books and records and to establish and maintain a system of internal accounting controls which meet certain objectives.

"Although rules have not yet been proposed, the Commission is likely to require, . . . a representation that an issuer's system of internal accounting controls is in compliance with the provisions of the Act. This could be accomplished through a representation from management that the issuer's system of internal accounting controls meets the objectives set out in the Act, together with an opinion of the independent public accountant as to management's representation or through an opinion, similar to management's representation described above, from the issuer's independent public accountant. . . ."

"Finally, the Commission has pending rule proposals which would supplement certain of the provisions of the Act. These rules, if adopted, would make it unlawful for any person to falsify corporate books and records and for any officer, director, or shareholder of a publicly-owned company to mislead an accountant in connection with his examination of corporate financial statements. . . ."

Consequences
Penalties for violations of the Accounting Standards Provisions of the Act are limited to $10,000 for companies and $10,000 plus 5 years imprisonment for company officials. Penalties for
violating the corrupt practices provisions (on influencing foreign governmental decisions) provide for $1,000,000 fines for companies and $10,000 fines and 5 years imprisonment for company officials. Further, any fines imposed on individuals may not be paid directly or indirectly by the company.

There are of course other implications—economic, social, and political—but they are not the burden of this text. Management, however, must not lose sight of the changing environment in which business must operate.

UNCERTAIN RESPONSIBILITIES

That major uncertainties are implicit in the Accounting Standards Provisions of the Act comes clear from the following items:

- The SEC brought the first court action in March 1978, charging that a company (Aminex) and certain of its officers had violated the Act’s Accounting Standards Provisions. Yet no government rules or guidelines on how the Act should be applied have been issued. Unless general guidelines are developed, determining whether individuals and companies have complied with the Act may have to wait until the provisions of the Act are applied and interpreted in specific administrative and judicial proceedings of alleged wrongdoing. This could prove a long, tedious and painful process.

- Internal accounting control objectives under the Act are excerpted from professional guidelines prepared by and for auditors in determining audit scope, and not from information prepared to define the responsibilities of companies subject to the Act. Just how should guidance prepared for outside auditors be interpreted by management in meeting the requirements of the Act?

- Precedents are not available as to what individual companies are doing about their record keeping and internal accounting control systems; and each company’s uniqueness will dilute the transferability of its experience to others.

- The latitude that management has in complying with the Accounting Standards Provisions of the Act is unclear. For example, in certain circumstances, management may believe that changes in personnel will more effectively enhance control than additional record keeping or internal accounting control systems and procedures.

- The Act applies to registrants—but what about subsidiaries that are not registrants? And there is the much more difficult question of minority investments in other companies, especially if accounted for on the equity method (because the investor may have real influence even though the ownership interest is minor).

The SEC complaint in the Aminex case does not allege bribes or illegal or questionable payments, but does allege violations of the Accounting Standards Provisions of the Act because of fraudulent activities concealed by false entries on the company’s books and records. If this complaint reflects the Commission’s intended direction, SEC application of the Act could be extensive.

These uncertainties complicate management's already difficult job of establishing the limits of its responsibilities. The role of judgment is central in determining what practices should be adopted.

NEW MANAGEMENT OBJECTIVES

Since the auditor's definition of internal accounting control is used in the Act for defining the responsibilities of management, its subjectivity and the judgments needed in applying it are important to an understanding of what may be required of management under the Act.

The two broad, interrelated objectives of inter-
nal accounting control are:

- Safeguarding assets against loss
- Producing reliable financial records for internal use and for external reporting purposes.

These are elaborated into many more specific control objectives relating to various assets and transactions. Systems and procedures should provide controls for each objective on a cost-effective basis and generally consist of combinations of seven elements:

- Competent, trustworthy personnel with clear lines of authority and responsibility
- Adequate segregation of duties
- Proper procedures for authorization
- Adequate documents and records
- Proper procedures for record keeping
- Physical control over assets and records
- Independent (yet internal) checks on performance.

For a detailed discussion of the specific control objectives and each of these seven elements, see Part II of this booklet.

CAN INTERNAL ACCOUNTING CONTROL BE REVIEWED? AND HOW?

The first answer is yes, and it was easy. The second answer is not so easy. We believe there are three fundamental steps management must take:

- Identify business risks and related exposures based on an understanding of the company's business and transactions.
- Describe and understand the systems used to process transactions, safeguard assets, and produce accounting reports.
- Evaluate the systems, giving particular consideration to possible material weaknesses. And be sure to give special attention to sensitive transactions even though monetary amounts are not significant. (For example: unusual bonuses to employees, unusual credits to customers, and any large disbursements in cash.)

Identify Business Risks and Related Exposures

Each business enterprise is faced with an ever present set of risks and exposures. Among the many are:

- Fraud and embezzlement
- Statutory sanctions
- Excessive costs/deficient revenues
- Loss or destruction of assets
- Competitive disadvantage
- Erroneous record keeping
- Unacceptable accounting
- Business interruption
- Erroneous management decisions

In fact, markets may disappear, a lawsuit may be filed, raw material prices may increase, a plant may burn down—possibilities are endless. Two of management's primary responsibilities are to anticipate these risks and to position the company so that the exposures can be economically minimized.

In identifying risks and exposures, management should assume that the Act applies to all controlled subsidiaries included in its consolidated financial statements. For minority investments accounted for on the equity method, the investor should obtain assurance that the investee has acted to demonstrate compliance with the Act. In some cases, it may be appropriate simply to have investee management confirm that they have taken action to comply with the Act. In other circumstances the investor may have to take an
actual role in demonstrating compliance.

In allocating resources to specific internal accounting controls and record keeping procedures, management should prioritize financial and related exposures by judging their risk of occurrence and possible impact on the company.

Describe and Understand the Systems Used to Process Transactions

Internal accounting controls are evaluated in terms of specific types of transactions and assets and their related specific control objectives. For example, specific controls should be designed to assure that raw materials purchased and used are properly recorded so that inventory accounts are a reasonably accurate representation of the usable items on hand.

An understanding of internal accounting controls requires a reasonably detailed description of the various accounting systems. To facilitate description, transactions are placed in natural groupings—called transaction cycles. Transaction cycles are described to show the flow of each type of transaction through the various functions of the business. The elements of internal accounting control (listed under New Management Objectives, and discussed in Part II) should be clearly displayed; flowcharting is often used for this purpose.

In addition to maintaining numerous transaction cycles—such as sales and collections, procurements and payments, payroll, and inventory and warehousing—most companies maintain a number of "corporate-level" controls. Examples of such controls are: an audit committee of the board of directors, internal audit, and a well defined conflict-of-interest policy. Additional examples are given in Part II. These controls are particularly important for larger companies; they enable management to assure that detailed systems are designed, maintained and functioning properly.

Evaluate the Systems

Do the systems adequately meet their stated objectives and minimize the exposures identified by management? If they do, are the system's costs commensurate with benefits, or can they be reduced without reducing control? And, if control is not being accomplished, are the weaknesses material, separately or in the aggregate? These are the questions that must be answered in evaluating systems of internal accounting control.

When auditors evaluate a company's system of internal accounting control, they look for weaknesses that can make important and not trivial differences. Our professional definition of a "material weakness" is:

"...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 normal course of performing their assigned functions." 

However, as we have already seen, those agencies which will enforce the Act may perceive a material weakness differently, especially where a possible illegal act is involved.

Nevertheless, the concept of reasonable assurance does apply; the benefits expected to be derived must always exceed the expected cost of internal accounting controls. The benefits consist of reductions in the risk of failing (a) to safeguard assets and (b) to produce reliable financial records. Although the cost-benefit relationship is the primary conceptual criterion in designing a system of accounting control, precise measurement of costs and benefits is rarely possible; evaluation usually requires estimates and judgments by management.

Continued Review and Judgment

In addition to evaluating internal accounting control at a point in time, management is
responsible for assuring that the system functions as intended over time. This means that recorded accountability must be compared with existing assets and liabilities at regular intervals. Examples of procedures that can achieve such comparison are reconciliation of cash balances with bank statements, physical inspection of plant and equipment, and physical count of inventories. See Part II for more detail.

While management styles vary, all managements judgmentally identify areas that require attention and determine the action to be taken. These judgments—as they relate to attempts to comply with the Act—will include consideration of what transactions should be more closely scrutinized, and what systems or areas require particular attention.

Interrelating and comparing operating results is usually the first step; this includes:

1) Comparing actual results to prior and expected performance,
2) Comparing the operating and financial performance statistics with those of similar companies if possible, and
3) Discussing apparent variations with those knowledgeable about expected or prior performance levels to determine the causes.

Ordinarily, these comparisons are made by product lines or segments, and concentrate on identifying and determining the reasons for variations.

Such procedures highlight areas that may require action and can also indicate possible control or record keeping deficiencies. These approaches are necessary because the myriad transactions, as well as the size and complexity of many business operations, make it impossible for management to have a continuing working-level involvement with all areas of the business. In essence, because there is a limit on the time and money that can be spent for record keeping and control systems, this approach helps to concentrate resources where they can do the most good.

Exception identification (isolating areas with performance different than expected) is often used, reporting only those items which do not meet a designated average or normal standard. This is an expeditious route to areas which may require additional consideration.

A variance is chosen for additional attention only when a cause is sought—i.e., when management asks “Why?” Specific studies, reports, or other analysis may be required, and when a cause is determined, additional business judgments may follow:

- Has a change in the business environment taken place, and is it being appropriately signalled by the variations?
- Should additional record keeping and systems controls be required?
- Are other changes, for example, personnel changes, needed?

If the variation is justified, i.e., it is based on underlying business or operating conditions, then no changes need be made in the record keeping or control systems—they are performing their functions. In this case, management must determine whether the return on investment continues to be, or promises to become, acceptable.

If the variation results from deficiencies in the record keeping or control system, there are two choices, or a combination of each, namely whether:

- Actions not related to accounting or record keeping systems should be taken; or
- Changes should be made in the internal accounting control and record keeping systems.

Consider a particular fact situation: a retail shoe store (like many other high-volume, low-unit-cost activities) has significant shrinkage from errors in billing, mishandling of physical inven-
tories, theft, and/or conversion by employees. For simplicity, although a combination of approaches could be appropriate, assume that the decision weighs two alternatives, namely:

- Increasing the amount of record keeping and controls; or
- Other changes in operating procedures.

Increasing the amount of record keeping or controls would require either increased personnel or changes in the duties of existing personnel and would be justified only if losses would be reduced appropriately.

On the other hand, various changes in operating procedures might be made. The decision could be made that each store would buy its inventory from the company. The manager would then be responsible for running the operation at a tolerable loss level. (Losses can be limited but only rarely eliminated.) Alternatively, a bonus system for better-than-average performance could accomplish the same objectives. All of these possible changes might achieve the purpose—bringing losses back into acceptable limits. Management has to choose the most effective way to reduce the shortages. In our hypothetical shoe store, frequent physical inventories and comparisons could show whether the assets are safeguarded at an acceptable level. It appears to us that no one of the alternatives is preferred because of the Act, but some alternative must be chosen.

Role of the Board of Directors

The board should be responsible for approving basic policies and for compliance oversight, not detailed specification and enforcement. Still, the primary responsibility for the sufficiency of a company's measures to comply with the Act lies here. The board of directors or its audit committee should—

- Understand in broad outline how the record keeping and internal accounting control systems function and judge their sufficiency to achieve compliance with the Act.
- Broadly monitor compliance, and suggest revisions as needed.
- Review existing policies and consider changes needed to comply with the Act; if adequate policies already exist, consider additional communication.
- See that appropriate actions are taken concerning possible violations of the Act, if any.

Role of Operating Management

Management's primary responsibility for maintaining adequate and effective record keeping and internal accounting control systems and for safeguarding assets is not new. But the Act focuses attention on these aspects of management's responsibility in a manner that compels greater attention than may have been true in the past. In fact, operating management is responsible for detailed implementation and enforcement to comply with the Act.

The board of directors or its audit committee, while exercising its oversight responsibilities, will look to operating management for information and to take any necessary corrective action.

Accordingly, operating management should—

- Identify the risks that are inherent in the business and the potential for errors and irregularities.
- Undertake to systematically document and
evaluate existing record keeping practices and systems of internal accounting controls throughout the company to identify instances of possible nonconformity with a reasonable interpretation of the Act.

- Identify and articulate the factors considered in assessing the practicality and cost/benefit aspects of suggested systems revisions.
- Initiate applicable revisions in corporate policies or directives.

Role of the Internal Auditor

Internal auditors are an important part of internal control. They can, separately or with operating management, accomplish most of the above. In addition, they can:

- Monitor compliance with existing policies of operating management or the board of directors.
- Assist in special studies for operating management or the board of directors.

Role of the Independent Auditor

The independent auditor is not part of a company's internal accounting control system. He has a unique objective—to form an opinion on the financial statements. This objective causes the independent auditor to plan that examination to search for errors or irregularities that would have a material effect in the financial statements and to use due skill and care in the conduct of the examination.

The adoption of the Act does not change the way an independent auditor goes about determining the scope of his examination. After a preliminary review of a company's internal accounting control systems, the auditor must decide the extent to which he will rely on the systems for his purposes. The auditor may decide that it is both feasible and cost effective to extensively test the internal accounting control systems and place major reliance thereon in formulating an opinion on the amounts in the financial statements. On the other hand, he may decide that it is more effective to perform direct extensive tests of documentation underlying the amounts in the financial statements, rather than relying on the internal accounting control system. In most cases, he will decide on a combination of reliance and direct testing. Accordingly, weaknesses that exist in a company's record keeping and internal accounting control systems, or portions thereof, may not be detected during the course of the independent auditor's examination because for valid reasons he has chosen not to rely on such systems.

Currently, if aware of material weakness in internal accounting control, errors or irregularities, or illegal acts, the independent auditor is required to communicate them to management (at least one level above those involved). Depending on the significance of the matters reported, the board or its audit committee may also be advised.

The independent auditor's responsibility for evaluating effectiveness and monitoring compliance of internal accounting control systems parallels the responsibility of the board and its audit committee. The independent auditor is in a unique position in that he can make a "hands on" evaluation of the system, an opportunity not readily available to the board or the audit committee. In addition, the independent auditor brings the experience of similar association with systems of other companies to the evaluation and judgment problem. As a result, the independent auditor has a unique perspective on the company, and the board of directors and audit committee may find the outside auditor especially helpful in fulfilling their policy and oversight duties. In fact, the independent public accountant can assist management in demonstrating compliance with the Act by:

- Recommending plans for the systematic review, documentation, and evaluation of internal controls
• Providing instructional manuals on methods and techniques for describing, testing and evaluating internal controls
• Conducting training programs for internal auditors and other company personnel selected to review internal controls
• Evaluating the efforts of company personnel reviewing internal controls
• Recommending changes in internal controls to overcome identified deficiencies.

CONCLUSION

In essence, the Accounting Standards Provision of the Act became effective when it was signed into law on December 19, 1977. No period for transition or adjustment is specified in the law. Companies that are affected can assume that no action is required since management has always been concerned with the adequacy of record keeping and systems of internal accounting control. However, we doubt that this is a prudent course of action. Instead we recommend a systematic and documented effort to review the adequacy of record keeping and internal controls and to make any improvements that business judgment dictates advisable. We see two benefits: evidence of compliance with the Act if challenged, and significant improvements in operations and control.

References for Part I

1. House of Representatives, Conference Report No. 95-831, December 6, 1977, p. 10 (See excerpts from this report in Appendix A.)
2. United States Senate; Report No. 95-114, “Report of the Committee on Banking, Housing and Urban Affairs”. May 2, 1977, pp. 7 and 8 (See excerpts from this report in Appendix B.)
7. Securities and Exchange Commission, Accounting Series Release 242 op. cit., pp. 9-10; the Commission is considering the numerous comments it has received on “... [a series of rulemaking proposals designed to promote among other matters the reliability and completeness of financial information] and will determine whether to adopt, modify, or withdraw those rulemaking proposals.”
8. Auditing Standards Executive Committee, AICPA, Codification of Statements on Auditing Standards No. 1 1973, Section 320, paragraphs, 12, 15, 17, 18, and 19.
9. Ibid., Section 320, paragraph 68.
The Specifics of Compliance

This part, dealing with the specifics of compliance, is adapted from Touche Ross internal manuals to develop the concepts of corporate controls—their objectives, the potential for errors and irregularities, and how controls can be reviewed and evaluated. The main topics discussed are

- Elements of internal accounting control
- Levels of controls
- Approach to evaluating controls
- Reviewing controls
- Limitations of internal controls.

ELEMENTS OF INTERNAL ACCOUNTING CONTROL

It is necessary that a system have certain elements or characteristics if the two broad objectives of internal accounting control, and the many detailed objectives they require, are to be fulfilled. There are seven such elements, as presented below.

Competent, Trustworthy Personnel with Clear Lines of Authority and Responsibility

The most important element of any system of internal control is personnel. If employees are competent and trustworthy, some of the other elements can be absent and reliable financial statements can still result. Honest, efficient people are able to perform at a high level even when there are few other controls to support them. On the other hand, even if the other six elements of control are strong, incompetent or dishonest people can reduce the system to a shambles.

Still, the employment of competent and trustworthy personnel is not by itself sufficient to meet the objectives of internal accounting control. People have a number of innate shortcomings due to their highly complex nature. They can, for example, become bored or dissatisfied; personal problems can disrupt their performance, or their goals may change. Consequently, it is important to make a judgment of the competence and integrity of employees, even though it is difficult to do, and to use this as a part of the total evaluation of the system. The evaluation of employees will result from observations, inquiries and review of their work.

Specific responsibility for the performance of duties must be assigned to specific individuals if the system is to operate effectively and work is to be properly performed. If a duty is not adequately performed, it is then possible to place responsibility with the person who did the work. The one assigned is thus motivated to work carefully, and corrective action by management is made possible.

Adequate Segregation of Duties

There are four general types of segregation of duties for the prevention of both intentional and unintentional errors that are of special significance. These are discussed below.

1. Separation of operational responsibility from
2. Separation of the custody of assets from accounting. The reason for not permitting the person who has temporary or permanent custody of an asset to account for that asset is to protect the firm against defalcation. When one person performs both functions, there is an excessive risk of his or her disposing of the asset for personal gain and adjusting the records to eliminate responsibility for the asset. If the cashier, for example, receives cash and maintains both the cash and accounts receivable records, it might be possible to take the cash received from a customer and adjust the customer's account by failing to record a sale or by recording a fictitious credit to the account. Other examples of inadequate segregation of the custodial function include the distribution of payroll checks by a payroll clerk who might be in a position to initiate a false employee on the payroll and keep the check for personal gain, and the maintenance of inventory records by storeroom personnel who might be able to sell items for personal gain and cover up the theft.

In an EDP system, any person with custody of assets should be prevented from performing the programming or operating function, and be denied access to punched cards or other input records. As a general rule it is desirable that any person performing an accounting function, whether it be in an EDP or in a manual system, be denied access to assets that can be converted to personal gain.

3. Separation of the authorization of transactions from the custody of related assets. It is desirable, to the extent that it is possible, to prevent persons who authorize transactions from having control over the related asset. For example, the same person should not authorize the payment of a vendor's invoice and also sign the check in payment of the bill. Similarly, the authority for adding newly hired employees to the payroll or eliminating those who have terminated employment should be performed by someone other than the person responsible for distributing checks to the employees. Nor should anyone who handles incoming cash receipts have the authority to determine which accounts should be charged off as uncollectible. As illustrated, the authorization of a transaction and the handling of the related asset by the same person increases the possibility of fraud within the organization.

4. Separation of duties within the accounting function. The least desirable accounting system is one in which one employee is responsible for recording a transaction from its origin to its ultimate posting in the general ledger. This enhances the likelihood that unintentional errors will remain undetected.

There are many opportunities for automatic cross-checking of different employees' work in a manual system by simply segregating the recording in journals from the recording in related subsidiary ledgers. It is also possible to segregate the responsibility for recording in related journals, such as the sales and cash receipts journals. In most cases adequate segregation of accounting duties, where each person performs his work independently, substantially increases control over errors without any duplication of effort.

In an EDP system, segregation of duties is of a different nature than in manual systems, but it is of equal importance. Because the need for frequent cross-checking is unnecessary due to the computer's ability to perform consistently and uniformly, the segregation of duties within the EDP operation puts greater emphasis on control.
over lost records, improper programming, and fraudulent transactions. For these reasons, the responsibility for processing of data by computer operators, for custody of transaction and library files, and for programming should be separated.

The overall organization structure of a business must provide proper segregation of duties, yet still promote operational efficiency and effective communication.

Proper Procedures for Authorization

Every transaction must be properly authorized if control is to be satisfactory. If any person in an organization could acquire or expend assets at will, complete chaos would result.

Authorization can be either general or specific. In performing its function of general authorization, management establishes policies for the organization to follow. Subordinates are instructed to implement these general authorizations by approving all transactions within the limits set by the policy. Examples of general authority are the issuance of fixed price lists for the sale of products, credit limits for customers, and fixed automatic reorder points for making purchases.

Specific authority has to do with individual transactions. For some transactions, management is unwilling to establish a general policy of authorization. Instead, it prefers to make authorizations on a case-by-case basis. An example is the authorization of a sales transaction by the sales manager for a used car company.

The individual or group who can grant either specific or general authority for transactions should hold a position commensurate with the nature and significance of the transactions, and the policy for such authority should be established by top management. For example, a common policy is to have all acquisitions of capital assets over a set amount authorized by the board of directors.

Approval of a transaction should be distinguished from authorization. Approval is only an indication that the conditions required by authorization have apparently been met. For example, the initials of approval on a vendor’s invoice may be intended to mean that the goods being paid for were ordered and received by the company; however, it is possible that they were in fact not, and that the approval and initialling were perfunctory. Because of this, it is often necessary to look beyond approval to other evidence of authorization when knowledge of the system and/or circumstances cause doubts about the effectiveness of the approval process.

Adequate Documents and Records

Documents and records are the physical objects upon which transactions are entered and summarized. They include such diverse items as sales invoices, purchase orders, subsidiary ledgers sales journals, time cards, and bank reconciliations; and they may be in either “hard-copy” form or in the form of machine readable media. Both documents of original entry and records upon which transactions are entered are important elements of a system, but the inadequacy of documents normally causes greater control problems.

Documents perform the function of transmitting information throughout the organization and between different organizations. The documents must be adequate to provide reasonable assurance that all assets are properly controlled and all transactions correctly recorded. For example, if the receiving department fills out a receiving report when material is obtained, the accounts payable department can verify the quantity and description on the vendor’s invoice by comparing it with the information on the receiving report.

Certain relevant principles dictate the proper design and use of documents and records. Documents and records should be:

a) Sufficiently simple to make sure that they are clearly understood.

b) Designed for multiple uses whenever possible, to minimize the number of different forms.
For example, a properly designed and used sales invoice can be the basis for recording sales in the journals, the authority for shipment, the basis for developing sales statistics, and the support for salesmen's commissions.

c) Constructed in a manner that encourages correct preparation. This can be done by providing a degree of internal check within the form or record. For example, a document might include instructions for proper routing, blank spaces for authorizations and approvals, and designated column spaces for numerical data. These help assure proper inclusion of all required information.

d) Prenumbered consecutively to facilitate control over missing documents, and as an aid in locating documents when they are needed at a later date.

e) Prepared at the time a transaction takes place, or as soon thereafter as possible. When there is a longer time interval, records are less credible and the chance for error is increased.

A control closely related to documents and records is the chart of accounts, which classifies transactions into individual balance sheet and income statement accounts. The chart of accounts is an important control because it provides the framework for determining the information presented to management and other financial statement users. It must contain sufficient information to permit the presentation of financial statements in accordance with generally accepted accounting principles, but in addition the classification of the information should help management make decisions. Information by divisions, product lines, responsibility centers, and similar breakdowns should be provided for. The chart of accounts is helpful in preventing misclassification errors if it accurately and precisely describes which type of transactions should be in each account. It is especially important that the descriptions clearly distinguish between capital assets, inventories, and expense items, since these are the major categories of concern to external users of the financial statements.

Proper Procedures for Record Keeping

If the financial statements are to properly reflect the actual transactions during the period, there must be procedures to assure the proper recording of all transactions. This aspect of control is especially significant because it relates directly to the objective of providing reliable data. Like many of the elements of control, this one is closely related to each of the others. If the other elements of control are proper, the likelihood of having adequate record keeping is enhanced. For example, the presence of competent, trustworthy personnel with well-defined responsibilities for keeping the records, but without access to assets, greatly increases the likelihood of proper record keeping. Similarly, the existence of adequate documents and records and adequate internal verification is also beneficial in providing adequate record keeping.

The procedures for proper record keeping should be spelled out in procedures manuals to encourage consistent application. The manuals should define the flow of documents throughout the organization and should provide for sufficient information to facilitate adequate record keeping and the maintenance of proper control over assets. For example, to assure the proper recording of the purchase of raw materials, a copy of the purchase order for acquiring the merchandise and a copy of the receiving report when the raw materials are received should be sent to accounts payable. This procedure aids in properly recording purchases in the accounts payable journal, and it facilitates the determination of whether the vendor's invoice from the supplier should be paid. If both purchase orders and receiving reports are prenumbered, the accounts payable clerk can account for the numerical sequence of these documents as a means of determining whether all purchases have been recorded.
Physical Control Over Assets and Records

The most important type of protective measure for safeguarding assets and records is the use of physical precautions. An example is the use of storerooms for inventory to guard against pilferage. When the storeroom is under the control of a competent employee, there is also further assurance that obsolescence is minimized. Fireproof safes and safety deposit vaults for the protection of assets such as currency and securities are other important physical safeguards.

Physical safeguards are also necessary for records and documents. The redevelopment of lost or destroyed records is costly and time consuming. Imagine what would happen if an accounts receivable master file were destroyed. The considerable cost of backup records and other controls can be justified to prevent this loss. Similarly, such documents as insurance policies and notes receivable should be physically protected.

Mechanical and electronic protective devices can also be used to obtain additional assurance that accounting information is current and accurately recorded. Cash registers and certain types of automatic data-processing equipment are all potentially useful additions to the system of internal control for this purpose.

Independent Checks on Performance (Internal Verification)

The last specific element of control is the careful and continuous review of the other six elements in the system. The need for a system of internal checks arises for at least three reasons: first, a system tends to change over time unless there is a mechanism for frequent review. Personnel are likely to forget procedures, become careless, or intentionally fail to follow them unless someone is there to observe and evaluate their performance. Second, both fraudulent and unintentional errors are always possible, regardless of the quality of the controls. And third, there is a need to periodically compare recorded accountability with physical assets in order to assure that they are properly safeguarded, and to determine the existence of possibly unrecorded or improperly recorded transactions.

An essential characteristic of the persons performing internal verification procedures is independence from the individuals originally responsible for preparing the data. A considerable portion of the value of checks on performance is lost when the individual doing the verification is a subordinate of the person originally responsible for preparing the data, or lacks independence in some other way.

The least expensive means of internal verification is the separation of duties in the manner previously discussed. For example, when the accounts receivable subsidiary records, the sales journal, and the general ledger are maintained by different people, each of them automatically verifies a part of the work of the others. Similarly, when the bank reconciliation is performed by a person independent of the accounting records and handling of cash, there is an opportunity for verification without incurring significant additional costs.

Some important types of verification can only be accomplished by a duplication of effort. For example, the counting of inventory by two different teams to make certain that the count is correct is costly, but frequently necessary. Another example is the use of a keypunch verifier in an EDP system. In this control procedure a second person keypunches the same information as was originally keypunched, and the results of these two independent activities are automatically compared for differences. Even though the cost of performing the same work more than once may seem excessive, it is sometimes the only practical way of ensuring accurate and reliable results.

The existence of an internal audit staff is usually a highly effective method of verifying the proper recording of financial information. If the internal audit staff is independent of both the operating and the accounting departments, and if it reports directly to top management or the audit commit-
tee of the board of directors, there is an excellent opportunity for extensive verification within the organization.

It is important to understand that the above elements of control are complementary and should not be thought of as alternatives. Any one control will have advantages and disadvantages when compared with other controls. An effective accounting system will utilize a mix of controls designed to compensate for the particular disadvantages of individual controls.

LEVELS OF CONTROLS

The concept of internal control includes all the control systems in an enterprise that affect assets and/or financial data. Because internal control is designed to help achieve pre-determined objectives, these will include the planning processes as well as the various detailed control systems.

The planning and control systems of an enterprise can be segregated into three levels:

a) Strategic planning
b) Management planning and control
c) Operational control.

Strategic planning relates to the long-term planning process of the enterprise. Strategic planning decisions determine the objectives of the enterprise and the nature of its business.

Management planning and control involves the short-term planning and control cycle used to accomplish the enterprise's objectives. For example, management control functions would include setting yearly budgets and monitoring performance against budgets.

Operational control is the function of assuring that day-to-day routine activities are performed effectively and efficiently. Operational controls can be viewed at two levels: systems-level controls and corporate-level controls. Systems-level controls relate to processing transactions by general classification (e.g., sales, cash receipts, cash disbursements). Corporate-level controls cut across all systems to assure that the systems are maintained. These include such things as internal audit and the chart of accounts. Corporate-level controls are in effect "controls on controls" and greatly facilitate both the effectiveness of the systems and the monitoring by management.

The following examples are given to illustrate the difference between these planning and control levels and to give examples of the types of activity that might be carried out at each level:

### LEVELS OF PLANNING AND CONTROL

<table>
<thead>
<tr>
<th>Strategic Planning</th>
<th>Management Control</th>
<th>Operational Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-range planning →</td>
<td>Formulating profit plans →</td>
<td>Recording transactions</td>
</tr>
<tr>
<td>Organizational structure →</td>
<td>Planning staff levels →</td>
<td>Hiring policies</td>
</tr>
<tr>
<td>Deciding marketing policies →</td>
<td>Formulating advertising programs →</td>
<td>Controlling placement of advertisements</td>
</tr>
<tr>
<td>Deciding financial policies →</td>
<td>Working capital planning →</td>
<td>Controlling credit extension</td>
</tr>
<tr>
<td>Deciding production policies →</td>
<td>Selecting product improvements →</td>
<td>Scheduling production</td>
</tr>
</tbody>
</table>
It is important to clearly understand these three levels of planning and control, and their interrelationship, because they will form the basis for understanding within a particular company the controls present in the accounting systems.

When a system is described and analyzed, this is generally done by dividing it into major transaction cycles, with controls which affect all transactions being classified as corporate-level controls. This procedure can be illustrated using the following transaction cycles which are common to most commercial and manufacturing companies:

—Sales and collections
—Procurement and payment
—Payroll
—Inventory and warehousing

Among the controls normally considered to be in the corporate-level category, are the following:

—An audit committee of the board of directors (most commonly for publicly held companies)
—The aspects of organizational structure which relate to organizational units, rather than specific systems
—Monthly financial statements
—Internal audit
—Procedural manuals
—The chart of accounts
—Bonding of employees in a position of trust
—A mandatory vacation policy
—A well defined conflict-of-interest policy and monitoring system
—Reasonable record retention policies in accordance with state and federal laws.

**APPROACH TO EVALUATING CONTROLS**

Notwithstanding the need to understand controls at all levels, the greatest portion of time in the typical review of internal controls is spent analyzing and evaluating the detailed controls intended to meet the broad objectives of safeguarding assets and assuring the reliability of accounting information.

**Objectives**

Within specific accounting subsystems (i.e., transaction cycles) elements of control are designed and related so as to prevent and/or detect seven general classes of errors, or stated alternatively, to achieve seven internal control objectives. These are more specific than those defined in the definition of internal accounting control and serve as a framework in evaluating internal controls. The seven objectives for any given transaction type together with examples of the types of errors for each objective, are given below:

**Recorded Transactions are Valid.** This objective deals with the possibility of invalid transactions being included in the records. Instances include the recording of a sale when no shipment took place, or a charge-off of an uncollectible account that has actually been paid.

**Transactions are Properly Authorized.** If a transaction takes place without proper authorization at the key points, an improper transaction may have occurred. Examples of transactions without proper authorization include the failure to authorize shipments and the acceptance of unauthorized sales returns and allowances.

**Existing Transactions are Recorded.** An error under this objective occurs whenever there is a failure to record a transaction. This objective is the counterpart of the validity of the recorded transactions objective inasmuch as it deals with valid transactions not being recorded rather than recorded transactions not being valid. One exam-
example is the shipment of goods without billing or inclusion in the accounting records. Less obvious examples are the recording of an increase in the allowance for doubtful accounts or reserve for inventory obsolescence when the respective asset values become impaired. Although these are not "transactions" in the strict sense, and are often viewed as separate from the processing of traditional types of recurring events (conventional transactions), they are recorded nonetheless, are subject to errors, and must be properly controlled.

**Transactions are Properly Valued.** Even though all transactions are included in the records and are authorized and valid, they may be stated at an incorrect amount. For the financial statements to be fairly stated, the individual transactions must be recorded at the correct amount. As an illustration, the quantities, prices, extensions, and footings on sales invoices must be correctly stated to meet this objective.

**Transactions are Properly Classified.** This objective deals with the possibility of a transaction in the cycle being classified improperly. Examples of misclassifications include the recording of the purchase of a fixed asset as an expense, the recording of the receipt of loan proceeds as a collection of an outstanding account receivable, and the recording of a collection of an account receivable as a cash sale.

**Transactions Are Recorded at the Proper Time.** In addition to being correctly recorded, transactions must be recorded in the proper reporting period. Failure to do so is referred to as a cutoff error, and can result in either an understatement or overstatement of the affected accounts. The failure to record transactions on a timely basis can also result in the complete omission of the recording due to the loss or mishandling of the records. It is important, therefore, to record transactions reasonably soon after they occur.

**Transactions are Properly Posted to the Subsidiary Records and Correctly Summarized.** Since the individual transactions are the source of the balances in the financial statements, they must be correctly posted to subsidiary records, the general ledger, and other reports and those must be correctly summarized. A defalcation can be covered up in sales by underfooting the sales journal or posting the amounts in the journal to the general ledger incorrectly. An example of unintentional error would be recording an amount owed the company in the wrong customer account.

---

**REVIEWING CONTROLS**

Once a good description of a system of controls has been developed, the review can be performed in the following manner:

a) Identifying the types of transactions processed by the system.

b) Identifying the types of errors that could occur for each transaction type using the seven general objectives/error types as a guide.

c) Tracing through the system description to identify:

(1) Those controls (elements or sets of elements) existing in the system which should prevent or detect and correct each type of error. These represent strengths in the system.

(2) Those types of errors for which no effective controls exist in the system. These represent system weaknesses.

As a general guide, the seven objectives/error types and the common elements of control used to deal with them are presented in the following form.
### REVIEWING CONTROLS

<table>
<thead>
<tr>
<th><strong>Internal Control Objective/Error Type</strong></th>
<th><strong>Common Elements of Control (Not All Inclusive)</strong></th>
</tr>
</thead>
</table>
| Recorded transactions are valid/invalid | • Segregation of duties  
                                          • Use of prenumbered documents which are accounted for  
                                          • Cancellation of documents to prevent reuse  
                                          • Monthly reconciliation of subsidiary records and follow-up by an independent person. |
| Transactions are properly authorized/not authorized | • Policy on specific or general authorization at key points (e.g., granting credit)  
                                                        • Procedures for approvals consistent with policy and requiring documentation (e.g., attaching signatures or supporting documents). |
| Existing transactions are recorded/not recorded | • Use of prenumbered documents which are accounted for  
                                                   • Segregation of duties  
                                                   • Monthly reconciliation of subsidiary records and follow-up by an independent person. |
| Transactions are properly/improperly valued | • Internal verification of details and calculations and posting by an independent person  
                                              • Reconciliation of details to control totals (e.g., bank reconciliation) by an independent person. |
| Transactions are properly/improperly classified | • Use of an adequate chart of accounts  
                                                      • Internal review and verification. |
| Transactions are recorded at the proper/improper time | • Procedures to assure prompt recording of all transactions  
                                                          • Internal verification. |
| Transactions are properly/improperly included in the subsidiary records and correctly/incorrectly summarized | • Segregation of duties  
                                                          • Monthly reconciliation of subsidiary records by an independent person  
                                                          • Internal verification. |

### Prevention vs. Detection Controls

In addition to considering controls in terms of levels in relation to corporate planning, and in terms of the elements comprising control, it is useful to categorize controls in other ways. In designing controls, particularly in the EDP area for example, controls are often segregated into two broad classifications: “prevention controls,” whose objective is to prevent errors from occurring, and “detection controls,” whose objective is to detect errors that have occurred and assure their correction on a timely basis.
Prevention controls are advantageous in that they are often highly cost effective. They are "built-in" as part of the system unrelated to the volume of transactions. Since they prevent errors, when they are functioning effectively, they avoid the cost of correcting errors, which can be quite high. Control elements which are generally preventive in nature are trustworthy personnel, segregation of duties (to prevent intentional errors), proper authorization, adequate documents and records, proper record keeping procedures, and physical controls over assets.

Detection controls, while more costly than prevention controls are nonetheless necessary. One reason is that they measure the efficiency of prevention controls. Secondly, there are certain types of errors which cannot be controlled preventively in a cost-effective manner. In order to be effective, detection controls must include procedures to assure timely correction of the errors that are detected.

Detection controls include record keeping procedures and independent checks on performance, often through segregation of duties. Whereas prevention controls may not always be noticeable because of their built-in nature, detection controls are generally obvious to those involved with them. However at the management level, some controls may exist which act as detection controls although they may not specifically be designed as such. For example, although management's review of monthly financial statements will usually be directed toward an analysis of variances from budget and the identification of the necessary corrective action, the investigation of variances will usually detect errors in the recorded results, since management will want to determine the cause of the apparent variance before attempting to correct the situation. Another example is that of a division manager who is held accountable through a responsibility accounting system designed to charge only variable (and, therefore, controllable) costs to his division. The manager's primary objective in reviewing divisional accounting reports may be directed to cost control, but an important by-product will usually be the detection of accounting errors. Other examples of these controls are:

- Reconciliation of cash balances with bank statement.
- Confirmation of bank balances using a standard confirmation, which would request information concerning loans and liens on assets to determine whether any off-the-book amounts or unrecorded liens on assets exist. This step attempts to address the prohibition against funds carried off-the-books. Management should recognize, in the attempts to comply with the Act, that funds can be raised by pledges of assets.
- Physical count of major cash funds.
- Inspection or confirmation of marketable securities.
- Reconciliation of income received from marketable securities to published sources.
- Reconciliation of accounts receivable details to accounts receivable controls.
- Review of accounts receivable agings to determine collectibility.
- Physical counts of inventories and analyses of variances.
- Physical inspection of plant and equipment.
- Review of underlying records of investees to establish the appropriate carrying amount.
- Confirmation with vendors of accounts payable.

These examples serve to illustrate that although the management process will usually be designed primarily to help achieve the objectives of the enterprise, it may also have an important influence on the reliability of the financial information.
LIMITATIONS OF INTERNAL CONTROL

Although reliance on internal control is essential in the operation of a business, complete reliance on internal control to the exclusion of special independent checks by internal auditors and external auditors particularly with respect to material amounts in the financial statements is unwise for three primary reasons.

First, control systems are designed to provide reasonable, but not absolute, assurance that the objectives of good internal accounting control will be accomplished. The concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits expected to be derived. Thus, systems will seldom exist which can “guarantee” that all errors will be prevented or detected and corrected on a timely basis.

Second, there are inherent limitations in the performance of many control procedures which preclude absolute reliance. These include possibilities for errors arising from such causes as misunderstanding of instructions, mistakes of judgment, and personal carelessness, distraction or fatigue. Procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. And procedures whose objective is to assure the execution and recording of transactions in accordance with management’s authorization may be ineffective against acts by management itself.

Finally, any projection of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.
Appendix A

Excerpts from Conference Report on the Foreign Corrupt Practices Act, including Title I of the law, P.L. 95-213

Appendix B

Appendix A

Excerpts from Conference Report on the Foreign Corrupt Practices Act, including Title I of the law, P.L. 95-213

FOREIGN CORRUPT PRACTICES

DECEMBER 6, 1977.—Ordered to be printed

Mr. STAGGERS, from the committee of conference, submitted the following

CONFERENCE REPORT

[To accompany S. 305]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the House to the bill (S. 305) to amend the Securities Exchange Act of 1934 to require issuers of securities registered pursuant to section 12 of such Act to maintain accurate records, to prohibit certain bribes, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its disagreement to the amendment of the House to the text of the bill and agree to the same with an amendment as follows:

In lieu of the matter proposed to be inserted by the House amendment insert the following:

TITLE I—FOREIGN CORRUPT PRACTICES

SHORT TITLE

Sec. 101. This title may be cited as the "Foreign Corrupt Practices Act of 1977".

ACCOUNTING STANDARDS

Sec. 102. Section 13(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(b)) is amended by inserting "(1)" after "(b)" and by adding at the end thereof the following:

“(2) Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 16(d) of this title 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.

“(3) (A) With respect to matters concerning the national security of the United States, no duty or liability under paragraph (2) of this subsection shall be imposed upon any person acting in cooperation with the head of any Federal department or agency responsible for such matters if such act in cooperation with such head of a department or agency was done upon the specific, written directive of the head of such department or agency pursuant to Presidential authority to issue such directives. Each directive issued under this paragraph shall set forth the specific facts and circumstances with respect to which the provisions of this paragraph are to be invoked. Each such directive shall, unless renewed in writing, expire one year after the date of issuance.

“(B) Each head of a Federal department or agency of the United States who issues a directive pursuant to this paragraph shall maintain a complete file of all such directives and shall, on October 1 of each year, transmit a summary of matters covered by such directives in force at any time during the previous year to the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate.”

FOREIGN CORRUPT PRACTICES BY ISSUERS

Sec. 108. (a) The Securities Exchange Act of 1934 is amended by inserting after section 30 the following new section:

“FOREIGN CORRUPT PRACTICES BY ISSUERS

Sec. 30A. (a) It shall be unlawful for any issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports under section 15(d) of this title, or for any officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to—

“(1) any foreign official for purposes of—

“(A) influencing any act or decision of such foreign official in his official capacity, including a decision to fail to perform his official functions; or

“(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,
in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person;

"(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of—

"(A) influencing any act or decision of such party, official, or candidate in his or her official capacity, including a decision to fail to perform its or his official functions; or

"(B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person; or

"(3) any person, while knowing or having reason to know that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of—

"(A) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, including a decision to fail to perform his or its official functions; or

"(B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person.

"(b) As used in this section, the term 'foreign official' means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or any person acting in an official capacity for or on behalf of such government or department, agency, or instrumentality. Such term does not include any employee of a foreign government or any department, agency, or instrumentality thereof whose duties are essentially ministerial or clerical.

(b) (1) Section 32(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78ff(a)) is amended by inserting "(other than section 30A)" immediately after "title" the first time it appears.

(2) Section 32 of the Securities Exchange Act of 1934 (15 U.S.C. 78ff) is amended by adding at the end thereof the following new subsection:

"(c)(1) Any issuer which violates section 30A(a) of this title shall, upon conviction, be fined not more than $1,000,000.

"(2) Any officer or director of an issuer, or any stockholder acting on behalf of such issuer, who willfully violates section 30A(a) of this title shall, upon conviction, be fined not more than $10,000, or imprisoned not more than five years, or both.

"(3) Whenever an issuer is found to have violated section 30A(a) of this title, any employee or agent of such issuer who is a United States citizen, national, or resident or is otherwise subject to the jurisdiction of the United States (other than an officer, director, or stockholder of such issuer), and who willfully carried out the act or practice constituting such violation shall, upon conviction, be fined not more than $10,000, or imprisoned not more than five years, or both.

"(4) Whenever a fine is imposed under paragraph (2) or (3) of this subsection upon any officer, director, stockholder, employee, or agent
of an issuer, such fine shall not be paid, directly or indirectly, by such issuer.”.

FOREIGN CORRUPT PRACTICES BY DOMESTIC CONCERNS

SEC. 104. (a) It shall be unlawful for any domestic concern, other than an issuer which is subject to section 30A of the Securities Exchange Act of 1934, or any officer, director, employee, or agent of such domestic concern or any stockholder thereof acting on behalf of such domestic concern, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to—

(1) any foreign official for purposes of—

(A) influencing any act or decision of such foreign official in his official capacity, including a decision to fail to perform his official functions; or

(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person;

(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of—

(A) influencing any act or decision of such party, official, or candidate in its or his official capacity, including a decision to fail to perform its or his official functions; or

(B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person; or

(3) any person, while knowing or having reason to know that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of—

(A) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, including a decision to fail to perform his or its official functions; or

(B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such domestic concern in obtaining or retaining business for or with, or directing business to, any person.

(b) (1) (A) Except as provided in subparagraph (B), any domestic concern which violates subsection (a) shall, upon conviction, be fined not more than $1,000,000.

(B) Any individual who is a domestic concern and who willfully violates subsection (a) shall, upon conviction, be fined not more than $10,000, or imprisoned not more than five years, or both.

(2) Any officer or director of a domestic concern, or stockholder acting on behalf of such domestic concern, who willfully violates sub-
section (a) shall, upon conviction, be fined not more than $10,000, or imprisoned not more than five years, or both.

(3) Whenever a domestic concern is found to have violated subsection (a) of this section, any employee or agent of such domestic concern who is a United States citizen, national, or resident or is otherwise subject to the jurisdiction of the United States (other than an officer, director, or stockholder acting on behalf of such domestic concern), and who willfully carried out the act or practice constituting such violation shall, upon conviction, be fined not more than $10,000, or imprisoned not more than five years, or both.

(4) Whenever a fine is imposed under paragraph (2) or (3) of this subsection upon any officer, director, stockholder, employee, or agent of a domestic concern, such fine shall not be paid, directly or indirectly, by such domestic concern.

(c) Whenever it appears to the Attorney General that any domestic concern, or officer, director, employee, agent, or stockholder thereof, is engaged, or is about to engage, in any act or practice constituting a violation of subsection (a) of this section, the Attorney General may, in his discretion, bring a civil action in an appropriate district court of the United States to enjoin such act or practice, and upon a proper showing a permanent or temporary injunction or a temporary restraining order shall be granted without bond.

(d) As used in this section:

(1) The term “domestic concern” means (A) any individual who is a citizen, national, or resident of the United States; or (B) any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship, which has its principal place of business in the United States, or which is organized under the laws of a State of the United States or a territory, possession, or commonwealth of the United States.

(2) The term “foreign official” means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality. Such term does not include any employee of a foreign government or any department, agency, or instrumentality thereof whose duties are essentially ministerial or clerical.

(3) The term “interstate commerce” means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State or between any State and any place or ship outside thereof. Such term includes the intrastate use of (A) a telephone or other interstate means of communication, or (B) any other interstate instrumentality.

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendments of the House to the bill (S. 305) to amend the Securities Exchange Act of 1934 to require issuers of securities registered pursuant to section 12 of such Act to maintain accurate records, to prohibit certain bribes, and for other purposes, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed
upon by the managers and recommended in the accompanying conference report:
The House amendment to the text of the bill struck out all of the Senate bill after the enacting clause and inserted a substitute text. The Senate recedes from its disagreement to the amendment of the House with an amendment which is a substitute for the Senate bill and the House amendment. The differences between the Senate bill, the House amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

**TABLE OF CONTENTS OF JOINT EXPLANATORY STATEMENT OF THE COMMITTEE ON CONFERENCE**

A. Corporate bribery of foreign officials:
   1. Title of the Act.
   2. Accounting:
      a. Integrity of accounting records and reports.
      b. Systems of accounting controls.
      c. Prohibition on falsification of books and records; false statements to accountants.
      d. National security.
   3. Payments to officials:
      a. Prohibition against certain payments to foreign officials by issuers subject to SEC jurisdiction.
       1. Definitions.
       2. Penalties.
      b. Prohibition against certain payments to foreign officials by domestic concerns:
       1. Definitions.
       2. Department of Justice injunctive power.

B. Disclosure.

**A. CORPORATE BRIbery OF FOREIGN OFFICIALS**

1. **TITLE OF THE ACT—FOREIGN CORRUPT PRACTICES ACT**

The Senate bill established the title of Title I of the Act as the "Foreign Corrupt Practices Act of 1977". The House amendment established the title of the Act as the "Unlawful Corporate Payments Act of 1977". The House receded to the Senate.

2. **ACCOUNTING**

   a. **Integrity of accounting records and reports**

The Senate bill contained a provision which required issuers subject to the jurisdiction of the Securities and Exchange Commission (the "SEC") to make and keep books, records, and accounts which accurately and fairly reflect the transactions and dispositions of the assets of the issuer.

The House amendment contained no provision. The House receded to the Senate with an amendment requiring such books, records and accounts to be made and maintained accurately and fairly "in reasonable detail". The 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 trans-
actions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes.

b. Systems of accounting controls

The Senate bill contained a provision requiring issuers to devise and maintain adequate systems of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to maintain accountability for assets.

The House amendment contained no provision.

The House receded to the Senate with an amendment deleting the word "adequate". Since the precise requirements of the system of internal accounting controls to be maintained by the issuer are set forth in specific terms in the statute, the term adequate was deemed superfluous.

c. Prohibition on falsification of books and records; false statements to accountants

The Senate bill contained provisions to make it unlawful for (1) any person knowingly to falsify any book, record, or account required to be made for any accounting purpose, and (2) any person knowingly to make a materially false or misleading statement or to omit to state or cause another person to omit any material fact necessary in order to make statements to an accountant not misleading.

The House amendment contained no comparable provisions because the SEC had already published for comment rules designed to accomplish similar objectives under its existing authority.

The Senate receded to the House. Although these provisions were supportive of the basic accounting section, the use of the "knowingly" standard has become involved in an issue never intended to be raised or resolved by the Senate bill—namely, whether or not the inclusion or deletion of the word "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 stated clearly in the Committee Report on S. 305, these provisions were to be severable from the rest of the securities laws.

Under the circumstances, the conferees determined the best method of proceeding was to retain only new section 13(b)(2) of the Securities Exchange Act of 1934. The conferees further decided that this legislation should not be converted into a debate on the important issues raised by the *Hochfelder* decision.

In deleting the Senate provisions, 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.

d. National security

The Senate bill contained provisions which excluded from any duty or liability under paragraph (2) any person acting in cooperation with and at the specific written directive of any Federal agency or department responsible for matters concerning national security. Such directives were to be executed with specificity and to expire annually unless renewed in writing. The President of the United States was directed to review such directives annually and to certify that such directives involved classified information and were in conformity to applicable statutes and Executive orders.

The House amendment contained no provision.

The House receded to the Senate with an amendment. The amendment required that each directive be issued only pursuant to Presiden-
tial authority to issue such directives.

In addition, the amendment provides that a summary of all such directives shall be submitted annually to the appropriate intelligence oversight committees.

The conferees intend to make clear, as set forth in the Senate provision, that the only matters to be excluded from the requirements of paragraph (2) are those which would result, or would be likely to result, in the disclosure of information which has been classified by the appropriate department or agency for protection in the interests of the national security and then only to the extent that such information is specifically related to the person's lawful cooperation.

3. PAYMENTS TO OFFICIALS

a. Prohibitions against certain payments to foreign officials by issuers subject to SEC jurisdiction

The Senate bill amended the Securities Exchange Act of 1934 (the "Exchange Act") to prohibit the corrupt use of the mails or other means of interstate commerce by any issuer of securities registered with the SEC pursuant to section 12(b) or required to file reports pursuant to section 15(d) of the Exchange Act as well as any officer, director, employee or stockholder acting on behalf of the issuer, in furtherance of an offer, payment, promise to pay, or authorization of the payment of money or anything else of value to any official of a foreign government or instrumentality thereof, any foreign political party, any candidate for foreign political office, or any other person which the issuer knows or has reason to know will make such offer, promise or gift. The scope of the prohibition was limited by the requirement that the offer, promise, authorization, payment, or gift must have as a purpose inducing the recipient to use his influence with the foreign government or instrumentality, influencing the enactment or promulgation of legislation or regulations of that government or instrumentality or refraining from performing any official responsibilities, so as to direct business to any person, maintain an established business opportunity with any person or divert a business opportunity from any person.

The House amendment was similar to the Senate bill; however, the scope of the House amendment was not limited by the "business purpose" test, nor did it contain the "in furtherance of" requirement.

The conference substitute includes provisions found in both the Senate bill and the House amendment. In section 30A(a), the conferees adopted the identical provisions of both bills with the addition of the Senate "in furtherance of" language. The conference substitute prohibits corporations subject to SEC jurisdiction from making corrupt use of the mails or other means of interstate commerce in furtherance of an offer, payment, promise to pay or authorization of payment of anything of value to any foreign official, foreign political party, candidate for foreign political office or any other person which the issuer knows or has reason to know will make such offer, promise or payment. The adoption of the Senate "in furtherance of" language makes clear that the use of interstate commerce need only be in furtherance of making the corrupt payment.

By incorporating provisions from both bills, the conferees clarified the scope of the prohibition by requiring that the purpose of the payment must be to influence any act or decision of a foreign official (including a decision not to act) or to induce such official to use his
influence to affect a government act or decision so as to assist an issuer in obtaining, retaining or directing business to any person.

1. Definitions.—The Senate bill contained no definitional section. The House amendment defined the terms “control” and “foreign official”. “Control” was defined as the power to exercise a controlling influence over the management or policies of an issuer. Any person who owned beneficially, either directly or through one or more controlled issuers, more than 50 percent of the voting securities of an issuer, was presumed to control such issuer and any person who did not own more than 50 percent of the voting securities of an issuer was presumed not to have such control.

“Foreign official” was defined to mean any officer or employee of a foreign government or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of such government, department, agency, or instrumentality. The term did not include employees whose duties were primarily ministerial or clerical.

The Senate receded to the House concerning the definition of “foreign official” and the House receded to the Senate concerning the definition of “control.”

2. Penalties.—The Senate bill provided fines of not more than $500,000 for willful violations by issuers and penalties of up to $10,000 and/or 5 years imprisonment for willful violations by any officer, director, employee or shareholder thereof.

The House amendment provided a fine of not more than $1 million for knowing and willful violations by an issuer. Penalties for knowing and willful violations by officers, directors, agents, or natural persons in control of any issuer were similar to those provided in the Senate bill. However, an agent’s liability was predicated upon a finding that the issuer violated the section. Finally, the House amendment prohibited an issuer from paying either directly or indirectly any fine imposed under this section upon any officer, director, agent or natural person in control of such issuer.

The conference substitute adopts the maximum corporate penalty in the House amendment and the penalties applicable to officers, directors, employees, and stockholders acting on behalf of the issuer as provided in the Senate bill. The conference substitute incorporates the “agent” provisions of the House amendment. To provide additional protection for agents and employees, the conference substitute predicates an employee’s or agent’s liability upon a finding that the issuer has violated the section. As in the House amendment, the conference substitute prohibits an issuer from paying, either directly or indirectly, any fine imposed upon any individual under this section.

b. Prohibition against certain payments to foreign officials by domestic concerns

Both the Senate bill and the House amendment applied their respective prohibitions and penalties from the previous sections to domestic concerns other than those subject to SEC jurisdiction.

The conference substitute parallels the agreement reached by the conference with respect to the provisions governing issuers.

1. Definitions.—The Senate bill defined several terms used in this section. “Domestic concern” is defined as an individual who is a citizen or national of the United States as well as any corporation, partnership, association, joint-stock company, business trust, or unincorporated organization which is owned or controlled by individuals who are citizens or nationals of the United States and which has its prin-
principal place of business in the United States or which is organized under the laws of a State or any territory, possession or commonwealth of the United States.

The Senate bill restated the definition of interstate commerce in the Securities Exchange Act of 1934.

The House amendment defined the terms “control” and “foreign official” as previously discussed. In addition, the House amendment defined the term “domestic concern” as any corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship (1) which is owned or controlled by individuals who are citizens or nationals of the United States, (2) which has its principal place of business in the United States, or (3) which is organized under the laws of a State of the United States or any territory, possession, or commonwealth of the United States. The House amendment extended the coverage of the section to U.S. controlled foreign subsidiaries.

The Senate receded to the House concerning the definition of “foreign official.” The House receded to the Senate concerning the definition of control. The House receded to the Senate in the definition of “domestic concern” with an amendment to make clear that any company having a principal place of business in the United States would be subject to the bill.

In receding to the Senate, the conferees recognized the inherent jurisdictional, enforcement, and diplomatic difficulties raised by the inclusion of foreign subsidiaries of U.S. companies in the direct prohibitions of the bill. However, the conferees intend to make clear that any issuer or domestic concern which engages in bribery of foreign officials indirectly through any other person or entity would itself be liable under the bill. The conferees recognized that such jurisdictional, enforcement, and diplomatic difficulties may not be present in the case of individuals who are U.S. citizens, nationals, or residents. Therefore, individuals other than those specifically covered by the bill (e.g., officers, directors, employees, agents, or stockholders acting on behalf of an issuer or domestic concern) will be liable when they act in relation to the affairs of any foreign subsidiary of an issuer or domestic concern if they are citizens, nationals, or residents of the United States. In addition, the conferees determined that foreign nationals or residents otherwise under the jurisdiction of the United States would be covered by the bill in circumstances where an issuer or domestic concern engaged in conduct proscribed by the bill.

2. Department of Justice injunctive power.—The House amendment authorized the Department of Justice to enforce violations of the bill by domestic concerns through civil injunctions.

The Senate bill contained no provision. The Senate receded to the House.

HARLEY O. STAGGERS,
BOB ECKHARDT,
RALPH H. METCALF,
ROBERT KRUGER,
CHARLES J. CARNEY,
SAMUEL DEVINE,
JIM BROTHILL,
Managers on the Part of the House.

WILLIAM PROXMIRE,
JOHN SPARKMAN,
HARRISON A. WILLIAMS, JR.,
EDWARD W. BROOKE,
JOHN TOWER,
Managers on the Part of the Senate.
Appendix B


Calendar No. 93

FOREIGN CORRUPT PRACTICES AND DOMESTIC AND FOREIGN INVESTMENT DISCLOSURE ACTS OF 1977

MAY 2 (legislative day, MARCH 28), 1977.—Ordered to be printed

Mr. PROXMIRE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT
[to accompany S. 305]

The Committee on Banking, Housing and Urban Affairs favorably reports a bill (S. 305) to amend the Securities Exchange Act of 1934 to require companies subject to the jurisdiction of the Securities and Exchange Commission to maintain accurate records, to prohibit certain bribes, to expand and improve disclosure of ownership of the securities of U.S. companies, and for other purposes, and recommends that the bill, as amended by the committee, do pass.

HISTORY OF THE BILL

During the 94th Congress, the Committee on Banking, Housing and Urban Affairs held extensive hearings on the matter of improper payments to foreign government officials by American corporations. The committee also considered several bills designed to deal with the problem in various ways including S. 3133 introduced by Senator Proxmire on March 11, 1976; S. 3379 introduced by Senators Church, Clark, and Pearson on May 5, 1976, and S. 3418 introduced by Senator Proxmire at the request of the Securities and Exchange Commission (SEC) on May 12, 1976.

On May 12, 1976, the committee received from the SEC an extensive “Report on Questionable and Illegal Corporate Payments and Practices,” (“SEC report”) which summarized the SEC’s enforcement activities and findings to that date. That report traced the history of the Commission’s discovery of conduct involving the misuse of corporate funds and the commencement of investigations which subsequently revealed that instances of undisclosed questionable or illegal corporate payments were indeed widespread and represented a serious breach in the operation of the Commission’s system of corporate disclosure and, correspondingly, in public confidence in the integrity of the system of capital formation. The SEC report also analyzed the public filings of 89 corporations that had disclosed varying types of
questionable payments, plus six special reports obtained as the result of SEC enforcement actions and the allegations made in eight additional cases in which the SEC had obtained some form of judicial relief. Finally, the report contained the SEC's analysis of the degree of disclosure required concerning questionable foreign payments under the existing Federal securities laws and outlined the legislative and other responses which the Commission recommended to remedy these problems.

On June 22, 1976, the committee met and ordered reported a bill, S. 3664, which incorporated the SEC's recommendations and a direct prohibition against the payment of overseas bribes by any U.S. business concern. On September 15, 1976 the Senate, by a unanimous vote of 86-0 passed S. 3664. The House of Representatives, however, did not complete work on that legislation before its adjournment on October 2, 1976.

Title II of S. 305, which would amend the Federal securities laws to enhance the present system of disclosure of the ownership of American business, has also been the subject of numerous hearings and careful deliberation by the committee in the past. Last year, as part of S. 3084, the committee reported favorably and the Senate passed the disclosure provisions as title III of S. 3084. No final action was taken by the Congress on this bill prior to adjournment either.

Shortly after the 95th Congress convened on January 18, 1977, Senators Proxmire and Williams introduced S. 305. As introduced, title I of the bill was identical to S. 3664, the measure which the Senate had passed unanimously during the prior Congress and title II was substantially the same as Title II of S. 3084.

The committee held hearings on S. 305 on March 16, 1977, and received testimony from Senator Metcalf, the Securities and Exchange Commission, the Department of the Treasury, the American Bankers Association, and the Securities Industry Association. Subsequently, on April 7, 1977, the committee met in open session to consider S. 305. The committee ordered the bill, with an amendment, to be reported to the Senate.

SUMMARY OF THE BILL

A. TITLE I—CORPORATE BRIBERY OF FOREIGN OFFICIALS

Title I of S. 305 is designed to prevent the use of corporate funds for corrupt purposes. As reported, Title I:

1. Requires companies subject to the jurisdiction of the SEC to maintain strict accounting standards and management control over their assets;

2. Prohibits the falsification of accounting records and the deceit of accountants auditing the books and records of such companies; and

3. Makes it a crime for U.S. companies to bribe a foreign government official for the specified corrupt purposes. Companies violating the criminal prohibitions face maximum fines of $500,000. Individuals acting on behalf of such companies face a maximum fine of $10,000 and 5 years in jail.

In the past, corporate bribery has been concealed by the falsification of corporate books and records. Title I removes this avenue of coverup, reinforcing the criminal sanctions which are intended to serve as the

1 See Senate Report No. 94-1031, 94th Cong., 2d sess.
Appendix B

significant deterrent to corporate bribery. Taken together, the accounting requirements and criminal prohibitions of Title I should effectively deter corporate bribery of foreign government officials.

NEED FOR LEGISLATION

A. TITLE I—CORPORATE BRIbery OF FOREIGN OFFICIALS

Recent investigations by the SEC have revealed corrupt foreign payments by over 300 U.S. companies involving hundreds of millions of dollars. These revelations have had severe adverse effects. Foreign governments friendly to the United States in Japan, Italy, and the Netherlands have come under intense pressure from their own people. The image of American democracy abroad has been tarnished. Confidence in the financial integrity of our corporations has been impaired. The efficient functioning of our capital markets has been hampered.

Corporate bribery is bad business. In our free market system it is basic that the sale of products should take place on the basis of price, quality, and service. Corporate bribery is fundamentally destructive of this basic tenet. Corporate bribery of foreign officials takes place primarily to assist corporations in gaining business. Thus foreign corporate bribery affects the very stability of overseas business. Foreign corporate bribes also affect our domestic competitive climate when domestic firms engage in such practices as a substitute for healthy competition for foreign business.

Managements which resort to corporate bribery and the falsification of records to enhance their business reveal a lack of confidence about themselves. Secretary of the Treasury Blumenthal, in appearing before the committee in support of the criminalization of foreign corporate bribery testified that: "Paying bribes—apart from being morally repugnant and illegal in most countries—is simply not necessary for the successful conduct of business here or overseas."

The committee concurs in Secretary Blumenthal's judgment. Many U.S. firms have taken a strong stand against paying foreign bribes and are still able to compete in international trade. Unfortunately, the reputation and image of all U.S. businessmen has been tarnished by the activities of a sizable number, but by no means a majority of American firms. A strong antibribery law is urgently needed to bring these corrupt practices to a halt and to restore public confidence in the integrity of the American business system.

NATURE OF THE LEGISLATION

A. TITLE I—CORPORATE BRIbery OF FOREIGN OFFICIALS

1. Accurate accounting

The committee recognizes that the SEC has broad authority to promulgate accounting standards for companies subject to jurisdiction under its existing authority. Nevertheless, the committee believes the Commission's current program for accurate accounting should be supplemented by an explicit statement of statutory policy. The accounting standards in S. 305 are intended to operate in tandem with the criminalization provisions of the bill to deter corporate bribery. S. 305 expresses a public policy which encompasses a unified approach to the matter of corporate bribery.

This legislation imposes affirmative requirements on issuers to maintain books and records which accurately and fairly reflect the transactions of the corporation and to design an adequate system of internal controls to assure, among other things, that the assets of the issuer are used for proper corporate purpose. The committee believes
that the imposition of these affirmative duties under our securities laws coupled with attendant civil liability and criminal penalties for failure to comply with the statutory standard will go a long way to prevent the use of corporate assets for corrupt purposes. Public confidence in securities markets will be enhanced by assurance that corporate recordkeeping is honest.

Section 102 of the bill as reported amends section 13(b) of the Securities Exchange Act by adding new paragraphs (b)(2), (b)(3), (b)(4), and (b)(5). The provisions of section 102 apply to issuers which have securities listed on an exchange pursuant to subsection 12(b) of the Securities Exchange Act, to issuers which meet the requirements of section 12(g) of that Act, and to issuers subject to the reporting requirement of section 15(d) of the Act.

The purpose of section 102 is to strengthen the accuracy of the corporate books and records and the reliability of the audit process which constitute the foundations of our system of corporate disclosure. Section 102 substantially embodies the measures which the SEC recommended to the committee in its May 22, 1976, report on questionable payments. New subparagraph (b)(2)(A) imposes an obligation on issuers to maintain books and records that accurately and fairly reflect the transactions and dispositions of the assets of the issuers.

Subparagraph (b)(2)(B) would require issuers to devise and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria. Because the accounting profession has defined the objectives of a system of accounting control, the definition of the objectives contained in this subparagraph is taken from the authoritative accounting literature. See American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 320.28 (1973).

The establishment and maintenance of a system of internal controls is an important management obligation. A fundamental aspect of management's stewardship responsibility is to provide shareholders with reasonable assurances that the business is adequately controlled. Additionally, management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis. An adequate system of internal accounting controls is necessary to management's discharge of these obligations.

The committee understands that auditors customarily provide management with comments on the state of the client's internal controls. Those comments are designed to assist the issuer in improving its system of internal controls and thereby to assist the auditor in the conduct of its audit. The committee recognizes that no system of internal controls is perfect, and that there will always be room for improvement. Auditor's comments and suggestions to management on possible improvements are to be encouraged.

The establishment and maintenance of a system of internal control and accurate books and records are fundamental responsibilities of management. The expected benefits to be derived from the conscientious discharge of these responsibilities are of basic importance to

---

5 The phrase "dispositions of its assets" is not intended as a limitation on the scope of the requirement that accurate books and records be maintained. The issuer's responsibility to keep records correctly reflecting the status of its liabilities and equities is no less than its obligation to maintain such records concerning its assets. The word "transactions" in the bill encompasses accuracy in accounts of every character.
Appendix B

investors and the maintenance of the integrity of our capital market system. The committee recognizes, however, that management must exercise judgment in determining the steps to be taken, and the cost incurred, in giving assurance that the objectives expressed will be achieved. Here, standards of reasonableness must apply. In this regard, the 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 generally accepted accounting principles or other applicable criteria. While management should observe every reasonable prudence in satisfying the objectives called for in new paragraph (2) of section 13(b), the committee recognizes that management must necessarily estimate and evaluate the cost/benefit relationships of the steps to be taken in fulfillment of its responsibilities under this paragraph. The accounting profession will be expected to use their professional judgment in evaluating the systems maintained by issuers. 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.

2. Prohibition against falsification of accounting records and deception of auditors

Paragraph (b)(3) would make it unlawful for any person, directly or indirectly, knowingly to falsify any book, record or account maintained, or required to be maintained, for an accounting purpose of an issuer subject to paragraph (b)(2) of section 13 of the Securities Exchange Act of 1934. This paragraph covers both actions of commission and omission.

Paragraph (b)(4) would prohibit knowingly making false or misleading statements, or knowingly omitting to state facts necessary to be stated, to an accountant in connection with any audit or examination of issuers identified in paragraph (b)(2) of section 13 of the Securities Exchange Act. This paragraph would also apply to audits in connection with a securities offering registered or to be registered under the Securities Act of 1933. Concepts of aiding and abetting are applicable to conduct covered by these sections. By specifically prohibiting the making of knowingly materially false or misleading statements or omissions to auditors, the bill is designed to encourage careful communications between the auditors and persons from whom the auditors seek information in the audit process. The committee is of the view that a proscription on knowing false statements to auditors will enhance the integrity of the auditing process.

The amendments to section 13(b) prohibiting the falsification of corporate books and records and the making of misleading representations to auditors are not intended to make unlawful conduct which is merely negligent. To clarify the purpose of these paragraphs, therefore, the committee inserted the term "knowingly" in appropriate places in both paragraphs (3) and (4). As 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.

The committee believes that the inclusion of the "knowingly" standard is appropriate because of the danger, inherent in matters relating to financial recordkeeping, that inadvertent misstatements or minor discrepancies arising from an unwitting error in judgment
might be deemed actionable. The committee does not, however, intend that the use of the terming “knowingly” will provide a defense for those who shield themselves from the facts. The knowledge required is that the defendant be aware that he is committing the act which is false—not that he know that his conduct is illegal. The inclusion of this standard is intended to be limited to matters arising under these new subsections and not to any other provisions of the securities laws. As a result, in this limited instance, in order to prove that falsification of corporate accounting records or deception of auditors is “knowingly” committed, the Commission will be required to establish this element in actions arising under new paragraphs 13(b)(3) and 13(b)(4).

The knowledge required is that the person be aware that he is or may be making a false statement or causing corporate records to be falsified through a conscious undertaking or due to his conscious disregard for the truth.

The bill, as reported, would also permit the head of any agency or department responsible for national security matters to exempt, on a limited basis, an issuer involved in an endeavor related to national security from the accounting and reporting requirements of the bill. The facts and circumstances to which the directive applies must be reported to the President.

3. Criminalization of foreign bribery

The committee recognizes that the SEC has diligently sought to enforce the existing provisions of the Federal securities laws by requiring corporate reports to disclose “material” payments. Nevertheless, the committee has concluded that—"The serious abuses which the Commission has uncovered justify an explicit congressional affirmation of our national commitment of ending corrupt foreign payments. While the Commission has made substantial progress in its enforcement program, the committee believes that legislation is appropriate to make clear that cessation of these abuses is a matter, not merely of SEC concern, but of national policy."

Secretary of the Treasury Blumenthal supported the criminalization of overseas bribery in testimony before the committee. The committee considered the matter extensively in the 94th Congress and concluded that the criminalization approach was preferred over a disclosure approach. Direct criminalization entails no reporting burden on corporations and less of an enforcement burden on the Government. The criminalization of foreign corporate bribery will to a significant extent act as a self-enforcing, preventative mechanism.

Sections 103 and 104 of the bill provide criminal penalties for foreign corporate bribery. Section 103 applies to issuers and reporting firms under the jurisdiction of the SEC. Section 104 applies to all other domestic concerns. Under sections 103 and 104, a corporation is prohibited from making payments to a foreign official for the purpose of inducing him to obtain or retain business for the corporation or to influence legislation or regulations of the Government.

Payment to officials of a foreign political office having the purposes set forth respecting payments to foreign government officials are likewise proscribed. And payments to agents, while knowing or having reason to know, that all or a portion of the payment will be offered or given to a foreign government official, foreign political party or candidate for foreign political office for the proscribed purposes are also forbidden.

The statute covers payments made to foreign officials for the purpose of obtaining business or influencing legislation or regulations. The
The statute does not, therefore, cover so-called "grease payments" such as payments for expediting shipments through customs or placing a transatlantic telephone call, securing required permits, or obtaining adequate police protection, transactions which may involve even the proper performance of duties.

The word "corruptly" is used in order to make clear that the offer, payment, promise, or gift, must be intended to induce the recipient to misuse his official position in order to wrongfully direct business to the payor or his client, or to obtain preferential legislation or a favorable regulation. The word "corruptly" connotes an evil motive or purpose, an intent to wrongfully influence the recipient. It does not require that the act be fully consummated, or succeed in producing the desired outcome.

Sections 103 and 104 cover payments and gifts intended to influence the recipient, regardless of who first suggested the payment or gift. The defense that the payment was demanded on the part of a government official as a price for gaining entry into a market or to obtain a contract would not suffice since at some point the U.S. company would make a conscious decision whether or not to pay a bribe. That the payment may have been first proposed by the recipient rather than the U.S. company does not alter the corrupt purpose on the part of the person paying the bribe. On the other hand true extortion situations would not be covered by this provision since a payment to an official to keep an oil rig from being dynamited should not be held to be made with the requisite corrupt purpose.

Section 305 as reported also covers the officers, directors, employees, or stockholders making overseas bribes on behalf of the corporation. This provision is intended to make clear that it is corporate or business bribery which is being proscribed. Whether or not a particular situation involves bribery by the corporation or by an individual acting on his own will depend on all the facts and circumstances, including the position of the employee, the care with which the board of directors supervises management, the care with which management supervises employees in sensitive positions and its adherence to the strict accounting standards set forth under section 102. The prohibitions against corrupt payments apply in this regard to payments by agents where the corporation paying them knew or had reason to know they would be passed on in whole or in part to a foreign government official for a proscribed purpose. Of course, where the corporation knows the payment will be passed on for a proscribed purpose, the violation is complete.

The committee has recognized that the bill would not reach all corrupt overseas payments. For example, the bill would not cover payments by foreign nationals acting solely on behalf of foreign subsidiaries where there is no nexus with U.S. interstate commerce or the use of U.S. mails and where the issuer, reporting company, or domestic concern had no knowledge of the payment. But a U.S. company which "looks the other way" in order to be able to raise the defense that they were ignorant of bribes made by a foreign subsidiary, could be in violation of section 102 requiring companies to devise and maintain adequate accounting controls. Under the accounting section no off-the-books accounting fund could be lawfully maintained, either by a U.S. parent or by a foreign subsidiary, and no improper payment could be lawfully disguised.

4. Enforcement responsibilities

After careful consideration the committee concluded that the SEC should continue to have a role in the investigation of violations of the
criminal prohibitions as they apply to companies under the jurisdiction of the SEC. The SEC has been the principal agency of the Government taking the lead in the investigation of foreign bribery. This is as it should be for the bribery of foreign officials often violates our securities laws to the extent the payment is not disclosed to investors. The SEC has thus developed considerable expertise in investigating corrupt overseas payments. This same expertise can be put to work in investigating potential violations of the antibribery provisions of this legislation. If this investigative responsibility were to be assigned solely to the Justice Department, as some had advocated, that agency would have to duplicate the investigative capability already in the SEC at a greater cost to the Government.

It should be emphasized that while the SEC investigates potential violations of the securities laws, the only remedy it can bring on its own is an injunctive action. When the SEC believes it has compiled enough evidence for a criminal action, it refers the case to the Justice Department for criminal prosecution. This same division of responsibility would also apply with respect to the antibribery provisions of this legislation.

The committee believes this division of responsibility will result in a stronger enforcement effort compared to an exclusive assignment to the Justice Department. It is often difficult to assemble the degree of evidence required in a criminal action, but enough evidence may exist to enable the SEC to halt a continuation of the corrupt practices through an injunctive action.

The committee expects that close cooperation will develop between the SEC and the Justice Department at the earliest stage of any investigation in order to insure that the evidence needed for a criminal prosecution does not become stale. The arrangements which the committee expects the SEC and Justice to work out on criminal matters is in no way intended to cast doubt upon the authority of the SEC to prosecute and defend its own civil litigation. Under the bill, the Justice Department retains sole investigative and prosecutorial jurisdiction over domestic concerns covered but which are not otherwise within the jurisdiction of the SEC.

The committee believes that, by assigning to the SEC enforcement responsibilities for the new prohibition, it will strengthen the Commission's ability to enforce compliance with the existing requirements of the securities laws, and with the new accounting provisions recommended by the Commission and included as section 102 of the bill. Obviously, there may be practical impediments to enforcement in individual cases, just as proof of bribery and other white collar crimes is often difficult to obtain in domestic cases. Nonetheless, the Commission's enforcement efforts under existing U.S. law demonstrate that it is entirely feasible for U.S. agencies successfully to investigate improper foreign payments made on behalf of American corporations.

The SEC's responsibilities would extend to conducting investigations, bringing civil injunctive actions, commencing administrative proceedings if appropriate, defending lawsuit against the Commission and its staff arising out of the Commission's obligations under this Act, and referring cases to the Justice Department for criminal prosecution on a timely basis. The Commission, of course, will retain all of its existing remedies under the securities laws, and the committee anticipates

---

*For example, rule 2(e) of the Commission's rules of practice, 17 CFR 201.2(e), authorises the Commission to censure, suspend, or bar professionals, such as accountants and lawyers, from practicing before the Commission. A public or private rule 2(e) proceeding might, in the Commission's view, be preferable, or used in addition to a civil injunctive action or criminal referral, in particular cases.
that the Commission will continue to tailor remedies to fit the circumstances of specific cases.

SECTION-BY-SECTION ANALYSIS

The purpose of this legislation would be accomplished by amending existing sections 13(b), 13(d), 15(d), and 32(a) of the Securities Exchange Act of 1934 ("the act") and by adding new sections 13(g), 13(h), and new section 30A, to the act. Further, a new provision would be added to the criminal code.

A. TITLE I—FOREIGN CORRUPT PRACTICES

Short title
Section 101. This title may be cited as the "Foreign Corrupt Practices Act of 1977."

Integrity of accounting records and reports
Section 102 of the bill would amend section 13 of the Exchange Act by renumbering existing subsection (b) as (b)(1) and by adding four new paragraphs. New paragraph 13(b)(2) would apply only to issuers which have a class of securities registered pursuant to section 12 of the act and issuers required to file reports pursuant to section 15(d) of the act ("reporting companies"). It would require reporting companies to make and keep books, records, and accounts which accurately and fairly reflect all of their transactions and dispositions of assets.

A reporting company also would be required to establish and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that:

1. Transactions are executed in accordance with management directions;
2. Transactions are recorded in a manner that permits the company to prepare its financial statements in accordance with generally accepted accounting principles or other applicable criteria and to maintain accountability for its assets;
3. Access to company assets is permitted only in accordance with management authorization; and
4. The recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to differences.

New Paragraph (3) would make it unlawful for any person knowingly to falsify or cause to be falsified any book, record, or account of a reporting company which has been made or is required to be made for any accounting purpose.

New paragraph (4) would make it unlawful for any person knowingly to make or cause to be made a materially false or misleading statement or to omit to state or cause another person to omit to state any material fact necessary in order to make statements to an accountant not misleading. This paragraph would apply to statements made to an accountant in connection with any examination or audit of an issuer with securities registered or to be registered under the Securities Act of 1933, as well as any examination or audit of a reporting company.

New paragraph (5) would provide that no duty or liability could be imposed under new paragraphs (2), (3), or (4) upon any person acting pursuant to a written directive of the head of an agency responsible for national security. This exclusion only applies, however, to the extent that the requirements of new paragraphs (2), (3), or (4) would be likely to result in the disclosure of properly classified national
security information. Every directive executed by a national security agency head under this paragraph would have to describe specifically the facts which are not to be disclosed and the surrounding circumstances. These directives would expire annually unless renewed in writing. Agency heads would maintain a file of these directives, and each year on October 1 all directives in force during the prior year would have to be transmitted to the President for his review and certification that all conformed to law.

Prohibition against certain payments to officials by registered companies

Section 103 of the bill would add a new section 30A to the Act to prohibit any reporting company, or any officer, director, or employee, or shareholder acting on behalf of such a company, to use the mails or the means or instrumentalities of interstate commerce corruptly in furtherance of an offer, payment, or promise to pay, or authorization of the payment of, any money, or offer, gift, or promise to give anything of value, to three classes of persons:

(1) An official of a foreign government or instrumentality of a foreign government.
(2) A foreign political party or an official of a foreign political party, or a candidate for a foreign political office, or
(3) Any other person while the issuer knows or has reason to know that money or a gift will be offered, promised or given to an official of a foreign political party, or a candidate for a foreign political office.

The scope of section 30A is limited by the requirement that the offer, promise, authorization, payment, or gift must have as a purpose inducing the recipient to use influence with the foreign government or instrumentality, or to refrain from performing any official responsibilities, so as to direct business to any person, maintain an established business opportunity with any person, divert any business opportunity from any person or influence the enactment or promulgation of legislation or regulations of that government or instrumentality.

Prohibition against certain payments to officials by other domestic concerns

Section 104 of the bill would prohibit persons included in the definition of the term “domestic concern” who would not be covered by new section 30A of the Act from engaging in any of the same types of conduct prohibited by that section.

The term “domestic concern” is defined in the bill to mean an individual who is a citizen or national of the United States as well as any corporation, partnership, association, joint-stock company, business trust, or unincorporated organization which is owned or controlled by individuals who are citizens or nationals of the United States and which has its principal place of business in the United States or any territory, possession, or commonwealth of the United States.

The term “interstate commerce” is defined to mean trade, commerce, transportation, or communication among the several States, or between any foreign country and any State or between any State and any place or ship on trade thereof. The term includes the interstate use of a telephone or other interstate means of communication and the intrastate use of any other interstate instrumentality.

The penalties for each violation of section 103 or section 104 would be a fine of up to $10,000 or imprisonment for up to 5 years, or both, but in the case of a corporation a fine of up to $500,000 could be imposed.