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STATEMENT OF

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BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS  
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

AND

SUBCOMMITTEE ON SECURITIES

ON

THE [IMPACT OF THE FOREIGN CORRUPT PRACTICES ACT  
ON U.S. BUSINESS]

Messrs. Chairmen and Members of the Committee:

We are pleased to be here today to discuss our recent report "Impact of Foreign Corrupt Practices Act On U.S. Business" (AFMD-81-34, Mar. 4, 1981). The Foreign Corrupt Practices Act was passed in December 1977 in response to widespread disclosure of questionable corporate payments. The law prohibits bribery of foreign officials and also contains significant accounting requirements that apply to all activities of companies registered with the Securities and Exchange Commission (SEC).

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We found that the act has brought about substantial changes in business activities which should strengthen corporate accounting controls and reduce illegal payments made to foreign officials. However, the act's provisions have been steeped in controversy and confusion over what constitutes compliance. The accounting provisions have been criticized as being vague and causing business to incur unnecessary costs. The antibribery provisions have been cited as ambiguous and causing U.S. firms to forego legitimate export opportunities. Senate bill 708--the Business Accounting and Foreign Trade Simplification Act--which you now have before you addresses these issues.

We initiated our review to obtain the baseline data we believe the Congress needs to assess the implementation and impact of the Foreign Corrupt Practices Act. Our report makes extensive use of information obtained from a questionnaire survey of 250 companies randomly selected from Fortune's list of the 1,000 largest U.S. industrial firms. I would like to point out that under the rules of statistics we are 95 percent sure that projection of our survey results to the 1,000 firms will be within 7 percent of the answers we would get if we contacted all 1,000 firms.

THE ACT HAS HAD A SUBSTANTIAL IMPACT  
ON CORPORATE ACTIVITIES

Our questionnaire survey of 250 companies (75 percent responded) shows that the act has brought about efforts to strengthen corporate codes of conduct and systems of

internal accounting controls. These changes should strengthen the system of corporate accountability.

Codes of conduct--the policies that define the standards of business conduct for employees--have undergone significant change. About 60 percent of the questionnaire respondents reported that the act has influenced changes in the codes' contents as well as in how they are communicated to employees. Important changes were frequently reported in the policy areas related to questionable or improper foreign payments. Other changes included increases in the number of employees who received the codes as well as increases in the number of written acknowledgments required from employees that they had read and/or would comply with the codes.

The act also caused almost all our questionnaire respondents to review the adequacy of their systems of internal accounting control with more than 75 percent of the respondents reporting changes. Extensive changes have been made in documenting and testing internal accounting control systems and in strengthening internal audit.

The internal accounting control changes have not been without cost. About 55 percent of the respondents reported that their efforts to comply with the act have resulted in costs that were greater than the benefits received. About half of these respondents believed the cost burden increased their accounting and auditing costs by 11 to 35 percent. Another 20 percent estimated these costs increased by more than 35 percent. Also a study of internal control in U.S.

companies performed for the Financial Executives Research Foundation, a research arm of the Financial Executives Institute, showed that executives believe their compliance programs often involve significant costs with noncommensurate benefits in terms of improved controls and recordkeeping. One such control change was the increased emphasis on the documentation of internal accounting control systems. The study noted that some corporate officials believed the increased documentation is a paper-gathering exercise to serve as a defense against SEC inquiries.

The act has also been perceived as having an adverse impact on U.S. overseas business. More than 30 percent of the questionnaire respondents engaged in foreign business reported they had lost overseas business as a result of the act. In addition, while more than 70 percent of the questionnaire respondents believed the act has been effective in reducing questionable foreign payments by American companies, over 60 percent of the respondents perceived that, assuming all other conditions were similar, American companies could not successfully compete against companies abroad that are not subject to the same prohibitions. Due to the sensitivity of the foreign bribery issue and the complexities inherent in international trade, quantifiable evidence of the act's impact on U.S. foreign business is not presently available. However, the perceptions themselves are important in any assessment of the act.

Almost all the respondents who reported a decrease in business stated that the act had discouraged foreign buyers

and agents from doing business with their firms. In some countries the use of foreign agents is a recommended practice; in other countries it is a necessity.

Our respondents believed that companies in the construction and aircraft industries were more likely to be adversely affected by the act--a belief supported by our limited nonrandom sample of leading companies in the two industries. Over half of these companies responding to additional questionnaires we sent indicated that the act had adversely affected their overseas business.

#### CONTROVERSY AND CONFUSION OVER THE ACT'S ACCOUNTING PROVISIONS

Since their enactment, the act's provisions have been the subject of much controversy and confusion. The business community has criticized the provisions as being too vague to provide guidance on what constitutes compliance. In addition, SEC and an American Bar Association committee disagree on whether the provisions contain a materiality standard--a threshold for financial disclosure which limits management's reporting responsibilities to material items.

#### The Accounting Provisions Have Been Criticized As Unclear

There is extensive dissatisfaction with the clarity of the accounting provisions. Our corporate sample, leading public accounting firms, and the previously mentioned Financial Executives Research Foundation study all give the provisions low marks for clarity. Over 30 percent of our questionnaire respondents rated the recordkeeping provision

as inadequate, and over 50 percent rated the concept of "reasonable assurance" as inadequate.

The respondents indicated that greater specificity is needed. One respondent commented that the accounting provisions are stated in very broad terms which are difficult to apply to specific situations. Another commented that the provisions are very subjective; there is no method for determining what is a sufficient system of internal accounting control and no general consensus of the definition of "reasonable assurance."

The leading public accounting firms reported similar views. They were concerned that the act provides no guidance on what constitutes a violation of the accounting provisions. One firm commented that deciding whether a company's recordkeeping is accurate and reflects matters fairly, or whether a system of internal accounting controls provides reasonable assurances, involves complexities and uncertainties that make it difficult, if not impossible, to determine whether a company has complied with the act.

Although using familiar accounting terms--for example, the internal accounting control provision was taken almost verbatim from professional auditing standards--the act's accounting provisions are inherently subjective and can be interpreted differently. The accounting profession and SEC have provided guidance to companies on how to comply with the act's accounting provisions, which should alleviate some uncertainty; but an element of uncertainty will probably

always exist due to the inherent subjectivity of the accounting terminology.

#### Controversy Over the Existence of a Materiality Standard

Increasing the uncertainty over what constitutes compliance is the controversy over whether the act's accounting provisions include a materiality standard. An American Bar Association committee guide to the accounting provisions says the act does contain a materiality standard; SEC says a materiality standard does not exist. Instead, SEC indicates a reasonableness standard exists.

Irrespective of whether a materiality standard exists, it is widely held that one is needed. Over 70 percent of our questionnaire respondents and all the accounting officials contacted believe that without a materiality standard, the amount and kind of effort required to comply with the accounting provisions is unclear.

We believe that without guidance on the factors and criteria to be considered in assessing compliance with a reasonableness standard, business may incur unnecessary compliance costs. To avoid potential noncompliance and possible enforcement action, companies may go to greater extremes in keeping books and establishing controls than the Congress intended. The act's legislative history indicates that the Congress did not intend to require companies to have perfect books and perfect systems of internal accounting control. Instead, the legislative history emphasized that management observe a standard of reasonableness in complying with the act's accounting provisions.

Because of the uncertainty as to what constitutes reasonableness, we recommended in our March 1981 report that SEC provide guidance to the business community on the factors and criteria that will be considered in assessing reasonableness of companies' compliance efforts.

Section 4 of Senate bill 708 would add an explicit materiality standard, related to financial disclosure, to the act's accounting provisions. This would alleviate businesses' concern over how the act is going to be applied. On the other hand, we would like to point out for the Committee's consideration that the application of the materiality standard, set forth in section 4, would create a minimum threshold below which errors and intentional acts would be allowed, which for many large companies would be quite high.

We share the concern of the bill's sponsors that, without further clarification of the present law as to what is expected, business may incur unnecessary compliance costs under the act's accounting provisions. Former SEC Chairman Williams, in a January 13, 1981, policy statement pointed out that although the reasonableness standard is a fluid legal standard, the lack of more specific guidelines seemed to have generated the greatest concern about the act.

#### Criminal Penalties Associated With the Accounting Provisions Should Be Repealed

Another reason companies may be incurring excessive compliance costs is their apprehension over the potential application of criminal penalties to what are essentially



intended to be management judgments over recordkeeping and internal control systems. The accounting provisions were designed to operate as a preventive measure--to prevent the use of corporate assets for corrupt purposes. Subjecting corporate management to potential criminal penalties for noncompliance with what is essentially a preventive measure could be counterproductive.

We strongly support the expressed intent of the act that business maintain accurate records and adequate systems of internal controls. However, we do not believe criminal penalties should be associated except for the most serious violations, such as the type of flagrant abuses that gave rise to the passage of the accounting provisions. Such abuses could best be addressed through new legislation which could expressly establish criminal penalties only in cases of flagrant abuse.

We recommended in our March 1981 report that the existing criminal penalties attached to the accounting provisions should be repealed and the Congress consider legislation to establish criminal penalties for the knowing and willful falsification of corporate books and records. This would cover situations, where corporate books and records were falsified for the purpose of aiding in or concealing the misuse of corporate assets. Section 4 (b) of Senate bill 708 provides that a violation of the accounting provisions could be civilly or criminally prosecuted only if there has been a knowing falsification of records, or wrongful attempt to circumvent or the knowing failure to maintain the control system.

ISSUES SURROUNDING THE ACT'S  
ANTIBRIBERY PROVISIONS

Our review showed that there is also confusion over what constitutes compliance with the act's antibribery provisions. In particular, the clarity of the antibribery provisions have been severely criticized by those questionnaire respondents who reported that the act has decreased their overseas business. Of the more than 30 percent of our respondents who reported that the act caused a decrease in their overseas business, approximately 70 percent rated the clarity of at least one of the antibribery provisions as inadequate or very inadequate. A general perception exists that because of these ambiguities, American companies may have forgone legitimate business opportunities.

The ambiguities include confusion or uncertainty about:

- The degree of responsibility a company has for the actions of its foreign agents and affiliates (the "reason to know" provision).
- The definition of "foreign official."
- Whether a payment will be considered corrupt.
- Whether a payment to a foreign official is a bribe, which is illegal under the act, or a facilitating payment; which is allowed under the act.
- Whether payments made in response to economic extortion will be considered bribes.

Justice Guidance Program to Reduce Uncertainty

Former President Carter expressed concern over the potential effect of the act's alleged ambiguities in

September 1978, only 9 months after the act's passage, and indicated that he hoped business would not forego legitimate export opportunities because of uncertainty about application of the act. To reduce this uncertainty, he directed the Justice Department to provide the business community with guidance concerning its enforcement intentions under the act.

In March 1980--18 months after the former President's directive--Justice implemented the "Foreign Corrupt Practices Act Review Procedure," which allows a company to seek guidance on contemplated foreign transactions. The procedure is modeled after Justice's Antitrust Division's business review procedure.

The review procedure requires that a top company official submit to Justice a detailed statement of all facts material to a prospective transaction in a foreign country. Prior to the transaction, Justice is to advise the company whether it would take enforcement action under the act if the company were to proceed with the proposed action. Justice attempts to respond within 30 days. Justice officials believe that with an advance ruling companies will be in a position to decide whether to proceed, and uncertainty about the act's application to a transaction will be eliminated.

The Justice guidance program has yet to effectively address the ambiguities, and it is doubtful it will in its present format. The program has been criticized by some

governmental and business officials, and it has been only nominally used by the business community. As of April 1981, only five companies had requested a review.

In commenting on the guidance program, officials of the Departments of the Commerce, Treasury and of State recommended that Justice issue guidelines using hypothetical situations. This method was rejected by Justice because it did not believe it had the experience needed to formulate hypothetical situations.

Another criticism of the guidance program has been the lack of SEC participation. SEC and Justice share enforcement authority for the act's antibribery provision. SEC declined Justice's invitation to join in the review program. As a result, business was concerned that SEC could initiate an investigation against an SEC registrant even though the company had obtained a review letter stating that Justice had no intention of seeking enforcement action. In late August 1980, SEC announced that it would accept until May 31, 1981, Justice's statements of enforcement intention for contemplated transactions under the act. Although still not participating in the formulation of Justice's advance rulings, SEC will not prosecute corporations for transactions that receive Justice clearance.

In our March 1981 report, we recommended that alternatives to address the antibribery ambiguities be developed. We offered two options: (1) provide additional guidance to businesses through the use of hypothetical situations, and

(2) develop legislation to clarify various terms used in the act.

Senate bill 708 provides for the establishment of a task force and gives the task force the authority to issue compliance guidelines that would describe specific types of conduct that it considers to be in compliance with the act, as well as precautionary procedures that would insure compliance. Under the bill, courtesy items, marketing education, or expenses related to the demonstration or explanation of products would not be considered bribes. The bill eliminates the "reason to know" provision of the act. The bill would also formalize Justice's review procedure; but, unlike the current review procedure, all documents submitted by companies would be exempt from disclosure under the Freedom of Information Act and either returned to the companies or destroyed.

Another issue addressed in the bill which we said in our report was a policy determination for the Congress is the shared enforcement of the act's antibribery provisions. Currently, SEC has civil enforcement authority for issuers who violate the act's antibribery provisions and the Department of Justice has enforcement authority for all criminal violations and certain civil cases. Section 5 of the bill would place all enforcement jurisdiction for the antibribery provisions with the Justice Department. Since the bill requires the Attorney General to administer the review procedure, we believe that enforcement should rest with those

responsible for interpreting the law so that business is subject to clear and consistent requirements. Therefore, we support the bill's approach to centralize enforcement authority.

#### Need For An International Antibribery Agreement

Compounding the perceived ambiguities in the act's anti-bribery provisions is the lack of an international anti-bribery agreement. The Congress has recognized that success in reducing bribery of foreign officials by all business is contingent on strong international efforts. Although the United Nations has been working on it for more than 4 years, it has been unable to achieve an international antibribery agreement.

Without an effective international ban against bribery, unfair competitive advantage could be given to non-U.S. firms. Over 50 percent of our questionnaire respondents believed an international agreement would strengthen America's competitive position abroad. As previously mentioned, over 60 percent of these respondents believed that, assuming all other conditions were similar, American companies could not successfully compete against foreign competitors who are bribing foreign officials. Recent news articles indicate that some foreign competitors are bribing. In some cases this bribery is reportedly done in an excessive and flagrant manner.

We also believe that a strong international antibribery agreement is needed and, in the long term, may be the most

effective approach. Although progress in developing an international agreement has been slow, the United States should continue to take a leadership role in this effort. We recommended that the Congress urge the President to actively pursue an international agreement.

Senate bill 708 is in line with our proposal that the Congress closely monitor the United States efforts to reach an international antibribery agreement. Section 10 of the bill expresses the intent of Congress that the President pursue negotiation of treaties to establish international standards of business conduct and calls for a report to the Congress on the progress of this negotiation.

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This concludes my statement. I would like to request that our report be made a part of the record and would be pleased to answer any questions you or other Members may have.