Accounting for Corruption: Abuse of Rank and Privilege

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Abstract

Rank, privilege and responsibility should be inseparable. However, investigations of corporate scandals typically reveal rank, privilege and irresponsible behaviour go hand in hand. The publicity and recriminations surrounding corporate scandals tend to focus first on corporate executives implicated in poor management or other inappropriate behaviour and then on the relevant regulators. Where financial manipulation is revealed, the external auditor also comes under scrutiny. The deficiencies in corporate regulation including accounting and audit standards are subject to less public inspection but are often the subject of enquiry by government-appointed bodies. Recommendations for regulatory reform follow and the public is assured the risk of similar scandals is minimised or at least reduced. What receives less scrutiny is the political manoeuvring resulting in loop holes and weaknesses in the resulting legislative and regulatory initiatives leaving the door open for the next scandal. Reforms following the Watergate scandal in the 1970s are typical of this trend and demonstrate that rank, privilege and irresponsibility characterise the actions of not only regulators and auditors but also the politicians and business interests that shape regulatory measures.

INTRODUCTION

When corporations suddenly fail or it is revealed that management or employees have been engaged in reprehensible activities, the veracity of the financial statements of those companies is often called into question. In the event that anomalies are found, criticism of the external auditors and regulators follows even in cases such as Enron, WorldCom and HIH[1], and most recently, the global financial crisis, where, technically, accounting standards and other forms of regulation were not breached. A prime example of laying the blame at the feet of regulators is the SEC Office of Inspector General Report (Securities and Exchange Commission, 2009) into the failure of the SEC to uncover the Ponzi scheme run for several years by Bernie Madoff. According to the Inspector General, the investigation showed

> ... despite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff's trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme well before Madoff confessed.

While not wishing to be seen as exonerating either the regulators or members of the accounting profession for their involvement or complicity in these events, this paper raises the issue of where were the legislators who should ultimately bear responsibility for regulatory failures.

In Australia, for example, accounting standards have had the force of law since 1991. While this can be seen as a positive regulatory approach, it does mean that in addition to the lobbying activity that occurs during the standard setting process, Parliament has the final say on the promulgation of a standard. Therefore, there is another level of the process where lobbing may result in changes to a standard before it receives statutory backing. Accounting standards in the USA do not have legal backing but, historically, Congress has played a major role in what can and cannot be covered by accounting standards. A prime example of this is accounting for options.

In the early 1990s, the FASB sought to promulgate a standard dealing with the reporting of expenses associated with options included in management remuneration packages. In 1993, Senator Joseph Lieberman and others introduced a bill to prevent the FASB from issuing this standard on the grounds that it might be defensible from the perspective of "abstract accounting theory" but it was "disruptive and unnecessary" in the context of public policy, job creation and competitiveness (Anonymous, 1993, p.15-16). Within 2 years, the FASB proposal was dropped in response to threats that Congress would vest standard setting responsibility with a government authority (Telberg, 1995, p.1).

Following the Enron collapse, the role of stock option remuneration on the earnings management activities of management was raised (for example, Smith, 2002). Lieberman denied that the expensing or otherwise of options was a factor in the Enron collapse. Instead,

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[1] For example, Enron used mark-to-market accounting to value contracts covering the sale of energy in the future. This accounting method gave management flexibility in the reporting of revenue and valuation of assets. Enron also used the ownership criteria of the consolidation standard (FASB 125) to shift debt from its balance sheet to that of special purpose entities created for this purpose. WorldCom unravelled following discovery of inappropriate capitalisation of expenses but management had, in fact, been manipulating the financial reports for many years by exploiting provisions of the mergers and acquisition standard. HIH used the provisions of the insurance standard to increase reported revenue and assets through re-insurance contracts. The lending/borrowing practices of non-bank financial institutions leading to the global financial crisis were sanctioned, if not encouraged, by the US government and further facilitated by the use of fair value accounting.

Lieberman (2002) accused “government watchdogs”, the auditors, the board of directors and others of failing to protect the interests of Enron’s shareholders and employees (Senate Governmental Affairs Committee, 2002). Clearly, while members of government are entitled, if not required to castigate regulators and accountants and auditors for their role in regulatory failures and corporate scandals, politicians cannot deny their own contribution to what are often financial and economic disasters for their constituents.

The purpose of this paper is to demonstrate the impact of politically motivated interference on legislation and accounting and audit standards by reference to revelations in the 1970s of corruption at the highest levels of the US government and bribery and payment of illicit campaign contributions to domestic and foreign governments by prominent US companies. This particular example has been chosen because it provides evidence of the failure of successive governments to enforce the illicit payments including campaign contributions provisions of the Federal Corrupt Practices Act of 1925. Accordingly when evidence of long term payment of bribes and campaign contributions by US companies came to light in 1972, prosecution was barred because the legislation had been blatantly ignored for more than 40 years. For example, the major recipient of illicit campaign contributions uncovered in 1972 was found to be President Richard Nixon. In 1956, Nixon was found to have been in receipt of illegal campaign contributions but without consequence politically or otherwise to him or contributors. As a consequence, only payments made after April 7 1972 could be prosecuted under the newly enacted Federal Election Campaign Act of 1971.

Furthermore, investigation of illicit payments demonstrated that financial records and statements were manipulated by both contributors and recipients. This activity was dubbed *money laundering* by the press[2]. Consistent with the hype and public recriminations following such scandals, questions were asked why accountants, auditors and regulators did not recognise that the financial reports of major companies and campaign committees were manipulated, in some cases, from as early as the 1950s, to disguise illicit payments. Congressional enquiries directed the SEC and the accounting profession to lift their game in response to claims that auditors had been deceived by management of corporate contributors. However, as the paper will show, subsequent regulatory measures aimed at curbing bribery and other illicit payments by US corporations, criminalising money laundering and requiring auditors to identify the use of financial reports to disguise the use of corporate funds for illicit purposes were watered down as the memory faded of what came to be known as the Watergate scandal.

The paper will take the following format. The background to the discovery of the use of corporate funds for purposes of bribery and illegal campaign contributions will be outlined. Evidence of the use of financial statements and records to disguise such payments will then be presented. Responses to this evidence will then be discussed. The following sections will analyse the effectiveness of legislative and regulatory initiatives based on the recommendations of various hearings and enquiries in the context of theories of the political economy of regulation.

The overall conclusion is the root cause of regulatory failures often lies in the politically motivated watering down of regulatory measures either directly through the nature and scope of legislation or regulation or through a failure to provide adequate funding or authority to enable enforcement. The result is the appearance of reform where none actually exists. Hence focusing only on corporate reform and ethical conduct of management and auditors following corporate scandals and failures is too narrow. The wanton abandonment of the public interest for political gain demonstrates a breakdown of ethics on the part of both

[2] For example, *The Guardian*, 1972, p.11)

legislators and lobby groups. This view is epitomised in two Watergate-related observations. The first appeared in *Time* (1975) to the effect the payment of illicit campaign contributions and bribes demonstrated 'an interweaving of Big Government and big business that creates a climate conducive to corruption … at the expense of the public interest …'. The second appeared in the Letter of Transmittal of the Final Report of the Senate Select Committee on Presidential Campaign Activities (1974, p.1227):

> Watergate is not the story of one powerful man. It is a story of people. Though my efforts have been directed toward the principles and institutions of this Nation I am well aware that their existence or disappearance reflects human behaviour. It is no source of pride to me as an American that the coinage of responsibility has been in inverse measure to rank and power. I was taught early on ... that rank has its privileges because rank has its responsibilities. Yet in the case of this President I've heard the word "privilege" used over and over again as a dodge of responsibility.

THE DISCOVERY OF ILLICIT PAYMENTS

Revelations of the illicit use of corporate funds by major US corporations emerged during investigations of an attempted burglary of the Democratic Party headquarters housed in the Watergate Building in Washington, DC. The break-in was part of the activities of what was known as the "dirty tricks department" of President Richard Nixon's re-election committee[3] (see, for example, House of Representatives, Committee on the Judiciary, 1974a). The brief of the dirty tricks department was to develop a "political intelligence operation" including electronic surveillance of "political enemies" and opponents (House of Representatives, Committee on the Judiciary, 1974a, pp.7, 9). The purpose of the "dirty tricks" was to discredit political opponents especially leading candidates thereby weakening their campaigns and likelihood of electoral success (see, for example, Senate Select Committee on Presidential Campaign Activities[4], Book 10, 1973, pp.3987-3988). Much of the public debate following media reports of the break-in focused on whether or not Richard Nixon had been aware of it and if so, when. In 1974, the Committee on the Judiciary resolved that Nixon be impeached, face trial and be removed from office on the grounds of "high crimes and misdemeanours" contrary to his "trust as President" (House of Representatives, Committee on the Judiciary, 1974b, pp.1-3). As a consequence, Richard Nixon became the first US President to resign from that position.

The aftermath of the burglary and Nixon's untimely departure from the Presidential office gave rise to numerous and diverse examples of corruption, extortion and other wrong doing at the highest levels of US government and politics as well as white collar crime including financial statement manipulation on the part of executives of many large and prestigious corporations. These revelations emerged from an investigation of the source of US$2,300 sequentially numbered bills found in the possession of the Watergate burglars. A subsequent search of the burglar's hotel room uncovered a further US$4,200 in sequentially numbered US$100 bills. The serial number sequence of the money taken from the burglars matched those of the money found in the hotel rooms (Lewis, 1972).

On August 1, 1972, the *Washington Post* reported that a cashier's cheque for US$25,000 had been deposited in the bank account of one of the burglars. It was further reported that the suspect had withdrawn a large number of US$100 bills from the same account. The serial numbers of fifty-three of these US$100 bills were matched to the sequence of those found in

[3] The Committee to Re-Elect the President often referred to by the dysphemism, CREEP, in the post-Watergate era.
[4] Hereafter referred to as the Ervin Report.

the possession of the five men arrested in the Watergate Building on June 17, 1972 (Bernstein and Woodward, 1972). It was also reported that a further US$89,000 in four separate cheques drawn on a Mexico City bank had been deposited in the same bank account and subsequently withdrawn. A subsequent audit of the finances of the Nixon election campaign established a link between the Watergate break-in and Nixon's re-election campaign team.

The audit uncovered the existence of a cash fund held by Nixon's chief fund-raiser. This fund was determined to have been the source of the US$25,000 cashier's cheque as well as the series of cheques totalling US$89,000 deposited in the bank account of the Watergate burglar **(**Senate Select Committee on Presidential Campaign Activities, Final Report, 1974, pp.514-515). According to the Final Report of the Senate Select Committee on Presidential Campaign Activities (1974, p.518), the source of the "Mexican cheques" was the president of a major U.S. company.

Further revelations relating to the illegal source of much of the Nixon re-election funds came from the Watergate Special Prosecution Force with an announcement on July 6 1973 that a US$55,000 illegal contribution had been made by American Airlines (McCloy et al. 1976, p.7). At the same time, the Watergate Special Prosecutor called for voluntary disclosure by other corporate officials of illegal political contributions paid from corporate funds. Voluntary cooperation with the Prosecution Force would be taken into consideration in the event of subsequent charges being laid (McCloy et al. 1976, p.7). It was subsequently reported in *Time* (1975) that in 1975 more than US$250 million in political contributions and bribes had been paid out by 25 companies. This money had been paid to politicians and government officials in both the USA and in other countries. The *Time* article also reported that the Securities and Exchange Commission (SEC) had sought civil injunctions against nine companies for making illegal campaign contributions from shareholders' funds and that another fifteen companies had cooperated by instituting investigations of their operations. In addition, it was reported that the SEC was investigating thirty large corporations suspected of making illegal campaign contributions.

The report of the US House of Representatives Committee on Banking and Currency (1972) estimated the funds raised by Nixon election committees alone prior to April 7, 1972[5] were between $15 and $20 million. This estimate was based on examination of cash balances of almost $11 million held by just 6 committees. At the time, there were 50 state committees. Furthermore, the investigation into illicit campaign contributions revealed up to 300 committees were created for the purposes of avoiding gift tax. These estimates do not include a separate cash fund of up to $1 million or contributions received after April 7, 1972. One such donation of $305,000 was alleged to have been received from a single contributor (House of Representatives Committee on Banking and Currency, 1972). Testimony to the Ervin Committee revealed that in early 1972, $1.7 million was held in cash in safes in the office of the Director of Finance of the Committee to Re-Elect the President (Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5719). It was also revealed that the budget for the 1972 campaign was about $40 million (Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5740). Accordingly, even an estimate of $20 million contributed to the Nixon campaign is not only conservative but probably represents only the tip of the iceberg. In addition, other candidates from both parties were beneficiaries of illicit campaign contributions.

[5] The date on which more extensive controls on the receipt and reporting of campaign contributions came into effect.

This view is substantiated by enquiries by SEC staff revealing falsification of financial records in order to disguise or conceal the source of funds used for illicit purposes including the creation of “slush funds” that were subsequently “disbursed outside the normal financial accountability system” (Securities and Exchange Commission, 1976a, p.2). The outcome of these enquiries was reported to the Senate Banking, Housing and Urban Affairs Committee dealing with questionable and illegal corporate payments and practices in 1976. The report revealed that some 400 corporations had admitted making illegal payments in excess of $300 million. Of these 400 corporations, more than 117 were Fortune 500 companies (House of Representatives, Report of the Committee on Interstate and Foreign Commerce, 1977).

Many people maintained that corporations often found it necessary to pay politicians to safeguard on-going operations (for example, see Vanasco, 1999, p.163). However, under the Federal Corrupt Practices Act of 1925, corporate contributions to political campaigns and unreported contributions from individuals in excess of $100 were prohibited. Furthermore, the SEC report to the Committee on Interstate and Foreign Commerce (House of Representatives, 1977) observed that falsification of accounting records was contrary to the principles of corporate accountability inherent in corporate disclosure requirements:

> The most devastating disclosure that we have uncovered in our recent experience with illegal or questionable payments has been the fact that, and the extent to which, some companies have falsified entries in their own books and records. A fundamental tenet of the recordkeeping system of American companies is the notion of corporate accountability. It seems clear that investors are entitled to rely on the implicit representations that corporations will account for their funds properly and will not “launder” or otherwise channel funds out of or omit to include such funds in the accounting system so that there are no checks possible on how much of the corporation’s funds are being expended in the manner management later claims (Securities and Exchange Commission, 1976a, p.13).

The following section will describe the major methods used by management to falsify books and records in order to conceal the use of corporate funds for illicit campaign contributions.

ACCOUNTING AS PART OF THE MONEY LAUNDERING PROCESS

At the time of Watergate, there was no statutory or other authoritative definition of money laundering. It was not until the 1980s that such definitions emerged in the form of legislation and committee reports dealing with the proceeds of crime. However, the term ‘money laundering’ or ‘laundering’ in the Watergate context was used to describe the processes used to obscure the source of funds used to pay bribes to domestic and foreign officials as well as illicit campaign contributions. Bernstein (Bernstein and Woodward, 1974, p.54), for example, reported that one Watergate investigator had said:

> It’s called “laundering” … you set up a money chain that makes it impossible to trace the source. … Stans[6] didn’t want any way they could trace where the money was coming from.

[6] Maurice Stans had been Nixon’s Secretary of Commerce and a one-time head of the American Institute of Certified Public Accountants. In 1952 and in 1954, Stans was the recipient of annual awards of the American Accounting Association and the Institute of Certified Public Accountants respectively. He was elected to the Accounting Hall of Fame in 1960 (Senate Select Committee on Presidential Campaign Activities, Book 2, 1973, p.694) At the time of the Watergate break-in, was chairman of the Committee to Re-elect the President but claimed he had no accounting responsibilities in this role (Senate Select Committee on Presidential Campaign Activities, Book 2, 1973, p.727) .

A similar description of laundering as concealing the source of contributions to Nixon's election campaign can be found in the Ervin Committee Final Report (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974) at p.569:

> laundering of funds is often accomplished by contributing and transferring funds from committee to committee so as to obscure the original source and make it impossible to trace the money to the intended beneficiary or use.

In addition to the laundering of funds through committees, the Ervin Committee Final Report (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974, p.574) noted that "during 1972 hundreds of thousands of dollars including illegal contributions from corporate funds were laundered through foreign banks and foreign companies".

The Subcommittee on Corporate Abuse (United States. Congress, 1976, p.7) summarised practices used to disguise the misuse of corporate funds as follows:

> (1) Bonuses to selected corporate employees which were rebated for use in making illegal domestic political contributions by such corporations;
>
> (2) Use of an offshore corporate subsidiary as "cover" for a revolving cash fund for distributing diverted corporate funds for both domestic and foreign political activities, all of which were illegal in the place where paid;
>
> (3) Anonymous foreign bearer stock corporations, used as depositories for secret illegal "kickbacks" on purchase `or sales contracts;
>
> (4) Payments to foreign consultants which were diverted to management and used for illegal domestic political contributions and commercial bribery;
>
> (5) Direct, corporate payments to foreign government officials in return for favourable business concessions; and
>
> (6) Payments, aggregating tens of millions of dollars, to consultants or com- mission agents, made with accounting procedures, controls and records which, if existent at all, were insufficient to document whether any services were even rendered by such consultants or agents, or whether such services were commensurate with the amounts paid.

It was also noted by the Subcommittee (United States. Congress, 1976, p.17), management of many corporations had filed reports with the Securities and Exchange Commission from which information had been omitted or materially misstated. Accordingly, these reports violated the provisions of the 1934 Securities and Exchange Act. The following sections will provide examples of how accounting was used as part of the money laundering process to conceal the payment of bribes and illicit campaign contributions.

Foreign Subsidiaries

According to the Ervin Committee Final Report (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974, p.447), foreign subsidiaries represented the most common source of corporate contributions to political activities revealed by the Watergate investigations. When questioned why a foreign subsidiary was used as the source of campaign contributions, one corporate executive explained, given the illicit nature of the contributions, the parent company did not want to attract the attention of the public, law enforcement or taxation authorities (Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5469). Using foreign subsidiaries also facilitated the use of foreign banks. As one executive explained, U.S. banks were less accustomed to dealing in large cash withdrawals and a $100,000 cash withdrawal would attract the attention of "everybody and his brother". On the other hand, Swiss banks were more sophisticated and large withdrawals were commonplace (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974, p.459). Accounting for corporate funds in the books of subsidiaries was accomplished in a variety of ways including charges for services that were not performed or that were invoiced at an inflated rate. In other instances, contributions were disguised as loans or bonus payments to corporate officers. The result was that expenses and assets were misrepresented in the financial reports.

Expenses

A common ploy was to account for corporate contributions as expenses in the books of subsidiaries. In most cases the expenses were totally fictitious although the sums accounted for included a component of compensation for legal representative or others who assisted in the laundering process by issuing invoices for non-existent services. One company, for example, admitted to sourcing a proposed contribution of $100,000 to Nixon's re-election campaign through the purchase of a bank draft payable to a Swiss bank account of another company (American Airlines Memorandum, 1973, pp.8-10). The principal of the recipient company was also the head of a foreign branch of the contributor and also its legal representative in the Middle East. The $100,000 transfer was charged as a special commission to the principal on the sale of used aircraft. It was carried in the books of the contributor company in a reserve fund for losses on the sale of aircraft (American Airlines Memorandum, 1973, p.14).

Subsequently, the principal transferred the funds to a New York bank account in his name. The funds were then withdrawn in cash with $55,000 being delivered to Nixon's re-election campaign committee in $100 bills (American Airlines Memorandum, 1973, pp.12, 14). The remaining $45,000 remained in a company safe until commencement of the investigation into corporate campaign contributions at which time it was returned to the company's operating capital (Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5502).

The company also admitted to using a rebate agreement with an insurance brokerage from at least the mid-1960s to conceal the use of corporate funds for political purposes. Under the scheme, the insurance brokerage firm was paid a fixed fee in an amount that exceeded the commission that would normally have been charged (American Airlines Memorandum, 1973, p.18). The difference between the fixed fee and the commission was accounted for in one of three ways:

1. A credit memorandum that was offset against a subsequent insurance invoice;
2. As a payment for unrelated actuarial fees; or
3. As a cheque receipt from the broker

Further evidence to the Watergate Special Prosecutor (Memorandum, October 9, 1973, p.2) the rebate scheme yielded cash in amounts of $25,000 in 1966, $25,000 in 1971 and $10,000 in 1972. A subsequent investigation by the Civil Aeronautics Board's (CAB) enforcement bureau found that the company had created and maintained a slush fund of at least $275,000 between 1964 and 1973. According to CAB, the diversion of cash was accounted for as entertainment expenses in the books of the company (*Time*, 1975).

The Watergate investigations revealed another company had contributed some $125,000 to political campaigns in the early 1970s. $100,000 of this sum was provided in cash to Nixon's Committee to Re-Elect the President (Final Report of the Senate Select Committee on

Presidential Campaign Activities, June 27, 1974, p.469; Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5461). The $100,000 contribution to Nixon's campaign was sourced in two separate bundles of $50,000 each from a subsidiary located in the Bahamas. The other contributions, of $10,000 and $15,000 each came from the same source. This $125,000 apparently was just the tip of the iceberg. Subsequent legal action[7] arising from Watergate revelations revealed that more than $10,000,000 was diverted from the company to domestic and foreign political groups.

As with the $100,000 contribution to the Nixon re-election campaign, the $10,000,000 was channelled from corporate funds through off-shore subsidiaries and a series of foreign banks. This process began as early as 1959 and ceased in 1973 (McCloy, Pearson and Matthews, 1976, pp.202-203). Cash transfers to foreign subsidiaries were recorded as deferred charges and written-off against expense accounts prior to year end (McCloy, Pearson and Matthews, 1976, p.42, p.46). To further obscure the use of corporate funds for questionable purposes, deferred charges were no longer recorded in the books of the parent but in those of a subsidiary. These charges were then reversed and recorded in the books of another subsidiary as miscellaneous expenses (McCloy, Pearson and Matthews, 1976, p.58).

Accounts Receivable

In another company, executives arranged for a contribution to Nixon's re-election campaign of $40,000 from corporate funds in March or April, 1972 (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974 p.462). Once again, funds for the contribution were sourced off-shore through a company owned and controlled by the manager and regional vice-president of a foreign branch of the contributing company. The contributing company made a cheque payment of $40,000 to the off-shore company in the guise of an advance payment for expenses and services. The payment was recorded in the books of the off-shore company as an account receivable. The cheque was endorsed and cashed by the owner of the foreign company with the proceeds being physically returned to the US and delivered in cash to Nixon's re-election committee (Final Report of the Senate Select Committee on Presidential Campaign Activities, June 27, 1974, p.462; Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, p.5481).

The accounts receivable in the books of the off-shore company was progressively "paid" through the cash sale by the foreign branch of a series of 'special tickets' provided by head office. These tickets were not registered on the books of the contributing company and so were issued only to passengers who paid cash. Accordingly, these sales were not recorded as revenue. Instead, the cash was accumulated by the manager of the foreign branch and periodically delivered to head office where it was used to 'reduce' the account receivable in the books of the off-shore company.

Further investigation by the CAB revealed some 3,626 unregistered tickets were sold by the office of the foreign branch of the contributing company. The proceeds of these cash sales

[7] William Shelensky et al., Plaintiffs, v. B. R. Dorsey, Charles M. Beeghley, Z. D. Bonner, E. D. Brockett, R. Hal Dean, James H. Higgins, James E. Lee, Beverley Matthews, Nathan W. Pearson, Edwin Singer, Edward B. Walker, III, James H. Walton, Fred Deering, Claude C. Wild, Jr., Royce H. Savage, William C. Viglia, William L. Henry, Herbert C. Manning, Zane Q. Johnson, Price Waterhouse & Company and Gulf Oil Corporation, Defendants, No. 77-1156, Appeal of William Shlensky et al., Plaintiffs No. 77-1157, Appeal of Project on Corporate Responsibility, Inc., Objecting Shareholder, No. 77-1158, Appeal of Pat S. HOLLOWAY, Objecting Shareholder Nos. 77-1156, 77-1157, 77-1158, United States Court of Appeals for the Third Circuit. 574 F.2d 131; 1978 U.S. App. LEXIS 12289; Fed. Sec. L. Rep. (CCH) P96,376; 25 Fed. R. Serv. 2d (Callaghan) 380

were estimated to be almost $1 million. These funds had been made available to company executives. Much of it was never accounted for (*Time*, March 24, 1975).

Bonus Payments

Another common method of disguising the use of corporate funds for illegal political contributions was to record the payments as bonuses to corporate executives and employees. Another company made a $100,000 contribution to Nixon's re-election committee. At least $25,000 of this contribution was disguised as bonus payments to up to eight employees. Arguably, the remaining $75,000 was also sourced from a bonus payment to the chairman and chief executive officer of the company (Final Report of the Senate Select Committee on Presidential Campaign Activities, 1974, p.451-459; Senate Select Committee on Presidential Campaign Activities, 1973, Book 13, pp.5404-5439).

Accounting for the bonus payments was achieved via an administration account and carried as an account receivable. In general, payment was not pursued but was included as a deduction for taxation purposes netting some $26,200 for the company. These funds were used either to make bonus payments or put in a trust account for future contributions.

As noted, the foregoing represents only a sample of the methods used to conceal the source and disbursement of political contributions. The following section will address government sponsored or prescribed enquiries and hearings aimed at determining appropriate official responses to the findings of the Watergate Special Prosecution Force. The primary focus will be accounting-based recommendations or suggestions for reform.

ENQUIRIES, HEARINGS, RECOMMENDATIONS AND RESPONSES

The burglary of the Watergate Building had far reaching consequences well beyond the question of political espionage and the proposed impeachment of a President of the United States. The seriousness of the Watergate break-in is evident in the appointment of the Watergate Special Prosecution Force[8] and the various government sponsored enquiries that followed. Many of the findings and recommendations emanating from these enquiries gave rise to further enquiries or establishment of committees to consider how best to implement these recommendations or address the findings. For example, Posadas (2000) traces the path to international efforts to curb corruption including an explication of the links between the Watergate enquiries and the Foreign Corrupt Practices Act of 1977. According to Posadas (2000, p.348)

> The Watergate investigations generated a high level of public awareness regarding the questionable conduct of some of the nation's political and business elite. Watergate led to other investigations into the role of major U.S. corporations in financing domestic political campaigns. These investigations, in turn, led to further enquiries into corporate involvement in foreign political campaigns, with questionable payments and contributions being made to foreign government officials.

The call by the Watergate Special Prosecutor for companies that had made illicit payments to domestic and foreign governments to come forward gave rise to further investigation of these companies by the Securities and Exchange Commission. In 1975, the SEC initiated a program calling for voluntary disclosure of questionable foreign payments by corporations coming under the Securities and Exchange legislation (Posadas, 2000, p.350). Based on

[8] As noted in the Final Report of the Senate Select Committee on Presidential Campaign Activities (1974, p.XXV) the Watergate Special Prosecution Force "was born in the crisis of a serious loss of confidence by the public in its national Government".

investigations by the Watergate Special Prosecution Force and the SEC, the U.S. congress held a number of closed hearings. On May 16, 1975, the Senate Committee on Foreign Relations held its first public hearing to determine "the magnitude of the problem" of questionable foreign payments and the appropriateness of a congressional response (Posadas, 2000, p.350). Posadas (2000, p.350) argues "the enquiries that followed produced the most extensive documentation of business-government corruption ever produced in history"[9] and culminated in enactment of the Foreign[10] Corrupt Practices Act in 1977 (FCPA). The accounting profession interacted with the SEC in determining its response. The result was a series of audit practice statements focusing on the auditor's response to suspicions of illegal acts on the part of clients and eventually, the auditor's duty to be aware of the possibility that the financial reports have been misstated due to fraud.

Senate Select Committee on Presidential Campaign Activities (the Ervin Committee)

The most extensive post-Watergate enquiry and report was that of the Senate Select Committee on Presidential Campaign Activities "established on February 7 1973 to make a "complete investigation and study of the extent ... to which illegal improper or unethical activities occurred in the 1972 Presidential campaign and election and to determine whether new legislation is needed to safeguard the electoral process by which the President of the United States is chosen" (Final Report of the Senate Select Committee on Presidential Campaign Activities, Letter of Transmittal, June 27, 1974). The Committee's final report numbered 1250 pages. The report was drawn from some 25 books comprising hearing transcripts and documents presented to the Committee. The deliberations of the Committee were divided into phases: Phase I Watergate Investigation (books 1-9); Phase II Campaign Activities (books 10-12; Phase III Campaign Financing (book 13); investigations of specified individuals and entities (books 14-24); and Supplemental Material on Campaign Practices and Finances (book 25 dealing with the campaigns of political candidates other than Nixon).

The Ervin Committee did not make any recommendations pertaining to accounting and audit standards and practices[11]. However, the Committee did hear evidence of the use of various accounting methods including foreign subsidiaries, expenses, accounts receivable and bonus payments to disguise the use of corporate funds to pay illicit campaign contributions. While accounting matters were not the focus of Committee hearings, Senator Ervin noted in regard to the records of Nixon's re-election committee (Senate Select Committee on Presidential Campaign Activities, Book 13, p.5449):

> We have an astounding fact here revealed by the testimony that over a $1 million in cash was disbursed by the ... Finance Committee To Re-Elect the President which was headed by an accountant and that no records were kept by the committee to show what became of the over $1 million.

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[9] Posadas lists 8 of the "most relevant hearings" leading to enactment of the Foreign Corrupt Practices Act (p.350 footnote 10).

[10] In spite of the similarity in titles, the *Federal* Corrupt Practices Act of 1925 and the *Foreign* Corrupt Practices Act of 1977 were quite different. The 1925 act dealt, inter alia, with the proscription of the payment of domestic campaign contributions by U.S. banks and corporations. The 1977 act principally addressed the issue of bribes paid by U.S. corporations to foreign government officials.

[11] Such recommendations would have been outside the Committee's brief to determine the need for changes in electoral laws.

With respect to a $40,000 corporate contribution, an exchange between Senator Ervin and a witness[12] demonstrated the use of a fictitious transfer between the parent company and a subsidiary to disguise the payment:

> Senator Ervin: This entry to the effect that this $40,000 had been transferred to (the subsidiary) was fictitious was it not to conceal what actually happened to it?
>
> Witness: Sir as I stated earlier I really do not feel that I can comment with respect to whether it was fictitious or not at the time. I have stated however that I found no expenses that may have occurred with respect to (the subsidiary).
>
> Senator Ervin: Can you tell exactly how this money got from Panama to the United States?
>
> Witness: Sir I have no knowledge about the money ....
>
> Senator Ervin: Do these papers disclose to you as an accountant as to how this $40,000 contribution managed to get from Panama to the United States?
>
> Witness: No sir they do not. What they do disclose is the money was deposited in the operating account in the First National in Dallas and therefore had to be physically carried to Dallas (Senate Select Committee on Presidential Campaign Activities, Book 13, p.5492-5493).

Recommendations regarding corporate disclosure and accounting and audit standards were incorporated in the hearings and reports of other Watergate-related enquiries. Two of those will be discussed in the following section.

Subcommittee on Priorities and Economy in Government of the Joint Economic Committee

The focus of the Subcommittee was "official corporate crimes and improper behaviour: bribes, kickbacks, illegal campaign contributions, and other improper uses of corporate funds" as opposed to *white collar* crimes such as embezzlement (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.5). The crimes and improper behaviour considered by the Subcommittee had been identified as part of the Watergate investigations, SEC investigations and the SEC's voluntary disclosure programme. In his opening statement, the Committee chair, Senator Proxmire, referred to the wrongful use of corporate funds. In general, these activities represented corporate policy approved by and with active participation of top corporate management leading Chairman Proxmire (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.5) to conclude:

> The numerous disclosures that have been made so far - involving some of the largest and most prestigious firms in America - suggest that at least an important part of the private sector is a house of marked cards, composed of kings of corruption, jacks of all illicit trades, and aces of political influence. We need look no further to understand the loss of consumer confidence than the companies that have been involved in these kinds of excesses. Private enterprise seems unable to monitor itself. Instead, it is undermining itself.

During the course of the hearings, representatives from the Securities and Exchange Commission provided a statement as well as responding to questions about the voluntary disclosure of illicit payments programme and actions instituted in response thereto.

[12] The Assistant Treasurer of one of the corporate contributors to Nixon's re-election campaign.

According to the Chair of the SEC (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.16)

> ... our enforcement actions to date, generally speaking, have been based upon alleged transactions involving the payments of large amounts of money which were caused to be inaccurately stated on the company's books and records by top corporate officials. They were concealed from the company's board of directors in most cases, as far as we can tell, and often from its auditors. ...
>
> The system of government regulation of business disclosure by the Securities and Exchange Commission will not work unless the books and records are kept in good faith.

In the actions commenced in relation to these matters, the SEC **a**lleged " ... the defendants violated the reporting provisions of the Securities Exchange Act of 1934 by filing periodic reports with the Commission which omitted or misstated material information" (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.17).

These revelations caused members of the Subcommittee to cast doubt on the efficacy of the reporting provisions of SEC legislation, its enforcement and penalties imposed for breaches of its provisions. Specifically, the disclosure and reporting procedures had failed because they were either "totally inadequate" or "woefully or inadequately carried out". Furthermore, while not directly criticising the accounting profession, it was noted that not one instance of financial statement manipulation to conceal or disguise the use of corporate funds for illicit purposes was reported "by the private firms, by the private accountants or auditing firms". Instead, they were discovered by either the Special Watergate Prosecution Force or through the SEC's voluntary disclosure programme (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.26). In addition, in most cases, the SEC had not conducted its own investigations. This revelation leads to questions of the actual extent of corporate bribery and other illicit payments.

Due to its limited resources, the SEC had largely relied on "the accounting world, independent public accountants, and the professional obligations of lawyers who represent these companies ... to make certain that ... corporations come forward". The SEC further revealed that information and disclosure reports given voluntarily were less detailed than those resulting from court orders. As noted by the Subcommittee Chairman, it was not realistic to "expect these corporations to police themselves effectively under any circumstances" (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.23). Friends and colleagues, such as those working in the corporations under discussion, tend to protect each other. Directors are often friends of the corporate officers who appoint them. Accordingly, how can voluntary disclosure based on investigations carried out by corporate appointees including the external auditors who had previously been "deceived" by management be relied upon to be complete? The reliability of voluntary disclosure reports was also questioned given, with few exceptions, none of those found by in-house investigations to be involved in concealing the illicit use of corporate funds had faced any sort of disciplinary action. There had been few if any resignations or dismissals (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.24). The issue of penalties imposed by the SEC was also raised.

The SEC representatives were asked if the falsification of corporate books and records were criminal violations of SEC laws and regulations. While the SEC conceded that some cases may have been criminal in nature, civil injunctions[13] were pursued because the interpretation of criminal laws was not the province of the SEC but of the Department of Justice. Accordingly, as noted by the Chairman of the Subcommittee, injunctive actions by the SEC were nothing more than "slaps on the wrist. ... They can do it and if they get caught they say they will be good boys, but there is no punishment" (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.37).

Although the Subcommittee did not make any formal recommendations at the time of the hearings, the Chairman suggested making falsification of corporate books and the payment of bribes to foreign officials criminal offences punishable by imprisonment. Furthermore, disclosure of the names of those receiving bribes and imposing responsibility on professionals including auditors and accountants would assist in reducing the payment of bribes to foreign officials by U.S. corporations (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, pp.37-38, p.180). In response to questions regarding the extent of corporate abuse and measures required to curb corrupt payments in the future, the SEC subsequently prepared a report and submitted it to the Subcommittee in May 1976.

Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices

The SEC's report of its analysis of illegal or questionable payments was similar to the information provided to the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee. Specifically, the cases considered by the SEC demonstrated the circumvention of the corporate accountability provisions of the country's securities laws. According to the SEC, the result was the inaccurate recording of millions of dollars of corporate funds diverted to "slush funds" used for the making of illegal or questionable payments outside the normal system of financial accountability and contrary to the disclosure requirement of federal securities laws. In effect, the resulting financial reports filed with the SEC and subsequently distributed to shareholders misrepresented the use of corporate funds. Furthermore, corporate employees, including, in some cases, top management, knew records were being falsified. In many instances, the falsification of records was concealed from external auditors, legal counsel and directors (Securities and Exchange Commission, 1976, p.2).

The overall conclusion of the SEC report (Securities and Exchange Commission, 1976, p.12) stated

> The problem of questionable and illegal corporate payments is, by any measure, serious and sufficiently widespread to be a cause for deep concern. Unfortunately, the Commission is unable to conclude that instances of illegal payments are either isolated or aberrations limited to a few unscrupulous individuals.
>
> Moreover, we suspect that some companies have engaged in similar activities that will remain undisclosed and undetected, and that others will attempt to obscure such activities in the future.

However, the Commission did not see the problem of illegal or questionable payments as insurmountable. The Commission's suggested approach to curbing the problem included assistance and cooperation from the private sector and the accounting and legal profession as well as legislative measures.

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[13] Basically, the corporation neither admitted nor denied the allegations but undertook not to engage in the activity in question in the future.

a. The role of the Private Sector

As reported to the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, the SEC report confirmed it had sought assistance from the private sector in order to identify and address issues related to the manipulation of financial information in order to conceal the illegal or questionable use of corporate funds (Securities and Exchange Commission, 1976, p.3). The report outlined the voluntary disclosure programme including the establishment of special review committees to investigate illegal or questionable payments and report the findings to the board of directors. The board of directors were then responsible for the review and implementation of the recommendations of the special committee including the provision of a report to the SEC. These committees were required to be composed of independent directors who often relied on the assistance of independent accountants and legal counsel in the conduct of the investigation. (Securities and Exchange Commission, 1976, p.3). It was envisaged that due to the limited resources available to the SEC, the private sector would need to continue to support the SEC. This support would see the private sector assume the initiative and responsibility for dealing with problem areas identified by the Commission (Securities and Exchange Commission, 1976, p.10). The SEC also called upon the accounting profession to play a part in curbing the incidence of illegal or questionable use of corporate funds.

b. The role of the Accounting Profession

The role of the accounting profession as espoused in the SEC report extended to individual audit firms as well as the professional accounting and audit standard setting bodies. The Commission noted the “increased sensitivity” of the “accounting community” to the problem of illegal or questionable payments. Many individual accounting firms had used examples of financial statement manipulation to formulate guidance for staff. In addition, an exposure draft of a proposed Statement on Auditing Standards “Illegal Acts by Clients” had been issued by the American Institute of Public Accountants. The proposed standard indicated that accountants conducting an audit should be aware that a client’s financial statements may have been materially affected by illegal acts. Procedures that could be used to identify such acts, including an evaluation of internal controls and tests of transactions, were also discussed. In the event the auditor suspected illegal acts may have occurred, the standard required further investigation in consultation, where necessary, with legal counsel (Securities and Exchange Commission, 1976, p.12).

While seemingly accepting that auditors had been deceived in the cases uncovered by the Watergate Special Prosecution Force and under the voluntary disclosure programme, the Commission reminded members of the accounting profession of their responsibilities under securities’ laws to certify the fair presentation of financial statements in accordance with generally accepted accounting principles. This included a need for the profession to continue to be sensitive to the evolving nature of the problems of illegal or questionable payments. Consequently

> Accountants are not free to close their eyes to facts that come to their attention, and in order properly to satisfy their obligations, they must be reasonably sure that corporate books and records are free from defects that might compromise the validity of these statements (Securities and Exchange Commission, 1976, p.11).

c. Proposed Legislative Measures

According to the SEC, “the extent of [questionable and illegal] payments [was] far more widespread than anyone originally anticipated and the methods of effecting and concealing these payments [were] varied and multifaceted" (Securities and Exchange Commission, 1976, p.12-13). The SEC stated its intention to continue to enforce existing disclosure requirements as it had to that time. The question of the criminality of illegal payments was considered to be beyond the realm of SEC activities and should be considered separately from securities law. However, "limited purpose legislation" governing disclosure was "desirable in order to demonstrate clear congressional policy with respect to a thorny and controversial problem" (Securities and Exchange Commission, 1976, p.13).

In light of the SEC's findings, its legislative proposals centred on prohibitions on

1. the falsification of books, records, accounts, or other documents;
2. misleading an accountant during the course of an examination or audit; and
3. a failure to implement adequate systems of internal control.

While recognising that its legislative approach would not guarantee success, the SEC believed its proposal would "help foster a climate in which" deliberate evasion of corporate accountability systems would "be frustrated by adequate internal controls". The Commission also stated its intention to investigate questionable or illegal payment and related practices as it had in the past. In addition, the Commission would continue to seek "prophylactic relief" in the form of enforcement actions prohibiting the making of such payments (Securities and Exchange Commission, 1976, p.13, p.14).

d. Legislative Response

The first legislative attempt to address financial statement manipulation in order to conceal the payment of bribes and illegal campaign contributions was the U.S. Foreign Corrupt Practices Act of 1977 (FCPA). Consistent with recommendations of the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee and the SEC report on illegal and questionable payments, the act included reporting requirements in the form of an amendment to the Securities and Exchange Act of 1934. The amendment went through several iterations[14] before the final version was enacted in December 1977. As will be discussed in a subsequent section, the legislation as eventually enacted did not go beyond the SEC's reporting requirements and audit standards that corporations must keep books and records and maintain an adequate system of internal controls. A proposed provision to prohibit the falsification of books and records and making false statements to accountants was dropped (House of Representatives, September 28, 1977). In addition, the act divided enforcement activities between the SEC and the Department of Justice. The SEC was to deal

[14] See, for example, "Foreign Corrupt Practices and Domestic and Foreign Investment Improved Disclosure Acts of 1977", *Report of the Committee on Banking, Housing, and Urban Affairs United States Senate to accompany S.305 together with Additional Views*, introduced on legislative day, March 28, 1977 and ordered to be printed, May 2, 1977, Senate, 95th Congress, 1st Session, Report No.95-114; "Unlawful Corporate Payments Act of 1977", Report of The Committee on Interstate and Foreign Commerce together with Minority Views. [To accompany H.R. 3815] [Including cost estimate of the Congressional Budget Office], submitted by Mr Staggers from the committee conference, ordered to be printed September 28, 1977, House of Representatives, 95th Congress, 1st Session, Report No.95-640; and "Foreign Corrupt Practices", *Conference Report [to accompany S.305]*, submitted by Mr. Staggers, from the committee of conference, ordered to be printed December 6, 1977. House of Representatives, 95th Congress, 1st Session, Report No. 94-831

with civil matters while the Department of Justice was given responsibility for criminal matters. The wisdom of this separation of duties will be addressed later in the paper.

Even though the term "money laundering" was used consistently throughout the Watergate Special Prosecution Force investigations and subsequent enquiries to describe the process of falsifying corporate books and accounts to disguise illicit payments, the Foreign Corrupt Practices Act, 1977 made no mention of it. It was 1986 before specific legislation, the *Money Laundering Control Act of 1986*, criminalized money laundering. The act contained no accounting-based provisions. Instead, the legislation dealt primarily with the use of the financial system to conceal the proceeds of organized crime such as drug trafficking. The response of the accounting profession was equally lack-lustre.

e. The Response of the Accounting Profession

As already noted, the SEC report and the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee identified the apparent inability of accountants and auditors to recognise the falsification of accounting books and records to disguise the use of corporate funds for illicit purposes. In response, the Auditing Standards Executive Committee issued in January 1977 *Statement of Auditing Standards (SAS) 17 Illegal Acts by Clients*. SAS 17 provided guidelines for the appropriate actions to be taken by an auditor on becoming aware of an illegal act having a material effect on the financial statements (paragraph 2). Illegal acts for purposes of the standard included illegal political contributions and bribes (paragraph 1).

In 1985, the AICPA, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors and the National Association of Accountants sponsored the National Commission on Fraudulent Financial Reporting[15]. The Treadway Commission report issued in October 1987 defined fraudulent financial reporting as "intentional or reckless conduct, whether act or omission that results in materially misleading financial statements" (National Commission on Fraudulent Financial Reporting, 1987, p.2). Recommendations set out in the report included changes to auditing standards imposing a responsibility on public accountants to detect fraudulent financial reporting and steps to be taken to facilitate achievement of this responsibility (National Commission on Fraudulent Financial Reporting, 1987, pp.13, 25 and 49). The first step in this direction was Statement of Auditing Standards 53 "The Auditor's Responsibility to Detect and Report Errors and Irregularities" issued by the AICPA in 1988. SAS 17 was reissued in the same year and renamed Statement of Auditing Standards (SAS) 54 Illegal Acts by Clients. SAS 54 did not refer to illegal political contributions or bribes. Illegal acts were redefined as violations of laws or governmental regulations on the part of the audit entity or management or employees acting on behalf of the entity (paragraph 2). The standard continued to focus on illegal acts having a direct impact on financial statements but went further by specifying that an audit could not guarantee the identification of illegal acts having an indirect impact on the financial statements (paragraphs 5, 6 and 7).

SAS 53 "The Auditor's Responsibility to Detect and Report Errors and Irregularities" (paragraph 3) defined irregularities as "*intentional* misstatements or omissions of amounts or disclosures in financial statements" including "fraudulent financial reporting … sometimes called *management fraud*, and misappropriation of assets …". Activities resulting in misleading financial statements included "manipulation, falsification, or alteration of

[15] Hereafter referred to as the Treadway Commission

accounting records or supporting documents from which financial statements" were prepared. In 1997, Statement of Auditing Standards (SAS) 82 "Consideration of Fraud in a Financial Statement Audit" superseded SAS 53. SAS 82 contained similar provisions to SAS 53 but went into more detail about how an auditor might go about identifying the risk of material financial misstatement due to fraud or misappropriation of assets.

As with the Foreign Corrupt Practices Act, none of the audit standards made reference to an auditors' responsibility with regard to money laundering. To date, this remains the case. Furthermore, the Financial Accounting Standards Board site makes no mention of either Watergate or money laundering.

RANK, PRIVILEGE AND [IR]RESPONSIBILITY

As noted by *Time* (1975) and in the Letter of Transmittal of the Final Report of the Senate Select Committee on Presidential Campaign Activities (1974) respectively, Watergate revelations were characterised by "interweaving of Big Government and big business" and a use of privileged positions to avoid responsibility to the detriment of the public interest. In spite of the "hue and cry" emanating from investigators and commentators, much the same can be said of regulatory responses to Watergate. This outcome is consistent with theories of the political nature of regulation including accounting standards of authors such as Mitnick (1980), Zeff (1978, 1982) and Mitchell, Sikka and Willmott (2001).

Mitnick, for example, sees regulation as a special case of the general policy-making process (1980, p79). Policy setting is a political process even though it is often touted as being determined by the public interest. However, as Mitnick (1980, p.91, p.242) argues the concept of the public interest is diverse, vague, indeterminate and often conflicting so that it is often reduced to "whatever the government does" (Mitnick, 1980, p.242). This view is reflected in the works of others such as Stigler (1971, p.3) and Posner (1974, p.341) that the regulated are able to "capture" or "dominate" the setting, administration and enforcement of regulation so that it either operates in their favour or has minimal impact on them. In other words, those in privileged positions such as "big business" (*Time* (1975) are able to achieve political ends at the expense of other less powerful groups (Tomasic, 1980, p28; Hart, 1980, p239).

The history of the drafting of what became the Foreign Corrupt Practices Act of 1977 and its subsequent implementation and enforcement suggests the original intent of the legislation may have been to prevent what were seen as activities having a serious and negative impact on American society[16]. However, putting the rhetoric aside, legislation is often a political tool allowing governments to point to legislative initiatives supposedly aimed at eradicating

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[16] See, for example, Unlawful Corporate Payments Act of 1977, Committee Conference Report, House of Representatives, Report No.95-640, Need for legislation:

> The payment of bribes to influence the acts or decisions of foreign officials, foreign political parties or candidates for foreign political office is unethical. It is counter to the moral expectations and values of the American public. But not only is it unethical, it is bad business as well. It erodes public confidence in the integrity of the free market system. It short-circuits the marketplace by directing business to those companies too inefficient to compete in terms of price, quality or service, or too lazy to engage in honest salesmanship, or too intent upon unloading marginal products. In short, it rewards corruption instead of efficiency and puts pressure on ethical enterprises to lower their standards or risk losing business.
>
> Bribery of foreign officials by some American companies casts a shadow on all U.S. companies. The exposure of such activity can damage a company's image, lead to costly lawsuits, cause the cancellation of contracts, and result in the appropriation of valuable assets overseas.

or at least curtailing anti-social activities. In reality, legislative initiatives as enacted are actually designed to maintain the status quo. As noted by Cranston (1982, p3):

> Often it is fallacious to assume that the forces dominant in formulating business regulation really intended to make any dent on commercial practices. Business regulation may be characterised as symbolic, since from the outset the purpose may simply have been to assuage public opinion or to divert its attention.

The following sections will address this opinion of the efficacy of the Foreign Corrupt Practices Act of 1977 and its related accounting and auditing provisions.

Administration and Enforcement of the Act

In spite of the condemnation of the illicit use of corporate funds derived from Watergate and related investigations and commentary by the press, the SEC and government representatives, Mattera (2007) states that shortly after the FCPA was enacted, the Carter Administration responded to concerns that the act would put U.S. corporations at a competitive disadvantage by signalling that it would not be too vigorously enforced. The Reagan Administration attempted, unsuccessfully, to weaken the law but continued the policy of limited enforcement of the FCPA. It appears the act was enforced to a certain extent under the Clinton presidency although Mattera (2007) maintains the level of FCPA actions was “miniscule”. According to Mattera (2007)

> optimists were claiming this was because the law was having a remarkable deterrent effect. Sceptics said that companies were being more careful to conceal their bribes, and prosecutors were focused elsewhere.

The Volcker report into the Oil-for-Food program provided irrefutable evidence that the latter argument was more likely the case than the former. As a consequence, FCPA enforcement actions noticeably increased. However, this was not due to increased efforts on the part of the SEC or the Department of Justice. Instead the Volcker investigation as well as the 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and stricter internal controls mandated by the Sarbanes-Oxley act made it more difficult for companies to conceal improper payments. As with the SEC voluntary disclosure programme of the 1970s, many companies admitted to FCPA violations. According to Mattera (2007), it appears the companies made these admissions in the expectation of sympathetic treatment.

Koehler (2010), however, argues the increased enforcement of the FCPA is a facade because most enforcement is through Department of Justice non-prosecution or deferred prosecution agreements or SEC settlements. The Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (1976, p.37) criticised such approaches as being nothing more than “slaps on the wrist”. Koehler (2010) provides evidence of a “slap on the wrist” approach as well as the possibility of preferential treatment to some offenders consistent with the principles of the political economy of regulation espoused by Mitnick (1980), Posner (1974), Stigler (1971), Tomasic (1980) and Hart (1980). For example, Koehler (2010) details an instance in 2009 where a judge refused to consent to an SEC settlement with Bank of America and ordering the matter go to trial. The judge described the proposed settle as “a contrivance designed to provide the SEC with the facade of enforcement and the management of (the company) with a quick resolution of an embarrassing inquiry ... at the expense of ... the shareholders ... [and] also of the truth”. Eventually, the SEC settlement was approved but the original fine of $33 million imposed by the SEC was increased to $155 million.

Koehler (2010) also demonstrates penalty differentials in cases where the facts were essentially the same. One company paid total fines and penalties of $3 million for FCPA violations involving bribery and books, records and internal control matters. The other company paid fines and penalties of $2.5million for books, records and internal control violations. In spite of the similarity in the activities engaged in by both companies, the second company was not penalized under the FCPA anti-bribery provisions while the first was. In addition, the second company had actually spent some $10 million on efforts to buy preferential treatment from foreign officials compared to $7 million paid by the first. Nonetheless, the first company faced more significant allegations than the second. Another anomaly was the first company had made voluntary disclosure. There was no mention of voluntary disclosure in the official documents related to the second company. Given that settlements are the subject of negotiation between the SEC and the defendant, the disparities noted by Koehler (2010) indicate the second company had greater bargaining power than the first.

Two issues raised by members of the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (1976) cast doubt on the ability of the SEC to effectively administer and enforce then existing corporate regulation and legislation. One of these was the matter of funding[17] and the other was potential interference in the operations of the SEC by other government factions or the use of the SEC for political purposes[18]. There is evidence that both matters have had negative impacts on the administration and enforcement of the FCPA.

a. SEC and Funding

Funding has long been recognized as a political tool. For example, research by Grabosky and Braithwaite into the Australian regulatory system found political interference based on funding. One example, cited by Grabosky and Braitwaite (1986a, p25) was a response from a government Minister to requests by Corporate Affairs Commissions[19] for additional resources stating "[t]he more resources you have, the more matters you will find to investigate". This comment supports Cranston's (1982) view that regulation may be more symbolic than real because without adequate funding, administration and enforcement are limited.

The history of the SEC indicates lack of funding was a limiting factor from its inception. In addition, the SEC has a long history of taking a conciliatory approach to corporate regulation. For example, Durr and Kinnane (2005) observed "the SEC began with a surplus of good leadership but ran a deficit when it came to funding". On his election in 1960, President Kennedy commissioned a study of regulatory agencies giving rise to the Landis Report (Landis, 1960). One of the conclusions of the study was

> [a] period of economic rigor, if not parsimony seems to have characterized the Bureau of the Budget's attitude toward the various agencies beginning in 1952, an attitude that was slowly being relaxed in 1960.

In demonstrating this point, Landis referred to SEC staffing between 1950 and 1960:

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[17] See, for example, the exchange between the Subcommittee Chair, Senator Proxmire, and the Chairman of the SEC at p.28 regarding the strain placed on SEC resources and the need for consideration of the best means of allocating them.

[18] See, for example, the exchange on pp.31 to 36 regarding the SEC's relationships of the Department of Justice and U.S. attorneys suggesting matters dealing with questionable payments were allocated to the SEC due to its inability to impose fines as well as instances where the SEC had referred criminal matters to the Department of Justice that were not pursued.

[19] The Australian equivalent of the SEC.

> During the fiscal year 1950, when 496 registration statements were filed with the Securities and Exchange Commission, the Bureau of the Budget approved 1,130 employees for the Commission, of which 1060 were authorized by Congress. As of fiscal year 1955 with 849 registration statements filed with the Commission only 717 employees were approved by the Budget Bureau of which 699 were authorized by Congress. As of fiscal year 1960 with 1628 registration statements filed with the Commission only 978 employees had been approved by the Budget Bureau of which 954 were authorized by Congress. Obviously either extravagance characterized the situation in 1950 or parsimony in 1960.

However, Hohenstein (2007) argues even though the Bureau of the Budget provided for an additional 250 employees, the new Kennedy administration only held a thin electoral margin in Congress. Ten years later, another review of SEC operations demonstrated that funding remained a problem through the 1960s.

In 1971, SEC Executive Director Yorke, undertook a management review of Commission operations. This review resulted in a successful bid to Congress to increase SEC funding being "the first such major increase in Commission resources in many years" (Securities and Exchange Commission, 1972, issue number 72.215). The increased funding permitted an increase in SEC staff from 1,356 in 1971 to 1,814 by 1974 (Hohenstein, 2007). However, the increase was obviously insufficient because limited resources required the SEC (Securities and Exchange Commission, 1976, p.3, p.10) to continue to rely on the cooperation and assistance of the private sector to investigate questionable payments as part of the voluntary disclosure programme. In addition to funding its own operations, the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (1976, p.29) also heard that the resources of the SEC were utilised to fund investigations of Federal Prosecutors. More recently, it is apparent that the SEC is still underfunded.

In January 2011, *Futures Magazine* published the press conference statement of Congresswoman Maxine Waters regarding proposals to freeze non-military discretionary spending at 2008 levels. The Congresswoman pointed out that such a freeze on spending would place the security of the U.S. financial markets at risk because it would further erode the ability of the SEC to police them. To demonstrate the point, the declining resources of the SEC between 2005 and 2009 were noted including a 10 per cent staff cut between 2005 and 2007 and a 50 per cent decline in investment in information technology. The decline in SEC resources coincided with the events leading to the financial crisis of 2008. Lack of funding was also a factor in the failure of the SEC to act upon complaints related to Bernie Madoff. As one commentator observed

> For years (if not decades) leading up to the Madoff scandal, the Enforcement Division has been known as a lean, effective unit that has performed well despite lacking the resources and manpower of its opponents. The problem with constantly trying to "do more with less" ... is that eventually you're almost always forced either to ignore matters that deserve attention, or to stretch resources so thin that the chance of costly mistakes soars (Securities Docket, 2009).

The political nature of the funding of the SEC lies in its relationship to the whims of Congress. The SEC is effectively self-funded through fees and fines it collects each year. However, each year, Congress appropriates, at its discretion, some of these funds to the SEC, the balance is allocated to other uses. The discretionary nature of budget appropriations leaves the SEC vulnerable because the level of funding is uncertain from year to year. As a consequence, long term planning including multi-year projects are impossible (Schapiro, 2009; Securities Docket, 2009).

b. SEC and Interference

There is ample evidence of politically motivated influence on the SEC. Hohenstein (2007), for example, uses the response of 1960s SEC Chairman, William Cary, to political nature of funding issues. According to Hohenstein (2007) Cary adopted a policy of "political pragmatism and administrative innovation". To demonstrate this point, Hohenstein (2007), said in reference to implementation of the findings of the Landis Report, Chairman Cary

> realized that in order to be most effective, the SEC would have to cooperate with some of the leaders in the industry it regulated. "If none of the industry's spokesmen feel there is a need and complaints mount," Cary commented in considering the implementation of the Special Study's recommendations, "Congressmen are likely to intervene and commence inquiry, and a committee may either stall the proposal or kill it" (citing Seligman, 2003).

Direct political interference in the activities of the SEC also emerged during the Watergate investigations. The SEC's General Counsel, who later became SEC Chairman, was pressured by Nixon aides to delete evidence of an SEC investigation of a prominent financier including allegations of an illegal contribution of $200,000 to the Nixon re-election campaign (Hohenstein, 2007). This instance was raised during the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (1976, pp.31-32) questioning of SEC representatives. As SEC Chairman, the former General Counsel appeared before earlier hearings of the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee and lied about the evidence against the financier. Subsequently, he recanted his testimony, admitting that he had lied twice about the matter and resigned as SEC Chairman. The Subcommittee Chairman expressed his outrage that no action was ever taken against the former SEC Chairman.

In a similar vein, the Subcommittee Chairman (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.29-31) broached the issue of criminal indictments connected with investigations of illicit corporate payments. Of particular concern to the Subcommittee was the number of criminal indictments resulting from investigations of the Watergate prosecutor as opposed to those from SEC investigations. To that date, "virtually all" criminal indictments had emerged from Watergate prosecutor investigations. In fact, no criminal indictments were the result of SEC investigations. Only civil actions had been instituted since April 1974 even though it was implied that potentially criminal matters had been referred to the Department of Justice. The Subcommittee Chairman commented that the Department of Justice appeared "to be allergic" to "prosecuting top officials of corporations or, for that matter, top officials in government (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.32).

This "allergy" was subsequently demonstrated by the outcome of a high profile case discussed with the SEC during the Subcommittee's hearing. The case dealt with a U.S. company's payment to bribes of high ranking foreign officials (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.33). The SEC representatives reported the Commission had expressed an interest in the case. However, the Department of Justice on behalf of its "client", the State Department, informed the Commission that the Secretary of State considered it was in the "national interest" to make documents related to the case available to the SEC. The SEC representatives denied that this was interference in Commission activities from the Secretary of State. However, the SEC did have to go to court in order to gain access to the files of this and another case. After a delay of "at least 3 to 4 months" some of the information was made available to the SEC. The SEC was unable to verify that it was in receipt of all the relevant information in the case but expressed the view that they hoped the court order would ensure any other available information would be forthcoming (Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, 1976, p.34). In April 1976, 3 months after his appearance before the Subcommittee, the Chairman of the SEC announced a settlement with the company "after months of investigation and negotiation" (Hills, 1976, p.7). No actions were taken against any member of the company's management even though their involvement in the payment of bribes was clear.

This example casts doubt on the bifurcation of FCPA enforcement between the SEC and the Department of Justice as it represents a layering of regulation. Grabosky and Braithwaite (1986b, p.88) maintain that the purpose of "layering", or the delegation of enforcement of regulation to various administrative layers, is to minimise the likelihood of bringing a prosecution to completion because of the time taken to transit the various administrative layers. Time-consuming investigations and administrative hurdles create legislative and judicial complications. Questioning of SEC representatives by the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee (1976) as previously discussed, suggests that this was the case in terms of the Commission's relationship with the Department of Justice.

The role of the accounting profession in the operation of FCPA enforcement also casts doubt on the effectiveness of the act. In particular, the reporting and disclosure provisions are based on audit provisions formulated by the accounting profession.

The Accounting Profession, FCPA and Audit Standards

The Foreign Corrupt Practices Act came into effect in December 1977. The legislation actually applied to both domestic and international corporate transactions and was originally intended to remedy the shortcomings of existing measures, including accounting and audit standards, revealed during the Watergate investigations. Work on accounting related provisions of the FCPA commenced in March 1976. The relevant bills lapsed when the 94th Congress adjourned in October 1976 (Congress Report, No. 95-114, 1977). A new bill, *Foreign Corrupt Practices and Domestic and Foreign Investment. Improved Disclosure Acts of 1977* was introduced in January 1977. The proposed bill provided, inter alia, for

- companies subject to the jurisdiction of the SEC to maintain strict accounting standards and management control over their assets; and
- on prohibition the falsification of accounting records and the deceit of accountants auditing, the books and records of such companies.

The report to Congress accompanying the bill (United States Senate, 1977) maintained that public confidence in the securities would be enhanced by these provisions. In particular

> 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.

A revised version of the bill was introduced to the House of Representatives (1977a). The original bill required companies coming within the jurisdiction of the SEC "make and keep books, records, and accounts which accurately and fairly reflect the transaction and disposition of the assets of the issuer" and to "devise and maintain adequate systems of internal accounting controls". The revised bill amended both provisions replacing the word "accurately" with "in reasonable detail" and deleting the word "adequate" completely. The prohibitions on falsification of books and records and making false statements to accountants were also deleted. The result was that the legislation as eventually enacted did nothing more than make the existing provisions of the Securities Act, 1934, explicit rather than implied.

In September 1977, the "Unlawful Corporate Payments Act of 1977" was introduced to the House of Representatives (House of Representatives, 1977b). This bill dealt with the criminalization of bribery and vested with the SEC jurisdiction over prohibitions against corrupt payments by companies filing reports with the Commission. The Securities Exchange Act of 1934 was to be amended accordingly. Domestic companies not within the SEC jurisdiction would be dealt with by the Justice Department. The SEC's responsibilities under the amendments were much the same as they had always been under securities legislation and included:

- conducting investigations,
- bringing civil actions,
- commencing administrative proceedings if appropriate, and
- referring cases to the Justice Department for criminal prosecution where warranted.

In essence, the Foreign Corrupt Practices Act enacted in 1977 did little to address the financial statement manipulation uncovered either by the Watergate Special Prosecutor or the SEC's voluntary disclosure of illicit payments programme.

The reasons for effectively maintaining the status quo in terms of the accounting provisions and their administration and enforcement by the SEC can only be described as political maneuverings. In the absence of concrete evidence, the House of Representative reports on the proposed amendments to the SEC and administration of the act as well as SEC reports and speeches and written proposals of the AICPA regarding the acts accounting provisions demonstrate some of the pressures that were brought to bear.

For example, the Conference Committee report to the House of Representatives (1977a) explained that the "accurate and fair" requirement presaged an element of "exactitude and precision". In contrast, "in reasonable detail" was seen as a realistic alternative. Similarly, the word "adequate" was dropped from the internal control requirements because it added no value. The prohibition on falsification of records and deceiving accountants was dropped because the SEC already had issued a proposal that would achieve similar objectives.

At least one source of these changes can be found in the testimony of the AICPA to the House of Representatives Subcommittee on Consumer Protection and Finance of the

Committee on Interstate and Foreign Commerce (American Institute of Certified Public Accountants, 1976). For example, the AICPA argued that in most of the companies found to have made questionable payments, there was a system of internal controls. Hence, a legislative requirement was redundant. Those controls had been circumvented. Furthermore, requiring an "adequate" system of internal controls would serve no purpose because there are no definitive guidelines on what such a system would be. Attaching illegality to a failure to have an adequate system of internal controls was, therefore, unfair. Also such a provision would tend to militate against open dialogue between external auditors and their clients (American Institute of Certified Public Accountants, 1976, pp.3-4). The influence of the AICPA can also be seen in that the SEC proposal deferred to by the Conference Committee report (House of Representatives, 1977a) was based on the AICPA's 1973 Statement of Auditing Standards No.1. (Securities and Exchange Commission, 1977a).

Justification for maintaining the SEC's jurisdiction over the accounting and internal control provisions included the existing close working relationship with the Department of Justice and its proven ability to discharge its mandate to protect the investing public through the instigation of civil suits under the securities legislation. In addition, because the SEC already had access to the books and filings of reporting entities, it was in a sound position to conduct investigations. Leaving the jurisdiction of the SEC over reporting companies would avoid duplication of effort should jurisdiction be place with another government body. The SEC had the required expertise in investigating bribery and other questionable payments as evidenced by its work in the aftermath of Watergate. Furthermore, the SEC had a reputation for independence. Independence was desirable where politically sensitive matters were concerned (House of Representatives, 1977).

A further explanation for the outcome on deliberations on the FCPA accounting provisions can be found in the Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission (Securities and Exchange Commission, 1977b). The focus of the report was the possibility of "radical modification of the disclosure system" (Securities and Exchange Commission, 1977b, p.2) including whether corporate disclosure should be left to market forces rather than being mandated and enforced by the SEC (Securities and Exchange Commission, 1977b, p.D-6). The finding of the Advisory Committee that no radical change was require was unsurprising given membership of the committee comprised members of the SEC staff assisted by the AICPA, the Financial Analysts Federation, Financial Executives Institute, members of the Ney York Stock Exchange and the Securities Industry Association (Securities and Exchange Commission, 1977b). Arguably, moves towards deregulation of the securities market constituted a threat to the existence of the SEC. Just as Chairman Cary had found in the 1960s survival of the SEC was contingent on "political pragmatism and administrative innovation" (Hohenstein, 2007).

Accountants and Money Laundering

As already noted, the accounting profession formulated audit standards dealing with illicit acts by clients, errors and irregularities and consideration of fraud in a financial statement audit. However, there has been little effort by the profession to address the use of financial statements in the laundering process. Instead, the accounting profession has consistently denied a relationship between money laundering, financial statements and accounting and audit practice. For example, the International Federation of Accountants (IFAC) issued statements in 2002 and 2004 maintaining money laundering only has indirect impacts on financial reports (IFAC 2002, p.6; 2004, p.6):

> Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are such types of fraud as misappropriations. Consequently, it is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible.[20]

Furthermore (IFAC 2004, p.2)

> Until relatively recently, the battle against money laundering and related financial crime was the exclusive domain of law enforcement, and for good reason. Most governments around the world define money laundering and the activities that lead to it, such as drug trafficking, as serious crimes.

Obviously, the profession's attitude towards money laundering is premised on the narrow view that money laundering is predominantly the domain of organised crime with financial institutions the primary vehicle for obscuring the source of illicit funds. However, as Mitchell et al (1998) point out "money laundering is not just the exclusive domain of offshore financial centres. Even in the major international financial centres ... companies can be formed with minimum issued share capital ... and can easily used to launder the proceeds of ... fraud and other anti-social activities".

As Watergate-related and SEC cases show, the first illicit act was the unauthorised use of corporate funds to pay bribes and contributions to political campaigns. The second phase of the process was the manipulation of financial reports by false entries in corporate accounts. Hence the money laundering process commenced before the funds entered the financial system.

Members of the profession have also maintained that if money laundering activities were reflected in financial statements, it would only be indirect such as through contingent liabilities associated with "potential money-laundering–related lawsuits" (Melnik, 2003). Therefore, as reported by Melnik (2003) in the CPA journal

> Under SAS 54, *Illegal Acts by Clients*, auditors are not required to design their audit procedures with the goal of detecting illegal activities that have an indirect effect on financial statements. Instead, SAS 54 requires the auditor merely to be aware of the possibility that illegal acts with indirect effects on financial statements have taken place.

This argument is only valid if money laundering does only have an indirect effect on financial statements. SAS 54 extends to illegal acts having either a direct or indirect effect on financial statements. Direct effects are generally associated with financial and accounting matters the audit of which is governed by the standard dealing with the consideration of fraud in a financial statement audit. On the other hand, indirect effects of legal acts are generally considered to be part of an entity's operations and are therefore covered by SAS 54 (Bostick and Luehlfing, 2007).

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[20] For other examples, see the Institute of Chartered Accountants in England and Wales: FRAG 10/94, "Requirements in Relation to Money Laundering" and Technical Release, FRAG 11/94, "The Recognition and Action to be Taken in Respect of Money Laundering" (cited in Audit 1/96, p.1); and Audit 1/96 *The Laundering of the Proceeds of Criminal Conduct. A discussion of the audit implications* and Melnik (2003)

Watergate-related cases confirm the indirect impact on financial statements of money laundering-related lawsuits and other charges. Examples include

- civil actions instituted by shareholders and others for the use of corporate funds for illicit purposes (*The Wall Street Journal*, 1975a, p.15; Weinstein, 1975, p.F-1);
- fines and other penalties imposed by regulators (Egan, 1975, p.1; Weinstein, 1975, p.F-1); and
- penalties arising from tax fraud charges (*The Wall Street Journal*, 1975b, p.18; Landauer, 1974, p.2)

However, in each case, the cause of action was manipulation of financial reports to conceal illicit payments. Accordingly, money laundering as described during Watergate investigations had both direct and indirect impacts on the financial statements of the companies concerned.

Other authors such as Sikka, Willmott and Mitchell have long maintained that accountants have actively played a role in the money laundering activities of some large international companies including BCCI and AGIP (Sikka, 2002; Mitchell, Sikka and Willmott, 1996, 1998). Much as has happened in the United States in terms of the FCPA, 1977 and the standards supposedly designed to address financial statement audit deficiencies revealed by Watergate investigations and the SEC's voluntary disclosure programme, Mitchell, Sikka and Willmott (1998) argue

> the deregulation mania and inadequate public accountability has facilitated secrecy and encouraged money laundering activities. Successive governments have indulged the City, big business and elite occupations (e.g. accountants, lawyers) through the system of self-regulation, or more correctly little/no public regulation.

SUMMARY ANALYSIS AND CONCLUSION

There is ample evidence from the Watergate and SEC investigations as well as more recent instances such as BCCI and AGIP that money laundering is not restricted to drug trafficking or other forms of organised crime. Not only that, the accounting system of many of these companies was used as part of the money laundering process. However, the legislative and accounting responses to Watergate and SEC investigations suggest there is still an "interweaving of Big Government and big business (*Time* 1975) and a shirking of the responsibility that come with rank and privilege (Final Report of the Senate Select Committee on Presidential Campaign Activities (1974, p.1227).

In many ways, the independence of the SEC is a myth. From its foundation in the 1930s, the SEC has been starved of resources. The continued preference of the SEC for civil remedies indicates the pragmatic approach of Chairman Cary in the 1960s has been continued by subsequent leaders of the SEC. The "slap on the wrist" tactic of the SEC was criticised following Watergate. Fines may now be imposed under the FCPA but reported differentials in penalties for cases with similar facts and other anomalies insinuate a political element in negotiations between the SEC and corporate management in bringing an investigation to a close.

Another pertinent point is that accounting and auditing practices were found in post-Watergate enquiries and hearings to be either woefully inadequate or applied. As argued by the AICPA in response to proposals to require companies to maintain adequate internal control systems, the problem for companies investigated by the Watergate Special Prosecutor and the SEC was that internal controls were in place but were circumvented. The fact that auditors were supposedly deceived by management and evidently did not recognise that controls were circumvented suggests that the audit guidelines were deficient. Nonetheless, the FCPA amendment to the securities law dealing with records, books and internal controls was based on an audit standard issued by the AICPA.

It was also pointed out during the post-Watergate hearings that the SEC had not actually conducted most of the investigations into questionable payments. Investigations were carried out by committees appointed by the relevant corporate management. In many instances, the external auditor, the person who had previously been deceived by management, was part of the investigating committee. This scenario belies the suggestion that the SEC should enforce the accounting provisions of the FCPA because it had a demonstrated expertise in investigating illicit payments. Lack of SEC resources left offenders to investigate themselves.

The audit standards developed in response to criticism following Watergate and the SEC's voluntary disclosure programme did not address money laundering. In addition, the concept of fraud did not enter the audit lexicon until the 1990s. However, responsibilities to suspect that the financial reports have been manipulated due to fraud do not equate with anti-money laundering obligations. Illegal acts by clients are still the subject of an audit standard but only for those having a direct impact on the financial statements. The profession has consistently argued that money laundering does not have a direct impact on a company's financial reports. As noted by Zeff (1978, p.56), accounting standards have potential impacts on decision making behaviour through their effect on financial statements. Standard setters must be cognizant of the economic consequences of mandated accounting practices. The political nature of the standard setting process can explain the failure of the accounting profession to address the use of the accounting system for money laundering purposes. If enough people say something for long enough, for example, money laundering is the province only of organised crime, it is likely to be seen as factual. By issuing an audit standard addressing procedures to be undertaken when money laundering is expected would signify the fallacy of the argument.

Politicians, corporate executives, regulators and members of standard setting bodies occupy positions of privilege in society and have an obligation to use their position to safeguard the interests of all rather than those with the most influence. Ranks has privileges but only because with rank comes responsibilities.

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