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Joseph A. Guillory

University of Kentucky

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The Audit Committee “Financial Expert” Requirement and the Internal Control Attestation: Effective Contributions to Corporate Governance?

Joseph A. Guillory

In light of recent corporate reforms promulgated by Congress, the Securities & Exchange Commission (“SEC”), and the national securities exchanges, increased emphasis has been placed on corporate governance, committee structure, and the qualifications of board members. The role of board committees has been thrust into the limelight and perhaps the most important of these committees is the audit committee, which is charged with oversight of the entire financial reporting process. While most board members have historically been closely related to the senior executives of the corporation, often with financial or personal ties, the audit committee has now been identified as an ideally autonomous body. In order to escape the influence of management, the audit committee must be entirely “independent,” as defined in the various rules of the SEC and the self-regulated organizations (“SROs”) or national securities exchanges such as the NYSE and NASDAQ. The independent members of the audit committee cannot receive any remuneration other than fees for committee service. Additionally, the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) requires listed companies to certify in their periodic reporting whether or not at least one

1 J.D. 2006, University of Kentucky College of Law; B.S., Georgetown College, 2000; Certified Public Accountant, Commonwealth of Kentucky. The author would like to thank his parents and sister for their love, support, and inspiration, as well as Professor Rutheford B Campbell for his assistance in formulating the topic for this note.

2 See infra notes 34-69 and accompanying text.


4 J. Loewenstein, The SEC and the Future of Corporate Governance, 45 Ala. L. Rev. 783, 786 (emphasizing how upper management remains largely in control of Board positions).


7 Laurence Goldfein & David Cace, What a Buyer Must Know About Sarbanes-Oxley, MERGERS & ACQUISITIONS JOURNAL, November 21, 2002.

member of their audit committee meets specified criteria to qualify as an “Audit Committee Financial Expert,” or ACFE.\(^9\) The SROs,\(^10\) although not explicitly requiring a member to meet such set criteria, also indicate that members of the audit committee must possess a higher level of financial literacy or practical experience than was required in the past.\(^11\) It is hoped that these more well-qualified individuals will be able to spot potential financial misstatements earlier and act with increased oversight and skepticism in their review of the financial reporting processes of the company and its senior executives.\(^12\)

Collectively, these requirements have driven corporations to seek out well-qualified, independent individuals for their audit committees who hold advanced degrees, professional certifications, or high levels of relevant industry experience in order to satisfy the new standards.\(^13\) Such credentials are definitely (or at least arguably) desirable in all corporate committee members. However, in the race to comply with the flurry of new regulations, corporations appear to have focused more on bare compliance than on the underlying goals of the ACFE requirement.\(^14\) As the new rules are proven through application, refinements will likely be necessary.\(^15\) At least one scholar has proposed that emphasis should be shifted from a token requirement for one “super-expert” to a more balanced approach evaluating audit committee members not only on objective quantitative factors but on criteria more focused on the overarching goal of the audit committee—monitoring.\(^16\)

\(^10\) The SROs, including the New York Stock Exchange and the National Association of Securities Dealers, among others, are quasi-regulatory bodies empowered by the SEC to develop and implement market regulations for securities traded within these exchanges. See Amir N. Licht, *Games Commissions Play: 2 x 2 Games of International Securities Regulations*, 24 Yale J. Int'l L. 61 80 (1999).
\(^13\) Stephen A. Scarpati, *CPAs As Audit Committee Members*, J. Acct., Sept. 2003, at 32.
\(^14\) J. Michael Cook, *Addressing Audit Committee Concerns: Balancing Relationships with the Audit Committee, Management, and the External Auditors*, 1449 PLI/Corp 1025, 1031 (2004) (discussing how in meeting the compliance requirements of Sarbanes-Oxley, there is a danger of “becoming ritualistic, distracting us from doing the things that are substantive and truly important”).
\(^15\) Backer, *supra* note 12, at 354 (purporting that Sarbanes-Oxley is likely “not the last word” in new regulations).
\(^16\) Id. at 366 (discussing the critical role of oversight and monitoring of the audit committee).
Another aspect of corporate governance reform that is critical to the success of these more well-rounded and enabled audit committees is an increased emphasis on a corporation's internal control structure. Internal controls are a corporation's own processes, systems, and safeguards that are designed to facilitate the timely and accurate processing of transactions and the reporting of financial and management results both internally and externally. This system of internal "checks and balances" has always been an item of interest for auditors, regulators, and corporate efficiency experts, but it has not received a great deal of attention from the general investing public. However, the corporate frauds of recent years have largely been the result of breakdowns in these systems of application processing and high-level monitoring. Thus, internal controls are finally receiving their due attention as an invaluable first-line of defense against management fraud, collusion, and false financial reporting. The major difficulty arises, however, because systems of internal control in a traditional accounting environment are designed and controlled by members of management themselves who may take advantage of opportunities to engineer creative loopholes or special exceptions to the rules.

The Sarbanes-Oxley Act section 404 deals with this, however, by requiring an annual certification by management, attested to by an independent accountant, that effective systems of internal control are in place and operating effectively to prevent or detect any material misstatement in the financial statements. In addition to the independent external audit of the financial statements that has long been required for public companies under the Securities Exchange Act of 1934, this "section 404 attestation" requires management to design, document, and test their system of controls for operating effectiveness. This internally conducted documentation of control systems is then, in effect, subjected to its own external audit-like procedures by the independent public accountants. The audit committee

17 See Kirkendall, supra note 3, at 2310 (discussing the design and implementation of effective internal controls as a key element of high-quality financial reporting).
19 See William O. Fisher, Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis, 39 GONZ. L. REV. 29, 90 (2003-04) (discussing how internal controls are "virtually, an accounting term of art" and not widely understood).
21 See Fisher, supra note 19, at 91 (discussing the SEC's adoption of internal control attestation requirements as part of recent corporate reforms).
is given exclusive and independent power to retain, evaluate, compensate, and communicate with the external auditors as a full delegation of corporate authority. This requirement necessarily involves the independent audit committee in the internal control process although at a somewhat removed degree from the process of actually designing and implementing the company's controls. This appears to be another area in which the new rules may eventually be "tweaked" once experience is gained in practice. The independent audit committee, consistent with its charge of monitoring the actions of management to ensure that the shareholders' best interests are protected, should be more involved in the detailed design and examination of the system of internal controls on the most basic level. This involvement of the audit committee, although a major task, is likely to provide a greater cost-benefit for the shareholders in terms of effective monitoring. Strong internal controls, when closely examined and applied by the independent audit committee, can provide an efficient and effective method of monitoring management's transaction processing and financial reporting systems from the ground up.

This Note begins with a survey of the new requirements concerning audit committee financial literacy and the internal control attestation, comparing the salient features of Congressional and SEC authorities with the applicable SRO listing standards. Part I focuses on the various requirements for audit committee member qualifications. The implications of these requirements as applied in practical experience are also discussed. Part II then examines the importance of the internal controls attestation, considering the use of such methods in other specialized industries. Part II also analyzes the effectiveness of both of these provisions within an integrated corporate governance framework. Finally, suggestions are offered to re-focus the efforts of regulators and corporate committee members on implementing these requirements with a more comprehensive emphasis on the fundamental goals of the audit committee as a monitoring body. These suggestions embody the spirit of recent corporate reforms, while calling for more practical and effective methods of implementation.

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26 Sarbanes-Oxley stops short of actually requiring the audit committee itself to design control systems from the ground up, as this job is still left to management. However, in their monitoring role over the independent accountants, the audit committee obtains a sort of derivative responsibility to ensure that internal controls are in place and operating effectively. See 15 U.S.C.S. §§ 7262, 7241 (2005).
27 See infra notes 29-88 and accompanying text.
28 See infra notes 89-141 and accompanying text.
The cornerstone goal of an audit committee, in abstract terms, is the effective and efficient monitoring of corporate finance and accounting systems. Closely intertwined with other functions of the business, the accounting function is a fundamental internal mechanism designed to systematically provide accurate and timely information regarding the results of operations and the status of the corporation's financial health. The audit committee should be an independent body acting omnisciently and without interference to ensure that this machinery is working properly.

This goal is achieved largely through two main approaches: the audit function (both internal and external) and the internal control/risk assessment structure. Both of these tasks are within the purview and control of the modern audit committee. The SEC and the national securities exchanges have introduced strict requirements for membership on the audit committee in order to effectively carry out and monitor these functions in order to protect the interests of the investing public.

A. Securities and Exchange Commission Requirements

Many of the SEC's new requirements were implemented as a result of the Sarbanes-Oxley Act of 2002, which was passed in the wake of corporate frauds propagated at firms such as Enron, WorldCom, Adelphia, and Tyco. Sarbanes-Oxley ushered in dramatic changes to the regulation of the public accounting industry, a multitude of new reporting requirements for publicly traded companies, and even governmentally mandated corporate governance structures for listed companies. Among such requirements, as detailed below, is the mandate that at least one member of the audit committee be a "financial expert," as defined by largely quantitative criteria set forth in the applicable regulations relating to financial literacy and work experience. As an integrated part of the SEC's Regulation S-K, this obligation applies to all publicly traded corporations subject to the periodic re-

29 See Backet, supra note 12, at 426 (emphasizing a duty of "suspicion" in overseeing the system of monitoring to "ferret out wrongdoing").
30 Arens & Loebbecke, supra note 18, at 4
31 Id. at 366 (discussing the critical role of oversight and monitoring of the audit committee).
32 Kirkendall, supra note 3, at 2310-11 (describing internal controls as a method to "prevent problems before they begin," in contrast to the independent audit, characterized as a "public watchdog" to catch errors once they have occurred).
33 See infra notes 34-69.
34 See infra notes 34-69 and accompanying text.
porting requirements of the Securities Exchange Act of 1934. The ACFE requirement has created a frenzy among corporate boards, as they search for well-qualified individuals to satisfy the financial expert requirement, among other new rules. Certainly if all audit committees—or corporate boards for that matter—were composed solely of “financial experts” who held advanced degrees in finance or accounting and had served as auditors, CFOs, or SEC investigators, such members would be well-suited to monitor and guide the audit and internal controls functions. However, the function of the audit committee, armed with the ability to independently retain counsel and other experts to advise them in the conduct of their duties, is to monitor the functions of the corporation, not necessarily to be able to conduct or understand each and every transaction themselves.

In the rush to meet the “financial expert” requirement, it appears that the overall monitoring goal of the audit committee has fallen out of focus. The existence of an ACFE on the committee, in and of itself, does little to further the goal of effective monitoring of the corporate reporting functions. This requirement, although representative of good intentions for reform, appears to have been implemented in the haste to enact stronger corporate governance regulations without sufficient analysis of the cost-benefit relation to an overall structure of effective monitoring. The effectiveness of an audit committee still depends in large part upon the personal commitment of all committee members to uphold their duties to the shareholders regardless of whether one member can check off quantitative criteria for SEC reporting purposes.

In conjunction with the myriad other reforms (not detailed here) concerning audit committee composition and responsibilities is the requirement that each company subject to the periodic reporting requirements of the Securities Exchange Act of 1934 have at least one “Audit Committee Financial Expert.” Embodied originally in section 407 of the Sarbanes-Oxley Act, the requirement forces each issuer to disclose in their annual Form 10-K whether the Board has determined that at least one member of the Audit Committee meets the specified requirements to be deemed an ACFE. If the Board cannot make this certification, such fact must be disclosed along with the qualifications and attributes of the Committee’s other members. Specific criteria that must be satisfied to qualify as an ACFE are

36 Id.
38 Scarpati, supra note 13, at 34.
39 Cook, supra note 14, at 1031–32.
set forth in Regulation S-K, falling into several overall categories. First, the member must possess an understanding of generally accepted accounting principles and the major financial statements (balance sheet, income statement, and statement of cash flow), as well as how these statements relate and apply to the issuer's individual business and industry. Special attention must be paid to any unique or specialized financial instruments, transactions, or accounting methods (such as statutory insurance company accounting). The ACFE must have developed and demonstrated this knowledge through actual practical experience in preparing, auditing, or evaluating financial statements with a level of complexity similar to that of the issuer, or through the supervision of others conducting such activities. Additionally, the member must have a thorough understanding of internal controls and both the internal and external financial reporting and audit processes, demonstrating the underlying goals of an audit committee and its role in effective corporate governance.

It is important to note that these requirements cannot be met part-and-parcel by several different committee members; one single member must hold all the necessary qualifications. However, the member's experience in the preparation or auditing of financial statements may be satisfied through the supervision, review, or analysis of such statements. Although the most likely candidates to fill these positions are former auditors and CFOs—individuals likely to be certified public accountants or hold advanced degrees with relevant work experience—other industry experts such as investment bankers and attorneys could likely also qualify. These individuals may be able to satisfy the requirements through experience gained in examining and reviewing financial statements and company internal control systems from an outside perspective. The SEC rules thus provide a fair amount of flexibility in meeting the requirements, although little (if any) additional work is required of an ACFE once their status is disclosed. Once the mere existence of an ACFE is noted in the company's reports, there are no other mandated responsibilities specified for this individual. Yet, the market for qualified individuals is fierce with some capable individuals declining invitations to serve as an ACFE because of currently

44 Id.
45 Scarpati, supra note 13, at 33.
49 Id.
51 Id.
unresolved questions regarding responsibility and liability. This obviates
the weaknesses in the new regulations to be analyzed below, questioning
their direct relation and impact upon the primary goal of effective monitor-
ing by the audit committee.

B. National Securities Exchanges Requirements

The national securities exchanges, or self-regulated organizations ("SROs"),
have followed suit by amending their own listing standards and regulations
to reflect new audit committee composition requirements as detailed be-
low. The Sarbanes-Oxley Act authorized the SEC to work in conjunction
with the SROs to implement such standards. Under the listing standards
for both the New York Stock Exchange ("NYSE") and the National As-
sociation of Securities Dealers Automated Quotations ("NASDAQ") sys-
tem, audit committees must be composed of at least three independent
members. Independence guidelines, a major subject of discussion and
controversy, are not detailed here. Yet, in summary, the committee mem-
bers must be free of financial and personal conflicts with management and
the issuer and be otherwise unrelated to the company. Additionally, all
audit committees must adopt and annually review and affirm an audit com-
mittee charter. This document affirmatively sets forth the committee's
purpose and how it relates to monitoring the company in the best interests
of the shareholders. The charter should also denominate procedures for
an annual evaluation of the committee's members and their work. Guide-
lines for retaining and communicating with internal and external auditors
must also be included. The NYSE limits an audit committee member's
ability to serve for multiple issuers. One individual cannot simultaneously
serve on more than three audit committees for public companies without
disclosure of such facts in the companies' proxy statements. Also, an af-

52 Cook, supra note 14, at 1031.
54 NASDAQ, Inc., Marketplace Rules § 4350(d)(2) (2004); NYSE, Inc., Listed Company
56 NASDAQ, Inc., Marketplace Rules § 4350(d)(1) (2004); NYSE, Inc., Listed Company
Manual § 303A.07(c) (2004).
57 NASDAQ, Inc., Marketplace Rules § 4350(d)(1) (2004); NYSE, Inc., Listed Company
58 NASDAQ, Inc., Marketplace Rules § 4350(d)(1) (2004); NYSE, Inc., Listed Company
59 NASDAQ, Inc., Marketplace Rules § 4350(d)(3) (2004); NYSE, Inc., Listed Company
firmative analysis must be completed by each of the respective boards of
directors concluding that the member can still serve effectively despite the
multiple commitments.\textsuperscript{60} Other requirements vary only slightly between
the exchanges, as noted below.

For companies traded on the NYSE, audit committee members must
be "financially literate" or acquire such literacy within a reasonable time
after their appointment to the committee.\textsuperscript{62} At least one member must have
"expertise" in accounting or related financial management.\textsuperscript{63} The NYSE
listing standards explicitly allow a Board to presume that an audit com-
mittee member meeting the SEC's definition of an ACFE will satisfy the
exchange requirements, thus impliedly incorporating the SEC standards
by reference.\textsuperscript{64}

Similar requirements have been included in the NASDAQ Listed
Company Manual. An ACFE per se is not required, although all members
of the audit committee must be able to read and understand the issuer's
financial statements.\textsuperscript{65} Additionally, at least one member must possess previ-
ous employment experience in accounting or finance, hold a professional
certification therein, or have other comparable experience such as serving
as an executive officer with financial oversight responsibilities.\textsuperscript{66} This re-
quirement appears to be the functional equivalent of an ACFE although
not termed as such.\textsuperscript{67}

Curiously absent from both the NYSE and NASDAQ standards are any
more detailed or explicit criteria for meeting the financial expert qualifi-
cations. This represents a departure from the highly structured, specific,
and formulaic SEC rules under Sarbanes-Oxley. Although the SROs' ap-
proach may seem to offer less guidance, it appears to be more focused on
the broader goals of the audit committee by allowing the issuer and its
shareholders to make the determination of what qualifications are most
desirable. Rather than recruiting an audit committee member solely with
an eye to the requirements of Sarbanes-Oxley section 407, the listing stan-
dards appear to allow a more holistic evaluation of needed attributes once
a basic threshold of financial literacy is satisfied.

The focus of the listing standards on more qualitative factors may be
due at least in part to the redundancy for most issuers of the listing stan-

\textsuperscript{61} See New Corporate-Governance Listing Standards, KPMG's DEFINING ISSUES, No. 03-24,
\textsuperscript{63} Id.
\textsuperscript{64} Id.
\textsuperscript{66} Id.
\textsuperscript{67} Id.
ards with the SEC regulations. It could be expected that the SRO listing standards would be more stringent than the SEC rules, as they largely would apply to a smaller sub-set of companies, although this has not been the case. The listing standards appear to have adopted a "wait and see" attitude by avoiding radical immediate change, thus allowing the federal regulations to be refined and inevitably revised as listed companies, the SEC, and the investing public adapt through practical experience and implementation.

C. Effectiveness of the ACFE Requirements

The intentions behind the "financial expert" requirement are quite genuine, and financial literacy and a higher-than-average level of business sophistication should be expected on corporate boards and especially on audit committees. That said, perhaps the new "expert" requirements are best viewed as a first step or as a wake-up call to corporate boards hearkening increased expectations for accountability in the future. Reaching beyond the traditional responsibilities of the committee, members should become more involved in the overall governance structure of the company, including overseeing ethics programs. Companies should broaden their focus, seeking to fill all of their audit committee and board positions with people who have a thorough understanding of the financial statements and the company's financial situation. While the ACFE requirements attempt to quantify these attributes through set criteria, ideally no single factor should control. Special attention should be given where an issuer has particularly complex or intricate operations or financial instruments, is subject to specialized statutory accounting requirements, or is involved in higher-risk industries or financial transactions. Although evaluating a potential committee member's ability to monitor management, auditors, and internal controls on a holistic level is more ethereal and difficult to quantify, corporate boards should seek to develop methods identifying candidates well suited for these tasks. Unique characteristics of each issuing corpo-

68 If a corporation is listed for trading on the NYSE or NASDAQ, by definition it must also comply with the SEC's periodic reporting requirements under the Securities Exchange Act of 1934, as it is "publicly traded." 15 U.S.C.S. § 78m (2006).

69 As some companies that are subject to the SEC's reporting requirements are not traded on a national exchange, the exchange requirements encompass a smaller subset of companies within the universe of "34 Act Companies."

70 Cook, supra note 14, at 1032.

71 Fisher, supra note 19, at 41.

72 Rob Rock & Molly Butler Hart, Turnaround Topic: Improving the Effectiveness of Audit Committees, 18 Am. BANKR. INST. J. 22 (May 1999) (discussing how the committee should assess and pay particular attention to areas where there is a high risk of fraudulent financial reporting).

73 Fisher, supra note 19, at 41 (discussing how boards should seek out audit committee
ration should be considered in the process, as optimal qualifications will inevitably be different for each company. There may not be an objective, checklist-type method to verify that an audit committee member complies with these requirements, but governance structures can be tailored such that members are closely evaluated and held accountable on a regular basis. Although individual evaluations of this sort may be less efficient than objective universal criteria, corporate boards and shareholders will gain more flexibility to adopt standards most beneficial to their situations.

These new requirements for membership on an audit committee have resulted in massive shifts in board composition. Particularly, section 407 of the Sarbanes Oxley Act of 2002 and, generally, parallel requirements in the SRO listing standards require that at least one "financial expert" be on each audit committee. As noted above, interpretation of this requirement has varied widely. However, in a rush to fill their audit committees with financial wizards who could single-handedly prepare and audit the most complex financial statements, many corporate boards appear to have lost sight of the goal and impetus underlying this requirement. In seeking to comply with the letter of the law in meeting this requirement, the primary purpose has been subsumed. "Checking boxes and signing things won't solve integrity problems," remarked one foreign CEO. In taking a step back, the overarching goal of the audit committee is to effectively monitor the financial structures of a corporation, but not necessarily to understand every minute detail. Granted, a fundamental comprehension of accounting and finance is greatly desirable and should not be understated. However, is the heightened "expert" requirement practical, and does it necessarily contribute to a more efficient and effective oversight of the financial systems of a corporation? Admittedly, a committee member with expertise in finance may be held to a higher standard of care than one without such knowledge, but this principle had been recognized long before the current corporate reforms. A committee member who is named the ACFE is not necessarily subject to any additional fiduciary liability simply as a consequence of his or her designation. The supposed additional knowledge and abilities of

members who do more than just satisfy the minimum exchange requirements).

74 See generally Rock & Hart, supra note 72.
76 Cook, supra note 14, at 1031.
77 Id.
78 Backer, supra note 12, at 430.
80 Id. at 1224 (discussing how SEC regulations protect an AFCE from "expert" status under the Federal securities laws, a standard implicating a higher duty of care for opinions of lawyers and accountants).
81 Id.
this member, therefore, do not seem to correlate to any increased responsibilities or tangible expectations. Additionally, the potential liability of other members of the committee is not diminished because they are not the resident "expert." Sarbanes-Oxley and its related reforms may best be viewed as an effort to integrate a system of corporate discipline on all levels, including all members of all corporate committees. The reforms represent increased governmental involvement in order to effectively supervise the supervisors. Yet, the singling-out of one member of the audit committee for special qualification appears contrary to the goal of raising standards across the board. Certainly, the other committee members may look toward the ACFE for insights and advice, which the expert should be fully able to provide, but does merely having such an "expert" engender undue reliance upon their advice by the other members of the board? Gratuitous reliance of this sort may actually result in lower decision-making standards being applied by other committee members. These non-expert members may place such a high level of dependence upon the expert's advice that they derogate their own duties to investigate and make informed decisions. Considering more normative factors for effective corporate governance, this risk of placing too much trust in and becoming overconfident with the opinions of the ACFE supports the proposition that financial literacy should be emphasized for all committee members, considering more normative factors for effective corporate governance.

D. Costs of Compliance

Compliance with the new standards has not come cheaply. It has been estimated that regulatory compliance costs have increased by almost ninety percent for some public companies following Sarbanes-Oxley. In order to attract qualified individuals who are willing to take on the increased scrutiny placed on corporate governance officers after Sarbanes-Oxley, director compensation has risen dramatically. However, the high costs of increased integrity and accuracy in financial statements may pale in comparison to the costs of corruption, corporate failures, and stunted economic growth. The specific authorization of the audit committee to hire outside independent counsel and other experts indicates in part that the ACFE does not

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82 Id.
83 Id.
84 Backer, supra note 12, at 333–34.
86 Backer, supra note 12, at 339.
have to rely entirely on his or her own knowledge or bear the entire burden of solving corporate problems. The entire committee can confer with specialists to gain a further understanding of specific transactions or financial statement amounts when it is appropriate to do so. Although the financial literacy requirement is certainly desirable, and a more than cursory understanding of accounting and finance should be expected from all corporate board members, compliance with the new requirement is not conclusive of “better” corporate oversight, and it does not necessarily guarantee that an audit committee can properly and efficiently accomplish its charged function of effective oversight and monitoring.

II. THE INTERNAL CONTROL ATTESTATION REQUIREMENT

As its name implies, one primary function of the audit committee is coordination of the internal and external audit functions. These critical safeguards provide independent and objective verification that a corporation’s financial statements are free from material misstatements. Although the importance of the audit function itself has been specifically cast into the limelight following recent corporate frauds, it is not the primary object of analysis here. The recent corporate reforms appear to signal a metamorphosis of the audit committee’s responsibilities to include broader objectives. Such reforms also represent an increased emphasis on existing functions of the committee that have been overlooked in the past, namely corporate governance policies. The retention, communication with, and evaluation of the external auditors has previously been hailed as the audit committee’s most important role and should not be diminished. However, coexistent with this goal should be more ex ante safeguards to accomplish effective and efficient monitoring of the company’s financial reporting systems through a robust system of internal controls. The internal control system, encompassing the firm’s internal processes, structures, and checks and balances, is a fundamental predicate of reliable financial information, which has been historically relegated to a position of lesser importance. However, as break-

88 See generally Goldfein & Cace, supra note 7.
89 ARENS & LOEBBECKE, supra note 18, at 142.
91 Cook, supra note 14, at 1030.
93 Fisher, supra note 19, at 90–91.
downs have occurred, the need for increased scrutiny of a company's own internal processes—and more importantly, the proper functioning of such systems—has become evident. Controls focus on all levels of transaction processing and reporting from management's oversight to the lowest-level employee's processing of orders and invoices. Viewed as a close ally of the external audit, strong internal controls can aid in preventing errors or misstatements—or at least detecting them at an earlier stage even before an audit may reveal them—by addressing the company's exposure to specific risks of inaccurate or fraudulent financial reporting. The frauds perpetrated at Enron were not discovered before it was too late, and investors and employees had already borne the greatest share of the losses. Internal controls, if effectively implemented and properly operated, can provide an affirmative immunization to misstatements (proactive prevention), rather than the after-the-fact damage control that may be necessary after errors are revealed through a substantive audit (reactive correction).

A comprehensive system of internal controls allows a corporation to focus its resources on areas of higher risk such as complex transactions, accruals, or estimates. Multiple levels of review in various remote branches and levels of the corporate hierarchy can take advantage of the redundant corporate bureaucracy to prevent even highly collusive frauds. These strong defenses can provide the most effective offensive protection against potential fraud and misstatement.

Assessment and testing procedures covering internal control structures have been conducted by external and internal auditors for many years. However, the analysis of these systems has largely been limited to the purpose of obtaining "audit comfort" by allowing auditors to place more reliance upon the actual numbers and figures produced by an accounting


95 Backer, supra note 12, at 343 (discussing increased emphasis on all employees as corporate actors contributing to the goal of accurate financial reporting).

96 Bodnar & Hopwood, supra note 92, at 177.

97 The huge losses suffered by individual investors called great attention to the post-hoc nature of the traditional audit. See S. COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 107TH CONG., OVERSIGHT HEARING ON ACCOUNTING AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER COMPANIES (2002) (providing the statement of Shaun O'Malley, former Chair, Price Waterhouse LLP, regarding the failing of all safeguards until it was "too late to repair the damage.").


99 H.R. REP. NO. 107-414, at 18 (2002) (discussing how Sarbanes-Oxley was engineered to close loopholes in the existing securities laws).

100 Arens & Loebbecke, supra note 18, at 301.
system, thus requiring less substantive testing and vouching of the underly-
ing transactions themselves.\textsuperscript{101} Therefore, the assessment of internal
tools has been much more of a means to an end (the opinion on the fair presentation of the financial statements) than an independent goal or object by which to judge good corporate governance and promote fair financial reporting.\textsuperscript{102}

Generally Accepted Auditing Standards ("GAAS") are the industry
rules developed and adopted by auditors, through the American Institute
of Certified Public Accountants ("AICPA"), to guide substantive audit pro-
cedures.\textsuperscript{103} Statement of Auditing Standards Number 61 ("SAS 61") sets
forth required communications between the independent auditors and the
audit committee.\textsuperscript{104} Included in the requirements are discussions of any
changes in accounting principles or management estimates used in prepar-
ing the financial statements, adjustments recorded or waived based upon
substantive audit procedures, and any disagreements or difficulties encoun-
tered during the conduct of the audit.\textsuperscript{105} These items represent the bare
minimum areas of interest that an audit committee should expect to be ad-
dressed by their auditors, and are intended to be supplemented as needed
through the professional business judgment of both the auditors and the
audit committee members.\textsuperscript{106} Special attention should be placed on matters
concerning internal control problems or suggestions.\textsuperscript{107} In the WorldCom
bankruptcy proceedings, it was alleged that the Company’s audit commit-
tee failed to sufficiently gain an understanding of the Company’s internal
financial structure\textsuperscript{108} and failed to communicate effectively with their audi-
tor, Arthur Anderson.\textsuperscript{109} Effective monitoring and communication with the
external auditors was lacking, and the audit committee failed to sufficiently
educate themselves concerning the corporation’s own finances.\textsuperscript{110} Both of
these weaknesses represented breakdowns in the overall functions of the
audit committee. Further, Statement of Auditing Standards Number 99

\textsuperscript{101} Larry Kudlow, 2004 Current Financial Reporting Issues Conference, FINANCIAL
DISCLOSURE WIRE, Nov. 8, 2004 (discussing how auditors have previously gained knowledge
about controls primarily to issue their opinion on the financial statements, not for the purpose
of evaluating the actual controls themselves).

\textsuperscript{102} Id.

\textsuperscript{103} ARENS & LOEBBECHE, supra note 18, at 17–18.

\textsuperscript{104} See AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, Statements on Auditing Standards No.

\textsuperscript{105} Id.

\textsuperscript{106} Id.

\textsuperscript{107} Id.


\textsuperscript{109} In re Worldcom Inc. Securities Litigation, 2003 U.S. Dist. LEXIS 21363, at *11

\textsuperscript{110} Id.
“SAS 99”) specifically addresses fraud found in connection with the financial statement audit, effectively imposing even higher obligations on both the external auditors and the audit committee when fraud is suspected. SAS 99, which became operative in 2002, effectively codified an emerging trend in auditing by calling for increased professional skepticism and questioning of management assertions and control processes. However, even the most thorough audit may not be able to detect all management fraud or collusion, as the impetus of the audit opinion is limited to the fair presentation of the financial statements, and the auditor cannot be held as an “insurer” of accuracy in management’s financial reporting. Corporate fraud may occur in ways that may not have a direct material effect on the financial statement amounts. Yet, the recent reforms reflected in SAS 99 indicate a broadening of the auditor’s responsibility to detect management fraud or illegal acts even to the extent that they may not materially impact the financial statement amounts. This standard recognizes that such acts have a direct bearing on management’s internal control structure and integrity and therefore impact the core foundations of fair financial reporting. Potential primary liability of auditors under the anti-fraud provisions of the Securities Acts is another driving force to increase scrutiny on their procedures.

With the adoption of Sarbanes-Oxley Act, internal controls have been increasingly recognized as an important element of the overall functioning of the accounting system. Section 404 requires that management assess and test their own internal control procedures and that registered companies obtain an attestation by external public accountants that such controls are in place and operating effectively. It has been suggested that this emphasis on controls is somewhat late in coming considering the role of

113 ARENS & LOEBBECKE, supra note 18, at 142.
116 See id. at 985; see also Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (holding that aiding and abetting fraud in connection with the purchase or sale of securities is no longer an actionable offense, although primary liability may be asserted against professionals who made actual false statements of fact or opinion).
117 148 CONG. REC. S7350-04 (daily ed. July 25, 2002) (statement of Senator Paul S. Sarbanes) (discussing how the Act is intended to restore integrity to the “fairest, most efficient and most transparent [financial markets] in the world.”).
weak control environments identified in corporate frauds perpetrated in the late 1980s and early 1990s.\textsuperscript{119} A commitment to fair financial reporting is emphasized at the highest levels of a company, effectively setting forth a positive "tone at the top."\textsuperscript{120} The attestation process of Section 404 is emphasized as a comprehensive review of a corporation's systems and control structures, and as an ongoing process—not just a one-time review.\textsuperscript{121} The goal is not only to foster current compliance with the new requirements upon implementation but also to perpetually improve the overall quality of financial information in the future.\textsuperscript{122} Once implemented, the internal controls documentation obtained may actually lower the cost of continuing compliance and improve the integration of effective controls in management decision making.\textsuperscript{123}

\textit{A. The Mechanics of Internal Controls}

Consistent with the overarching audit committee goal of monitoring the company's operations and financial reporting, internal control structures are a first line of defense to prevent and detect accounting and reporting irregularities.\textsuperscript{124} An effective system of controls includes both application and monitoring measures.\textsuperscript{125} Application controls include "nuts and bolts" systems for transaction approval, processing financial information, and the production of internal and external reports.\textsuperscript{126} Typical controls of this genre include required approvals, separation of key accounting and reporting duties, and independent confirmation of accounts and transactions.\textsuperscript{127} Monitoring controls, on the other hand, are designed to monitor the proper operation of the application controls and alert management to any deviation from routine procedure.\textsuperscript{128} These controls are normally on a higher level such as one member of management verifying that an account


\textsuperscript{120} See \textit{id}. COSO advocates a documented, firmly established control structure involving board members and senior executives, in order to help prevent the majority of corporate frauds, which usually originate at the highest levels of company management.

\textsuperscript{121} Kudlow, supra note 101.

\textsuperscript{122} \textit{Id}. (discussing implementation of the Sarbanes-Oxley § 404 Internal Controls Attestation).

\textsuperscript{123} \textit{Id}.

\textsuperscript{124} Kirkendall, supra note 3, 2310 (2003).

\textsuperscript{125} \textit{See infra} notes 117–32 and accompanying text.

\textsuperscript{126} Bodnar & Hopwood, supra note 92, at 187–92.

\textsuperscript{127} \textit{Id}.

\textsuperscript{128} \textit{See} Kudlow, supra note 101.
reconciliation (an application control in itself) done by another individual is performed regularly and properly.\textsuperscript{129} While an effective control environment incorporates both application and monitoring controls designed from the ground up as part of an integrated system, corporate board and audit committee attention is more likely to be focused on monitoring controls.\textsuperscript{130} Toward this end, one of the audit committee's best weapons in ensuring a strong control environment is the internal audit function.\textsuperscript{131} Under the exclusive control of the audit committee, internal auditors should analyze appropriate controls on all levels, identifying weaknesses and proposing changes where necessary without having to report through the levels of financial managers that may have contributed to control weaknesses in the first place.\textsuperscript{132}

\textbf{B. Internal Control Attestation Requirements in Other Industries}

The internal controls assessment requirement as embodied in Sarbanes-Oxley is not totally new. A separate opinion by external accountants, attesting to the existence and effectiveness of internal controls, has been required for many years in audits of federal grants and expenditures under the Office of Management and Budget's Circular A-133 ("OMB A-133").\textsuperscript{133} Pursuant to these regulations, any person, agency, or organization receiving federal grant funds in a single year over a threshold amount must have an independent "single audit" conducted by a public accountant.\textsuperscript{134} The opinion rendered must include not only the fair presentation of the recipient's financial statement amounts, but also whether or not management has internal control systems in place and operating effectively to ensure proper compliance with grant requirements.\textsuperscript{135} This requirement recognizes the importance of control systems in monitoring the processes that organizations have in place to ensure the accurate and timely reporting of financial information concerning the use of government funds.

Additionally, other highly regulated industries have been subject to internal control attestation requirements in the past. Over-the-counter ("OTC") derivatives dealers must file a separate report with the SEC each year indicating that they have an internal risk control system in place and

\textsuperscript{129} See Roth and Esperson, \textit{supra} note 98.

\textsuperscript{130} Backer, \textit{supra} note 12, at 359 (discussing the interconnected nature of controls within the management structure, relating to their duty to report accurate and complete information).

\textsuperscript{131} Fisher, \textit{supra} note 19.

\textsuperscript{132} \textit{Id.}


\textsuperscript{134} 31 U.S.C.S. § 7502(c) (2005).

that such systems have been documented and tested.\textsuperscript{136} This management certification must also be subjected to testing procedures by an independent public accountant.\textsuperscript{137} Similarly, depository institutions under Federal Deposit Insurance Corporation ("FDIC") regulation must submit a statement signed by the chief executive officer and chief accounting or financial officer recognizing that management is responsible for implementing a system of adequate internal controls for financial reporting and that such controls are effective.\textsuperscript{138} Again, this statement must be subjected to testing procedures by the company's independent accountants.\textsuperscript{139} Thus, the extension of the internal control attestation requirements to \textit{all} registered companies places increased emphasis on concerns that have been recognized by other industries and agencies for many years.\textsuperscript{140}

Consistent with the theory that the audit committee, external auditors, and corporate lawyers should serve as "gatekeepers" to prevent corporate fraud,\textsuperscript{141} the heightened involvement of the audit committee in the internal control attestation process provides a solid foundation for reform. This involvement should focus the efforts of corporate reformers on scrutinizing the corporation's own systems and procedures from the ground-up and from the inside-out at the earliest stage possible. An ounce of prevention in the form of effective internal control has the potential to be one of the most effective tools in corporate governance reform. By concentrating the focus of reliable financial reporting on prevention and monitoring through an enabled audit committee, corporate boards can provide efficient and beneficial assurance that complete, accurate, and timely information is provided by the company to its stakeholders and the market at large.

\section*{III. Conclusion}

In conclusion, although the ACFE requirements represent an important step in recognizing the need for increased audit-committee financial literacy, the criteria do little to actually foster any effective change in practice beyond simple compliance. As some foreign commentators have criticized Sarbanes-Oxley as being implemented too quickly without full consideration of available options, continued analysis and amendment should

\begin{itemize}
  \item \textsuperscript{136} 17 C.F.R. § 240.17a-12(l)(1) (2005).
  \item \textsuperscript{137} 17 C.F.R. § 240.17a-12(k) (2005).
  \item \textsuperscript{138} 12 U.S.C.S. § 1831m(b)(2) (2005).
  \item \textsuperscript{139} \textit{Id}.
  \item \textsuperscript{140} See Kudlow, \textit{supra} note 101 (discussing how Sarbanes-Oxley § 404 segregates and places individual attention on internal controls as a worthy goal in and of themselves).
  \item \textsuperscript{141} See generally Rutheford B Campbell and Eugene R. Gaetke, \textit{The Ethical Obligation of Transactional Lawyers to Act as Gatekeepers}, 56 \textit{RUTGERS L. REV.} 9 (2003).
\end{itemize}
be considered. This author believes that the financial expert standards should be modified to include broader metrics to evaluate audit committee effectiveness and monitoring when applied to all board members. More qualitative, company-specific factors should be considered in applying such standards to the diverse situations encountered by corporate boards in different industries. Care should be taken to avoid undue reliance by other audit committee members upon the advice and opinions of the ACFE. In order for the rising tide of corporate governance and responsibility to lift all boats, a higher level of financial sophistication should be demanded from all board members. Instead of a disproportionate distribution of financial knowledge wherein one committee member could be a genius while others barely know the difference between assets and liabilities, a requisite level of financial literacy and monitoring acumen should be demanded from all. However, the current super-expert requirements of the ACFE are probably not the most efficient standards by which to judge the required level of literacy. A CPA or former CFO would definitely be desirable on the audit committee, but the mere presence of these individuals does not automatically result in a higher level of audit committee effectiveness. More importantly, audit committee members should be keen in their monitoring abilities, in order to recognize situations where outside expert consultation should be sought out, as part of the company’s own defense against potential fraud or misstatement. This more enlightened, self-actualized audit committee provides the basis on which to implement and refine a solid internal control structure in close connection with the committee’s duty of monitoring.

The internal control attestation requirements should continue to be given top priority as corporate boards and audit committees recognize the importance of such controls as their first line of defense in upholding their monitoring duties. By broadening the primary focus of an audit committee’s responsibilities from the ex-post emphasis on the external audit to the ex-ante safeguards of internal controls, an effective early warning system can be implemented. Internal controls emphasize the overarching goal of corporate board members (to be diligent advocates protecting the interests of the absentee shareholder and the market) by scrutinizing the corporation’s own processing of information for financial reporting. Once understood by the investing public, such measures can greatly contribute to the overall goal of corporate reforms: to restore confidence in the integrity of the most robust financial markets in the world.

143 Cook, supra note 14, at 1032.
144 Fisher, supra note 19, at 41.
111.htm (commenting that the impetus of the reforms is to restore integrity to the nations financial markets and to serve the interests of U.S. investors).