A Legal Study on the Internal Control System for Direction of Legislation in Korea

Sungbum Kwon

Indiana University Maurer School of Law, ksb1016@gmail.com

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A LEGAL STUDY ON THE INTERNAL CONTROL SYSTEM FOR DIRECTION OF LEGISLATION IN KOREA

SUNGBUM KWON

Submitted to the faculty of Indiana University Maurer School of Law in partial fulfillment of the requirements for the degree Master of Laws – Thesis

December 2017
Accepted by the faculty, Indiana University Maurer School of Law, in partial fulfillment of the requirements for the degree of Master of Laws – Thesis.

Thesis Committee

[Signature]

Brian Jeffrey Broughman
Director of the Center for Law, Society, and Culture
Professor of Law

[Submission date of thesis – December 15, 2017]
The concept of internal control began in accounting professional groups, gradually expanded to the administrative control and the risk management from accounting control, and became an important area that cannot be excluded from the operation of the public companies in the U.S.

When the Enron scandal struck the credibility of the stock market in the U.S. in 2001, the authorities implemented reformative measures including the SOX enactment to protect investors. Although there has been a controversy over this legislation since the enactment of the SOX, it appears that the U.S. capital market has been restoring confidence with the efforts of regulators.

Also, when the foreign exchange crisis and large-scale corporate accounting frauds occurred in Korea, there were demands that companies should establish internal control systems through legislations. However, the authorities in Korea tried to solve the problem by importing internal control system mainly from the U.S. and Japan since there was no various discussions of internal control for a long time. As a result, Korea individual legislations separately imported the internal control provisions from the U.S. and Japan,
and they have contained illogical and cost increase problems. The most fundamental problem is that it is difficult to apply extensive concept of internal control like risk management to public companies that are not financial companies, because there is no general provision related the internal control in the Commercial Act, a general act for public companies. Next, cost problem companies are neglected to establish the internal control. Last, that is a conflict problem of internal control provisions in Korea legislations.

To solve these legislative problems, a general provision on internal control should be created in the Commercial Act. Second, it is necessary to approach companies with indirect regulation method like the U.S. and Japan to minimize the cost of establishment. Finally, it is required to integrate and operate internal control agencies that possibly cause confusion. Also, it is necessary to encourage companies to participate in establishing internal control system by implementing proper incentive systems rather than only imposing regulation.
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I. Introduction

A. Background

The credibility of capital markets fell, and the stock price collapsed due to the Enron\(^1\) and World Com scandal\(^2\) in 2001. The Enron which reported $138.7 billion in revenues and placed the company at the seventh position on the Fortune Global 500 for the nine months of 2001,\(^3\) filed for bankruptcy protection in December of that year. It was revealed that 96% of the net income reported in 2000 was by accounting manipulation. The reason for this was the lack of supervision by the board of directors and independence of external auditors. Illegal acts within the Enron have broken at once the trust of the U.S. capital markets that boasted the world class level of transparency and fairness. After this case, the most innovative measure was taken to restore the credibility of the U.S. capital market with the consideration that the existing regulations were not capable of responding

\(^1\) Choi, Joon-Sun, migug-ui gieobgaehyeogbeob - 2002nyeon-ui sabeinseu ogseullibeob [The U.S. Corporate Reform Act – Sarbanes Oxley Act of 2002], 9(2) THE JOURNAL OF COMPARATIVE PRIVATE LAW 507, 507-8 (Oct. 2002). The Enron scandal is a case in which the Enron quickly has grown into the world class energy company, but eventually went into bankruptcy with financial and lobbying activities, not normal business. The Enron reached more than $ 100 billion sales performance, and it became the U.S. 7th largest company in 2000, but it went insolvent within a year. The company shift its debt and losses to subsidiaries, and it violated ‘generally accepted accounting principles’ (GAAP), using special purpose entities. The Enron’s stock price was US$ 90.75 per share in mid-2000, but plummeted to less than $1 by the end of Nov. 2001. After the Enron’s bankruptcy, the company recorded the largest corporate bankruptcy in U.S. history until WorldCom’s bankruptcy.


effectively to large accounting fraud. In this crisis, the most innovative reform legislation, the Sarbanes-Oxley Act of 2002 (hereafter “SOX”) was promulgated since the Securities Act of 1933 and the Securities Exchange Act of 1934 which had played an important role as the fundamental legislations of the U.S. capital market.

Also, the Daewoo Group was forced to be dissolved by the court’s decisions, for excessively expanding its business in 1999. The Supreme Court found the chairman of the Daewoo Group, Kim, Woo-Choong was guilty for being involved in the fraudulent accounting of 41 trillion won [approximately $ 36.7 billion (1,115 won/1 U.S. dollar)]. After the financial crisis in 1997 and several fraudulent accounting scandals of conglomerates, various bills were introduced for the advancement of the accounting system.

Particularly, the Korea has prepared the revision of the individual bills by importing main provisions of SOX since the enactment of the act in the U.S. The general provisions for the internal control were not legislated to the Commercial law, a general law for public companies was individually imported to the various special laws in Korea although the

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4 OHMYNEWS, Daewoo bunsighoegye 50jo... 200eogdalleo haeoebimilgwanli [Daewoo Fraudulent accounting 50 trillion...$20 billion foreign secret management], http://www.ohmynews.com/NWS_Web/View/at_pg.aspx?CNTN_CD=A0000031666 (last visited Nov. 29, 2017). The chairman Kim has been managing over $20 billions over the past three years through British Finance organization (BFC) established in London, the U.K.

5 Suh, Hun Je, 2002nyeon migug gaeoobgaehyeogheob-e daehan yeongu [A Study on the U.S. Sarbanes-Oxley Act of 2002], 6(2) CHUNG-ANG L. REV. 161, 214-6 (July 2004). These reformative legislations were revised bills of the Securities and Exchange Act, the Act on External Audit of Stock Companies, and the Certified Public Accountants Act. Particularly, the bills of the Securities and Exchange Act included the provisions related to the certification system of the CEO and other relevant officers, importing the Article 302 and 906 of SOX. However, the opposite views were raised by public companies that the bill could be the burden to the CEO because financial statements were ultimately decided by the board, even if the CEO and other accounting officers could make them.
U.S. introduced the internal control system for public companies. In addition, the penal clauses of the Securities and Exchange Act of Korea were lighter than those of SOX, and had limitations as to the effectiveness of the law.6

B. Purpose and Synopsis

The purpose of this study is to review the development of the internal control concept, the legislations amendments, and the relevant judicial precedents in the U.S. for the implication of the legislations related to the internal control in Korea. This Thesis consists of five parts.

Part II begins with describing how the U.S. internal concept had begun and developed. In the process, I will review the Foreign Corrupt Practice Act of 1977(hereafter “FCPA”) and parts related to the internal control of the U.S. Sentencing Guidelines for Organizations prior to the SOX. It is necessary to examine how the internal control concept shaped and developed the Committee of Sponsoring Organizations of the Treadway Commission reports (hereafter “COSO reports”) and how they had created modern internal control concepts. After that, I will explain main provisions related to the internal control of the SOX which has considered to be the most reformative legislation since the Securities Act of 1933 and the Securities Exchange Act of 1934 in the U.S. After analyzing the

6 *Id.* at 217. If management breaches the certification obligation, the defendants shall be punished by imprisonment for not more than 20 years or a fine of $ 5 million under the SOX, but only imprisonment for not more than 5 years or less than a fine of 30 million won [$ 26,905 (1,115 won/ 1 U.S. dollar)] under the Securities Exchange Act of Korea.
relevant cases about the internal control obligations, I will write about how the courts had evaluated the duties of boards of directors on internal control.

In part III, I will explain the main clauses and the problems of three legislations about the internal control system in Korea. Those are the internal accounting management regulations of the External Audit Act, the compliance officer of the Act on Corporate Governance of Financial Companies, and the compliance assistant of the Commercial Act. Comparing to the U.S. internal control system, I would like to point out the problems of the legislations of internal control in Korea. First, it is difficult to apply the concept of the internal control to public companies that are not financial companies because there is no a general provision on internal control in the Commercial Act as a general law for public companies. Next, I will describe the cost burden problems of companies to implement the internal control provisions. Even if the ideas of the internal control is positive, if the burden of public companies is ignored, the legislations will be subjective to formal administrative regulations, and it will be hard to expect substantial effect to the investors’ protection. Additionally, I will mention the conflict issues related to the internal control in Korea. Those are mainly about the works inefficiency and duplication problems such as the distinction problems between the compliance officer and the compliance supporter and the reporting issues of them.

In part IV, I will suggest several implications that the legislature can refer to make laws related to the internal control system in Korea. The internal control system had to relied on imports of the U.S. and Japanese legislations. Issues in regards to this matter were not addressed and discussed until many years later unlike the laws in the U.S.
legislations. As a result, there are a contradiction that the general provision for the internal control cannot applied to public companies that are not financial companies because the provision was not included in the Commercial Act. For that reason, the Commercial Act should include a general provision for the internal control system. To minimize the cost of implementing the internal control clauses, I will suggest my opinion as how to make the criteria of public companies to which the internal control provisions can be applied. Also, I will mention which regulation approach can be more effective between direct and indirect method for the internal control. The last part will address the need for an appropriate incentive system to encourage public companies to voluntarily participate. The part V will summarize the conclusion of this study.

II. Development and Current situation of Internal Control System in the U.S.

A. The beginning of the concept of internal control

Generally speaking, “Internal control serves as a first line of defense in safeguarding assets and preventing and detecting errors and fraud”.7 Historically, the term of internal control has been mainly used by the accounting professional groups and the accounting groups have used the term ambiguously as to the exact meaning and scope at

first. In 1949, the term of ‘internal control’ first emerged in a publication of the American Institute of Accountants, the predecessor of the American Institute of Certified Public Accountants (“AICPA”).

AICPA Committee on Auditing Procedure published a special report titled 「Internal Control: Elements of a Coordinated System and Its Importance to Management and The Independent Public Accountant」 to conceptualize internal control. The report defined internal control as “the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.” In other words, the accounting groups broadly recognized the definition of internal controls as beyond those matters which relate directly to the functions of the accountings from the outset.

Afterward, these concepts distinguished between accounting controls that directly relate to the financial records and the safeguarding of assets and administrative controls by Statements on Auditing Procedure No. 29 in October 1958. Although the audit procedure

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9 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS. COMMITTEE ON AUDITING PROCEDURE, INTERNAL CONTROL: ELEMENTS OF A COORDINATED SYSTEM AND ITS IMPORTANCE TO MANAGEMENT AND THE INDEPENDENT PUBLIC ACCOUNTANT, special report, 6 (1949); Peter Ferola, Internal Control in the Aftermath of Sarbanes-Oxley: One Size doesn’t Fit All, 48 S. Tex. L. Rev. 87, 90 (2006).

10 THE COMMITTEE ON AUDITING PROCEDURE OF THE AICPA, STATEMENTS ON AUDITING PROCEDURE No. 29: SCOPE OF THE INDEPENDENT AUDITOR’S REVIEW OF INTERNAL CONTROL 36 (1958) (stating that “accounting controls generally include the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports. On the other hand, Administrative controls generally
might be classified as accounting controls and administrative controls and the auditor’s responsibilities are basically limited to accounting controls, the control methods could vary depending on individual circumstances. For example, if the auditor believes that certain administrative controls affect the financial records, he could consider the need of such controls.11

However, Because the term of internal control has been approached beyond the accounting functions of a company, and accounting groups have ambiguously used the term, there was a limitation that prevented from successfully defying the term. After that, there has been several attempts to distinguish between the accounting controls and administrative controls. The AICPA formally abandoned the efforts in 1988.12

B. Introduction of internal control regulation by public agencies.

1. Foreign Corrupt Practice Act (1977)

Basically, private organizations mainly have discussed problems of the internal control because they were the discretion of enterprise’s management to decide whether to establish internal control systems within the organizations for business purposes. However, the FCPA which was passed by the U.S. Congress in 1977 enacted the first public

include statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.”

11 Id. at 37.

12 Id.
regulations on the U.S. internal controls.\footnote{13}

The FCPA was originally triggered by the Watergate scandal,\footnote{14} and the SEC investigation discovered over $300 million of questionable payments by U.S. companies to foreign government officials.\footnote{15} Subsequently, the SEC began investigations, and proposed an autonomous disclosure program in which companies could report suspicious internal and external payments or accounting practices to the SEC on March 8, 1974. As a result, approximately 360 companies reported their funding and accounting practices until March 1977, and eventually about 400 companies participated in the program. After the SEC’s investigation, it was revealed that unlawful payments required secret funds based on accounting fraud and inappropriate accounting books and records. Therefore, the FCPA adopted two approaches to counter bribery, which were accounting provisions and anti-bribery provisions.\footnote{16} The accounting provisions focus on disclosure. It requires all companies registered with the SEC to keep accounts of all transactions, and establish an

\footnote{13} Tor Krever, \textit{Curbing Corruption – The Efficacy of the Foreign Corrupt Practice Act}, 33 N.C.J. INT’L L. & COM. REG. 83, 84 (2007). The U.S. Foreign Corrupt Practices Act of 1977, also, was the first legislation in the world to recognize and seek to curb the contribution of domestic corporations to foreign corruptions. After that, the FCPA was incorporated into the Securities Exchange Act of 1934.

\footnote{14} Daniel L. Goelzer, \textit{The Accounting Provisions of the Foreign Corrupt Practices Act – The Federalization of Corporate Recordkeeping and Internal Control}, 5 J. CORP. L. 1, 6 (Nov. 1979). (stating that “when the Watergate investigation uncovered instances of the covert use of corporate funds for illegal corporate political contributions, the SEC began to consider whether the concealment of these contributions violated the disclosure requirements of the federal securities laws.”)

\footnote{15} Krever, supra note 14, at 87. The 527 companies, the SEC report listed, were major U.S. corporations such as Exxon Mobile, Boeing, Lockheed Martin, and Gulf Oil.

\footnote{16} Id.
internal accounting control system. The anti-bribery provisions prohibit the U.S. companies from making payments to foreign officials for her help to retain business.

2. The United States Sentencing Commission (1991)

The U.S. Sentencing Commission announced the U.S. Sentencing Guidelines for Organizations, which provide an effective compliance and ethics program, in 1991. It


(2) Every [SEC-reporting] issuer… shall…

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that –

(i) transactions are executed in accordance with management’s general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management’s general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

18 Id.


According to the U.S. Sentencing Guidelines, Compliance officers rely on the seven steps of the Guidelines to implement an effective compliance program.

1. Set up standards and procedures to prevent and detect non-compliance with the regulatory scheme.
was the U.S. Sentencing Commission, an independent organization in the federal judiciary that declared a sentence guideline for organizations.

The main content was that punishment could be reduced if companies effectively establish an internal control system that can prevent and detect criminal conducts, even if the firms violate the laws. Specifically, if a company reports to relevant authorities within a reasonable period, actively cooperates with the investigation, and expressly acknowledges the responsibility for the criminal conducts, punishment can be significantly reduced. Internal control system including a compliance program was required to quickly report to the authorities. It could be evaluated that the U.S. Sentencing Guidelines for Organizations provided incentives for establishment of internal control system within the

2. Top management and the board must play a proactive role in overseeing the program.

3. Eliminate individuals with authority whose prior conduct is inconsistent with strict compliance standards.

4. Communicate standards and procedures effectively among directors and officers.

5. Monitor and audit the compliance program periodically and maintain an effective system for reporting non-compliance.

6. Enforce the program through effective incentives and establish appropriate disciplinary procedures to deal with non-compliance, including compensation reduction.

7. If non-compliance is discovered, take reasonable and prompt steps to avoid future problems, including modifying the compliance program, as needed.

Id. at 37. The U.S. Supreme Court held that “if a company has an anti-harassment compliance policy and procedure in place, and an employee fails to use them to report harassing behavior, the employer can present the compliance program as an affirmative defense to a hostile work environment claim.” in Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998).
organizations.\textsuperscript{21} The Guidelines created a new position, the Ethics & Compliance officer, and spurred companies to improve existing compliance programs or create new compliance programs.\textsuperscript{22}

C. The Formulation of Internal Control Concept

1. Treadway commission (1992)

One of the institutions that played a major role in establishing the concept of internal control in the U.S. was the Committee of Sponsoring Organizations of the Treadway Commission (hereafter “COSO”) under the National Commission on Fraudulent Financial Reporting (hereafter “Treadway Commission”). The COSO published the report of the Treadway Commission to identify the causes of fraudulent financial reporting, and review measures to deter its occurrence, with the cooperation of American Institute of CPAs, American Accounting Association, Financial Executive International, Institute of Internal Auditors, and National Association of Accountants in 1980s.

After that, the COSO reviewed the corporate structure, not limited to financial reporting, to prevent and rectify frauds within the organizations, and published a final

\textsuperscript{21} Yang, Man-Sig, \textit{Isaui naebutongjesiseutem-ui guchugchaeg-imgwa hyeonsang-e gwanhan yeongu [A Study on Responsibilities and Current States of the internal Control]}, 25(1) \textit{BUSINESS LAW REVIEW} 249, 252-3 (2011).

report on how to define the concept of the internal control and the evaluation standard in 1992. This report is the “Internal Control-Integrated Framework” (the COSO report of 1992) that comprehensively defines and describes the internal controls.


i. The definition of Terms for the Internal control (COSO of 1992)

The COSO report of 1992 describes that the concept of internal control is a reasonable process implemented by a board of directors, management and other employees to achieve three objectives that are ① effectiveness and efficiency of operations, ② reliability of financial reporting, ③ compliance with applicable laws and regulations.\(^\text{23}\) In order to achieve the above three objectives, the report explains that it is necessary for five elements to be worked organically. The five elements are ① Control environment (integrity, ethical values and abilities, management philosophy and behavior style, etc.), ② Risk assessment (duties to identify and analyze risks related goals achievement), ③ Control Activities (policies and procedures to ensure that management orders are implemented), ④ Information and communication systems, ⑤ Monitoring.\(^\text{24}\)

According to the report, the purpose of establishing internal control is to achieve


\(^{24}\) Id.
the above three objectives that are effectiveness and efficiency of business activities, reliability of financial reporting, and compliance with related laws and regulations. In other words, the central task of internal control is to comply with laws and regulations to attain management objectives of a company effectively and efficiently, and as a result, the appropriateness of financial reporting is needed. Also, the subject to accomplish these goals should be management, and the obligation to monitor and improve their effectiveness continuously is also a part of management. Eventually, the concrete way to achieve the management goals depends on the management’s own discretion.\(^{25}\) Since then, the internal control concept in the COSO report of 1992 has been accepted by the SOX in 2002, which has also affected legislations in other countries, including Korea and Japan.

\[\text{ii. Integrated Framework as Risk Management (COSO of 2004)}\]

In the COSO report of 2004, the concept of internal control has been described in ‘the Enterprise Risk Management-Integrated Framework, integrating the concept in the SOX report of 2002. In other words, it was clearly declared that the internal control was a system to effectively manage the entire risks of company’s business activities as a premise of management activities.

The reason to release the COSO report of 2004 was that it required the maintenance of an internal control management system beyond the SOX. Namely, it was

\(^{25}\) Yook, Tae-woo, Migug ilbon dog-il-eseoui gieob keompeullaieonseu gaenyeom mich jedoui baljeongwa uli beobjee daehan sisajeom [Development of Definition and System of Corporate Compliance in USA, Japan, and Germany and Its Implications on Korean Legal System], Gyeong-yeongbeoblyul [Business Law], 369 (2017).
not guarantee the success of the business, and it was required new risk management system to achieve business goals properly according to the COSO report of 2004. Therefore, risk management was required as the next step, based on the completeness of reporting under the SOX.\textsuperscript{26}

The COSO report of 2004 defines Enterprise risk management (hereafter “ERM”) as follows.

Enterprise risk management is a process, effected by an entity’s board of directors, management and other personnel applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.\textsuperscript{27}

Enterprise risk management structure consists of ① Strategic (high-level goals, aligned with and supporting its mission), ② Operation (effective and efficient use of its resources), ③ Reporting (reliability of reporting), ④ Compliance (compliance with applicable laws and regulations).\textsuperscript{28}

\textsuperscript{26} Son, Young Hoa, \textit{Naebutongjewa junbeobjiwon-injedo [Internal Control and Compliance System in Korea]}, 60 Seonjinsangsabeoblyul-yeongu [ADVANCED COMMERCIAL LAW RESEARCH], 151 (2012).


\textsuperscript{28} Id. at 3.
There are several differences between the internal control in COSO of 2002 and the Enterprise risk management in COSO of 2004 as follows. First, the concept of internal control in the COSO of 1992 had three objectives, but the strategy perspective was added and had precedence over the other three objectives in the COSO report of 2004. Next, although the internal control integration structure had three components, it expanded to eight components in the report of 2004. The enterprise risk management in 2004, also, included the integrated structure of internal control in the report of 1992, and described that the internal control-integrated structure was an indispensable element as a part of the enterprise risk management. As a result, the enterprise risk management expanded and refined the components of internal control described in COSO report of 1992.29

iii. Ensuring the Reliability of Non-Financial Reports (COSO of 2013)

The COSO has reviewed its internal control, and has published an updated version of 2004 report in 2013 (hereafter “COSO report of 2013) after conducting an international online survey in November 2011. The COSO of 2013 expanded the scope of financial reporting and supplemented unclear or abstract parts, complementing the internal control concept in the COSO report of 1992.  

The COSO report of 2013 defined “internal control as a process, effected by board of directors, management, and other personnel, designed to provide reasonable assurance

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30 COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, supra note 27, at 5.

regarding the achievement of objectives relating to operations, reporting, and compliance.”32

There are similarities in the concept of internal control of between the COSO report of 1992 and 2013, nevertheless there are multiple differences and they are as follow: First, the term, reliability of financial reporting in the purpose of internal control in the COSO report of 1992 was changed to reliability of reporting. The reason is that it is necessary to secure the reliability of the entire reports including the disclosure of non-financial information such as a CSR (Corporate Social Responsibility) report and a Sustainability report. The monitoring, also, which was one among the five internal control components in the COSO report of 1992, was changed to ‘monitoring activities’ to prevent the component from concentrating only on the control itself.33 Next, although the COSO report of 1992 used the existing departmental units and the entire company as an organizational unit, the COSO report of 2014 had internal control implemented by each unit, clarifying roles and responsibilities of functional units, operational units, business units, and subsidiary companies. Additionally, the COSO report of 2014 considered the governance structure of the audit committee, the compensation committee, and the executive recommendation committee besides the board of directors. Above all, the most significant


33 Id. at 4. (stating “Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment. They may be preventive or detective in nature and may encompass a range manual and automated activities such as authorizations and approvals, verifications, reconciliations…”).
feature of the COSO report of 2013 is to provides only a minimal set of principles for the internal control, and to gives the discretion to companies to customize it.34

D. The legislation of Sarbanes-Oxley Act

1. The Overview of SOX of 2002

The internal control concept of the COSO report of 1992 was reflected by the SOX in 2002, which affected the regulation for public companies of other countries including Korea and Japan. The SOX which had been enacted in July 2002 after the Enron scandal in 2001, required a complicated compliance structure for public companies. The SOX dealt with the independence of auditors, the responsibilities of public companies, the improvement of internal control, and the enhancement of financial disclosure provisions. Under the Act, a powerful and independent Public Company Accounting Oversight Board (PCAOB) has been established to deal with corporate scandals, and to oversee audits of public companies which are applied to the Securities Exchange Act of 1934.35

The SOX prohibited the auditors from conducting works affecting the audits to avoid the conflict of interest, and tried to prevent companies from committing fraudulent acts by provisions related to whistleblowers, and strengthened the penalties for company frauds.


35 Yook, supra note 22, 142-6.
The SOX, also, strengthened corporate disclosure system to protect investors. Management was held responsible for establishing internal control system and evaluating the effectiveness of the system. The auditors were liable to attest the evaluation of management, and had the obligation to report the results to the Audit Committee. The public companies should disclose any significant changes in the financial statements including non-financial statements.

2. Main provisions of the SOX

i. Procedures for Complaints under Audit Committee (Section 301)

It is effective to establish procedures for complaints in which employees of public companies can raise problems regarding unlawful behaviors. Generally, it is difficult to detect illegal acts such as forgery or embezzlement that occur in the business before internal staff report misconducts. There is consistent evaluation that it is effective to establish internal reporting system to deter frauds, which are increasingly intelligent and confidential. In the U.S., Whistle-blowers in the federal governments were first protected in the 1970s. The SOX obligated the Audit Committee of listed companies to establish anonymous procedures for complaints regarding accounting, internal accounting controls, or audit matters. If a whistle-blower, also, reasonably believed that there is a violation of

36 Park, supra note 31, at 58.

37 Id.

federal law that regulates fraudulent behaviors related to Finance, Securities, and Shareholders, he could be legally protected.\textsuperscript{39}

\textbf{ii. Certification responsibility of CEO and other financial officers (Section 302)}

The principal executive officer’s certification requirements of the SOX section 302(a) are mainly related to internal control through disclosure regulations. In other words, principal executive officers, principal financial officers, and other officers should certify specific matters in the company’s periodic reports which is submitted to the SEC under the Securities Exchange Act of 1934 section 13(a) or 15(d).\textsuperscript{40} The relevant officers should certify that the financial statements and other financial information fairly present the financial condition and operation of the company.\textsuperscript{41} The officers should disclose to the auditors and the audit committee all significant deficiencies in the operation of internal

\begin{flushleft}
\textsuperscript{39} Id. § 806. “Remedies --(1) In general - An employee prevailing in any action under subsection (b)(1) shall be entitled to all relief necessary to make the employee whole. (2) Compensatory damages - Relief for any action...”
\end{flushleft}

\begin{flushleft}
\textsuperscript{40} Id. § 302(a)
\end{flushleft}

\begin{flushleft}
\textsuperscript{41} Id. § 302(a)(3). Also, according to the SOX § 302(a)(4), (stating “the executive officers are responsible for establishing and maintaining internal controls, have designed such internal controls, and have evaluated the effectiveness of the issuer's internal controls, and have presented in the report their conclusions about the effectiveness of their internal controls.”)
\end{flushleft}
control and any fraud that involves management.\textsuperscript{42}

Also, the signing officers should specify and certify in their periodic reports whether there has been a material change and other factors that could significantly affect the internal control system after the evaluation date.\textsuperscript{43}

\textbf{iii. Management Assessment of Internal Control (Section 404)}

Management should evaluate the changes in the internal control system of a company that materially impacts or is reasonably expected to impact on the financial reporting. In other words, annual report should include internal control report under the SOX section 404. An internal control report should prescribe \begin{enumerate}
\item the responsibility of management to establish and manage an adequate internal control structure and procedures for financial reporting, and
\item an assessment of the effectiveness of the internal control structure as of the end of the most recent fiscal year of the company.\textsuperscript{44}
\end{enumerate} Also, each public accounting firm which issues the audit reporter for the company should attests to the assessment made by the management.\textsuperscript{45}

\begin{small}
\footnotesize
\textsuperscript{42} Id. § 302(a)(5).

\textsuperscript{43} Id. § 302(a)(6).

\textsuperscript{44} Id. § 404(a).

\textsuperscript{45} Id. § 404(b).
\end{small}
iv. Code of Ethics for Senior Financial Officers (Section 406)

According to the SOX, the definition of code of ethics is standards to promote “① honest and ethical conduct, ② full, fair, accurate, timely, and understandable disclosure in periodic reports, and ③ compliance with applicable governmental regulations.” 46 The SOX requires a public company to disclose whether the company had adopted a code of ethics for senior financial officers and persons performing similar functions. 47 If a public company does not disclose the adoption of the code of ethics, the company should disclose the reason for not disclosing it. 48

3. Effects of Sarbanes-Oxley Act

i. Positive Effect

First, it is evaluated that the SOX pursues the effectiveness of accounting provisions by a certification of signing executive officers and other officers who perform similar functions. 49 Under the SOX, the principal executive and financial officers should certify that “the financial statements and other financial information in the report fairly present the financial condition and result of operation of the company for the periods presented in the

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46 Id. section 406(c).

47 Id. section 406(a).

48 Id.

report.”50 If whoever willfully certifies an inadequate report, he or she “shall be fined not more than $5,000,000 or imprisonment not more than 20 years, or both.”51

It is also positive that internal control system is included in the certification to supplement the provision. This clause not only requires the CEO to certify whether there is a wrongdoing, but is also a guaranteed device that can make him find the wrongdoer. Signing officers should assure the flow of financial information, and evaluate the effectiveness of internal control system within ninety days prior to the publication of the reports, establishing the system.52 The Corporate law status did not enforce the internal control system prior to the SOX, however, it evaluated that the SOX establish a standard for its effectiveness.53

Additionally, The SOX has enforced the quality and independence of the audit function by assuring more autonomy of the audit committee.54 According to the SOX, the audit committee can hire any registered public accounting firm, oversee the work, receive audit reports, and hold directly responsible for contents of the reports.55 The SOX prohibits the use of non-audit business which can affect the audit from public accounting firms to

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50 Id. § 302(a)(2).

51 Id. § 906(c)(2).

52 Kim, supra note 49, at 247.

53 Id.

54 Id. at 242.

55 Sarbanes-Oxley Act, supra note 38, § 301(2).
strengthen the independence of auditors.56

ii. Negative Effect

According to Bob Greifeld, “foreign IPO candidates are now reluctant to consider the U.S. capital market as result of SOX compliance issues.” 57 He claims that “approximately 90% of international small companies intending to go public are choosing to list abroad because of SOX costs and concerns.” 58 According to the GAO report, many public companies are going private. For example, the number of companies going private increased drastically from 143 in 2001 to 245 in 2004 (see figure 2). 59 Even though these numbers are a small percentage of entire public companies, the trends explain that more

56 Id. § 201(g).

Prohibited Activities (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible.


59 U.S. Government Accountability Office, supra note 7 at 76.
small companies are reconsidering the cost and benefits of keeping public.\textsuperscript{60}

Why did small companies go private? Many companies mentioned both the direct and the indirect costs of maintaining their public company status. After the SOX enactment, the companies needed more the direct cost that were the accounting and legal fees and the indirect cost like the time to comply with SEC’s reporting requirements.\textsuperscript{61} The Table 1 shows that the direct cost increased to 62.2\% in 2005 from 12.3\% in 1998, and the indirect cost also increased to 28.9\% in 2005 from 5.3\% in 1998. Therefore, it can be presumed that cost considerations like direct and indirect costs were the leading reasons for the small companies exiting the public market.

**Figure 2. Total Number of Companies Identified as Going Private from 1998 to 2005\textsuperscript{62}**

\textsuperscript{60} Id.

\textsuperscript{61} Id. at 22

\textsuperscript{62} Id. at 77.
Table 1. Primary Reasons Cited by Companies for Going Private (1998-2005)\textsuperscript{63}

<table>
<thead>
<tr>
<th>Year</th>
<th>Direct costs</th>
<th>Indirect costs</th>
<th>Market/liquidity issues</th>
<th>Private company benefits</th>
<th>Critical business issues</th>
<th>Other</th>
<th>No reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>12.3</td>
<td>5.3</td>
<td>14.0</td>
<td>26.3</td>
<td>15.8</td>
<td>3.5</td>
<td>54.4</td>
</tr>
<tr>
<td>1999</td>
<td>33.3</td>
<td>12.2</td>
<td>33.3</td>
<td>42.2</td>
<td>8.9</td>
<td>3.3</td>
<td>37.8</td>
</tr>
<tr>
<td>2000</td>
<td>20.0</td>
<td>11.1</td>
<td>32.2</td>
<td>37.8</td>
<td>20.0</td>
<td>5.6</td>
<td>38.9</td>
</tr>
<tr>
<td>2001</td>
<td>32.2</td>
<td>13.3</td>
<td>31.5</td>
<td>23.8</td>
<td>20.3</td>
<td>3.5</td>
<td>49.0</td>
</tr>
<tr>
<td>2002</td>
<td>44.4</td>
<td>13.9</td>
<td>35.4</td>
<td>22.9</td>
<td>16.0</td>
<td>1.4</td>
<td>45.1</td>
</tr>
<tr>
<td>2003</td>
<td>57.8</td>
<td>27.5</td>
<td>38.5</td>
<td>21.3</td>
<td>19.7</td>
<td>0.8</td>
<td>31.6</td>
</tr>
<tr>
<td>2004</td>
<td>52.7</td>
<td>25.7</td>
<td>28.6</td>
<td>15.9</td>
<td>15.5</td>
<td>1.2</td>
<td>38.4</td>
</tr>
<tr>
<td>2005 Q1</td>
<td>62.2</td>
<td>28.9</td>
<td>28.9</td>
<td>8.9</td>
<td>12.2</td>
<td></td>
<td>27.8</td>
</tr>
</tbody>
</table>

Source: DAO analysis of SEC filings and relevant press releases.

E. Relevant Cases of Internal Control System

1. Caremark case

The Caremark case\textsuperscript{64} of the Delaware court in 1996 concerns the director’s obligation for the company’s compliance and ethics program. In this case, the court decided that there was no fault or negligence on the supervisory obligation of the board of directors because there was no ground that the company’s board lacked their duty of care or

\textsuperscript{63} Id. at 23.

\textsuperscript{64} Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 CARDOZO L. REV. 237, 261-2 (1997). The facts of the case were that “Caremark entered into various agreements with health-care providers, including consultation agreements with, and research grants to, physicians. At least some of these physicians prescribed or recommended Caremark services or products to Medicare recipients and other patients. Based on these agreements and grants, Caremark was indicted for violating APRL.”
knowingly connived the violation of the company rules.\textsuperscript{65} Instead, the supervisory duties of the board were deemed to have met if the board of directors had worked to establish a compliance program as a good manager.\textsuperscript{66}

2. Stone case

The Delaware Supreme Court expressly approved the so-called Caremark doctrine, which was on the board’s responsibility with respect to the organization and monitoring of the enterprise through the Stone case. The Stone case made it clear that the duty of care in the Caremark was the part of the fiduciary duty of the directors,\textsuperscript{67} and it was needed to prove “knowing violation of statute” in order to ask for the responsibility of the director.

We hold that Caremark articulates the necessary conditions predicted for director to oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their

\textsuperscript{65} In re Caremark International Inc. Derivative Litigation, 698 A.2d 956 (Del. Ch. 1996) at 972.

\textsuperscript{66} \textit{Id.} at 972.

\textsuperscript{67} CHARLES R.T. O’KELLERY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS CASE AND MATERIALS 374 (Vicki Been et al. eds., 7th ed. 2014). (stating “the Caremark standard for so-called “oversight” liability draws heavily upon the concept of director failure to act in good faith.”)
attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligation. Directors fail to act in the face of a known duty act, they demonstrated a conscious disregard for their responsibilities, by breaching their duty of loyalty and by failing to discharge that fiduciary obligation in good faith.68

III. Current internal system and Problems in Korea

A. Status and Analysis of Legislation on Internal Control in Korea

Conglomerates in Korea have been demanded transparency and soundness of corporate management from overseas investors since the IMF financial crisis.69 Specifically, much interests were concentrated on securing transparency of accounting areas as accounting fraud cases in the U.S. and fraud incidents involving Japanese financial institutions. As a result, it became compulsory for a list of companies to be more transparent in regards of assets and to establish an internal control system by executive orders. The internal control system under the legislations of Korea is that ① Internal


69 Korean Law via the Internet, IMF Crisis, http://www.koreanlii.or.kr/w/index.php/IMF_Crisis?ckatempt=1

(last visited on Nov. 29, 2017) (stating “IMF Crisis means the financial crisis experienced by Korean people in the late 1990s, which was caused by the severe foreign exchange shortage on the brink of default of South Korea in December 1997, and bailed out by the IMF Standby Credit Facility and other international financial supports.”)

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Table 2. THE INTERNAL CONTROL SYSTEM UNDER THE KOREAN LEGISLATIONS71

<table>
<thead>
<tr>
<th>Internal Control</th>
<th>Purpose</th>
<th>Target Companies</th>
<th>Legislations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Accounting Management System</td>
<td>Accounting Control</td>
<td>Public companies with assets of more than 100 billion won</td>
<td>External Audit Act</td>
</tr>
<tr>
<td>Compliance Officer</td>
<td>Administrative Control including Compliance Control</td>
<td>Financial companies including banks, insurance companies, etc.</td>
<td>Financial Company Governance Act</td>
</tr>
<tr>
<td>Compliance Assistant</td>
<td>Compliance Control</td>
<td>Public companies with assets of more than 500 billion won</td>
<td>Commercial Act</td>
</tr>
</tbody>
</table>

1. Internal Accounting Management System of External Audit Act

A compliance system, the Internal Accounting Management System, was first enacted in the Corporate Restructuring Promotion Act as a temporary statute (2001. 9. 15


71 Chung, supra note 29, at 288. If 1 U.S. dollar can be converted to 1,115 won (Korean currency unit), 100 billion won is approximately $ 89,686,098, and 500 billion is about $ 448,430,493.
by the influence of the SOX of the U.S. in 2001. Thereafter, the compliance system was transferred to the Act on External Audit of Stock Companies (hereafter “External Audit Act”).

The External Audit Act is a law that sets out the matters necessary for the accounting of the company under the audit of the external auditor. It is stipulated that the internal accounting management regulations and the internal accounting management system should be established for the preparation and public notice of reliable accounting information under the Article 8(1) of the External Auditing Act. However, privately held

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72 Yang, supra note 21, at 262. The Ministry of Planning and Economy submitted to the Congress a bill of the Securities Transactions Act, the Act on External Audit of Stock Companies, and the Certified Public Accountant Act in June 2002, and they were passed in the Congress in December 2003.

73 Jusigheoesa deung-ui oebugamsa-e gwanhan beoblyul [Act on External Audit of Stock Companies], Act No. 3297, Dec. 31, 1980, amended by Act. No. 15022, Oct. 31, 2017, art. 1 (S. Kor.). “The purpose of this Act is to protect interested persons and to contribute to the sound growth of companies by ensuring appropriateness of accounting through obliging a stock company to be audited by an external auditor who is independent of such company”.

74 Id. art. 8(1) (Operation, etc. of Internal Accounting Management System)

(1) Any company (excluding a company other than a stock-listed corporation, whose total amount of assets is less than 100 billion won at the end of the immediately preceding business year; hereafter the same shall apply in this Article) shall have internal accounting management regulations which include the following matters and shall have the system to manage and operate them (hereinafter referred to as "internal accounting management system") for the preparation and public notice of reliable accounting information:
1. Matters concerning the method of identification, mensuration, classification, recording and reporting of accounting information (including transaction related information which forms the basis for accounting information; hereafter the same shall apply in this Article);
2. Matters concerning the method of controlling the errors of accounting information and revising them;
3. Matters concerning the internal verification, such as a regular inspection and adjustment, etc. of accounting information;
4. Matters concerning the method of managing books to record and keep accounting information (including magnetic tapes, diskettes and other information storage devices) and the controlling procedures to prevent forgery, alteration, damage, or destruction;
5. Matters concerning the segregation of duties and responsibilities of the executives and employees related to the preparation and public notice of accounting information;
6. Other matters prescribed by Presidential Decree which are necessary for the preparation and public notice of reliable accounting information.
companies whose total amount of asset is less than 100 billion won at the end of the immediately preceding business year are exempted from this application. 75 The representative of a company shall assume the responsibility for the management and operation of the internal accounting management system and appoints one full-time director who is appointed as the internal accounting manager.76 Also, the representative of the company has an obligation to report the operating status of the internal accounting control system to the shareholder, the board of directors, and the audit committee every business year.77

An external auditor who reviews a stock company’s report on the current operational status of its internal accounting management system, shall examine whether the internal accounting management system has been designed and operated properly, through inquiries to relevant executives and employees verification of relevant documents, and inspection of the current operational status of the internal control.78 A list of stock companies shall publish matters concerning its internal accounting management system, as prescribed by the Financial Services Commission.79

75 Id.
76 Id. art. 8(3)
77 Id. art. 8(4)
79 Id. Art. 2-3(3)
Table 3. MATTERS TO BE INCLUDED IN INTERNAL ACCOUNTING MANAGEMENT REGULATIONS

1. Matters concerning the method of identification, mensuration, classification, recording and reporting of accounting information (including transaction related information which forms the basis for accounting information; hereafter the same shall apply in this Article);
2. Matters concerning the method of controlling the errors of accounting information and revising them;
3. Matters concerning the internal verification, such as a regular inspection and adjustment, etc. of accounting information;
4. Matters concerning the method of managing books to record and keep accounting information (including magnetic tapes, diskettes and other information storage devices) and the controlling procedures to prevent forgery, alteration, damage, or destruction;
5. Matters concerning the segregation of duties and responsibilities of the executives and employees related to the preparation and public notice of accounting information;
6. Other matters prescribed by Presidential Decree which are necessary for the preparation and public notice of reliable accounting information.

2. Compliance Officer of Financial Company Governance Act

The purpose of Act on Corporate Governance of Financial Companies (hereafter “Financial Company Governance Act”) which was enacted on August 1, 2016, is to protect depositors, investors, policyholders, and other financial consumers by regulating the qualifications of financial company executives, the composition, and operation of the board

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80 Act on External Audit of Stock Companies, supra note 73, Art. 2-2(1).
of directors.\textsuperscript{81} Financial companies shall have establish internal control standards, and have at least one compliance officer to report to the Audit Committee or Auditor under the Financial Company Governance Act.\textsuperscript{82} Also, the companies shall establish the risk management committee as a committee within the board of directors,\textsuperscript{83} and have at least one risk manager to examine and manage risks incurred in business affairs and other various transactions.\textsuperscript{84}

Specifically, the Enforcement Decree of the Act on Corporate Governance of Financial Companies article 19 sets forth matters to be included in the internal control standards so that internal control can be effectively implemented. Matters which should be included in the internal control standard are as follows.

\textbf{Table 4. MATTERS TO BE INCLUDED IN THE INTERNAL CONTROL STANDARD}\textsuperscript{85}


\textsuperscript{82} \textit{Id.} art. 25

\textsuperscript{83} \textit{Id.} art. 16

\textsuperscript{84} \textit{Id.} art. 28

1. Job allocation and organizational structure;

2. The procedure that executive officers and employees shall observe in performing their duties;

3. The roles that the board of directors, executive officers, and compliance officers shall serve in connection with internal control;

4. Human resources and support organizations with expertise in performance of internal control;

5. Establishment of a system that can efficiently convey information necessary for making decisions on business management;

6. The procedure and method for ascertaining whether executive officers and employees observe the internal control standards and measures to be taken against executive officers and employees who breach the internal control standards;

7. The procedure or standards for preventing violations of finance-related statutes by executive officers and employees (including the procedure or standards for preventing unfair conduct, including the reporting of details of transactions of financial investment products by executive officers and employees);

8. The procedure for establishing or amending the internal control standards;

9. The procedure for appointing or dismissing compliance officers;

10. The method, procedure, etc. for managing conflicts of interest (not applicable to cases where the relevant finance company is a financial holding company);

11. Rules on the production of advertisements of products or services and the contents of such advertisements;

12. Evaluation and management of concurrent office of executive officers and employees under Article 11 (1) of the Act to ascertain whether the criteria under Article 11 (4) 4 are met;

13. Other matters specified and publicly notified by the Financial Services Commission as those that shall be prescribed in detail by the internal control standards.
3. Compliance Assistant of Commercial Act

Public companies which have more than five billion won assets shall establish compliance guidelines, and shall have at least one compliance assistant under the Commercial Act in Korea. 86 Also, a compliance assistant shall check whether the compliance guidelines is being followed and if the outcomes are being reported to the board of directors. 87

As reviewed above, the three components of Korea’s internal control systems are ① the internal accounting control system of the External Audit Act, ② compliance officer of Financial Company Governance Act, and ③ compliance assistant of the Commercial Act. As a result, in the case of financial companies, the combination of ① and ②, and in the case of public companies whose assets are more than 5 billion won, ① and ③ are combined as internal control systems. However, public companies which are not financial companies, could be concerned about the gap in internal control because the compliance officer in the Commercial Act lacks the general concept of internal control and risk management. 88

87 Id. art. 542-13(3).
88 Kwon, supra note 70, at 142.
B. Problems of Legislations related to Internal Control

1. Omission of general Provision for Internal Control in Commercial Act

Legal professional groups including the legislature have recognized the importance of internal control system, and the systems have been extended from private to public legislations in the U.S. The internal control system should have been introduced from the perspective of Strategic Risk Management in Korea. However, it can be evaluated that Korea has introduced internal control systems through importing individual U.S. laws, without comprehensive review of the systems.\(^89\)

As a result, there are no a general provision for internal control system in the Commercial Act although the act adopted the compliance officer clauses. This is different from the legal system of Japan and the U.S. In Japan, the Corporate law (general law) overly governs the internal control systems and the Financial Instruments and Exchange Act\(^90\) (special law) only regulates financial accounting controls. On the other hand, in the U.S., the internal controls mainly focus on accounting controls, but the legislations contain comprehensive internal control concepts of COSO reports.\(^91\)

It can be a legislative mistake that there is a no general clause for the internal control in Commercial law as a general law, emphasizing the importance of the internal control

\(^89\) Chung, supra note 71, at 291.

\(^90\) The Financial Instruments and Exchange Act (金融商品取引法 Kin'yū shōhin torihiki-hō), promulgated on June 14, 2006, is the main statute codifying securities law and regulating securities companies in Japan.

\(^91\) Yook, supra note 22, 167-9.
system of public companies.\textsuperscript{92} Also, it is desirable that directors of companies should be liable to establish the internal control system, regardless of being public companies like the Stone case.\textsuperscript{93} All directors should bear the responsibility to establish internal control systems although the content of internal control might vary depending on the size and circumstances of the company.\textsuperscript{94} In order to do so, it is appropriate that a general provision for internal control system should be created in the Commercial Act through the revision of act.

\textbf{2. Problems of Cost for Establishing Internal Control System}

It is substantially impossible for management to grasp every works of employees because functions of large-scale firms are highly specialized and complicated. For these companies, it is also impossible for executive officers to conduct surveillance tasks without effective internal control systems. For this reason, it can be said that director’s liability for

\begin{flushright}
\textsuperscript{92} Chung, \textit{supra} note 29, at 288.
\end{flushright}

\begin{flushright}
\textsuperscript{93} Supreme Court [S. Ct.], 2006Da68636, Sept. 11, 2008 (S. Kor.). Korea Supreme Court benchmarked the judgment of the Caremark case and the Stone case of the U.S. The Court decided that if the company has established a rational internal control system, and operated it properly, the liability of the representative of the company could be reduced.
\end{flushright}

\begin{flushright}
\textsuperscript{94} The directors bear the duties of care, and loyalty by the delegation contract of the company under the Commercial Act Article 382-3 in Korea. Directors are obliged to maintain an internal control system as a duty of care, and have discretion to design the internal control system depending on the size of the company and type of business.
\end{flushright}
internal control is legislated.

The establishment of internal control related to cost. The cost problem is closely connected to (1) which company should establish internal control system under the relevant law, (2) how to concretely regulate companies for internal control implementation. 95 For example, a public company which has more than 500 billion won shall have at least one compliance assistant. However, many listed companies do not have compliance supporters. 82 (approximately 40%) out of 304 companies were found not to appoint a compliance assistant according to a survey on compliance assistant retention in April 2015. 96 The reason is that there is no incentive for companies considering cost. Also, it can be interpreted as the companies not wanting to retain compliance assistants because there is no sanction provision on violation of the duty in the Commercial Act.

95 Kwon, supra note 70, at 144.

96 Kang, Euntae, sangjangsa 88gae, junbeohjiwon-in seon-im-uimun wiban [88 listed companies violate the commercial law provisions that the listed companies shall have one or more compliance assistants], NSP NEWS AGENCY, May 6, 2015, available at http://www.nspna.com/news/?mode=view&newsid=124188 (last visited on Nov. 8, 2017). Considering the burden of the companies, the standard of the listed of companies was more than one trillion won in 2012, the criteria has been expanded to more than 500 billion since 2014.
Table 5. The Ratio of Compliance Assistant Retention in the Listed Companies

(UNIT: THE NUMBER OF COMPANIES, WON- KOREAN CURRENCY UNIT)

<table>
<thead>
<tr>
<th>Survey Date</th>
<th>The Number of listed Companies</th>
<th>Answer</th>
<th>Unanswered</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Compliance Assistant</td>
<td>No Compliance Assistant</td>
</tr>
<tr>
<td>April, 2012</td>
<td>172 (More than 1 Trillion Won)</td>
<td>69 (60%)</td>
<td>46 (40%)</td>
</tr>
<tr>
<td>April, 2014</td>
<td>306 (More than 500 Billion Won)</td>
<td>108 (49.5%)</td>
<td>110 (50.5%)</td>
</tr>
<tr>
<td>April, 2015</td>
<td>304 (More than 500 Billion Won)</td>
<td>123 (60%)</td>
<td>82 (40%)</td>
</tr>
</tbody>
</table>

The following problem is how much to regulate public companies for the internal control implementation. In relationship to this problem, there are two different arguments. One opinion is that only basic things are needed, and public companies should have autonomy to decide. The other opinion is that specific standards are needed. As we have

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97 Id. If 1 U.S. dollar can be converted to 1,115 won (Korean currency unit), 1 trillion won is approximately $ 896,860,986, and 500 billion is about $ 448,430,493.

98 Choi, Joon-sun & Kim, Jung-ho, Naebutongjejedo mich naebuhoeyegwanlijedoui jeonghibang-an tolonhoe [Debate on the Improvement of Internal Control System and Internal Accounting Management System], 16 PUBLIC COMPANY CFO FORUM NEWSLETTER, 7 (Dec. 2010).
seen (Table 4), in the case of financial companies, the 13 matters are prescribed to be included in internal control standard under the relevant law. It is believed that individual companies will not be able to flexibly operate internal control systems, and it will eventually return to the burden of the firms since it is too specific.

3. Conflict Problems of Internal Control System

i. Problems for Distinction between Compliance Officer and Compliance Assistant

It is a problem of distinction between the compliance officer who should be appointed by financial companies and the compliance assistant in public companies under the Commercial Act. It is distinguishable that duties of compliance assistant are limited to the legal risks of public companies while the responsibilities of compliance officer affect entirely the risk of financial companies. It, however, is substantially hard to distinguish between the two agencies’ duties because a duty of compliance officer checking whether executive officers and employees observe the internal control standards, has nature of compliance control.

Also, the legislature should consider the burden and efficiency of the companies in the internal control legislations. For example, if a financial company which has already a compliance officer meets the criteria of a company with more than 5 billion won assets, the company must retain at least one compliance assistant additionally. In this case, legal considerations are needed. It is necessary to clarify the obligations of the compliance officer and the compliance assistant, and reasonably explain why a separate system should
be established.

ii. Reporting Obligation Issues

In principle, a compliance officer of the Commercial Act should check compliance with the compliance standards of public companies, and report the results to the board of directors. I, however, do not think that compliance officer should report to only the board of directors. In some case, it may be necessary to report to the Audit Committee first.

In comparison, although a compliance officer of financial companies should report to the Audit Committee under the Financial Company Governance Act, it is not necessary to limit the reporting duty of the officer to the Audit Committee. It is necessary to flexibly regulate the reporting duties of compliance officers and compliance assistants.

IV. Suggestion for the legislation of internal control system in Korea

A. Need of General Provision for Internal Control in Commercial Act

A general provision for internal control system should be created in the Commercial

99 Sangbeob [Commercial Act], supra note 86, art. 542-13(3) (S. Kor.).

100 Geumyunghoesai Jibaegujo-e Gwanhan Beobyul [Act on Corporate Governance of Financial Companies], supra note 86, art 25 (S. Kor.).

101 Chung, supra note 71, at 291.
This is because the internal control concept of public companies which is not financial companies, is limited to compliance functions. The concept of risk management should be introduced to public companies’ business areas by making a comprehensive internal concept in the Commercial Act. It is necessary to apply strict internal standards to financial companies, taking into consideration the public interest and publicity of financial companies in the Financial Company Governance Act of public companies. The internal control regulations of the Commercial Act (general law) and the Financial Company Governance Act (special law) should be reasonably adjusted.

Additionally, the internal control legislations of Korea can be determined to be very unique compared to the U.S. and Japan. First, provisions of the special law, the Financial Company Governance Act, related to compliance officer comprehensively define internal controls, which include compliance and business area. Next, the duty of compliance assistant provisions of general law, the Commercial Act, are restricted to the compliance area only.

In the U.S., although the SOX mainly focuses on accounting controls, the act adopts a comprehensive idea of the internal concept. The SOX defines the three areas of accounting, auditing, and corporate governance. In this sense, the SOX itself is a legislation covering all elements of the COSO internal control concept as a general law for public companies. Also, in Japan, the Corporate law has a provision to regulate all internal control

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102 Kwon, *supra* note 70, at 143.
areas as a general law, and the Financial Instruments and Exchange Act mainly prescribes accounting control.

**B. Minimization of Internal Control Costs**

As discussed previously, the cost of establishing internal control is related to how much regulation is burdened to companies which are applicable to the act. If the Commercial Act has a general provision for internal control, it is reasonable that the provision should be applied to public companies that have assets of more than 2 trillion won, and have a board of directors based on outside directors. Companies who have more than total assets of 2 trillion won should appoint at least three outside directors, and the outside directors should account for more than half of the total number of directors under the Commercial Act. The companies who have outside board of directors are most likely to be weak because outside directors are not familiar with company business. Therefore, the companies who are have outside directors should establish internal control system to

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103 *Id.* at 136. In the Corporate Act of Japan, the obligation of directors for internal control establishment is to concretize the duty of care of directors. The purpose of the provision is not limited to securing the reliability of accounting reports, but includes the effectiveness, efficiency, legal compliance, and asset protection of the entire business.

104 *Id.* at 135. The purpose of the Financial Product Act of Japan is for internal controls related to corporate accounting statements to ensure the reliability and transparency of the accounting. In other words, the listed companies should establish internal control systems related to accounting reports, submit reports evaluating the internal control to the prime minister, and let Certified Public Accountants certify the reports.

105 Sangbeob [The Commercial Act], *supra* note 86, art. 542-8(1) (S. Kor.): Sangbeobsihaenglyeong [Enforcement Decree of The Commercial Act], Presidential Decree No. 11485, Aug. 16, 1984, *amended by Presidential Decree No. 28211, July 26, 2017* art. 34(2). "Listed companies determined by Presidential Decree" in the provision to Article 542-8 (1) of the Act means listed companies with total assets valued at two trillion won or more as at the end of the latest business year.
fix this problem.\textsuperscript{106}

The following is a problem of how specifically internal control provision should be prescribed. In this regard, it is necessary to consult cases of the SOX. Particularly, there have been claims that the internal control regulations became a burden to small-sized public companies. It has been said that the U.S. stock market lost their competitiveness as the companies go to foreign stock markets. The SOX is basically a system in which the management evaluates financial statements including internal control system, and then external auditors attest the reports.

At first, the methods of evaluating the internal control were different depending on the management or situations of public companies, which has been a reason for causing a cost increase. Therefore, new auditing standards of the PCAOB have been announced, and practical procedures for the SOX have been continuously improved.\textsuperscript{107}

Considering this point, it is desirable to implement the internal control system as legislations. However, laws should take into consideration the burden of companies, and allow flexibility to operate the systems depending on the conditions of firms.

\textbf{C. The Necessity of Indirect Enforcement of Internal Control System}

There are direct and indirect enforcement methods in relation to the application of

\textsuperscript{106} Kwon, \textit{supra} note 70, at 144.
\textsuperscript{107} Id. at 146.
the internal control system. Direct enforcement is a method of establishing standards for the listed companies, and forcing the companies to establish the internal control systems. Indirect enforcement suggests basic standards, and let the management evaluate their internal control activities, and have the companies disclose the results as reports.\textsuperscript{108}

In relation to internal control, there are two things to consider. First, even if the management do not establish internal control systems, that is not a management responsibility, internal control is not the only mean of ensuring the effectiveness and efficiency of business. Next, internal control is not a system that can be applied to all companies regardless of the size and type of the firm. It is necessary for companies to operate flexibly in consideration of the size and type of companies because internal control is also related to corporate governance.\textsuperscript{109}

Considering these points, the indirect enforcement method is more reasonable. This is an effective way, which allows companies to consider the situation they are facing, and they are more flexible on the contents of internal control like the SOX in the U.S. and the Financial Instruments and Exchange Act in Japan.\textsuperscript{110} It is necessary that the government

\textsuperscript{108} Id. at 147.

\textsuperscript{109} Yook, supra note 25, at 374. (stating that the Corporate Governance includes the Enterprise Risk Management (ERP), and the ERP contains internal control system); Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 Cardozo L. Rev. 237, 251 (1997). Additionally, “the board has an important role to play in the design and administration of the internal control structure.”

\textsuperscript{110} Id. at 137. The Financial Instruments and Exchange Act in Japan does not directly impose an obligation on management to establish internal control. It only forces the management to evaluate the validity of internal control, disclose it, and assume accountability to the investors. This is an indirect regulatory approach, and even if the management does not establish internal control, it does not in itself violate the Financial
suggests general guidelines for internal control, and the companies select their models to flexibly pursue their values depending on the situations of firms like SOX in the U.S.

D. Unification of Internal Control System

1. Unification of Compliance Assistant and Compliance Officer

Although compliance assistants for public companies and Compliance officers for Financial Companies have different terminology, the duties of organs are overlapped, and substantially is the same system.\textsuperscript{111} Therefore, since compliance assistant and compliance officer are merely a list of the same system, there is a need to unify terms and operate the system efficiently.\textsuperscript{112} For example, in the case of a financial company which has more than 500 billion assets, the company should have at least one compliance assistant besides a compliance officer. In this case, it is necessary for a company to have its discretion to select one system between a compliance assistant and a compliance officer by the legislation, in consideration of the burden of the firm.


\textsuperscript{112} Id.
2. Work Area Adjustment of Audit Committee and Compliance Officer

According to the general corporation law, South Korea Commercial Act Article 412 (1), auditors shall audit directors’ performance of duties and this provision shall apply mutatis mutandis to the audit committee.\textsuperscript{113} Also, financial company shall have at least one compliance officer who conducts inspections on compliance with internal control standards and who plays a role as a risk manager under the Act on Corporate Governance of Financial Companies Article 25 and 28.\textsuperscript{114} Accordingly, while audit committee or auditors basically

\textsuperscript{113} Sangbeob [Commercial Act], supra note 86 art. 412, 415-2 (S. Kor.).

Article 412 (Auditors' Duties and Power to Demand Reporting and to Inspect)

(1) Auditors shall audit directors' performance of duties.
(2) Auditors may, at any time, request a director to report on the relevant business and may inspect the business affairs and financial conditions of a company.
(3) Auditors may seek assistance from professionals at the expense of the company.

\textsuperscript{114} Geumyunghoesaui Jibaegujo-e Gwanhan Beobyul [Act on Corporate Governance of Financial Companies], supra note 81, art 25, 28 (S. Kor.).

Article 25 (Appointment, Dismissal, etc. of Compliance Officers) (1) Every financial company (excluding the investment advisory business entities and discretionary investment business entities specified by Presidential Decree, taking the size of assets, etc. into consideration) shall have at least one person who shall conduct inspections on compliance with internal control standards, investigate violations of internal control standards, and take charge of general affairs related to internal control (hereafter referred to as “compliance officer”), and the compliance officer may report results of investigation to the audit committee or auditor, if he/she finds it necessary.
(2) Every financial company shall appoint compliance officers, from among inside directors or operating officers: Provided, that a financial company or a domestic branch of a foreign financial company, specified by Presidential Decree in consideration of the size of assets, the financial business in which it engages, etc., may appoint compliance officers, from among employees who are neither inside directors nor operating officers.
(3) When a financial company (excluding domestic branches of foreign financial companies) intends to appoint or dismiss a compliance officer, it shall obtain a resolution thereon from the board of directors, and a resolution on dismissal shall be passed with concurrent votes of at least two-thirds of all directors.
(4) The term of office of a compliance officer shall be at least two years.
(5) Where a financial company appoints a compliance officer, from among its employees under the proviso to paragraph (2), it shall not appoint a fixed-term or part-time worker under the Act on the Protection, etc. of Fixed-Term and Part-Time Workers as a compliance officer.
(6) Every financial company shall formulate and implement separate standards for remuneration for compliance officers and evaluation of compliance officers, which shall not be linked to financial business performance of the company.
can be organs which keep a close watch on fraudulent acts like embezzlement and breach of trust, compliance officers have duties to prevent violation of law in advance through employee training and education. However, there is no substantial difference between the two duties of them from a business perspective.

This problem can cause confusion and inefficacy while two organs are performing their duties within the organization. To reduce business confusion and burden of cost, it is reasonable that audit committee and internal auditors should streamline their organization’s operation. In detail, Board of directors should establish internal control standards and appoint compliance officer. Appointed compliance officer’s duties should be limited to checking matters prescribed in internal control standards, and accounting inspection authority should be given to audit committee. Audit committee, a subcommittee of board, should hear reports about compliance matters from financial officer and ultimately have a right to decide for only matters containing certain problems. It will guarantee compliance officer’s expertise because compliance officers can concentrate on compliance duties. Audit committee can recognize compliance officers as assisting organs, and it can

Article 28 (Appointment, Dismissal, etc. of Risk Managers)(1) Every financial company (excluding investment advisory business entities and discretionary investment business entities specified by Presidential Decree, taking into consideration the size of assets, the business in which the financial company engages, etc.) shall have at least one risk manager who shall take charge of examining and managing risks incurred in the course of managing assets, performing business affairs, and other various transactions.

be anticipated for them to create synergy effect through cooperation.\textsuperscript{116}

E. Improvement of Incentive System

Internal control is very important system for corporate governance. There, however, is no optimal corporate governance for all companies, regardless of type of business or size of companies. In that sense, internal control system needs to be more flexible with companies when choosing their system depending on the business situations, and it is necessary to encourage more companies to establish a system. It requires an incentive system that exempts or reduce the responsibilities of the management if the companies faithfully abide by guidelines of internal control.

The Commercial Act also has had an incentive system provision related to the establishment of internal control. If the public companies are punished by a fine for transactions with interested persons including major shareholders, directors, and auditors,\textsuperscript{117} and the companies faithfully perform the duty related to internal control system, the firms are exempted from penalties.\textsuperscript{118} This incentive provision, is limited in that it can only apply to specific companies ‘transacts with interested persons’, and is ‘punished by a fine as a joint penalty’. For the positive effect of the incentive system, it is necessary to establish a provision to exempt the liability of the companies irrespective of

\textsuperscript{116} \textit{Id} at 866.

\textsuperscript{117} Sangbeob [The Commercial Act], \textit{supra} note 86, art. 542-9(1) (S. Kor.)

\textsuperscript{118} \textit{Id.} at art. 634-3
the type of the offensive behaviors, like a U.S. Sentencing guideline.  

V. Conclusion

The purpose of this study is to provide implication for legislation on the internal control system in Korea, reviewing the formation and development of the concept of internal control in the U.S. The concept of internal control began in accounting professional groups, gradually expanded to the administrative control and the risk management from accounting control, and became an important area that cannot be excluded from the operation of the public companies in the U.S.

When the Enron scandal struck the credibility of the stock market in the U.S. in 2001, the authorities implemented reformative measures including the SOX enactment to protect investors. Although there has been a controversy over this legislation since the enactment of the SOX, it appears that the U.S. capital market has been restoring confidence with the efforts of regulators.

Also, when the foreign exchange crisis and large-scale corporate accounting frauds occurred in Korea, there were demands that companies should establish internal control systems through legislations. However, the authorities in Korea tried to solve the problem by importing internal control system mainly from the U.S. and Japan since there was no various discussions of internal control for a long time. As a result, Korea individual legislations separately imported the internal control provisions from the U.S. and Japan,

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119 Kwon, supra note 70, at 147.
and they have contained illogical and cost increase problems. The most fundamental problem is that it is difficult to apply extensive concept of internal control like risk management to public companies that are not financial companies, because there is no general provision related the internal control in the Commercial Act, a general act for public companies. Next, cost problem companies are neglected to establish the internal control. Last, that is a conflict problem of internal control provisions in Korea legislations.

To solve these legislative problems, a general provision on internal control should be created in the Commercial Act. Second, it is necessary to approach companies with indirect regulation method like the U.S. and Japan to minimize the cost of establishment. Finally, it is required to integrate and operate internal control agencies that possibly cause confusion. Also, it is necessary to encourage companies to participate in establishing internal control system by implementing proper incentive systems rather than only imposing regulation.
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