

**DOES SARBANES-OXLEY ADD VALUE TO AUDIT  
COMMITTEES?**

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## Introduction

The summer of 2001 was very reminiscent of the summer of 1938. In the summer of 1938 the corporate accounting scandal of McKesson & Robbins rocked the nation causing Senate hearings and a detailed investigation.<sup>1</sup> The result of the 1938 firestorm was the creation of the first audit committees in the early 1940’s. In the summer of 2001, the Enron scandal was a repeat performance. The result of the 2001 scandal was the Sarbanes-Oxley legislation. This paper will examine the regulator scheme of audit committees under Sarbanes-Oxley.

First, this paper will look at the historical perspective on audit committees and examine what their initial purpose was and how this purpose developed prior to the passage of Sarbanes-Oxley. Next, the audit committee portions of Sarbanes-Oxley will be examined in detail. Out of this analysis, two main

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<sup>1</sup> SEC, Report on Investigation, McKesson & Robbins, Inc. (1940). see also Acct. Ser. Rel. 19 (1940); 5 SEC Ann. Rep. 110-111, 119-120 (1939); 28 Geo. Wash. L. Rev. 176, 186-193 (1959).

questions arise: 1) Do we need regulation to ensure the independence of the audit function from management? 2) Can the Market determine the qualifications necessary to serve on the audit committee? The conclusion of this paper is that regulation is needed to ensure the independence of the audit committee, but regulation is not needed to ensure the qualification of audit committee members.

## Historical Context

In 1938, McKesson & Robbins had inflated assets and earnings by \$19 million through the reporting of nonexistent inventory and fictitious sales.<sup>2</sup> In 2003 dollars the \$19 million would be over \$250 million.<sup>3</sup> The McKesson & Robbins Board's response to the 1938 scandal was to claim that because they did not have independent control over the auditors, they did not have the tools to know or prevent what happened.<sup>4</sup> In 1940 in response to the scandal, the SEC recommended all public companies create audit committees. The SEC further recommended that outside directors should be on the board.<sup>5</sup> Between 1940 and 1978 many public companies created audit committees, but there was no actual independent control of the auditor by the audit committee. The number of companies with audit committees gradually increased until in 1978 and 1989 the NYSE and NASD, respectively, required a company to have an audit committee in order to be listed, thereby forcing all publicly listed US companies to have audit committees.

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<sup>2</sup> Id.

<sup>3</sup> Inflation Calculator at the U.S. Department of Labor <http://www.bls.gov/cpi>

<sup>4</sup> SEC, Report on Investigation, McKesson & Robbins, Inc. (1940). see also Acct. Ser. Rel. 19 (1940); 5 SEC Ann. Rep. 110-111, 119-120 (1939); 28 Geo. Wash. L. Rev. 176, 186-193 (1959).

<sup>5</sup> Id.

Case law has also impacted the development of audit committees. For example, in 1996 the Delaware Supreme Court further defined general board duties in In re Caremark Int'l<sup>6</sup>. The Court held that board members had a duty to monitor the corporation. While this opinion did not focus on audit committees, it did reinforce the role of the audit committee to monitor the corporation. The audit committee does not need to act as if they are a second set of managers or so called shadow management. Instead the board needs to monitor the corporation to attempt to prevent fraud or other bad faith manipulations of the corporation.

In September 1998, Arthur Levitt, the Chairman of the SEC, gave a speech titled “The ‘Numbers Game’” in which he criticized ‘managed earnings’ and pointed to ‘accounting hocus pocus’ such as ‘big baths’ as a major concern in corporate America.<sup>7</sup> This speech helped to focus attention on accounting in general and audit committees specifically.

After Chairman Levitt’s speech, the Blue Ribbon Committee (BRC) was formed to examine corporate governance in general.<sup>8</sup> The BRC had members from many different backgrounds. In 1999 the BRC came out with its recommendations. The BRC recommendations included 1) defining an independent director as not receiving any additional compensation and not having worked for the company in previous 5 years, 2) creating a charter for each audit committee detailing what that audit committee does, and 3) making all

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<sup>6</sup> In re Caremark Int'l, 698 A.2d 959 (Del. Ch. 1996).

<sup>7</sup> Arthur Levitt, “The ‘Numbers Game,’” Remarks at New York University Center for Law and Business (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>

<sup>8</sup> See generally National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission on Audit Committees (2000).

companies disclose their independent director and charter status.<sup>9</sup> The BRC also recommended that if the company has greater than \$200 million worth of assets than the audit committee should have at least three members, all of whom are independent and 'financially literate' or become 'financially literate' in a short period of time.<sup>10</sup> 'Financially literate' is defined as basically able to read and understand financial statements.<sup>11</sup> Lastly the BRC recommended that in a company with greater than \$200 million worth of assets at least one member of the audit committee have accounting or related financial management expertise.<sup>12</sup> In 1999 the NYSE and the other self-regulating organizations (SRO's) adopted the BRC recommendations.

In the summer of 2001, the Enron scandal broke resulting in the adoption of The Sarbanes-Oxley Act of 2002. On April 1, 2003, the SEC required all SRO's to follow the audit committee portions of Sarbanes-Oxley. Both the NASD and NYSE have adopted rules consistent with Sarbanes-Oxley. There are minor differences between the two rules, but they are consistent with Sarbanes-Oxley as well as each other.

The audit committee history up to the passage of Sarbanes-Oxley fundamentally reinforced that all public companies should have an audit committee consisting of independent directors with independent control. It was not until the 1999 BRC that 'financial literacy' and a financial management expertise was required.

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<sup>9</sup> Id.

<sup>10</sup> Id.

<sup>11</sup> Id.

<sup>12</sup> Id.

## Audit Committees Under Sarbanes-Oxley

In light of this historical context, Sarbanes-Oxley continued the theme of establishing audit committee independence, control of the audit process, and also used concepts related to the recent 'financial literacy' requirement. The Sarbanes-Oxley Act of 2002 states that the audit committee must 1) consist entirely of independent directors<sup>13</sup>, 2) have the auditor report directly to the audit committee<sup>14</sup>, 3) control the appointment, compensation, and oversight of the work of the auditor and any other public accounting company<sup>15</sup>, 4) pre-approve all audit and non-audit work done by the auditor<sup>16</sup>, 5) have control over the audit committee funding<sup>17</sup>, 6) be able to engage independent counsel and other advisers<sup>18</sup>, 7) disclose the 'financial expert' status of the audit committee<sup>19</sup>, and 8) setup procedures for handling complaints regarding accounting, internal accounting controls and auditing matters<sup>20</sup>. To implement this, the SEC promulgated a rule on April 1, 2003 that all SRO's must require companies to adhere to Sarbanes-Oxley completely in order to be listed on the exchange. By implementing Sarbanes-Oxley in this way, Congress has avoided attempting to create a new area of law.

Sarbanes-Oxley requires that each member of the audit committee be independent. 'Independent' is basically defined the same as previous regulations

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<sup>13</sup> The Sarbanes-Oxley Act of 2002 Sec 301(3)

<sup>14</sup> Id. at Sec 204

<sup>15</sup> Id. at Sec 301(2)

<sup>16</sup> Id. at Sec 202

<sup>17</sup> Id. at Sec 301(6)

<sup>18</sup> Id. at Sec 301(5)

<sup>19</sup> Id. at Sec 407

<sup>20</sup> Id. at Sec 301(4)

as fundamentally not being affiliated with the company or any of its subsidiaries and not receiving any compensation in addition to board and committee pay.

The independence of the audit committee members attempts to establish delineation between management and the audit function.

A change to previous regulation is that the audit committee now has direct control over the auditor and audit functions. This is achieved through sections 202, 204, and 301(2) requiring that the auditor report directly to the audit committee and that the audit committee appoint, oversee, and compensate the auditor. The last function given to the audit committee to ensure control over the auditor is that the audit committee must pre-approve any work to be done by the auditor and any other public accounting company. Again, these changes are directed at audit committee independence and seem designed to reinforce the delineation between management and the audit function to ensure an unbiased approach.

The next change is to give the audit committee complete control over its funding and allow it to consult outside counsel and other advisors. Again, this change is attempting to separate the audit function from management. The ability to consult outside counsel and to control its own funding seems to give the audit committee unlimited resources and potentially creates a shadow management. The only limit on this function appears to be the shareholders ability to vote out over-spending audit committee members.

While the above sections of Sarbanes-Oxley are attempts to reinforce the independence of the audit committee and the audit function, section 407

attempts to impart qualification requirements for the audit committee. While section 407 does not require that all committee members be 'financial experts' it does require that the committee disclose at least one 'financial expert' or give a reason for not having a 'financial expert'. 'Financial expert' is defined as a person with an understanding of generally accepted accounting principles (GAAP) with experience in financial statements, internal audit controls, and audit committee functions. This definition would seem to include virtually anyone within the senior management of any reasonable size company. It also would seem to include anyone who managed a group that maintained its own budget that fed into financial statements of their company. The definition allows for many people who do not have extensive experience, yet these people would be called a 'financial expert' to the investing public.

Lastly, the audit committee has a new role as the primary repository for collecting and handling accounting complaints about the company. This seems to go back to the independence concept because it implies distrust of management to handle the complaints properly or to forward relevant complaints to the audit committee.

In all, Sarbanes-Oxley enhances the independence requirements dramatically and creates a new concept by requiring disclosure about audit committee member qualifications. The question becomes is regulation necessary either 1) to ensure the independence of the audit committee or 2) to ensure that audit committee members are qualified. This paper will argue that

regulation is needed to ensure the independence of the board, but is not needed to ensure the qualifications of the audit committee members.

## **Commentator Criticisms of Sarbanes-Oxley**

The two primary commentators that will be focused on are Prof. Ribstein and Prof. Elson. Prof. Ribstein takes the fundamental view that rather than regulation to prevent future scandals, investors need to be more skeptical of the market and of disclosures.<sup>21</sup> Prof. Elson takes the view that directors, particularly independent directors, do not devote sufficient time to board activities to adequately fulfill their duties and are beholden to management for their positions.<sup>22</sup>

Prof. Ribstien's three main points regarding audit committees are: 1) the concept of independent directors is good, but they do not have sufficient time to contribute to the process, 2) the concept of having the audit committee control the audit process is good, but again the time constraints are a concern, and 3) regulation in general and particularly in this area creates a false sense of security for the investor.<sup>23</sup>

Prof. Elson argues that corporate boards today are passive and in their most extreme form, simply rubber stamp managements decisions.<sup>24</sup> Prof. Elson states that 1) the passivity of the board is shown by the very limited time that board members put into their positions, 2) the board is beholden to management

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<sup>21</sup> Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 Iowa J. Corp. L. 1 (2002).

<sup>22</sup> Charles M. Elson, Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure, 50 SMU L. Rev. 127, 127-30 (1996).

<sup>23</sup> Ribstein

<sup>24</sup> Elson

(the so called 'captured board syndrome') because of the benefits received by board members, and 3) independent directors are chosen for their relationship with management, not what they can bring to the corporation.<sup>25</sup> Prof. Elson goes on to argue that compensating board members is beneficial for focusing the board members attention.<sup>26</sup> However, instead of giving benefits that are not related to the stock, even the outside directors should be compensated with stock to encourage them to be more involved and act like owners.<sup>27</sup>

Prof. Ribstien's position, as well as Prof. Elson's position are used extensively in this analysis of Sarbanes-Oxley.

### **Regulation is needed for Audit Committee Independence**

The concept of audit independence has been understood since the McKesson & Robins scandal of 1938. The board's response to the scandal was to point to the fact that they did not have audit control so they did not know enough about the scandal to prevent it. With the potential exception of the virtually unlimited funding provision, Sarbanes-Oxley articulates a strong set of regulations for maintaining audit committee independence. Regulation is needed because 1) the cost of proper regulation is very low compared to the potential of preventing even one scandal, 2) the implementation of Sarbanes-Oxley was done such that it did not usurp State Laws, 3) the nuances of independence have not been the sort of issue that the market focuses on, and 4) independence is an objective criteria that can be regulated. Of course, this is a new regulation and

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<sup>25</sup> Id. at 127-30, 137-44, 157-59

<sup>26</sup> Id. at 157-59

<sup>27</sup> Id.

needs to be monitored to see if the benefit exceeds the cost. The primary arguments against regulation in this area are: 1) structural bias may render attempts to force independence moot because the directors are beholden to management for their positions on the board, 2) even without the unlimited funding, the audit committee charged with the exclusive responsibility of managing the audit process may become shadow management, 3) the time constraints of most directors, especially independent directors means that potentially very little attention will be focused on the audit process, 4) the forced separation of the audit committee and management could decrease communication, and 5) the regulation could foster a false sense of security within the market. Despite these valid arguments, it can also be argued that the low cost of maintaining an independent audit is very easily outweighed by even a single scandal prevented.

### **Reasons for Regulation**

The cost of regulating independence is low, especially if the unlimited funding requirement were repealed. The cost of implementing this regulation falls into two categories, the cost of the SRO's to monitor compliance and the cost of the companies to adhere to the regulation. Monitoring is very inexpensive in this case, because it simply requires each company to disclose which directors are on the audit committee and what fees they receive. Furthermore, most of this monitoring is already done to confirm that each company has an audit committee. The cost of the company to adhere to the regulation is also low because the only potential adverse impact would be that companies that do not

currently have many independent directors would have to change their board composition to have more independent directors. While there is still debate about whether independent directors add substantial value, very few would argue that a company should not have at least enough independent directors to fill the audit committee. There is an outstanding question about whether independent directors have sufficient time to perform the audit function, but this will be addressed in the criticisms of regulation. On the other hand, the potential benefits of regulation are clearly substantial. A single scandal avoided is well worth these minor costs.

Related to the cost is the potential for creating a new burdensome area of law that would usurp the law of the states. However, Sarbanes-Oxley was implemented in such a manner as to specifically avoid this possibility. The regulation was implemented by having the SEC require the SRO's to make Sarbanes-Oxley a public listing requirement. Thereby adherence to Sarbanes-Oxley is a voluntary issue and not one governed directly by the federal government. Therefore, the law of the states is left untouched and this potential problem does not impact the cost of the regulation.

Lastly there is a potential concern of the costs of monitoring the Audit Committee itself. That is to say with increased responsibilities, some may argue that the Audit Committee needs a monitor. However, there must be an end to checking and historically, we have allowed shareholders to check the board by giving them a cause of action against the board for breaching their duties.

Independence is an objective straightforward concept, but the nuances of establishing it are more than the market will and does look at. In order for the audit committee to be independent, it must 1) consist of independent directors who are not affiliated with the company and do not receive any compensation other than director fees and 2) have complete control over the auditor and the audit process. While this appears straightforward and is clearly simple to articulate in a regulation, the market does not seem to focus enough on it to require it. For example, how much in affiliated compensation does an audit committee member need to receive before it should impact the stock price? The market's reaction has been and will be to ignore it until there is a failure. Instead of allowing this to happen, the use of the regulation will at least maintain the independence of the audit function. While the independence alone will not prevent all scandals, it will at least provide one other perspective of the company.

### **Evaluating the New Regulations**

The value of the regulation appears clear at this point in time, but it needs to be monitored to ensure that its benefits exceed its costs. It is very difficult to attempt to isolate the independence function and say precisely how much it has benefited the market. Instead, the best test will be over time the number of potential scandals that are found early after the passage of Sarbanes-Oxley versus the number of potential scandals discovered prior to the passage of Sarbanes-Oxley. That is not to say that any regulation will fix all scandals because nothing can stop the person bent on committing fraud, but at least forcing the independence will bring a new perspective to the problem.

## **Potential Problems with the Regulation**

The principal concerns with regulating independence focus on structural bias, the effectiveness of the independent directors generally, and the potential for substantial costs if the process is abused. While these arguments point out potential concerns with boards of directors generally, they do not invalidate the value of forcing the audit process to be separate from management

Structural bias is defined as a presumed bias of directors in the favor of management because shareholders usually approve management's slate of directors. The argument is that this makes the directors beholden to the management for their positions and, as a result, will virtually always agree with management. This argument states a problem with boards generally and not the audit committee specifically. Additionally, even if the audit committee members were generally beholden to management, it is at least one step removed from the management directly controlling the audit process and thereby being able to steer auditors clear of issues they know to be problems. Lastly, there are several counter arguments and reasons why independent directors are able to be independent: 1) the directors have personal liability for their board actions, 2) director's fees are not usually substantial nor the directors' only source of income, and 3) the directors' reputation is worth more than the small amount of directors' fees. Admittedly, the company indemnifies the directors against liability, but the director's reputation is not protected.

Professor Elson's criticism of independent directors goes straight to the heart of the second argument that independent directors may not be effective.

Professor Elson found that directors spent approximately 3 hours a month in preparation for their monthly meetings. This amount of time might seem to indicate that directors will not have sufficient knowledge or understanding to control the audit process. However, this presumes that management will have no input into the process. The audit committee needs to maintain control over the process, but management can and should do much of the preparation. Furthermore, the auditor will do all the work it previously did, only now it will not have the threat of needing to comply with management because that is who controlled the relationship. While this concern raises questions about boards in general, it does not call into question regulating the independence of the audit committee.

Another concern about regulating the independence of audit committees is the potential of audit committee becoming essentially a shadow management. This concern is based on the idea that if the audit committee is responsible for the audit process it may feel that it is responsible for checking every decision made by management. This concern is further enhanced by the fact that under Sarbanes-Oxley, the board has an unlimited budget and the ability to seek outside advice. However, the audit committee will likely be held in check by its continuing responsibility to the shareholders and the threat of being voted out if they become too inefficient. Furthermore, as stated above, the auditor will still be doing the majority of the work making the audit committee function purely an oversight function.

An additional concern of the regulation is that forced separation of management and the audit committee may decrease communication from management to the board, thereby weakening not only the audit function, but the effectiveness of the board. This argument assumes that management's reaction to the separation will be to take an adversarial role against the audit committee. This assumption may be correct, but certainly is not a forgone conclusion. In the pre-Sarbanes-Oxley environment, management was sometimes adversarial with the auditors, trying to prevent them from discovering issues.<sup>28</sup> An adversarial situation with the audit committee is likely to arise in the same places where there was a previously adversarial relationship with the auditors. Therefore the new regulation only shifts the party to the conflict. If management is going to have a conflict with a group concerning the audit, it should be at the level of the board/audit committee to help prevent management from controlling the outcome of the issue. While the communication issue may be a concern, the independence will not create a more hostile environment than already may exist.

Lastly, as Prof. Ribstien points out, investors need to be more skeptical to help insure that companies focus on the shareholders interest. Any regulation has the potential of giving shareholders a false sense of security by leading the investor to believe that the government is protecting their interest. However, in this case, the regulation is structural and forces the audit process to be controlled by the audit committee. Structural regulation does not generally create a false sense of security because it does not attempt to guarantee something like

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<sup>28</sup> Andrew Reiss, Powered by more than GAAS: Section 10A of the Private Securities Litigation Reform Act Takes the Accounting Profession for a New Ride, 25 Hofstra L. Rev. 1261, 1273 (1997).

qualifications. Therefore, the independence regulation is unlikely to foster a false sense of security by the market.

## **The Market is better for determining Member Qualifications**

In contrast to the over 60 years of the market failing to implement the independence of the audit function, the market has been able to discern board member qualifications. Most board members have extensive paper qualifications and the courts have consistently held all board members to the same standard regardless of background <sup>29</sup>. Markets are better at determining board member qualifications because 1) the market and shareholders are already doing a successful job at monitoring the quality of board members in general 2) creating labels such as ‘financial expert’ merely creates a false sense of security within the market, 3) Sarbanes-Oxley creates lax requirements that effectively allow any current or former manager of a sizable unit to qualify, 4) qualifications are subjective and are not easy to quantify into regulation, and 5) courts already create a floor on the ability of board members by holding all board members to at least a rudimentary understanding of the business and a duty to monitor the corporation.<sup>30</sup> The principal arguments against allowing the market to control are: 1) regulation creates a slightly higher minimum threshold for the highly sensitive position of member of the audit committee, 2) if the title ‘financial expert’ causes a false sense of security, simply change it to for example ‘minimum qualifications’, and 3) the implementation of these regulations does not usurp

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<sup>29</sup> Francis v. United Jersey Bank, 432 A.2d 814 (NJ 1981)

<sup>30</sup> Id., In Re Caremark

state laws. While these arguments point out some potential value for regulation, the minor value is outweighed by the cost of the intrusion into market forces.

### **Reasons the Market is Better**

Since the very first corporate boards started, the shareholders have always been able to express their will by electing the board of directors. While it is true that more often than not management chooses the directors then shareholders endorse them by voting with management, the voting of the shareholders is not blind and there are many examples of change of control done by proxy (i.e. the shareholders voting against the wishes of management). Furthermore, current boards are made up of largely competent and knowledgeable board members, demonstrating that shareholders can determine who makes a good board member. This is further reinforced by the increased skepticism of the market after the recent series of scandals. Investors are more cautious and more likely to look even more carefully at who is being elected to represent their interest. Lastly, the increasing role of the institutional investor helps to ensure that well qualified members will be on the audit committee. The market can and has successfully determined what makes a good director, therefore the market should not be disturbed.

The label 'financial expert' conveys to the market that the audit committee has at least one person who is more knowledgeable than the vast majority of investors. This concept would make the vast majority of investors feel that they did not need to consider who the audit committee members were because the

'financial expert' is the critical person. Therefore, creating labels such as 'financial expert' merely creates a false sense of security within the market.

The 'financial expert' qualifications within Sarbanes-Oxley are very loose and would encompass just about any current or former manager of a sizable unit. Because all that is required is to have worked with accounting to the extent that it impacts the financial statements and have used those skills to manage your own budget, a manager of a sizable group could be labeled a 'financial expert'. While the skills of such a person would undoubtedly be valuable to the audit committee, they may not be a true 'financial expert'. 'Financial expert' is defined so loosely that it could foster a false sense of security by the market. This false sense of security dramatically increases the total costs of attempting to regulate by potentially creating more scandals. This calls into question any potential gains from the regulation.

The reason that Sarbanes-Oxley's definition of a 'financial expert' is so loose is because it is very hard to quantify what makes a person qualified to serve on the audit committee. What makes a good board member generally and audit committee member specifically is very subjective and virtually impossible to quantify. Regulation generally works when you can say definitively what is needed, but when you cannot quantify what it is trying to achieve, regulation merely creates an opportunity for the system to be manipulated. Critics may argue that this only means that the regulations should be tightened. However, because of the subjective nature of qualifications, if the qualifications were to be made tight enough that only the most completely qualified people could serve on

audit committees, the majority of the good qualified board members would be excluded. Thereby this results in only a handful of people serving on all audit committees, driving up the costs substantially.

The markets are also better because the courts have already created an effective floor by requiring all board members to have a rudimentary knowledge of the business and a duty to monitor the corporation. In the Frances case, the courts said that an elderly lady who had no knowledge about the business could still be found liable for failing her duties as a director because she was an active board member. The court found that all board members are held to at least a minimum standard. Furthermore, the courts have also found that all board members have a duty of care that extends to a duty to monitor. Therefore, all board members are already held to at least the minimum standard that a reasonable regulation would be attempting to achieve, rendering regulation unnecessary.

The last reason markets are better is because of the increasing role of the institutional investor. Institutional investors have steadily been increasing their influence over the corporations they are invested in. Some companies are as much as 70% owned by institutional investors, such as pension and mutual funds. With so much of the stock concentrated in the hands of one group, that group often can demand a place on the board. It is in the interests of the institutional investor to put a highly qualified independent director on the board to protect their investment. It is also in their interest to pressure management to allow this person to serve on the audit committee. While the institutional

investor's influence is likely not be enough to successfully force the corporation to have true audit committee independence, it is likely enough to ensure that qualified members are on the board. Therefore the market can do a better job of determining what makes a qualified director.

### **Potential Problems with the Market**

The primary argument against allowing the market to control focuses on the potential value of creating a higher minimum threshold for the highly sensitive position of member of the audit committee. Some may argue that because of the increased control that the audit committee has over the audit function, there needs to be at least one member of the audit committee who is well versed in the audit process. While there is clearly a potential benefit to having people with financial knowledge on the audit committee, the court has enforced a minimum level of competency for board members in general and boards already have people with financial backgrounds on the audit committee without any regulation forcing them. Furthermore, as mentioned above, to create an artificial minimum for at most only one member of the committee by way of regulation merely creates a false sense of security and sends a signal to the market not to focus on this issue. Whatever gain can be achieved by this regulation is already achieved by the market.

Critics may argue that if the term 'financial expert' causes the false sense of security, simply change it to a more neutral term. However, whatever term you call it, it is still a message to the market that the regulation is taking care of the member qualifications. It is true that 'financial expert' certainly sends a very

strong signal, but whatever the term, it still sends a signal that the market does not need to concern itself with member qualifications.

The last argument in support of the regulation is that the implementation of Sarbanes-Oxley does not usurp state laws and therefore should be permissible. It is true that if Sarbanes-Oxley had been implemented another way and attempted to usurp state laws, the cost of anything within Sarbanes-Oxley would be substantially greater because it would create a whole new area of jurisprudence that companies would have to try and navigate. However the mere fact that it does not create this added cost does not mean that it does not create other even more serious costs.

Whatever minor potential benefits could be achieved by this regulation are substantially outweighed by the false sense of security that the regulation would create alone. Therefore, Section 407 of Sarbanes-Oxley should be repealed and the market allowed to control audit committee member qualifications.

### **Michigan's View of Board Independence and Qualifications**

States have taken a different approach to board independence. For example, Michigan's current law regarding independent directors allow the board or the shareholders to designate someone as independent as long as they 1) have 5 or more years of business, legal or financial experience or the equivalent (as an director, senior executive, or attorney), 2) has not engaged in for profit transactions in the past three years totaling over \$10,000, 3) is not themselves or a member of their family currently an executive of the company or any of its

affiliates, and 4) has never been an executive with the company for more than 3 years.<sup>31</sup> Michigan seems to put an increased emphasis on maintaining the independence by permanently denying a person the right to be 'independent' once the person has been an executive for 3 years. In comparison under even Sarbanes-Oxley, the person only has to wait 5 years and they can be seen as independent. Furthermore, Michigan seems to have incorporated the ideas of either 'financially literate' under the BRC or 'financial expert' under Sarbanes-Oxley by simply including a reasonable amount of business, legal, or financial experience into the definition of independent. This seems like the ideal way of ensuring that you have a reasonably sophisticated audit committee without creating a false sense of security within the market.

## **Conclusion**

The role of the audit committee has evolved since it was first created in response to a 1938 scandal that was eerily similar to the Enron scandal. In the over 60 intervening years between the McKesson & Robins scandal and the Enron scandal, we have not been able to establish independence of the audit committee by using market forces. The cost of using independence regulation is relatively low and the potential to prevent even one scandal is worth the low cost. On the other hand, the market can and does correctly evaluate the qualifications of board members in general and audit committee members specifically. Furthermore, it is extremely difficult if not impossible to quantify what a qualified committee member means. This makes regulation nearly impossible and very

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<sup>31</sup> Mich. Comp. Laws Ann. § 450.1107 (2002).

costly if it were attempted. The current 'Financial Expert' definition is so loose that it simply creates a false sense of security within the market. If we must have a regulation of qualifications, than it should be similar to the Michigan model where it is imbedded in the requirements for independent director and is very generic. In conclusion, Sarbanes-Oxley successfully solidifies the independence of audit committees but seems to be over reaching concerning committee member qualifications.