

Internal Control Liability Concerns Post Sarbanes-Oxley: Perspectives on Legal Liability and Reasonableness

Richard Mark

Roberta Ann Barra

Martin E. Taylor*

1. The Role of the Accounting Profession in Internal Control

With passage of the Securities Act of 1933 (the 33 Act) and the Securities Exchange Act of 1934 (the 34 Act), Congress directed the SEC “to protect the public from false and misleading information by requiring publicly-owned corporations to disclose financial and other information in a manner which accurately depicts the results of corporate activities. Congress gave the SEC broad authority to establish accounting and reporting standards as part of its mandate to administer and enforce the provisions of the Federal securities laws.”¹ The Securities Acts also created a need for accountants to act as independent auditors by requiring that certain information reported to the public by corporations be independently certified.² Under the 33 and 34 Acts, the SEC had the authority over the establishment of accounting and auditing standards. The SEC decided not to exercise that authority, but instead to rely upon accounting and auditing

* Richard Mark and Martin E. Taylor are, respectively, Associate Professor and Professor, both at the University of Texas at Arlington. Roberta Ann Barra is an Assistant Professor at the University of Hawai'i at Hilo.

standards established by the private sector as long as these standards had “substantial authoritative support”.³

Over the years, three bodies provided authoritative support for accounting standards: The Committee on Accounting Procedure (CAP), the Accounting Principles Board (APB) and, currently, the Financial Accounting Standards Board (FASB). Auditing standards were promulgated by an executive committee of the American Institute of Certified Public Accountants (AICPA); namely, the Auditing Standards Board (ASB).

Coincident with development of these auditing standards was the development of legal liability and responsibility. Generally, those responsibilities and resulting liability were emphasized by the U.S. Supreme Court, through Justice Warren Burger, who concluded that accountants perform a public watchdog function that demands total independence from the client at all times and requires complete fidelity to the public trust.⁴

Prior to passage of the Sarbanes-Oxley Act (SarbOx) in 2002,⁵ it was the states, not the federal government that historically interpreted the Supreme Court standard when corporate misconduct, either civil or criminal, occurred. Unfortunately, each state was left to its own devices to determine liability standards. In all instances, the states chose to use nebulous equity principles (e.g., do what's right under the circumstances) rather than apply structured legal standards to evaluate corporate governance. At the time, using these vague equity principles seemed to serve the purpose of courts, governments, and various professions by allowing the standards to remain unquantifiable and murky.⁶ As a result, before SarbOx, neither the state, the federal courts, nor the legal community had turned their attention toward the legal responsibilities of accountants as well as resulting potential liability in an internal control setting.⁷

As early as 1974, the Supreme Court had qualms about the reliability of the auditor's pronouncements:

Doubts as to the accuracy and reliability of information reported by corporations have resulted from continual revelations of corporate misconduct which was not found or not reported by independent auditors. Congress and the public have little assurance that corporate financial statements accurately portray the results of business activities because of flexible, alternative accounting standards. Public confidence in independent auditors, which is essential to the success of the Federal securities laws, has been seriously eroded.⁸

Clearly the role of the accounting profession in the promulgation of accounting and auditing standards, and the ability of the profession to detect fraudulent activities by companies was being questioned. In the years that have elapsed since this Supreme Court statement, events have occurred that have had a significant effect on financial reporting and on the accounting profession. The number of large public accounting firms has decreased from eight to four, and a major public accounting firm, Arthur Andersen, went out of business. There have been corporate failures such as Enron and WorldCom in which investors have lost billions of dollars. To reduce the probability of future corporate failures, in 2002 Congress enacted SarbOx and established the Public Company Accounting Oversight Board (PCAOB). The PCAOB was given the authority to establish auditing standards, effectively removing this function from the accounting profession.⁹

In the legal realm, the Justice Department's Attorney's Manual directs attorneys to consider both internal controls and compliance programs in deciding whether to prosecute and what sentences to impose, yet the only parameters specified are the internal control system's design integrity in detecting or preventing violations and the company's efforts in enforcing the programs. No principles of "reasonableness" (legal or otherwise) are specified in the Attorney's Manual to be used in deciding on internal control sufficiency.¹⁰

But Sarbanes-Oxley changed the landscape. It has now inserted the federal courts into what had been the states' exclusive domain. SarbOx, through Section 404, now focuses the legal community's attention on internal control.

Section 404 requires a separate report on the adequacy of internal control by management and the independent auditor. This provision, coupled with the new authority of the PCAOB to set auditing standards now requires the auditor to make two separate evaluations of internal control: one on internal control itself, and the other as part of his or her audit of the financial statements in order to express an opinion on whether the financial statements present fairly. Separate reporting on internal control has been considered and rejected by other countries on the grounds that its costs outweigh its benefits.¹¹

Legal scholars writing after SarbOx have uniformly concluded that auditor liability may likely force all involved to develop a new and more definitive set of criminal and civil law standards for "reasonable" internal controls.¹²

Keep in mind that the Supreme Court has made a number of points in the area of accounting standards that may well apply to internal control:

- First, it is very clear that the courts (state courts before SarbOx and federal as well as state afterwards) retain the right and responsibility to measure the accounting profession's performance of its internal control watchdog function under legal, not accounting criteria. Consequently, the fact that an internal control attestation was performed appropriately under Generally Accepted Auditing Standards (GAAS), Generally Accepted Accounting Principles (GAAP), international or other accounting standards is "...evidence which may be very persuasive but not necessarily conclusive..."¹³ in deciding ultimate liability.

- Secondly, the fact that a company is reporting consistent with a government agency's requirement does not relieve it of, nor establish the criteria for, its legal obligations (and liability).¹⁴
- Thirdly, Enron, WorldCom and other corporate fiascos have left the Supreme Court with qualms about the reliability of the auditor's judgment which may make it less likely for any court to accept accounting standards as an appropriate measure of internal control liability.

In fact, legal scholars are already beginning to create theoretical models estimating accountants' and auditors' post-SarboX liability. Tally, in 2006, remarked that "...auditors continue to face potential risks of liability for a host of potential causes of action at both the state and federal level. Moreover, the aggregation of such risks can - at least under the right theoretical conditions - create a risk portfolio that is "cataclysmic" in nature...". [Tally (2006)].

So what authorities and research should be relied upon to determine whether or not internal control is reasonable or effective? How are the courts to be satisfied that internal control design and implementation in the particular organization are "effective" and "reasonable"? Is there authoritative support in the academic literature and empirical findings for these contentions? Attorneys are expecting to find such evidence to bring to the courts, but, unfortunately, evidence is lacking, and this problem is the basis for the paper.

The paper is organized as follows: Section two covers internal control from a legal perspective, including legal research regarding internal control. Section three examines the extant academic internal control research. Section four offers areas for future internal control research. Section five contains conclusions.

2. Internal Control – Legal Perspective

Accountants view the world through a pragmatic lens of efficiency. Auditors cannot audit each transaction, so they rely on audit sampling techniques to obtain sufficient competent evidential matter to enable them to express an opinion whether or not the financial statements present fairly. Similarly, internal controls contain, in the accountant's opinion, "inherent limitations" (including costs), that set the "reasonableness" standard for structuring internal control audits.

Accountants seem to presume that the law and the courts will accept this slant on "reasonableness" when the time comes to evaluate their efforts in a court of law or through regulatory actions. Much of the post-SarboX written material has focused on the framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as an accounting measure of internal control adequacy. While there are other, equally valid, measures, such as Turnbull (U.K.) and CoCo (Canada), this paper will focus on COSO because it seems to have become the first choice for measuring internal control adequacy.

Lawyers have a different perspective. Their "pragmatism" is based on interpretations of precedent and legal liability. In this case, since there were no viable interpretational standards for internal control prior to SarboX, in this post-2002 era the concern of lawyers is not cost or adequacy of statistical sampling but "reasonableness". In short, most measures of legal responsibility boil down to whether a group's actions (be it accountants, management or boards of directors) are consistent with what a reasonable person of similar background would have done under those same circumstances. The accountant's perceptions of "reasonable assurance" need to be re-evaluated under this new microscope. The conflict arises when the accounting profession, using its own terminology and self-evaluation, presumes to conclude that the

appropriateness of their actions (or inactions) translate successfully into the legal “reasonableness” standard. The authors have created Table 1, Legal versus Accounting Perspectives, to summarize potential differences in perspective on these issues (see Table 1).

Next, this article will review the “reasonableness” concept from the legal perspective, both pre- and post-SarbOx, by examining the internal control concept, followed by a consideration of the perceptions that legal scholars have about the availability, or lack thereof, of academic research to support current interpretations of “reasonableness” under existing post-SarbOx structures.

2.1 The Inherent Legal Conflict in Internal Controls

For whose benefit is internal control created? A simple question that, one would think, is addressed by SarbOx. However, the academic literature in this area has consistently acknowledged that SarbOx has potentially created multiple, conflicting sets of standards for internal control effectiveness, depending on the claimant's perspective (e.g., equity provider, management, board of directors, etc). This lack of clarity has led various groups who benefit from a perceived threat of liability to interpret the requirement in a self-serving manner. [Langevoort, 2006]

For example, management’s legal obligation as agent for the corporation is to design and operate internal control to the best interest of the beneficiaries of the corporation. At least one commentator uses one of the benchmarks in corporate law as authority for arguing that internal control may be the exception to the rule – that failure to provide an effective internal control system may breach officers’ and directors’ fiduciary duties to shareholders. [Langevoort, 2006] But even within these limits, there is the potential for management to use a “don’t ask, don’t tell” approach to internal control.

The auditor's primary legal obligations are to the company and to investors. The company relationship is contractual whereas their obligation to the investing public is imposed by states as well as federal courts in equity, and by the AICPA through its code of professional responsibility.

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.¹⁵

So conditions become ripe for the inevitable. Presume management concludes that portions of internal control design and/or operations are not in the best interest of the company. Or presume that the auditors conclude that portions of internal control design and/or operations are cost prohibitive and therefore it is unnecessary for them to issue an opinion on the effectiveness of the company's internal control as they relate to the financial statements. Both are exercising their obligations to their respective constituencies, both are operating in good faith and with the best interests of those constituencies in mind, yet both are now in a Hobson's Dilemma in that they may well be subjecting themselves to liability under an as-yet-undefined legal standard.

There is a second conflict within SarBox: the courts have rarely used or wanted to use external standards such as GAAP and GAAS as a measure of either criminal or civil liability absent some specific link created by Congress in a particular Act. Yet so far, in discussions with practitioners and in the literature on SarBox, there is a presumption that such standards as, for example, COSO or the Turnbull Report (for the UK), can be used by management, directors and the auditors as a basis for satisfying their legal obligations. Why and how are we all making this association when, at least in the legal arena, it is well know that such a relationship can't be forged without some help by Congress?

2.2 The Legal View of “Reasonableness” Both Pre- and Post-SarbOx

When new legislation, such as SarbOx, comes along, legal scholars and professionals must enter uncharted territory to evaluate the standards that will be used to measure liability.¹⁶ In the law, “reasonableness” is a circumstantial variable, based on perspective, whether civil or criminal. [Wellner (2005)] In short, context matters. When a significant piece of legislation such as SarbOx occurs, most legal scholars anticipate that SarbOx will incorporate a reasonableness standard whose maturation process will depend heavily on available academic as well as professional research [Arlen and Kraakman (1997); Langevoort (2004); Johnson and Sides (2004)] in addition to court, legislative and administrative interpretational activity. This interim will be a chaotic period that will offer an exploitation opportunity to those parties with motives that encourage them to take advantage of the uncertainty in the standard. [Langevoort (2004)]

Could or should those boundaries include the accounting concepts of “inherent limitations” and adequate statistical sampling? The answer is discussed below, but in summary, the legal community requires adequate, disclosed standards through accepted research as a basis to evaluate potential liability.

2.3 Accountant’s Liability under Pre-SarbOx Standards

Well before SarbOx, in 1993, the Public Oversight Board of the AICPA’s SEC Practice Section recommended that:

. . . registrants to include in a document containing the annual financial statements: (a) a report by management on the effectiveness of the entity’s internal control system relating to financial reporting; and (b) a report by the registrant’s independent accountant on the entity’s internal control system relating to financial reporting” [AICPA (1993)]¹⁷

In that same year, the COSO Report made a first attempt at outlining the concept of “reliable financial reporting”. COSO defined reliability as:

Used in the context of published financial statements, reliability is defined as the preparation of financial statements fairly presented in conformity with generally accepted (or other relevant and appropriate) accounting principles and regulatory requirements for external purposes, within the context of materiality. [COSO Report.]¹⁸

Interestingly, COSO made it a point to note that it was limiting its definition of “reliable” “... in terms of the preparation, but not in terms of the contents, of the financial statements...”¹⁹

The ABA’s review of COSO concluded that it’s Framework and Reporting volumes definitions were self-serving and created an “effectiveness” double standard that was, to the legal profession, disconcerting.

We are concerned that it might be argued (in a liability context) that because, in the judgment of the accounting and auditing experts, a material weakness must be disclosed when a “management” report is issued, this constitutes an implicit judgment that a material weakness is per se a fact that should be disclosed whenever an SEC-reporting company files or distributes a report requiring disclosure of material risks of investment in the company. [American Bar Association (1992)]

The ABA was concerned that investors would not necessarily know of the report’s existence, let alone COSO’s manipulation of common terminology (e.g., “reasonable”) coupled with COSO-derived variances and limits on the terminology. The ABA’s concern was that an investor would apply the terms as used in common parlance and hold management, the auditors and the board responsible under those conditions no matter how carefully COSO attempted to limit the accountant’s responsibilities and liabilities

The ABA Report could not find the term used in accounting literature and noted that

One of the everyday meanings of the verb ‘to rely’ is to place faith without reservation, from which reliable might be interpreted reasonably to mean dependable in achievement, accuracy, or honesty. The potential liability implications of a representation or assertion to the effect that financial statements or reports are reliable in the sense of accurate or correct are enormous.²⁰

More importantly, the ABA paid particular attention to the fact that courts were under no obligation to follow GAAS, GAAP or accounting literature in delineating their concept of “reliability” or “fairly present”.

Prior to SarbOx, the SEC’s Rules 13(a)-15(c) set the standard for internal control effectiveness at a “...suitable, recognized control framework established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.”²¹ One preeminent legal authority concludes that, at least for the SEC, “reasonable” equates to “adequacy”. [Cunningham (2004B)] Factors the SEC deems relevant in assessing a system’s adequacy include: board and audit committee involvement; policy communication throughout the organization; assigning authority and responsibility; investing competent compliance personnel with integrity and accountability; and objectivity and effectiveness of internal audits.

Within the Foreign Corrupt Practices Act (the FCPA) some legal scholars believe that “...’reasonable assurance’ connotes a level of comfort that would satisfy prudent persons when conducting their own affairs. ...” [Cunningham (2004B); Maris and Singer (2006)]. Other legal scholars would equate reasonableness to “reasonable detail” based on a standardized list of factors similar to the COSO standards. [Gleich and Woodward (2005)].

Internationally, a recent forum on audit quality and concepts in the UK acknowledged that “...the concept of reasonable assurance is not easily understood or clearly defined.”²² Interestingly, the forum participants also perceived a distinction between what they were calling “reasonable assurance” and what they believed was being required under SarbOx:

If auditors are being asked to go beyond the provision of reasonable assurance then this suggests a move towards either or both of a Sarbanes-Oxley Section 404 type report and a different level of audit enquiry.

After considerable discussion, the group was forced to acknowledge that boiling down internal control “reasonable assurance” into a checklist-type activity made the entire evaluation process a result-driven approach that ignored the overriding auditor responsibilities of professional skepticism, objectivity and judgment.²³

While the accounting profession, as well as the SEC and PCAOB, would want to incorporate a pragmatic, cost/benefit, attitude toward internal control audits, the ABA’s reaction to this approach (expressed as early as the time the COSO report was issued) was, at best, tepid:

We have difficulty in seeing how... cost may be relevant to a determination that an existing deficiency is or is not a material weakness, which is defined in terms of the level of risk of a material misstatement. It would seem that the absence of a certain control, or the inadequacy of existing controls, would (or would not) give rise to a certain “risk of material misstatement” without reference to the cost of instituting the control. But because the cost of a control is relevant to reasonable assurance, the question is whether that cost may be considered by the entity in stating its belief in a public report that, notwithstanding the fact that the absence or inadequacy of the control constitutes a material weakness, its system is nevertheless effective (in that it provides reasonable assurance).

... In other words, if there is a material weakness, the system is not effective without the control, regardless of cost.²⁴

The ABA, later in the same report, made a point of recognizing that “reasonable assurance” may evoke differing standards when applied to (1) outside third parties; and (2) management and the board of directors.

The distinction is important in understanding the COSO Report’s discussions of effectiveness, because the Framework volume lays down standards for determining effectiveness which we believe would be appropriate for management and the board to use in establishing and maintaining the system, while the Reporting volume sets forth a more precise criterion solely for the purpose of determining “effectiveness” in connection with (and relevant only to) a report to third parties. [ABA].²⁵

2.4 SarbOx, Accountant Liabilities and Available Research

Even before SarbOx, the American Bar Association (the ABA) had concluded in its comments on the COSO report that there was a lack of valuable research in the area of “effective” internal control.

The [COSO] Reporting volume approaches the analysis of assessment of effectiveness for purposes of reporting to third parties in a slightly different manner—it does not address directly the question of the effective functioning of the five components of internal control.²⁶

SarbOx creates a new, legally-unevaluated triumvirate of internal control responsibilities. Accountants, for the first time, are now required to certify the effectiveness of the internal control systems. Lawyers, possibly with or without the accountants, are advising management on their internal control responsibilities and on how to structure the internal control. Separately, the board (through the audit committee) will be seeking advice from both accountants and lawyers on how to satisfy their internal control obligations. And the lawyers are looking to the accounting profession and its academic arm to provide the substance that they can use to take into court to create the groundwork for these new obligations.

The perception that the integrity of auditor-sanctioned internal control systems and their components are not supported by competent research has carried through to a variety of post-SarbOx articles by legal scholars and professionals. Romano of the Yale Law School concluded in her criticisms of SarbOx that the value to executive certification of financial statements is unsupported by the empirical academic literature. [Romano, 2005]. Professor Romano concludes that SarbOx's "corporate governance provisions" regarding (1) independent audit committees, (2) auditor provision of nonaudit services (NAS), (3) executive loans, and (4) executive certification of financial statements are unsupported by the empirical academic literature. [Romano (2005)]. Prentice and Spence, on reviewing Romano's comments conclude:

We concede that Congress does not seem to have perused in any great detail the Journal of Finance and perhaps allowed its subscription to the Accounting Review to lapse.”

More significantly, we will demonstrate that a broader and more recent examination of the extant empirical academic literature actually supports several of the provisions that Romano and others critique. It turns out that "even a blind hog finds an acorn every now and again." [Prentice, R.A. and Spence, D.B. (2007)]

A number of other legal scholars have concluded that the US perceives its accounting standards to be superior to other global accounting standards and that, therefore, an audit satisfying those standards should be considered by all involved to be legally defensible and reasonable. [Choi & Pritchard (2003)]. Yet Leuz found that U.S. GAAP reports do not produce financial statements of higher informational quality than do international financial accounting standards (IFRS). [Leuz (2003)]

Grundfest and Bochner examine SarbOx Section 404 and argue that “...AS2 creates an incentive for auditors to examine processes that arise at the borderline of the remote and the inconsequential, processes that have an expected value impact as low as five one-hundredths of one percent of an issuer's net income.” That “...people will implicitly assign different quantitative values to the phrases "reasonably possible" or "remote" or, alternatively, reduce the analysis to the vagaries of subjective feelings. This variability adds to the difficulties generated by the definitions at the core of AS2.” [Grundfest, J.A. and Bochner, S.E , (2007)]

When making recommendations to the PCAOB on its rulemaking activities in the internal control arena, the ABA concluded that the PCAOB was equating “reasonable assurance” in AS2 with a “high level of assurance”. In making its analysis, the ABA noted that “...To be sure, **there is no empirical evidence indicating what level of reporting accuracy the procedures specified in AS 2 will yield.**” [emphasis added.] [ABA Section of Business Law (2006)]

3 Extant Academic and Empirical Research on Internal Control

Attorneys are clearly looking for empirical research to advise clients, and there has been some empirical research done in this area. [Maijoor (2000)] identified three areas of internal control on which current researchers are focusing: internal control from an external auditing perspective, internal control from an organizational theory perspective, and internal control from an economics perspective. By far the largest amount of academic research is being conducted in the area of external auditing perspective. This research includes major studies by [Ashton (1974)]; Mock and Turner (1981)]. Much of the research in this area focuses on traditional accounting controls in the context of decision making by auditors. Emphasis is on studying lower level controls such as accounting controls for specific cycles and transactions, and does not look at broad control concepts such as the control environment.

From an organizational perspective, control research includes a wider area and a focus on control at the departmental and divisional levels, particularly as it relates to results controls, personnel controls, and cultural controls. [Merchant (1998)] Agency theory is the primary focus of control research from an economic perspective.

3.1 Separation of Duties

The area of internal control that has received the most attention is separation of duties (SOD). Recent analytical research indicates that SOD loses effectiveness unless it is coupled with a reward program [Beck (1986); Barra and Griggs (2007)]. Beck uses a principle/agent model to conclude that SOD with a reward program (the type of reward program is not specified in his model) for reporting collusion attempts is cost effective and lowers audit fees. Barra and Griggs also use a principle/agent model and extend Beck by removing the reward program. They find that, without a reward program in place, SOD is at least 20% less cost-effective to the company.

There is no current data available on how many organizations have reward programs in place. This remains a question for future research.

3.2 Passwords

Another internal control design area to receive recent attention is password protocols. Two different studies conclude that changing passwords frequently is not effective. [Howard (2006)] used an analytical model and found that using longer passwords (11 or 12 characters, for instance) was more effective against hacking than changing passwords. He called the latter a “doomed strategy”. [Heins (2006)] used a cost/benefit empirical model and found zero incidences of fraud, waste, or abuse that “...could be attributed to the failure to force password changes on a regular interval.” The Heins study was a case study, limited to the University of California System and may be limited to the circumstances. However, taken together with Howard’s analytical research, the evidence is somewhat more compelling than industries “Best Practice” urging frequent changes of passwords which is based on nothing more than conjecture and guesswork.

3.3 Inventory Controls

Hollinger and Clark [1983] investigated employee theft in hospitals, retail firms and manufacturing firms. While the primary focus of their study was sociological in nature (e.g. examining theft motivations and prevalence) Hollinger and Clark did attempt to correlate the effectiveness of inventory controls with employee theft. Unfortunately, their study measured inventory control effectiveness by sampling management’s personal evaluations of their own systems. They found a moderate to weak negative correlation between the executive’s evaluations of effective controls and the self-reports of employee theft rates in hospitals, a moderate to weak positive correlation between these two same variables in manufacturing firms

(note this is in the wrong direction!), and a statistically significant negative correlation between the variables in retail firms. While their methodology is crude, this does suggest a possible industry effect for control implementation; that one size does not fit all for what may constitute an effective control system.

3.4 Working Papers

Novoselov [2007] ²⁷ applies principle/agency theory to examine the internal control costs and benefits of collusive activity and reaches some very intriguing conclusions about whether collusion between agents as well as between principles and agents can, in fact, oftentimes be tolerated under a cost-benefit analysis. Novoselov's premise is based on an apparently self-defined concept of internal control that ". . . the purpose of internal control is to reduce the negative consequences of information asymmetry between the principal and the agents." Interestingly, Novoselov also labels SOD as an internal control model rather than as simply a procedure within internal control.

Barra [2007] determined that, for non-managerial employees, an optimum cost-effective internal control strategy is for imposing/enforcing *minimum* penalties on these employees. But for managerial employees, the firm's least-cost scenario, perversely, is to ignore internal control controls in favor of enforced *maximum* penalties. The study would lend support to the strong penalties imposed by the SarbOx legislation and also supports, to a certain extent, some of current practices.

3.6 Closely Related Research

Rather than investigate the controls themselves, most internal control research investigates issues surrounding the controls using an explicit, or implied, assumption that control properties are known. Examples of this type of research include Simon [1974], Ashton [1974], Cushing

[1974], and Bodnar [1975]. Following Cushing and Bodnar, there are also a number of mathematical models developed to evaluate internal control systems (e.g. Robinson [1981], Grimlund [1982], Cooley and Cooley [1982], Helal [1983] Knechel [1983], and Srinidhi [1988] among others.) There are also numerous studies that have examined the consistency of an auditor's evaluation of the internal control system. Felix and Niles [1988] list 58 articles published in the 1970s and 1980s on audit-related internal control research.

4 Areas for Future Research

In his 1970 Accounting Review article, Carmichael explicitly laid out what he believed were the untested and unresearched assumptions currently applied to support the internal control structures in today's business organizations. Consider, for instance, the previous cost/benefit discussion that is currently applied by the PCAOB and SEC to internal control .

Effective future research into internal control costs and benefits will first force researchers *to define a point of view*. Once a point of view is established, the "how" as well as the "when" of measuring costs and benefits must occur. Do we use the same point of view as we did for costs? The costs might consider only the company's operational perspective while benefits arguably accrue not just to the company but to stakeholders as well. Research establishing how one might isolate the appropriate costs and benefits for internal control analysis would be welcomed by many stakeholders as well as the legal community. Would (should) potential liability become a part of the cost?

Separately, research paradigms into internal control effectiveness might also be developed to take into account the relative effectiveness of the variety of internal control protocols inherent in any internal control system. Some initial research has been done on separation of duties and passwords. Yet even those studies have only just scratched the surface with their inquiry into

those two controls. There are literally thousands of controls in use in today's firms, none of which have been validated through scientific enquiry. Each control activity's parameters need to be established. When are these controls effective, and how are we going to define "effective"? Aside from that, once we've established how we are going to define effectiveness, when is a control effective? Are there controls that work better in one industry than in another industry? Do they work better in some cultures than in others? Is there a combination of controls that are more or less effective when taken together? Are there controls that work better when your labor force is largely unskilled than when your labor force is composed of largely skilled labor? Are there controls that work better when your labor force speaks English as a second language or are there controls that work better when your labor force is largely articulate? Are there computer controls that work better when they are very simple and easy such as the controls one finds in low-end packages such as Peachtree and Quickbooks? Or do the controls work better when there are very many of these controls such as those one finds in the complex packages such as SAP or Peoplesoft? Are there particular software controls that actually make the process more prone to errors?

Keep in mind that the needed research encompasses all levels of internal controls. In short, the research must address not just components of internal control but the structure(s) themselves, their creation, implementation and operation. For example, are there different types of internal control systems and, if so, which are better or worse and in what circumstances? How does one know what a "key component" of an internal control system is? Will those key components change based on type of system, size of organization, and management structure? How will key components be audited? Will statistical sampling always be adequate? Once identified, how will you test each key component? Will that testing depend on organization size, management structure, other factors? Within an internal control system, does separation of duties work better

or worse and what limitations are inherent? Similar questions can be asked of other key components. It is possible that some of these questions can only be answered by “instinct” and experience. If so, we will need to find ways to test for that. The research potential is almost infinite.

5. Summary and Conclusions

This paper examines significant differences in perspective between the legal and accounting profession regarding each other’s role and responsibilities for a company’s internal controls. For better or worse, SarbOx made internal control a part of the legal realm, and it is therefore imperative that accountants begin to understand how distinct the legal profession’s view of responsibility for internal control is from the current accounting perspective. There are clear differences in how accountants and lawyers view the concept of reasonable assurance as well as the very basic issue of the scope of the inherent limitations of any internal control system or component.

When the legal profession begins to examine both the accountant’s and their own internal control responsibilities, they find what is to them a disconcerting lack of viable research to support many of the currently recognized and recommended internal control practices being put forward by accountants. This need for research is at odds with accountants who do not see research into the effectiveness of internal control as essential. Accountants view internal control effectiveness to be a condition of control that can be measured and validated statistically. They use statistical validation as the basis for confirming to boards of directors and to management that they have reasonable assurance the internal control objectives are being met. While the lawyers also acknowledge that the guiding standard is “reasonable assurance”, their view of the standard and its responsibilities differs significantly from the accounting view.

Similarly, while accountants see cost/benefit as the driving force in evaluating internal control effectiveness as well as the reasonableness of any internal control system, lawyers acknowledge cost/benefit to be only one of a multitude of components driving the final evaluation of any internal control system’s effectiveness.

In this brave new world of SarbOx, “reasonable assurance” – the driving force in measuring internal control effectiveness for both accountants and lawyers – is a contextual variable. It is

certain that it's meaning under SarbOx will evolve as criminal and civil lawsuits are filed and resolved. When the ABA considers the PCAOB's pronouncements equating reasonable assurance with a high level of assurance, it is concerned that there is no empirical evidence to indicate the level of reporting accuracy that the procedures specified in Auditing Standards No. 2 will yield.

This does not imply that legal scholars and the law require absolute certainty. But it should be clear that the methods and approaches to evaluating the creation, implementation and operation of internal controls must be legally reasonable (not absolute) under the circumstances. More importantly, the legal community, both professional and academic, is asking for more empirical evidence to support internal control design and implementation as a basis for measuring effectiveness.

For accountants, the conventional wisdom has been that there is no perfect internal control system and that frauds will always happen. They have used this attitude to explain the current lack of empirical research. However, the number and magnitude of recent frauds that went undetected for a long time begs the question – should internal control systems be performing better than this?

The authors submit that they should. Even with the caveat that all internal control systems are imperfect and that frauds will still occur, they should not occur with such magnitude and frequency. The current approach to internal control systems needs an overhaul. It is time to develop acceptable research paradigms and scientific methodologies to establish the parameters to internal control activities.

More importantly, SarbOx and inevitable future legal battles have made such research imperative. Attorneys and the courts do not share the accountant's view of internal control. The accounting profession will need to back up their assertions with the support of solid research, otherwise, it is the legal, not the accounting, view that will prevail in a court of law.

Table 1: Legal versus Accounting Perspectives

	Legal Perspective	Accounting Perspective
ABA Treaty	Limits Attorney response or they face ethical violations	Allows for increased “comfort” letters beyond contingencies into areas of GAAP and materiality issues
Reasonableness	Were the actions consistent with what a hypothetical "reasonable person" with same background and experience would do in the same circumstances?	A concept that no matter how well designed; an internal control cannot guarantee that objectives will be met
Effectiveness	Lack of valuable research...suitable, recognized control framework...that has followed a clear process	Research not necessary; a state of condition of a control that can be measured; Board and management have reasonable assurance that objectives have been met
Cost-Benefit	If there is a material weakness the system is not effective without the control regardless of cost	Integral part of reasonableness. But measurement is seldom done in practice
Inherent Limitation	Did someone commit fraud, or were they negligence or did they breach their contractual obligations?	Consistently recognizes that no control system is perfect; designers are not to blame for fraud/errors of an imperfect system

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The opinions of the authors are not necessarily those of Louisiana State University, the E.J. Ourso College of business, the LSU Accounting Department, Roosevelt University, the Senior Editor, or the Editor.

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