

**Transplanting Audit Committees to Korean Soil:
A Window into the Evolution of Korean Corporate Governance**

Kon Sik Kim*

I.	INTRODUCTION	163
II.	CORPORATE AUDITORS AND THE AUDIT COMMITTEE.....	165
	A. <i>Development of Corporate Auditors</i>	165
	B. <i>The Audit Committee Versus the Corporate Auditor</i>	168
III.	ISSUES WITH ORGANIZING THE AUDIT COMMITTEE	170
	A. <i>Audit Committee Appointment</i>	170
	B. <i>Financial Experts</i>	171
	C. <i>Full-time Versus Part-time Members</i>	172
IV.	ISSUES WITH OPERATING THE AUDIT COMMITTEE.....	173
	A. <i>Audit Committee Powers</i>	173
	B. <i>The Operation Audit</i>	174
	C. <i>The Legality and Soundness of Corporate Action</i>	175
	D. <i>Accounting Audit</i>	176
	E. <i>Outside Audit</i>	177
	F. <i>Audit Committee Supporting Staff</i>	178
	G. <i>Internal Control and the Audit Committee</i>	179
	H. <i>Dangers of an Overly Active Audit Committee</i>	181
V.	CONCLUSION	182

I. INTRODUCTION

The 1997 financial crisis brought a number of changes to corporate governance in Korea.¹ Since 1997, Korea's corporate governance has taken one step closer to an Anglo-Saxon corporate governance model—at least in form. One of the most notable changes in the corporate governance scene is the rise of outside directors in listed firms. As of 2005, the number of outsiders exceeds five members (about 58 percent of the board) on average for large listed firms with assets over two trillion

* Professor of Law, Seoul National University, Seoul, Korea. I currently serve as audit committee member at two listed firms in Korea.

¹ See generally Hwa-Jin Kim, *Toward the "Best Practice" Model in a Globalizing Market: Recent Developments in Korean Corporate Governance*, 2 J. CORP. L. STUD. 345, 345 (2002) (arguing that "the Korean corporate governance system successfully adapts to the best practice model accepted by global standards").

won.² Concomitant with the rise in outside directors, audit committees have been established in many large listed firms.

It was only after the financial crisis that outside directors were required for listed firms in Korea. In 1999, the corporate statutes of the Korean Commercial Code (KCC) were revised to allow a corporation to establish an audit committee in place of a corporate auditor.³ In 2000, the government revised the Securities and Exchange Act to require large listed firms to establish an audit committee composed primarily of outside directors.⁴

The concept of an outside director was not entirely new to the business community in Korea. Beginning in the 1980s, a few academics started advocating monitoring boards composed of outside directors within large firms. By the mid-1990s, a small number of government-owned firms were required by law to have a board dominated by outside directors. Thus, by the time outside directors were required for listed firms, the business community had at least a minimum understanding of their role in corporate governance.

However, the situation was quite different for audit committees. The audit committee was introduced primarily under pressure from international institutions such as the International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD).⁵ At that time, the audit committee concept was not well known even among business lawyers, not to mention business leaders. Introducing a foreign institution like the audit committee under outside pressure was somewhat humiliating. Thus, it was natural that local corporate law specialists as well as the business community were generally opposed to its implementation in their firms. Now, however, hostility toward the audit committee seems to have substantially decreased, at least in the business community.⁶ One hundred thirty-six—approximately one fifth of the firms listed on the primary section of the Korea Exchange—have an audit

² CORPORATE GOVERNANCE SERVICE, GIEOB JIBAI GUJO BAIGSEO [2006 CORPORATE GOVERNANCE WHITE PAPER] 146 (2006).

³ I was on the government committee responsible for drafting provisions relating to committees including the audit committee under the KCC.

⁴ Cheungwon georai beob [Securities & Exchange Act], Act No. 972 of 1962 (last amended by Act No. 7762, Dec. 29, 2005), arts. 191-17, 54-6; Presidential Decree No. 18757, Mar. 28, 2005, art. 84-24.

⁵ International institutions first suggested that the audit committee be required for all listed firms in Korea. The lack of experts that were qualified to serve on the audit committee was a primary factor in limiting the rule's coverage.

⁶ Corporate law specialists still appear generally opposed to the audit committee.

committee (see Table 1). Of these 136 firms, fifty-nine firms have adopted the audit committee voluntarily.

TABLE 1: Adoption of the Audit Committee by Firms Listed on the Primary Section of Korea Exchange⁷

Year	Listed Firms	Firms with AC	Mandatory	Voluntary
2004	666	132	74	57
2005	662	136	77	59

The audit committee is expected to play a more significant role under Korea's accounting and audit systems, which have been strengthened under the influence of the Sarbanes-Oxley Act. Despite the rapid spread of the audit committee in Korea, however, substantial misunderstanding and confusion persists even among experts in Korea over the roles and functions of the committee in firm operations. Audit committee practices are not yet well established and some of the basics are still in dispute. In other words, the process of convergence has started, but is not yet complete.

In this paper I examine some issues raised in the process of transplanting the audit committee to Korean corporations. The audit committee serves as an ideal window to glimpse the larger picture of corporate governance in Korea, which is currently undergoing a rapid and dynamic evolution. In Part II, I highlight the status of the audit committee in Korea in order to provide some background information. In Part III, I address issues related to organizing the audit committee. In Part IV, I discuss issues in operating the audit committee. In Part V, I focus on the perils of too much action, which may be unique to the audit committee in Korea.

II. CORPORATE AUDITORS AND THE AUDIT COMMITTEE

A. *Development of Corporate Auditors*

If the number of investors involved is small and the business is relatively simple, the investors themselves may be able to supervise corporate managers. However, this is not a feasible option for a large corporation with numerous investors. Such a firm will need a professional supervisor working on behalf of investors.

⁷ CORPORATE GOVERNANCE SERVICE, *supra* note 2, at 184.

The structure of management supervision may be divided into two major types: the American model with its outsider-dominated board and the German model with its supervisory board (*Aufsichtsrat*).⁸ A principal difference between the two models is the separation of supervision and management functions. The supervisory board function in Germany is formally separate from the management function, which belongs to the management board (*Vorstand*). The board in the United States is in charge of management—at least in principle. As the ratio of outsiders to managers increases in the board of directors, the American model in effect becomes similar to the German model.⁹

The corporate auditor in Korea does not quite fit into either of the two models. The corporate auditor, like many other institutions in Korea, is not Korea's own creation, but is a concept imported from Japan. The corporate auditor concept was introduced in a draft of the Japanese Commercial Code prepared by Hermann Rösler, a German legal counsel hired by the Meiji government.¹⁰ Although his draft was never formally implemented, the concept of a corporate auditor took root in the Japanese Code and still remains, despite numerous revisions over the last one hundred years. In designing a supervisory structure, Rösler basically followed the German model by separating corporate auditors from the management function. However, he added an interesting twist. Unlike members of the German supervisory board, a corporate auditor was not given the power to appoint directors. Instead, shareholders appointed directors at the general shareholders meeting ("GSM"). Apparently, Rösler was afraid that the corporate auditor would become too powerful and would be prone to abuse its power to appoint and dismiss directors. Thus, given that it is difficult to expect that a supervisory organ could play an adequate supervisory role with no power to replace those under its supervision, it is hardly surprising that the corporate auditor was criticized for its lack of power right from the beginning.

When the Japanese Code was extensively revised in 1950, the American-style board of directors was introduced. Nonetheless, the corporate auditor remained largely intact. The corporate auditor's power

⁸ See generally Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories, Reforms*, in *COMPARATIVE CORPORATE GOVERNANCE—THE STATE OF THE ART AND EMERGING RESEARCH* 227 (Klaus J. Hopt et. al. eds., 1997) (offering a historical and functional discussion of the German supervisory board).

⁹ Of course, differences still exist between the two models. Perhaps the most important of such differences is labor representation on the German supervisory board.

¹⁰ See generally Hideaki Kubori, *Iinkaito setchi kaisha eno kitai to mondaiten* [*Expectation and Problems of the Companies with Committees*], 136 HO NO SHIHAI 83 (2005).

was reduced to accounting matters as the newly introduced board assumed the role of supervising the execution of directors' duties. Even the new board of directors was soon reduced to a nominal organ in reality, primarily because there was virtually no independent director on the board. Given the absence of meaningful supervision of management, it was perhaps inevitable that corporate crimes such as accounting fraud were allowed to occur.

In theory, the lack of supervision could be remedied in two different ways. The first option was to introduce outside directors to the board, similar to the American model. The second option was to somehow strengthen the position of the corporate auditor. As recently as 2003, Japan essentially adopted the second option in its numerous reform attempts. For instance, the power of the corporate auditor was expanded to cover management affairs. Large firms were required to have at least three statutory auditors on the board of corporate auditors. Large firms were also required to appoint outside corporate auditors as well as full-time corporate auditors. Despite various attempts to expand the role of corporate auditors, their overall level of performance does not seem to have improved in any meaningful fashion in Japan.¹¹ It is not clear why the institution of corporate auditor failed to achieve its proposed function in Japan. It might be at least partly due to the corporate auditor's lack of power to replace directors.¹²

In 2003, the Japanese Code was amended to allow firms to adopt the American-style board dominated by outside directors performing monitoring functions.¹³ A firm adopting the American-style board is required to have an audit committee instead of corporate auditors. One may wonder why it took such a long time for Japan to escape from the grip of the concept of corporate auditors.¹⁴

Corporate auditors in Korea were not any more effective than their Japanese counterparts. Legislators in Korea enacted a special provision

¹¹ Shigeru Morimoto, *Inkaito setchi kaisha seido no rinen to kino (ge)* [Goals and Functions of the Committee-based Corporation System (III)], 1668 SHOJI HOMU [COMMERCIAL LAW MATTERS] 14 (2003).

¹² *Id.* at 19.

¹³ See, e.g., Ronald J. Gilson & Curtis J. Milhaupt, *Choice As Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 353-54 (2005) (providing a theoretical analysis of the 2002 amendment).

¹⁴ A leading commentator still emphasizes that the replacement of corporate auditors by the audit committee does not necessarily reflect a negative judgment on corporate auditors. Shigeru Morimoto, *Inkaito setchi kaisha seido no rinen to kino (jo)* [Goals and Functions of the Committee-based Corporation System (I)], 1666 SHOJI HOMU [COMMERCIAL LAW MATTERS] 6 (2003).

to strengthen the independence of corporate auditors. In an effort to limit the influence of controlling shareholders, the KCC prevents large shareholders from voting in excess of the 3 percent ceiling when appointing a corporate auditor.¹⁵ In practice, however, this provision has failed to significantly contribute to the independence of corporate auditors.

In the past, one could generally classify corporate auditors into three categories: (1) sinecures, (2) executives, and (3) meddlers. A sinecure auditor is appointed just to comply with the statutory requirement and is someone who does virtually nothing as corporate auditor. In many cases, this person is someone the controlling shareholder needs to treat well, such as his in-law or a former bureaucrat. This type of corporate auditor normally works part time.¹⁶ An executive corporate auditor is a corporate auditor in name only and in effect performs an executive function. Executive auditors are often found in small- and medium-sized firms that cannot afford to have sinecure auditors. Meddlers are rather rare and found mostly in government-controlled corporations. Elected not by the CEO, but by the government, this type of corporate auditor tends to feel independent of the CEO. He sometimes tries to maximize his influence as against his competitor, the CEO, meddling in day-to-day operational matters.

B. The Audit Committee Versus the Corporate Auditor

Given the lethargy of corporate auditors in Korea, the Korean government's decision to introduce the audit committee is understandable. Although the audit committee was introduced in Japan as an alternative to the corporate auditor, the audit committee is mandatory for large listed firms in Korea. True, the Korean government's decision to require an audit committee may be criticized for limiting a firm's freedom to choose an appropriate organizational structure.¹⁷ However, if the audit committee is generally more effective when compared to the corporate auditor, such a mandatory approach may be acceptable.

¹⁵ Sang beob [Commercial Code], Act No. 1000 of 1962 (last amended by Act No. 6545, Dec. 29, 2001) art. 409(2).

¹⁶ As of 1995, the average number of corporate auditors in a listed firm was 1.51—more than half of them worked part-time. For example, Samsung Company had only two part-time corporate auditors: one was a retired Supreme Court judge and the other was the head of the group Chairman's office. Kon Sik Kim, *Chaebol and Corporate Governance in Korea* 151 (1995) (unpublished Ph.D. dissertation, University of Washington) (on file with author). During the last decade, the ratio of part timers has decreased. As of 2005, only one in four firms adopting the corporate auditor system has part timers. CORPORATE GOVERNANCE SERVICE, *supra* note 2, at 180.

¹⁷ An overwhelming majority of firms respond that they want such freedom.

Corporate law specialists in Korea have questioned the value of the audit committee as compared to the corporate auditor. These critics emphasize the following three points. First, commentators argue that the audit committee is not free from self-audit. According to this line of reasoning, it is unrealistic to expect the audit committee to be fair and active in monitoring corporate management because the audit committee members have already participated in the decision-making process of the board, as directors. Widely cited in the existing academic literature on the audit committee,¹⁸ this argument may sound plausible as an abstract proposition. However, the self-audit critique is not supported by corporate realities.¹⁹ For example, items covered in a board meeting are only a small part of the business operations subject to audit. In addition, corporate auditors are not significantly better than the audit committee on this self-audit issue. Although a corporate auditor has no vote, she is required to attend board meetings and is expected to express her views.²⁰ If she fails to indicate any reservations on an issue at a board meeting, it would be awkward for her to take any negative measures later on. Moreover, participation of the audit committee members in the management decision-making in board meetings may prove more beneficial as they can try to block a problematic decision beforehand.

Second, some critics point to the subordinate nature of the audit committee as a subcommittee of the board. Under the KCC, the board is authorized to appoint audit committee members.²¹ This seems to be the point that made commentators most uncomfortable. From their perspective, it was unrealistic to expect the audit committee—a mere committee of the board—to properly audit the work of the board, its superior organ.²² Again, this view may appear logical on the surface, but not persuasive in practice. As long as the audit committee is composed of independent and competent outside directors, it may not matter much that the board formally appoints the audit committee. Additionally, some critics believe that a resolution of the audit committee, like other

¹⁸ See, e.g., CHUL-SONG LEE, HOESABEOB GANGUI [LECTURES ON CORPORATE LAW] 670 (13th ed. 2006).

¹⁹ The self-audit concern does not seem to have many supporters in Japan. See Morimoto, *supra* note 14, at 19.

²⁰ Sang beob [Commercial Code], *supra* note 15, art. 391-2(1).

²¹ *Id.* arts. 393-2(1), 415-2(1).

²² This is the reason why the Securities and Exchange Act was revised to require that the GSM intervene in electing the audit committee members. See Cheungwon georai beob [Securities and Exchange Act], *supra* note 4, art. 191-11(1).

committee resolutions, may be overturned by the full board.²³ This view does not take account of differences between the audit committee and other board committees. Unlike other board committees, the audit committee's authority derives from specific provisions in the KCC, not from the board of directors. Accordingly, the board can not overturn a decision by the audit committee because such decisions are outside of the scope of the board's statutory authority.²⁴

The third argument against the audit committee is based on a more practical consideration. How can the audit committee, which is primarily composed of outside directors working part-time, carry out increased responsibilities? This concern, however, is also applicable to corporate auditors because a corporate auditor does not generally need to be employed full time.²⁵ On the other hand, an outside director does not have to be a part-timer either. If the workload of the audit committee is heavy enough to justify a full-time position, the firm may choose to appoint a full-time director. Indeed, many financial institutions have a full-time member on the audit committee. One cannot say this practice is good or bad as a matter of principle. The answer depends upon the weight of responsibility in each case. This point will be discussed in greater detail later.

As the discussion above shows, concerns about the audit committee appear rather formalistic and devoid of analysis based on reality. On the one hand, this may be partly due to a prevalent tendency in Korean legal scholarship to concentrate on formal logical consistency. On the other hand, local scholars may have advanced these negative arguments to disguise their blind hostility to yet another unfamiliar foreign institution.

III. ISSUES WITH ORGANIZING THE AUDIT COMMITTEE

A. *Audit Committee Appointment*

Although the KCC does not explicitly empower specific body to elect audit committee members, there has been no dispute that the board has the power to select and dismiss members of the audit committee, as it

²³ Sang beob [Commercial Code], *supra* note 15, art. 393-2(4)(ii).

²⁴ The government bill to revise the Commercial Code has a provision explicitly indicating that a decision by the audit committee is not to be overturned by the full board.

²⁵ As of 1995, only about half of the corporate auditors of listed firms worked full time. See Morimoto, *supra* note 14. The Securities and Exchange Act now requires a large listed firm to have at least one corporate auditor working full time. Cheungwon georai beob [Securities and Exchange Act], *supra* note 4, art. 191-12(1).

has for other committees of the board.²⁶ Some commentators have expressed concern that the audit committee would not be independent if the board elects the members. Under the KCC, a corporate auditor is appointed at the GSM, taking into account that the 3 percent ceiling applies to large shareholders in voting.²⁷ This difference was cited as yet another ground for the superiority of corporate auditors over the audit committee.²⁸

The Securities and Exchange Act was revised to apply the 3 percent limit to a resolution appointing audit committee members.²⁹ This added requirement causes much confusion in corporate practice.³⁰ In order to apply this 3 percent limit, many companies make a separate resolution at the GSM for an outside director who will serve as a member of the audit committee. In such companies, it is the shareholders at the GSM, not the board, who actually selects audit committee members. This practice will not cause any material problems for a firm that has opted out of cumulative voting. However, in a small number of firms subject to cumulative voting, it may generate a significant difference. When appointing ordinary directors and the audit committee members at the same time, some firms split the appointment resolutions in two in order to minimize the effect of cumulative voting.³¹

B. *Financial Experts*

Influenced by the Sarbanes-Oxley Act, the Securities and Exchange Act requires the audit committee of a listed firm to include at least one expert in accounting or finance.³² The Presidential Decree enforcing the Securities and Exchange Act sets forth five categories of experts that meet this requirement.³³ Perhaps the most problematic

²⁶ The board is explicitly authorized to establish a board committee. Sangbeob [Commercial Code], *supra* note 15, art. 393-2. Additionally, the KCC treats the audit committee as a board committee. *Id.* art. 415-2(1).

²⁷ Sang beob [Commercial Code], *supra* note 15, art. 409(2).

²⁸ Lee, *supra* note 18, at 670.

²⁹ Cheungwon georae beop [Securities and Exchange Act], *supra* note 4, arts. 191-17(2), 54-6(6).

³⁰ Kon Sik Kim, *Beobjeog sigag eseo bon gamsawiwonhoi* [The Audit Committee Viewed from a Legal Perspective], 13 BFL 35, 38-39 (2006).

³¹ Judgment Mar. 14, 2006, Daijeon jibang beobwon [Daijeon District Court], 2006 Gahab 242.

³² Cheungwon georai beob [Securities and Exchange Act], *supra* note 4, arts. 191-17(2), 54-6(2)(ii).

³³ Presidential Decree No. 18757, *supra* note 4, art. 37-7(2).

category is that of former employees of the government and the Financial Supervisory Service³⁴ with at least five years of experience in activities related to finance, accounting, or supervisory activities covering finance or accounting. It is not clear what kind of employees can qualify as such an expert. Moreover, it is highly doubtful whether this category of experts has any of the necessary qualities for serving on an audit committee. It is widely suspected that this category has been inserted to help former regulators land decent second jobs in the private sector. Indeed, in many financial institutions, former officials of the Financial Supervisory Service serve as full-time members of audit committees.³⁵

C. *Full-time Versus Part-time Members*

Under current law, at least two-thirds of audit committee members must be outsiders.³⁶ In a growing number of large listed firms, the audit committee is composed solely of outside directors. In most financial institutions, an audit committee member works on a full-time basis. In practice, such a full-time member is treated as a non-outsider. This interpretation is based upon the Securities and Exchange Act, which defines an outside director as a director not engaged in “regular activity.”³⁷ The Korean term for regular activity, *sangmu*, which may also be translated as ordinary or daily activity, is normally used for full-time directors. The dividing line between outsiders and insiders, however, should be the nature of their work, not the length of hours worked.

Is it desirable to have a full-time audit committee members? Those who support the idea of a full-time member point to the increased work load of the audit committee. Indeed, it is acknowledged that in a fair number of Japanese firms a member of the audit committee works full time.³⁸ A full-time audit committee member may also face problems. First, if a member of the audit committee works full-time, his independence from management may likely be compromised. Compared

³⁴ The Financial Supervisory Service is the non-governmental operating arm of the country’s principal regulator, the Financial Supervisory Commission.

³⁵ Although the Securities and Exchange Act explicitly mentions accounting or finance, audit experience may be of more relevance to the audit committee. In reality, however, it is difficult to invite such an expert, as most candidates, affiliated with big accounting firms, hesitate to become outside directors for conflict-of-interest reasons.

³⁶ Sang beob [Commercial Code], *supra* note 15, art. 415-2(2); Cheungwon georai beob [Securities and Exchange Act], *supra* note 4, arts. 191-17, 54-6(2)(i).

³⁷ Cheungwon georai beob [Securities and Exchange Act], *supra* note 4, art. 2(19).

³⁸ KAISEI KAISHAHO SEMINA [SEMINAR ON COMPANY LAW REFORM] 292 (Kenjiro Egashira et al. eds., 2006) (remark by Shigeru Morimoto)..

to directors with other careers, the full-time member may be anxious to maintain his position and therefore more vulnerable to pressure from management. Second, an information gap may arise between the full-time member and the part-time members, whereby the part-time members depend on the information provided by the full-time member. Finally, it may be more difficult to find a qualified person who is willing to work full-time. In large listed firms at least, outside directors are selected from those who have been highly successful in their own careers. For these people, working full-time on an audit committee may not be attractive as a career option.

IV. ISSUES WITH OPERATING THE AUDIT COMMITTEE

A. *Audit Committee Powers*

Under the KCC, the audit committee, like a corporate auditor, shall “audit the execution of director’s duties.”³⁹ In Korea, this audit committee function is generally referred to as the operation audit. Although the operation audit should cover accounting matters as well, the audit on accounting matters is separately called the accounting audit. In support of the supervisory function, the KCC grants the audit committee a wide range of powers to:

- (1) request a business report from directors and to investigate the corporate operational matters and financial status;⁴⁰
- (2) attend board meetings and express opinions;⁴¹
- (3) request that the board of directors call a GSM;⁴²
- (4) request a business report from a subsidiary of the firm and, in certain circumstances, to investigate the subsidiary’s operational matters and financial status;⁴³
- (5) review directors’ proposals and documents to be submitted at a GSM and to comment on their compliance with the law and the articles of incorporation;⁴⁴

³⁹ Sang beob [Commercial Code], *supra* note 15, arts. 412(1), 415-2(6).

⁴⁰ *Id.* art. 412(2).

⁴¹ *Id.* art. 391-2(2).

⁴² *Id.* art. 412-3(1).

⁴³ *Id.* art. 412-4.

⁴⁴ *Id.* art. 413.

- (6) report to the board of directors if it is found that a director has violated, or is likely to violate, the law or articles of incorporation;⁴⁵
- (7) enjoin a director from violating the law or articles of incorporation if such violation would irreparably harm the corporation;⁴⁶
- (8) file a suit against a director on behalf of the corporation;⁴⁷ and
- (9) audit financial statements and to submit an audit report.⁴⁸

B. The Operation Audit

As discussed earlier, the power and duty of the audit committee in Korea is much broader than its counterpart in the United States. While the audit committee in the United States is primarily concerned with accounting matters, its Korean counterpart is additionally required to audit “the execution of the directors’ duties.” The execution of directors’ duties may be interpreted as covering almost every aspect of business operations. Critics wonder how the audit committee, primarily composed of part-time outsiders, can implement such enormous tasks. This issue will be discussed later.

A question arises over how to distinguish between the audit committee’s audit and the board’s supervision functions. Under the KCC, the execution of directors’ duties is subject to supervision of the board.⁴⁹ The difference between the terms “audit” and “supervision” does not necessarily help clarify the different functions of the two different organs. A clue to our inquiry may be found in the different powers of the board and the audit committee, as regards to the CEO, a “representative director” under the KCC parlance.

As a matter of law, the board is the decision-making body on management issues and the CEO is the officer in charge of executing decisions made by the board. Although the audit committee has various powers that may be exercised to restrain the CEO, it has no power to appoint or dismiss the CEO. It is natural that the board should have the power to appoint and dismiss the CEO when he fails to carry out the

⁴⁵ *Id.* art. 391-2(2).

⁴⁶ *Id.* art. 402.

⁴⁷ *Id.* art. 394.

⁴⁸ *Id.* art. 447-4.

⁴⁹ *Id.* art. 393(2).

board's decisions.⁵⁰ Exercising this power, the board would be given the power to supervise every aspect of the CEO's performance.

The core of the audit committee's powers may be its power to file a lawsuit on behalf of the corporation for damages incurred by a CEO's violation of his fiduciary duties and to enjoin a CEO's illegal behavior. Thus, the primary purpose of the operation audit should be to ensure the firm's compliance with the law (including the articles of incorporation) and the fiduciary duties of officers and directors.

C. *The Legality and Soundness of Corporate Action*

There has long been a debate among commentators as to whether the power of a corporate auditor is limited to the legality of a corporate action or whether power extends to its soundness. As legality and soundness are not mutually exclusive concepts, this kind of dispute may prove unproductive. Since the statutory powers of the corporate auditor are focused on the laws and fiduciary duties, an audit should concentrate on the legality of corporate decisions. But if a decision made by the CEO is found to be grossly inadequate, it may constitute a violation of his fiduciary duty of care, which amounts to illegality. However, the line between legality and soundness is often vague. Therefore, the corporate auditor is not completely excluded from inquiring into the soundness of any management action. The same issue arises for an audit committee as well. The distinction between legality and soundness becomes even less relevant given the fact that the audit committee consists of directors, who are members of the board in charge of business decision-making.

On the soundness-related power of the audit committee, two points should be mentioned. First, the operation audit by the audit committee is subject to limits engendered by the business judgment rule, which has been functionally adopted by the courts in Korea.⁵¹ As long as management or the board has reached a decision based on a careful review of relevant information, the audit committee should refrain from making further inquiries. Second, the audit committee needs to prudently exercise the power to look into the soundness of corporate decisions. The audit committee is not obligated to review every substantial business decision in advance. Such a review would also not be in accordance with best practice since the costs of such an intervention would far outweigh

⁵⁰ The KCC expressly allows the GSM, rather than the board, to appoint a representative directors if such a mechanism is set forth in the articles of incorporation. *Id.* art. 389(1).

⁵¹ See generally Hwa-Jin Kim & Tehyok Daniel Yi, *Directors' Liabilities and the Business Judgment Rule in Korea*, Apr. 15, 2004, <http://ssrn.com/abstract=530442> (providing analysis of the business judgment rule in Korea).

the benefits. Most CEOs are bound to exercise their best efforts in order to enhance corporate performance. If corporate performance falls short of the board's expectations due to a serious blunder committed by management, the board may in theory replace the management.

D. Accounting Audit

Although not expressly provided by the KCC, the CEO is ultimately responsible for the accuracy of accounting information.⁵² However, the CEO may not be eager or competent to provide accurate figures. A CEO may even try to distort such figures for various reasons. In a large firm with numerous shareholders, this problem is addressed by external audits. The KCC requires the audit committee or a corporate auditor to audit the financial statements.⁵³ The KCC, however, is silent as to how the audit committee should carry out its audit responsibility. The KCC merely requires that certain items be included in the audit report that the audit committee is required to submit within four weeks of the end of the business year.⁵⁴ For example, the report must include whether the:

- accounting records of the company are deficient or whether the balance sheet or the income statement is not in accord with the accounting records;
- balance sheet and income statement accurately present the state of the assets and profits (or losses) in accordance with the laws and the articles of incorporation; and
- detailed statements supplementing the balance sheet and the income statement are deficient or are not in accord with the accounting records, the balance sheet or the income statement.

For a firm of any size, it is not an easy task to assess these matters within four weeks. This is by no means a task that a few part-time members of the audit committee can personally carry out. This problem may in theory be approached in two different, but not mutually exclusive, ways. The first is to appoint full-timers to the audit committee, a solution favored by many commentators. As mentioned earlier, however, a full-timer may be less independent, and it may be more difficult to find a qualified candidate. Moreover, as the size of a firm grows, even full-timers will have difficulty in performing the audit work.

⁵² Under the KCC, the financial statements prepared by representative directors are subject to approval by the board. Sang beop [Commercial Code], *supra* note 15, art. 447.

⁵³ *Id.* art. 447-4.

⁵⁴ *Id.* art. 447-4(2).

The second approach is to rely on supporters from outside the firm as well as those in-house. As mentioned earlier, a corporation with assets of seven billion won (approximately seven million dollars) or more is subject to outside audit.⁵⁵ In this kind of corporation, the outside auditor, an accounting firm in most cases, is better qualified than the audit committee to assure the accuracy of accounting information. It is unclear, however, to what extent the audit committee can rely on an audit report prepared by an outside auditor. In practice, it is invariably the chairman of the audit committee or a corporate auditor who reads the audit report at the general shareholders' meeting. A model audit report widely used in practice uses language that suggests the audit committee itself undertakes the audit work. In practice, however, the audit committee rarely engages in any audit activities personally. The audit committee chair performs his duty by reading a short audit report prepared by the internal audit department. So the question arises as to whether or not, and to what extent, the internal audit department is subject to the control of the audit committee. This issue will be discussed later.

E. Outside Audit

During the last decade, a series of reforms have been made to improve the quality of outside audit. Many of the prescriptions of the Sarbanes-Oxley Act have been imported to Korea almost verbatim. Under the current laws, the audit committee has the power to approve the appointment of an outside auditor,⁵⁶ and to approve the non-audit services of the outside auditor.⁵⁷ In practice, the audit committee routinely approves the accounting firm recommended by management. In a few firms under professional management, however, the audit committee starts playing a more active role, exercising the power on proposals and interviews with accounting firms.

The audit committee is required to make sure that the outside auditor does her job properly. However, many audit committee members are often too busy or ill-equipped to take the initiative. Even when they have the motivation to be more active, they often do not know exactly what they are supposed to do. A small but growing number of audit committees have become more active in communicating with audit firms by holding closed sessions with outside auditors on a regular basis.

⁵⁵ Jusig hoesai oebugamsa e gwanhan beobryul [Act on External Audit of Stock Companies], Act No. 3297 of 1980 (last amended by Act No. 7524, May 31, 2005) art. 2.

⁵⁶ *See id.* art. 4(2).

⁵⁷ Gongin hoegesabeob [Certified Accountant Act], Act No. 5255 of 1997 (last amended by Act No. 7796, Dec. 29, 2005) art. 14(3).

F. Audit Committee Supporting Staff

The audit function requires substantial expertise and efforts on the part of the audit committee. It is simply unrealistic to expect the audit committee to carry out all its responsibilities by itself. Although the audit committee may in principle rely on outside experts, it is undesirable for the audit committee to depend exclusively on external sources. Thus, the audit committee has basically two options. Either the audit committee uses its own in-house team of audit experts, independent from the CEO or it relies on an internal audit department of the firm.

Of the two options, the in-house team approach seems more popular among commentators. It may appear reasonable in theory, but may not work well in practice. In addition to cost concerns, it may not be easy to recruit good people for positions separate from the regular corporate hierarchy. For such people, prospects for promotion within the firm are limited. Moreover, as lateral hiring among firms is still infrequent in Korea, such people may have a hard time landing a job in other firms.

Even if the audit committee manages to find competent people, they may not function effectively. Regarded as outsiders by the firm's inside directors and officers, they may be soon alienated from the rest of the organization.⁵⁸ In the United States, it is known to be highly unusual for the audit committee to have a separate staff.⁵⁹

Then, only the internal audit department option remains. Indeed, the audit committee is known to utilize the audit department in most cases. A principal weakness of the internal audit department option may be the lack of independence of the internal auditors from the CEO. Many argue that the audit committee, not the CEO, should take charge of the internal audit department.⁶⁰ But this is not acceptable, as internal audit constitutes an element of internal control, one of the CEO's management responsibilities. If the audit committee undermines the internal audit department's control, the CEO will have to organize his own audit team again.

⁵⁸ I know of only one case where the audit committee hired a high-level assistant from outside the company. However, this person left after only one year.

⁵⁹ NATIONAL COMM'N ON FRAUDULENT FINANCIAL REPORTING, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 43 (1987), *available at* <http://www.coso.org/Publications/NCFFR.pdf>.

⁶⁰ At least one large listed firm is known to have the internal audit function under the exclusive control of the audit committee.

Although there are some instances (mostly government-owned corporations) where a corporate auditor is in charge of internal audit, it is general practice that the internal audit department is formally under the control of the CEO. In a growing number of firms, the audit committee is granted the power to issue an order to the internal audit department and to provide input into the appointment and dismissal process. Such powers will not be enough to make the internal audit department a neutral organ. If necessary, the audit committee should hire outside experts for advice or investigation.⁶¹

G. *Internal Control and the Audit Committee*

Recently, in connection with monitoring by the board or the audit committee, the concept of internal control has attracted attention in Korea. Internal control was first discussed in the context of financial institutions.⁶² Now, internal control is becoming important in industrial corporations as well. The concept of internal control, however, is not well understood in the boardroom. An internal control examination manual issued by the Financial Supervisory Service, the executive arm of the Financial Supervisory Commission (FSC), defines internal control as “a series of processes continuously implemented by all members of the firm for the purpose of protecting corporate assets, securing the accuracy and reliability of accounting materials, promoting efficiency in operation, and complying with business policies and laws and regulations.” Internal control, from this standpoint, constitutes an essential element of management to which the board and the CEO are accountable. The audit committee is only responsible for assuring that the internal control system established by management is adequate and for making suggestions for change. If the internal control system is adequate, the audit committee should be entitled to rely on it unless other special circumstances exist.

The problem is how to introduce the concept of internal control into Korean law. As discussed earlier, Korean law is generally silent on internal control of non-financial corporations.⁶³ A few statutes, however, deal with certain aspects of internal control. For example, a regulation promulgated by the FSC under the Securities and Exchange Act requires the audit committee to attach a statement on the operational status of the

⁶¹ Sangbeob [Commercial Code], *supra* note 15, art. 415-2(5).

⁶² See Eunhyaing beob [Banking Act], Act No. 911 of 1950 (last amended by Act No. 7428, Mar. 31, 2005, art. 23-3; Cheunggwon georai beob [Securities and Exchange Act], *supra* note 4, art. 54-4.

⁶³ Of course, that does not necessarily mean that the concept of internal control is not applicable to an industrial corporation. Regardless of the statutory basis, the CEO and the board have the duty to establish an adequate internal control system.

“internal monitoring mechanism” to the annual report.⁶⁴ Although monitoring constitutes only a part of internal control under the famous COSO (Committee of Sponsoring Organizations) report,⁶⁵ it is reasonable to interpret the Korean term for internal monitoring as internal control. An important concept like internal control, however, should be squarely set forth in the statutes, not in an administrative regulation. In any event, audit committees have so far not paid much attention to this requirement, and this requirement is generally satisfied in a cursory fashion.⁶⁶

A more recent and conspicuous development may be the internal accounting control system required under the Outside Audit Act.⁶⁷ Influenced by the Sarbanes-Oxley Act, the internal accounting control system is defined as “a process continuously implemented by all members of the firm, including the board and managers, as an internal control mechanism for assuring reasonable confidence in the reliability of the financial statements of the firm.”⁶⁸ It is accepted that the internal accounting control system constitutes a core component of the internal control under the COSO report. The Outside Audit Act explicitly provides that it is the CEO’s responsibility to establish an internal accounting control system.⁶⁹ The Outside Audit Act requires an internal accounting control officer, a position generally held by the CFO, to submit an operation report to the audit committee, which is required to evaluate the operation report and present its findings to the board.⁷⁰ Large listed companies seem more serious about this new requirement and some have consulted one of the Big Four accounting firms as to how to satisfy the evaluation requirement. The audit committee and the outside auditor of the company are required to include an opinion on internal accounting control.⁷¹ Some commentators in Korea question how the audit

⁶⁴ Korea Financial Supervisory Commission, Regulation on the Issuance of Securities and Disclosure, art. 72(3)(i)(F).

⁶⁵ COMM. OF SPONSORING ORG. OF THE TREADWAY COMM’N, INTERNAL CONTROL—AN INTEGRATED FRAMEWORK (1992).

⁶⁶ In my experience, it seems that even many of those corporate employees who are responsible for the annual report are not well aware of this requirement.

⁶⁷ Jusig hoesau i oebgamsa e gwanhan beobryul [Act on Outside Audit of Stock Companies], *supra* note 55, art. 2-2(3).

⁶⁸ *Id.* art. 2-2(1).

⁶⁹ *Id.* art. 2-2(3).

⁷⁰ *Id.* arts. 2-2(4); 2-2(5).

⁷¹ As in the United States, accounting firms in Korea are known to charge substantial fees for this additional service.

committee should prepare its own report on internal accounting control. Sole reliance on a draft report prepared by the internal audit department may be inadequate because the audit department is a part of the system being evaluated. Therefore, it may be necessary for the audit committee to hire an expert, at least once every three or four years.

H. Dangers of an Overly Active Audit Committee

In the United States, attention has been given to making the audit committee more independent and active. The report of the Blue Ribbon Committee⁷² is a prime example this, and has been widely studied in Korea. The Sarbanes-Oxley Act included measures to make audit committees more independent and active, increasing the workload of audit committee members. Still, the audit committee in Korea also needs to be encouraged to play a more active role. Lacking technical competence and faced with non-cooperative management, audit committee members are likely to remain passive.

At the same time, however, one should note that there is a possibility for too much action on the part of audit committee members and an overly active audit committee can lead to counter-productivity. As explained earlier, the power and duty of the audit committee is extensive, covering almost every aspect of business operation. However, Korean statutes are not clear as to the details of what the audit committee should do to carry out its duties. The audit committee enjoys a considerable amount of discretion as long as it does not violate the Korean equivalent of fiduciary duty. As a matter of principle, too much, as well as too little, action may result in liability.

However, because it is highly unrealistic to expect a court to hold an audit committee member liable for too much action,⁷³ it is safer for the audit committee to be active, rather than passive. Some audit committee members may want to do more because they have no other things to do or are more interested in expanding their influence. True, there is a low risk of excessive activism on the part of the audit committee in Korea. Nonetheless, the risk does exist. Popularity of arguments in favor of a full-time member or in-house supporting staff may be evidence of such a risk. As outside directors gain more power against management, such risk may become more real.

⁷² BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES, REPORT AND RECOMMENDATIONS (1999), *reprinted in* 54 BUS. LAW. 1067, 1067 (1999) (including recommendations for improving the independence, effectiveness, and accountability of audit committees).

⁷³ It is also difficult to imagine a case where the audit committee's liability for too much action is justified.

Equipped with the power to conduct an operation audit, an overly active audit committee may slow down, if not cripple, corporate decision-making. If the audit committee is involved in too many corporate decisions, the burden of its members will increase, which discourages qualified candidates with other commitments from serving on audit committees.

How then do we go about discouraging too much action on the part of the audit committee? I have two suggestions. First, it may be helpful to define the activities of the audit committee according to best-practice standards. The best practice standards will in effect serve as the maximum limit of the audit committee action and require audit committee members to justify their activities not supported by the best practice. Second, and more importantly, the courts should take an active role in overseeing audit committee members. Currently, an outside director that fails to perform his fiduciary duties (as a member of the audit committee) may be held liable for damages under the KCC.⁷⁴ Such a case may arise when an outside director has failed to take some appropriate action, not when he has taken any action. In order to seek damages caused by his non-action, the plaintiff must prove the existence of a duty to act. An audit committee member certainly has a duty to act. As mentioned earlier, however, it is not clear what he should actually do to avoid legal liability. Ultimately, the courts will make a decision on the merits of each case. The line will be drawn somewhere between the two poles—the pole of inaction and the pole of best practice. The court needs to be cautious, as its decision will critically affect the audit committee practice now emerging in Korea. It seems wiser for the court to start with a relatively lenient standard. My suggestion is that if the audit committee has paid some attention to internal control, they should be exempt from legal liability at a minimum. Given a small number of qualified candidates, applying too high a standard will deter relatively competent candidates from serving on the audit committees and will likely lead to excessive auditing.

V. CONCLUSION

Under current statutes in Korea, the audit committee enjoys a special status, with powers over operational, as well as accounting matters. In reality, however, the audit committee does not play a significant role. It is overshadowed by the board in operation auditing, and by outside auditors in accounting auditing. In conducting the operation audit, the line between the board and the audit committee is not clear. The corporate auditor is given the power of the operation audit because

⁷⁴ See Sang beob [Commercial Code], *supra* note 15, arts. 415-2(6), 414.

legislators were concerned that the board may not properly perform the monitoring function. In a small but growing number of large listed firms, the board has taken a more active role in monitoring, primarily due to the increase of outside directors on the board. If the board is properly engaged, the role of the audit committee may be adjusted to concentrate on accounting matters. In addition, for firms that are required to perform an outside audit, the audit committee should be allowed to rely on the work of outside auditors. This change would make the audit committee in Korea function like the audit committee in the United States.

Finally, a few remarks on the significance of the Korean experience with the audit committee are in order. Corporate governance scholars have widely held that despite globalization, formal convergence will not take place in the near future, if ever.⁷⁵ Developments in Korea may be pointed out as a prime example of counter-evidence to this well-known proposition. Outside directors and the audit committee were virtually unheard of within Korea's business circles until the early 1990s. In less than a decade, however, they are now becoming increasingly visible throughout the business community.

Formal convergence is not limited to the corporate organizational structure. The Korean government has just prepared a bill to revise its corporate statutes. The bill includes many of the changes made in the new Japanese Corporate Code. Principles that are intended to protect creditor interests will be substantially diminished, if not completely abandoned. The securities that a corporation may issue will be substantially expanded. In short, Korean statutes will become more like their American counterparts.

This kind of formal convergence seems to be occurring in other developed countries as well. Japan is a good example, and the European Union and its member countries also seem to be moving in the same direction, albeit far more slowly. Arguably, this convergence is occurring only in form, but not in substance. Both outside directors and the audit committee in Korea behave differently than their American counterparts. This is hardly surprising given that the people and the business environments (the legal profession, social norms, cultures, job markets, etc.) are different between the two countries.

Difference in substance should not be overemphasized, however. For example, outside directors and the audit committee were much less important in corporate governance in the United States thirty years ago. Many firms in the United States may still fall far short of best practice standards. True, the establishment of a well functioning board and an

⁷⁵ See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 337-39 (2001).

audit committee may not be as easy as manufacturing cars or electronic appliances. As time passes, however, the role of outside directors and the audit committee in Korea may grow to become as important as in the United States. From a long-term perspective, even convergence in substance may not be as difficult as it first appears.