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Sarbanes Oxley Act (SOX) Disclosure, Internal Control Disclosure as an Important Part in Corporate Governance (CG)

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Abstract
The Sarbanes–Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002), also known as the "Public Company Accounting Reform and Investor Protection Act" (in the Senate) and "Corporate and Auditing Accountability, Responsibility, and Transparency Act" (in the House) and more commonly called Sarbanes–Oxley, Sarbox or SOX, is a United States federal law that set new or expanded requirements for all U.S. public company boards, management and public accounting firms. There are also a number of provisions of the Act that also apply to privately held companies, for example the willful destruction of evidence to impede a Federal investigation. The bill, which contains eleven sections, was enacted as a reaction to a number of major corporate and accounting scandals, including Enron and WorldCom. The sections of the bill cover responsibilities of a public corporation's board of directors, adds criminal penalties for certain misconduct, and required the Securities and Exchange Commission to create regulations to define how public corporations are to comply with the law.After a prolonged period of corporate scandals involving large public companies from 2000 to 2002, the Sarbanes-Oxley Act was enacted in July 2002 to restore investors' confidence in markets and close loopholes for public companies to defraud investors. The act had a profound effect on corporate governance in the United States. The Sarbanes-Oxley Act requires public companies to strengthen audit committees, perform internal controls tests, set personal liability of directors and officers for accuracy of financial statements, and strengthen disclosure. The Sarbanes-Oxley Act also establishes stricter criminal penalties for securities fraud and changes how public accounting firms operate their businesses. Internal control is a process conducted by the company's board of management, the management, and other personal designed (1) to give certainty about the effectiveness and efficiency of the company's operation, (2) the reliability of financial statements, and (3) the obedience towards the law and regulations (Ghosh & Lubber ink, 2006).The internal control is also needed in generating the financial report so that it reflects the company's real operation. The assurance of the effectiveness of the company's internal control is an obligation for the company which stock is traded at the capital market. An effective internal control system will benefit the company, especially to attract the market. (Shaun & Weiss, 2009). This is a theoretical study based on SOX disclosure and the effect of internal controls on executive compensation according to the theoretical standards as an important part of corporate governance (CG).

Keywords: The internal control disclosure, financial report, executive compensation, timeliness, corporate governance, control system, the responsibility, risk management, evaluate the effectiveness.

1. Introduction

The effort to increase the internal control's activities will cause an increase in significant cost for the manager. The manager needs more cost for their efforts to reach an effective internal control system, compared to the benefits that the company will receive. Hence, the incentive is very much needed to reach this benefit. The company will adjust the compensation contract to motivate the managers to create an effective internal control system (Shon & Weiss, 2009). The result of Shon & Weiss (2009) had proven that there existed a positive relationship between the executive compensation and the effective control system. Also, with the study result of Lang & Ding (2011), they had found that the internal control disclosure at the company's financial report was related with the executive compensation. The same was also concluded from the study by Balsam, Gordon, Li, & Runes son (2012). The result of their analyses had strongly supported the relationship between the obligatory disclosures regarding the executive's compensation, because the obligatory disclosure will motivate the management to increase the control and responsibility. The internal control system is considered an important mechanism in assuring corporate governance quality because it improves monitoring action of the independent audit committee, increases the responsibility of senior managers on the reliability of financial statements, helps the board and management to better control internal and external company's risks, makes more effective the external company's risks, makes more effective the external auditor activities and certifications (Power,1997; Spira&Page,2010).

In response to recent corporate scandals in major developed countries, governments required companies to strengthen their internal control systems and to demonstrate this commitment through a personal certification of senior managers (CEO and CFO) (Cunningham,2004; Healy & Palepy,2003).The new rules in the U.S.A. (Sarbanes Oxley Act of 2002) and other countries, attempt to restore stakeholders' confidence and to increase firm's disclosure on risk management, by monitoring and controlling the reliability and efficiency of business processes. The rationality and credibility that firms have in designing, implementing and assessing the international control systems are publicly disclosed in order to demonstrate the reliability of their business model.

The sole external certification that financial reporting has been prepared according to correct accounting principles and faithfully represents firms' economic and financial capital is not sufficient. The demands for accountability push firms to demonstrate they have full control over all business processes (operative and financial) that determine the reliability of financial statements.

An effective internal control system can be a tool for owners to manage business risks by mitigating agency costs. It appears not sufficient to equip executives with experience and professionalism, resources and power, on the assumption that the responsibility for the results alone would be enough to solve the problems of agency (Riccaboni,1999).The recognition of the possibility of huge personal gains through rich stock option plans has not always produced the expected effects (Culpan&Trussel,2004).Since executives are personally accountable for the internal control system, as they must personally certify its effectiveness bearing a penal responsibility (Sarbanes-Oxley Act Section 404),then it is likely that they are willing to manage firms with ineffective internal control systems only if owners recognize them higher compensations. This assumption is logically sustainable given the fact that executives bare more personal risks and consequently, are willing to assume more risks only by negotiating higher compensations. On the other side, if owners do recognize the internal control as a monitoring system, they will "disinvest" in other substitute mechanisms, likely lowering the compensation level (Gillan, 2006).

2. Sarbanes Oxley Act (SOX): Regulation of Internal Control Disclosure

Sarbanes-Oxley Act is one of the most important corporate reforms in the U.S.A., comparable to the Securities and Exchange Acts of 1933 and 1934 in the regulation of financial markets. In the wake of scandals that staggered the business community and accounting profession at the verge of 2000, the act introduced several measures to strengthen corporate accountability, improve transparency of financial accounting and struggle against accounting fraud (Romano,2005, Healy& Palepu,2003).

Other major developed countries have followed different paths within the scope of regulating firms' internal control systems. The rules established in the U.S.A. by the Sarbanes – Oxley Act (SOX) of 2002 have helped to exert some influence on the corporate law at the international level (OECD, 2009). Nevertheless, in the European countries has prevailed the "comply-or-explain" approach on which basis the firms may adopt a code of practice or they may choose not to adopt such code if they justify the reasons of such conduct.

The SOX sections dedicated to the effectiveness of internal controls (404&302) are among the shortest of the act, but also those that generated the most controversy debate both within the U.S.A. and internationally (Ramos,2006).The SEC has determined that the company's annual report must contain : a declaration by which top management takes direct responsibility for the development and maintenance of an adequate internal control over financial statements of the company (ICFR); a statement identifying the framework used by management to evaluate the effectiveness of internal controls related to the most recent fiscal year clearly indicating an overall positive or negative conclusion by identifying any material weaknesses in internal controls; a statement by the external auditor containing its opinion on the effectiveness of internal control.

The SEC has clarified that the declaration of effectiveness and report only relate to internal controls over financial statements. Management is not required to consider other aspects such as internal controls for efficiency and operational effectiveness, but must identify the risk that threaten the reliability of the assertion implied in the financial reporting and must check, document and evaluate the design and operational effectiveness of controls in place to mitigate risks, in order to prevent and promptly correct risky situations. According to the interpretation of the SEC, the term ICFR includes all policies and business practices that : ensure the accuracy of the accounting records in faithfully reflecting the operations of management and company assets; are designed to provide reasonable assurance that transactions are recorded in a timely and appropriate manner for the preparation of financial statements in accordance with generally accepted accounting principles and that the revenues and expenses are earned or incurred, under the authorization of the managers and directors of the company; prevent or timely detect unauthorized transactions that could have a material impact on the financial statements. With regard to the approach in conducting the evaluation of the effectiveness of internal control, the SEC has emphasized the ICFR as a management process (SEC, 2007). By these means, SOX involves a detailed structure of internal controls in which the internal auditors play a key role in supporting the operational management and interfacing with the external auditors (Roth & Espersen, 2003). The implementations of the regulation for the management are very important. The demand for formal proof of effectiveness of internal control over financial reporting produces a cascade effect throughout the entire organizational structure that involves all the executives (Green,2004).On the one hand, the new rules allocate more responsibility on the CEO and CFO and consequently to all management, but on the other hand, a strong internal control system lowers the personal risk, by assuring the management on the accuracy of the operations and financial statements (Wagner &Dittmar,2006).

3. Research issues raised by Sarbanes-Oxley Act

Several studies have analyzed the impact of SOX both generally and specifically with regard to effects on the behavior of firms and markets resulting from the regulation of internal controls.

In particular, prior theoretical and empirical research on internal controls over financial reporting has focused on four main areas of research; the costs of compliance to SOX 302 and 404 (O'Brein,2006; Zhang I.X.,2007); its effects over markets with particular regard to the relationship between the disclosure of internal control weaknesses and the cost of equity (Beneish, Billings & Hodder, 2008; Li, Pincus & Rego, 2008; Jan & Rezaee, 2006; Elbannan, 2009; Ogneva, Subramanyam, & Raghunandan, 2008); effectiveness of its implementation as a management process. (Alles & SDatar, 2003; Gupta & Leech, 2006; Wagner & Dittmar, 2006).

The better evaluate the impact of SOX it has to be analyzed both costs of implementation of the act and benefits from firm and market side (Mulherin,2007). However, given the current implementation of the Act, only some studies have given evidence on the realized effects of SOX. (Waver,2010). Others have examined and predicated the expected outcomes of the act. (Ribstein,2002).

Sarbanes–Oxley Section 302: Disclosure controls

Under Sarbanes–Oxley, two separate sections came into effect—one civil and the other criminal. 15 U.S.C. § 7241 (Section 302) (civil provision); 18 U.S.C. § 1350 (Section 906) (criminal provision).

Section 302 of the Act mandates a set of internal procedures designed to ensure accurate financial disclosure. The signing officers must certify that they are "responsible for establishing and maintaining internal controls" and "have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared." 15 U.S.C. § 7241(a)(4). The officers must "have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report" and "have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date." *Id.*.

The SEC interpreted the intention of Sec. 302 in Final Rule 33–8124. In it, the SEC defines the new term "disclosure controls and procedures," which are distinct from "internal controls over financial reporting."[30] Under both Section 302 and Section 404, Congress directed the SEC to promulgate regulations enforcing these provisions. External auditors are required to issue an opinion on whether effective internal control over financial reporting was maintained in all material respects by management. This is in addition to the financial statement opinion regarding the accuracy of the financial statements. The requirement to issue a third opinion regarding management's assessment was removed in 2007.

3.1 History and context: events contributing to the adaption of Sarbanes Oxley

A variety of complex factors created the conditions and culture in which a series of large corporate frauds occurred between 2000–2002. The spectacular, highly publicized frauds at Enron, WorldCom, and Tyco exposed significant problems with conflicts of interest and incentive compensation practices. The analysis of their complex and contentious root causes contributed to the passage of SOX in 2002. In a 2004 interview, Senator Paul Sarbanes stated:

"The Senate Banking Committee undertook a series of hearings on the problems in the markets that had led to a loss of hundreds and hundreds of billions, indeed trillions of dollars in market value. The hearings set out to lay the foundation for legislation. We scheduled 10 hearings over a six-week period, during which we brought in some of the best people in the country to testify...The hearings produced remarkable consensus on the nature of the problems: inadequate oversight of accountants, lack of auditor independence, weak corporate governance procedures, stock analysts' conflict of interests, inadequate disclosure provisions, and grossly inadequate funding of the Securities and Exchange Commission."

- **Auditor conflicts of interest**: Prior to SOX, auditing firms, the primary financial "watchdogs" for investors, were self-regulated. They also performed significant non-audit or consulting work for the companies they audited. Many of these consulting agreements were far more lucrative than the auditing engagement. This presented at least the appearance of a conflict of interest. For example, challenging the company's accounting approach might damage a client relationship, conceivably placing a significant consulting arrangement at risk, damaging the auditing firm's bottom line.
- **Boardroom failures**: Boards of Directors, specifically Audit Committees, are charged with establishing oversight mechanisms for financial reporting in U.S. corporations on the behalf of investors. These scandals identified Board members who either did not exercise their responsibilities or did not have the expertise to understand the complexities of the businesses. In many cases, Audit Committee members were not truly independent of management.

- **Securities analysts' conflicts of interest**: The roles of securities analysts, who make buy and sell recommendations on company stocks and bonds, and investment bankers, who help provide companies loans or handle mergers and acquisitions, provide opportunities for conflicts. Similar to the auditor conflict, issuing a buy or sell recommendation on a stock while providing lucrative investment banking services creates at least the appearance of a conflict of interest.
- **Inadequate funding of the SEC**: The SEC budget has steadily increased to nearly double the pre-SOX level.[9] In the interview cited above, Sarbanes indicated that enforcement and rule-making are more effective post-SOX.
- **Banking practices**: Lending to a firm sends signals to investors regarding the firm's risk. In the case of Enron, several major banks provided large loans to the company without understanding, or while ignoring, the risks of the company. Investors of these banks and their clients were hurt by such bad loans, resulting in large settlement payments by the banks. Others interpreted the willingness of banks to lend money to the company as an indication of its health and integrity, and were led to invest in Enron as a result. These investors were hurt as well.
- **Internet bubble**: Investors had been stung in 2000 by the sharp declines in technology stocks and to a lesser extent, by declines in the overall market. Certain mutual fund managers were alleged to have advocated the purchasing of particular technology stocks, while quietly selling them. The losses sustained also helped create a general anger among investors.
- **Executive compensation**: Stock option and bonus practices, combined with volatility in stock prices for even small earnings "misses," resulted in pressures to manage earnings. Stock options were not treated as compensation expense by companies, encouraging this form of compensation. With a large stock-based bonus at risk, managers were pressured to meet their targets.

4. The Extent of the Disclosure and the Timely Reporting of the Financial Report

Referring to the regulation no. 104 Sarbanes-Oxley Act 2002 regarding the obligation to disclosure the internal control system, the consequence for the company is, that it must be able to timely identify the internal control problem. With a timely information presentation, it is hoped that the company can have a reliable financial report that will increase the confidence of the investors. However, due to some reason, the obligation to disclose the weakness of the internal control will not always result in a presentation of a timely financial report (Ghosh & Lubberink, 2006). The weakness of the internal control system of the company influences the ability of the company to begin, to note, to process, and to report the financial data. The weakness of the material internal control happens if there is a lack at one or more of the useful components of the company's internal control which is useful to detect and to avoid one of the materials in its timely financial report. A previous study related to the timely financial statement report was conducted by Karim, Ahmed, & Islam (2006), who had conducted a study about the timely financial reporting in Bangladesh, and its result indicated that there was no improvement in the timely reporting after the government regulation regarding the delivery of the financial reporting.

5. Executive Compensation and the Internal Control System

The executive compensation variable shows the amount of compensation received by the Management Board. Balsam, Gordon, Li, & Runes son (2012) had only used the CFO compensation to measure the executive compensation variable related with the IFRS adoption by 16 countries compared with 5 countries that have not yet adopted the IFRS. This was carried out because the CFO had a direct interaction when compiling the financial report, so that it provided an incentive for the CFO's. Shon & Weiss (2009) had used one of the four executive compensation proxies, that is, the natural logarithm from the total CEO annual cash compensation, the natural logarithm from the annual CEO total cash compensation, the natural logarithm from the total CEO's annual cash compensation, the natural logarithm from the total annual CEO's bonus compensation, and the natural logarithm from the annual CEO equity. While Armstrong, Blouin, & Larcker (2012), had used the total compensation value, which was received for one year by the company's executives and the compensation mix which consisted of the ratio of each compensation component towards the total compensation value received. Armstrong, Blouin & Larcker (2012) had measured the executive compensation from the whole types of compensations provided to the Management board.

Earlier studies, have defined the agency problem in terms of degree of separation between the ownership and control (Jensen & Meckling, 1976: Ros, 1973; Fama E.F.,1980; Fama & Jensen,1983). Because the interest of principals (equity holders) and agents (executives) differ, the agency problem is to determine the optimal contact for the agents 'service. A classic agency problem in case of incomplete information is the unobservable agent behavior which leads the principals to two possible options. On the one hand, to control agent's behavior the principal can purchase the information on agent's behavior and give rewards consequently, requiring surveillance mechanisms (i.e. internal control system) (Eisenhardt,1985).On the other hand, the risk can be transferred by aligning the agent's outcome to firm's performance (pay for performance).Thus, the central issue in the agency theory id the tradeoff between the cost of controlling agent behavior and compensation costs (Devers,Cannella,Rielly& Yoder,2007).

In an extensive review of compensation research, Gomez-Mejia and Weiseman (1997) reframe and categorize the compensation design in three dimensions: (1) criteria used in determining compensation (e. g.firm performance,firm size); (2) consequences of the executive (e.g. the level of compensation and the risk of pay); (3) mechanisms used to link the compensation criteria to the compensation consequences.

New certification requirements have been determined under the responsibility of CEO/CFO in the form of a SEC-order and SOX 404 (Geiger &Taylor,2003).The SOX of 2002, Section 302.CEO/CFO annual and quarterly report assurances, internal control assurances for financial reporting; disclosure controls and procedures assurances; and disclosure to the audit committee and external auditors of material weaknesses in internal controls and fraud.Section 404.CEO/CFO assessment of internal control over financial reporting in the form of an internal control report filed with each annual report and a separate requirement that external and independent auditors issue an attestation report on management's assessment of internal controls.

6. Conclusion

The costliest part of the Sarbanes-Oxley Act is Section 404, which requires public companies to perform extensive internal control tests and include an internal control report with their annual audits. Testing and documenting manual and automated controls in financial reporting requires enormous effort and involvement of not only external accountants, but also experienced IT personnel. The compliance cost is especially burdensome for companies that heavily rely on manual controls. The Sarbanes-Oxley Act encouraged companies to make their financial reporting more efficient, centralized and automated.

The Sarbanes-Oxley Act changes management's responsibility for financial reporting significantly. The act requires that top managers personally certify the accuracy of financial reports. If a top manager knowingly or willfully makes a false certification, he can face 10 to 20 years in prison. If the company is forced to make a required accounting restatement due to management's misconduct, top managers can be forced to give up their bonuses or profits made from selling the company's stock. If the director or officer is convicted in securities law violation, he can be prohibited from serving in the same role at the public company.

The effort to increase the internal control's activities will cause an increase in significant cost for the manager. The manager needs more cost for their efforts to reach an effective internal control system, compared to the benefits that the company will receive.

There was a relationship between the extent of the disclosure of the internal control with the executive compensation and the timely publication of the company's financial report. This means that the more extensive internal control disclosure the higher compensation received by the executive. The more extensive disclosure of the internal control indicated a good executive performance so that it could push the effective internal control. The good executive performance will push the compensation higher.

The result of this study was in accordance with Shon& Weiss (2009), which had proven that there was a positive relationship between the executive compensation and the effective internal control system. Also, with the study result of Leng& Ding (2011), in which they had found that the disclosure of the internal control system at the company's financial report was related towards the executive compensation. The same could also be concluded from Balsam, Gordon, Li, &Runesson (2012) study. Their analysis had given a strong support to the relationship between the obligatory disclosures of the executive compensation, because the obligatory disclosure will compel to management to increase their control and responsibility.

Therefore, it can be concluded that the efforts to increase the internal control effectiveness will cause a significant increase in cost for the managers. The managers need more cost for their efforts to achieve an effective internal control, compared to the benefits that the company will receive. Hence, incentive is very much needed in their effort to reach that benefit. The company will adjust the compensation contract to motivate the mangers in creating an effective internal control (Shon& Weiss, 2009).

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