SARBANES OXLEY ACT (SOX) DISCLOSURE, EXECUTIVE COMPENSATION, INTERNAL CONTROL DISCLOSURE AND FINANCIAL REPORTING IN CORPORATE GOVERNANCE (CG).

Ph.D. Rezart Dibra[1]

ABSTRACT

Corporate governance (CG) is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community. 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 & Lubberink, 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. (Shon & 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: *internal control disclosure, financial report, executive compensation, timeliness*
JEL Classification: *M12, M41, M42*

1. Introduction

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 & Lubberink, 2006). The internal control is also needed in generating

[1] Faculty of Economics, Professional Business Academy, Rr. Vangjel Noti, Nr.25, Laprake, 1001, Tirana, Albania.
E-mail: rdibra@apb.edu.al, rezartdibra@yahoo.com.

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. (Shon & Weiss, 2009).

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 Leng & 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, & Runesson (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 & Financial Reporting.

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 *(https://en.wikipedia.org/wiki/Sarbanes Oxley Act)*. The Sarbanes-Oxley Act of 2002 (the Act) was passed in response to these financial scandals to reinforce corporate accountability and professional responsibilities, and to rebuild investor confidence. The SEC has issued more than 20 rules to implement provisions of the Act. Other professional organizations (AICPA, AMEX, Conference Board, NASDAQ, NYSE) have issued standards and corporate governance guiding principles to restore public trust in corporations, the capital markets, and the financial reporting process. Sarbanes-Oxley requires public companies to assess how effective their internal controls over financial reporting are at preventing misstatements that could be material to the financial statements. While public companies have long been required to maintain effective systems of internal controls, pursuant to the Foreign Corrupt Practices Act of 1977, SOX requires them to annually evaluate their financial internal controls and to disclose the results of that assessment. This includes whether there were any weaknesses that may not prevent or detect a material misstatement in the financial statements. In a effective corporate governance (CG), Sarbanes-Oxley greatly expanded the responsibilities of audit committees. SOX required the boards of companies listed on US stock exchanges to establish audit committees made up solely of board members independent from management. Because of SOX, audit committees, not management, are directly responsible for the appointment, compensation and oversight of the work of external auditors, who are charged with evaluating whether the financial statements prepared by management are fairly presented in accordance with the relevant financial reporting framework. To facilitate its oversight of a company’s financial reporting, SOX required companies to provide audit committees with the resources and authority to engage independent counsel and advisers to help them carry out their duties. SOX also required audit committees to establish procedures for receiving whistleblower complaints regarding accounting, auditing and internal control irregularities and to provide for the confidential and anonymous treatment of employee concerns regarding such matters. In addition, SOX enhanced the external auditor’s required communications with the audit committee to include the following: •A discussion of all critical accounting policies and practices used by the company •All alternative accounting treatments that have been discussed with management, the ramifications of the use of alternative disclosures and accounting treatments and the accounting treatment preferred by the audit firm • Other material written communications between the auditor and management. These reforms significantly empowered audit committees and they began to take a more active role to carry out their increased responsibilities. For example, audit committees for the S&P 500 companies met on average five times a year in 2001. The average number of annual meetings has nearly doubled to nine today. Audit committees also are exercising ownership of the relationship with the auditor. 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). 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 Leng & Ding (2011), they had found that the internal control disclosure at the company's financial report was related with the executive compensation. 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 chose 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).

Internal controls over financial reporting are processes that provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. These include policies and procedures that : 1.Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer 2.Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the registrant 3.Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements. The requirements to conduct the assessment and provide the related disclosures have widely been credited with improving public companies' systems of internal control and have also given investors additional insights and confidence with respect to a company's financial reporting.

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 (Beneish,Billings,& Hodder,2008;Li,Pincus&Rego, 2008; Jan&Rezaee, 2006;Elbannan, 2009).
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).

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 Internal Control System in CG system.

Executive compensation and internal control system are very important in corporate governance system.The separation of ownership from control (Berle and Means, 1932) is the primary source of agency conflicts where the decisions are made by managers and the ultimate costs or benefits of these decisions are borne by investors (Fama and Jensen, 1983). In the principal-agent framework, both the principal (shareholders) and the agent (managers) are assumed to follow their own interests. This implies that corporate resources may not be used entirely to increase shareholder value, but instead may be used for the benefits of corporate insiders (Demsetz and Lehn, 1985). Hence, the agency problem arises as the result of conflicts of interests between the agent and the principal (Jensen and Meckling, 1976). In order to alleviate the negative consequences of this problem, agency theory describes the need for monitoring and contracting arrangements (Fama and Jensen, 1983; Jensen and Meckling, 1976).
Information asymmetries and conflicts of interest between contracting parties are considered important reasons for the commitment to increased transparency and higher quality financial reporting (Healy and Palepu, 2001). As argued by Armstrong et al. (2010, p.179) “the information environment plays a central role both in determining the extent of these conflicts and in designing the mechanisms to mitigate them.” In particular, detailed information about firms’ operating systems, financing, and investing activities, is essential for the efficiency of contracting arrangements. Accounting is a fundamental part of contracting mechanisms since it provides information for designing and evaluating contracts. This implies that certain contractual arrangements are more efficient than others in reducing agency costs, depending on the accounting numbers that are used in contracts (Watts and Zimmerman, 1986). The role that corporate financial reporting and disclosure plays in mitigating agency costs has been considered to be an important area of governance research in the accounting literature (Bushman and Smith, 2001).
Earlier studies, have defined the agency problem in terms of degree of separation between the ownership and control (Jensen & Meckling,1976: Ros, 1973; Fama 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

Corporate governance is a term that is frequently used by researchers, practitioners, the media, regulators, and the general public focusing on control mechanisms. While common definitions of corporate governance typically take into account the means to mitigate conflicts of interest between managers and investors (see Bushman and Smith, 2001), it has not been possible to find a complete general agreement on the definition of corporate governance. Internal control relating to financial reporting is based on a control environment that includes the organisation, the decision-making process, authority and responsibility and which has been documented and communicated in management documents. An example of this is the division of responsibility between the board and the chief executive officer as well as instructions for authorisation rights, and accounting and reporting instructions. The internal auditors and external auditors of the organization also measure the effectiveness of internal control through their efforts. They assess whether the controls are properly designed, implemented and working effectively, and make recommendations on how to improve internal control. Corporate governance concerns, including independent boards of directors and efficient executive compensation contracts, are subject to extensive debate in many countries. In Europe, there has been an increased focus on enforcing strong legal institutions for better investor protection, introducing corporate governance codes for improving governance practices, and promoting more transparency and shareholder oversight on executive compensation. Therefore, it is of contemporary significance to examine how these recent reforms in corporate governance affect the transparency and governance of corporations. An increased transparency, higher quality of financial reporting, and effective corporate governance system are at the center of attention of practitioners, regulatory bodies, and academics. In particular, the above discussion shows that there is a close connection between efficiency of contracts, information transparency, and governance mechanisms. 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. 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 and Financial Reporting as a important parts of corporate governance. 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).

Finally good corporate governance creates a transparent set of rules and controls in which shareholders, directors and officers have aligned incentives. Most companies strive to have a high level of corporate governance. For many shareholders, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behavior and sound corporate governance practices.

References

1. Akle, Y. H., 2011. The relationship between corporate governance and financial reporting timeliness for companies listed on egyptian stock exchange an empirical study. *Internal auditing & risk management*, 6 (2).
2. Armstrong, C. S., Blouin, J. L., & Larcker, D. F. 2012, The incentives for tax planning. *Journal of Accounting and Economics,* 53 (1), 391-411.
3. Ashbaugh-Skaife, H., Collins, D. W., & Kinney Jr, W. R. 2007, The discovery and reporting of internal control deficiencies prior to SOX-mandated audits. Journal of Accounting and Economics. *Journal of Accounting and Economics*, 44 (1), 166-192.
4. Balsam, S., Gordon, E. A., Li, X., & Runesson, E. 2012, Mandatory Disclosure Reform and Executive Compensation: Is CFO Pay Higher After the Mandatory Adoption of IFRS?
5. Ezat, A., & El-Masry, A. 2008, The impact of corporate governance on the timeliness of corporate internet reporting by Egyptian listed companies. *Managerial Finance*, 34 (12), 848-867.
6. Ghosh, A., & Lubberink, M, 2006, Timeliness and mandated disclosures on internal controls under section 404. City University of New York.
7. Karim, W., Ahmed, K., & Islam, A. 2006, The effect of regulation on timeliness of corporate financial reporting: Evidence from Bangladesh. *JOAAG*, 1 (1), 15-35.

8. Leng, J., & Ding, Y. 2011, Internal Control Disclosure and Corporate Governance: Empirical Research from Chinese Listed Companies. *Technology & Investment,* 2 (4).
9. Moradi, M., Salehi, M., &Mareshk, M. S. 2013, A Survey on Timeliness in Financial Reporting and Corporate Governance: Evidence from Iran. *Asian Journal of Research in Business Economics and Management,* 3 (11), 328-337.
10. Owusu-Ansah, S. 2000, Timeliness of corporate financial reporting in emerging capital markets: Empirical evidence from the Zimbabwe Stock Exchange. *Accounting and business research,* 30 (3), 241-254.
11. Shon, J. J., & Weiss, R. 2009, SOX 404 Effective Internal Control Systems and Executive Compensation. *Journal of Applied Business & Economics*, 10 (2).
12. Türel, A. 2010, Timeliness of financial reporting in emerging capital markets: Evidence from Turkey. Istanbul University *Journal of the School of Business Administration*, 39 (2).