The Role of Internal Audit in the Context of Corporate Governance

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Abstract

The hereby paper aims at presenting the issues related to the Sarbanes-Oxley Act, act which was adopted in the summer of 2002. This US federal law is based on a controversial history when large companies have been accused of fraud. The advent of this Act has had a significant impact on publicly traded companies on the New York Stock Exchange and has influenced their internal controls. This paper aims at analyzing the main elements required for the adoption of the Sarbanes-Oxley Act, which was the impact and how this internal control helps companies to develop. This paper will present studies related to the costs required to implement a control as well as the research on the needs of companies concerning the complexity of controls. We can summarize the concept of internal audit by the fact that the activity is appropriate to a procedure of monitoring the efficiency of an economic activity, useful especially for the management, a method that helps having control over the business and monitoring its development. At the same time, by keeping track of internal controls, the audition may have the effect of reducing the risk of fraud and non-compliance with the financial rules of the audited company. The effect of an audit is rendered by its utility, low risk of fraud and control.

Keywords
Sarbanes-Oxley Act, Internal Audit, Corporate Governance, Performance, Management
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Introduction

Considering that we are witnessing the process of globalization, the increase of competition, the role of internal audit becomes more and more important in the hierarchy of an organization. The introduction of the internal audit is a crucial step in the evolution of either public or private entities, being significant in increasing performance, limiting the possibilities of corruption fraud, detecting and correcting deficiencies. The internal audit is a qualified system that contributes to the improvement of an entity's activity, in the management process placing an important emphasis on internal controls. By organizing the internal audit activity, the governance is provided assistance so as to manage the organizational processes, to increase the efficiency of the controls, to achieve the purpose and objectives of the entity (Abbott, et al., 2004). In carrying out a mission the auditor analyses and examines analytically based on materials - supporting documents, information, statements, related to a reference system or in accordance with a methodological tool, the quality, level of functionality and performance of the auditable object. The internal audit report is the standard tool for communicating the results consisting of conclusions and recommendations. The report must have a coherent, unitary composition, it must be sustained by supporting documents, it must contain relevant information that is communicated to the management in connection with the auditable field. The internal audit approach is materialized in the consultancy granted by formulating some recommendations in the report, which once implemented will ensure the improvement of the audited activity and will bring added value. The moral principles that govern the internal audit activity are integrity, objectivity, confidentiality and competence according to the Deontological Code. In the literature there are several definitions, both nationally and internationally, assigned to the concept of internal audit due to the need to adjust this activity to the evolution of the business environment in general and to increase the importance of internal audit at different levels of the organization.

The internal audit has now been extended to all types of organizations, operating regardless of their field of activity. It also has an important role to play in ensuring the efficiency of financial reporting, which includes it as a key element in ensuring confidence in the business environment and capital markets (Klein, et al., 2002). In terms of its conception and general acceptance, we believe that the internal audit is treated as a manifestation of control of fairness and analysis of financial performance, providing objective and independent assessments of risk management, control and leadership, starting from what the annual accounts and supporting documents reflect in accordance with the law and regulations published in the field, as well as ensuring transparency and disclosure of information, thus contributing to the achievement of the entity's objectives and increasing its performance (Drogalas, et al., 2016). In its evolution, the internal audit has outlined its importance in the corporate governance system as well as in the risk management system by gradually undertaking an independent and objective opinion on the different levels within an organization.

Literature review

The beginning of the third millennium was marked by a profound development in terms of globalization of markets, thus pursuing the economic and socio-cultural development. Unity is pursued not only in speech but also in thinking, as far as the form of the organization of companies is concerned, as well as the way they are audited and managed. Therewith, the accounting principles and methods and practices for the drawing up and presentation of financial statements are followed (Jain and Rezaee, 2006).

For the development of this economic sector, several international conferences are held in different parts of the world, where the debate on this issue was pursued, while also pursuing the obstacles and difficulties that companies face in the process of globalization. The method of organizing and running privatized companies was called Corporate Governance, the OECD principles being as follows: "Corporate Governance is expressed through a set of relationships between the company's management, its board, its shareholders, other holders of securities; at the same time, it provides a structure through which the necessary means are established to achieve these objectives and the monitoring of the pursued performance". This concept is based on rules and regulations aimed at pursuing the administration and management by the board, with the interest of winning new investors or satisfying the existing ones (Lin and Hwang, 2010).

Through the concept of Corporate Governance we can also emphasize the fact that it establishes the structure and objectives of the company, the way in which they are achieved but also the pursuit of performance. By imposing this form of organization, the aim was to change the way of operation and the government to establish the appropriate legal framework, thus reducing risks, accelerating performance, thus having a free gateway to financial markets (Drogalas, et al., 2016). At the same time, this form of organization has improved the way in which the management carries out its activity, thus generating transparency and social responsibility. Through this new form, the marketing for goods and services also grew, the increase of its ability being significantly visible. In the absence of clear rules, chaos would have been generated in the way companies would have been operated, thus encouraging fraud and false promises, lies and other elements that could not be controlled. This new form aimed at finding a regulation based on business, which can give creditors and investors a fair financial picture (Jo and Kim, 2007).

Nowadays, this form of organization is becoming more widespread globally, and in order to ensure the success of the corporation and the efficient combination of a large mass of capital from numerous investors and to find an administration that is carried out effectively with a large number of employees and owners, we find four features:

- Free movement of shares;
- Legal personality;
- Centralized management;
- Limited spread of investors;

Research methodology

In order to achieve the proposed objectives on the topic addressed, the study will be based on specific methods of scientific research. The methodology of scientific research that we will use in this study combines qualitative research with the quantitative one. Generally speaking, we will use the method of document analysis for data collection, the main method used is the observation one, which is appreciated as the most common method in research. Scientific observation means the careful and systematic follow-up of certain facts so as to observe the essential or differential aspects.

Results of the research

The Sarbanes-Oxley Act 2002, also known as the "Public Company Accounting Reform (Listed Companies) and Investor Protection Act" or shorter "SOX" is a law issued in U.S. in 2002 that sets new standards, improved for the Boards of Directors, the management and audit/accounting firms of all public companies. The U.S. Congress called the Sarbanes-Oxley Act 2000 to protect investors from the risks of accounting fraud in corporate activities, based on rigorous reforms to improve corporate financial shortfalls and to prevent corporate accounting fraud. The emergence of this law had a consequence followed by the big scandals that shook the business environment, for well-known companies such as: Enron, Tyco International, Adelphia, Peregrine Systems and Worldcom. The purpose of this law was to restore investor confidence and cover the disadvantages of companies in terms of security and fraud protection. The Sarbanes-Oxley Act of 2002 consists of eleven sections or titles containing provisions on additional responsibilities of the corporate board, criminal sanctions and it imposes the Securities and Exchange Commission (SEC) to implement decisions on compliance requirements. A public agency, called the Public Company Accounting Oversight Board or PCAOB, has also been set up to oversee, regulate, inspect and discipline accounting firms in their role as auditors of public companies listed on the stock exchange. This law is not addressed to private companies but only to those that are listed on the stock exchange. In the 11 titles it contains, SOX aims at:

- Additional responsibilities of the Board of Directors
- Independence of auditors
- Corporate governance
- Evaluation of internal controls
- Improving financial information

The second section of the SOX Act sets standards for the independence of the external auditor in order to limit conflicts of interest. Furthermore, the new requirements for the appointment and approval of auditors, the rotation cycle of mission partners and the reporting requirements of auditors are provided. A particularly important aspect is that the provision of non-audit services is restricted to audit clients, for instance consulting services. Section 404 is the most discussed and debated aspect of the SOX Act, which requires both the governess and the external financial auditor to report on the adequacy of the company's internal control over the financial reporting. For the companies concerned, this is the most expensive aspect of the law to be implemented, as documentation and testing of accounting, financial policy textbooks, important procedures and automatic controls require considerable effort. According to section 404 of the law, the management is responsible for the design and operational effectiveness of the selected internal controls related to significant accounts and relevant statements.

Furthermore, an "internal control report" as part of each annual report must be drawn up. The report must state "the responsibility of the management to establish and maintain an adequate internal control structure and financial reporting procedures" and also "contain an assessment, at the end of the most recent fiscal year of the company, of the effectiveness of the issuer's internal control structure and procedures for the financial reporting". To this means, managers generally adopt an internal control framework, such as the one described in COSO, one of the most well-known international models of internal control. Both the management and the external auditor are responsible for conducting their evaluation and for the conclusions drawn regarding the adequacy of the internal control over the financial reporting.

SOX 404 compliance costs are a tax of inefficiency, encouraging companies to centralize and automate their financial reporting systems. This is obvious in the comparative costs of companies with more decentralized operations and systems, compared to those with more efficient centralized systems. The costs of evaluating manual control procedures are dramatically reduced by automation. For smaller companies, the cost of implementing the requirements of section 404 of SOX has a disproportionate impact on it because it involves a significant fixed cost involved in completing the assessment. For example, in 2004, U.S. companies with revenues of more than $ 5 billion spent 0.06% of revenue on SOX compliance, while companies with revenues of less than $ 100 million spent 2.55 %.

The added value of SOX is that the auditors' opinion accompanied by the financial statements is based on a well-defined procedure and rules. Following an external audit control, the auditors will test the procedures applied by the company and also its internal control, and in the end an opinion will be expressed on the two elements. The role of internal auditors is to evaluate the company's internal processes, which include corporate governance and the applied accounting system. They aim at tracking certain elements that are intended to be in accordance with the laws, rules, accuracy and time of financial reporting together with the data collected, thus helping to achieve efficiency in identifying current or possible risks before they are discovered by an external control. Their role in an internal audit process of a company's operations and corporate governance is critical in that the 2000 Sarbanes-Oxley Act aims at pursuing legal responsibilities for compliance with the financial statements. SOX is applied identically through audit controls, and financial integrity along with the accounting application standards have helped form a method of using standard management. While internal controls are expensive, by implementing a properly applied control system, the company can be helped to have increases in terms of efficient operation, the ultimate goal being to prevent fraud.

When talking about the implementation of a SOX control we should keep in mind certain factors that can influence the costs related to the implementation so that the forecasting is done in the fairest and most efficient way. Depending on the needs, risks and vulnerabilities of the company, control will provide added value and security for investors. But the most important factor underlying these elements is the field of activity of the company. Depending on the field, all other elements are influenced in such a way that everything related to the implementation of a SOX control is directly influenced by the field of activity where the company carries out its activity. Specialists have concluded that it is particularly important to consider the field when referring to the number of controls and the complexity of the controls of companies that apply SOX. It is necessary that when talking about the internal audit of the company to mention the number of internal controls that the company applies. We can say that when a large number of controls is present, the company is very strict in terms of security and fraud prevention. When establishing an internal audit control, the most important element is determined by the field of activity and the risks which the company is facing. However, it is important to establish that not only the numbers of controls are important but also how a control is applied as well as its complexity.

Risks are the most important elements to consider when establishing the criteria of an internal control. In the case of some companies, depending on the field of activity as well as other vulnerabilities, controls are established so as to cover all needs. In most cases, in order to fully cover the risks and avoid fraud, companies have to implement a large number of internal controls, so as to cover everything that involves their ultimate purpose. It is also important to state that a significant element that can influence and determine their number is related to costs. The estimated costs for implementing the Sarbanes-Oxley Act in the company's internal controls are high enough, which can make it difficult for internal auditors to determine how these controls are designed.

We can thus argue that the number of internal controls is determined by the needs and possibilities of the company. The relationship between auditors and corporate governance changed when the Sarbanes-

Oxley Act was adopted in 2002. SOX came up with new strict rules that changed the way in which the internal audit was performed as well as the evaluation of such controls. The disadvantage of these new rules was generated by the fact that most of the resources were allocated for the implementation of SOX controls but not for improvements.

In 2006, PWC conducted a survey of U.S. companies which apply SOX and found that more than half of their resources were required when the controls were implemented. The purpose of the internal audit is to determine whether the internal policies established by the corporate governance are complied with, which indicates the importance of such controls and added value to the company. The audit committee is considered to be a subcommittee of the board of directors that plays a very important role in corporate governance and internal audit by monitoring the activities of managers on financial disclosure. A study conducted by the Canadian Institute of Chartered Accountants (CICA) in 1981 demonstrated that there are 5 main factors that point out the responsibilities and objectives of the internal audit committee such as:

- assisting the board of directors in corporate governance and other actions related to financial reporting;
- facilitating communication between the external audit and the board of directors;
- validating and ensuring transparency in financial reporting;
- helping in the communication between the administration within the company and the external one, managers or auditors;
- ensuring the independence of external auditors.

Conclusions

All companies listed on the US stock exchange must comply with and apply the provisions of the SOX law. However, we must consider that although the listing is on the American market, the activity of companies is in other countries, which also influences the labour market when we think of auditors. The major problem facing large companies is related to the training that must be provided to employees so that they get to know very well the law required to be able to develop SOX controls and ensure that they are SOX compliant. Of course, the effects are visible in the costs that the company allocates for labour as well as the longer time needed to become aware of the Act and to be sure that it is properly applied.

Sarbanes-Oxley has brought to the attention, not only of those in corporate management, the impact on the changes required to improve the company's performance and the risks they are exposed to, but also the fact that economic education plays a particularly important role in future employee decisions. Concluding on everything stated above, we can say that these changes have resulted in modifications brought not only to the legal framework but also to the business environment and the educational one, thus all these changes having an interest to each party involved in a more or less significant way. To improve performance, this set of new rules helped identifying the shortcomings in the business environment and the famous scandals that helped shape this law being a great example to pursue in order to present the consequences and effects of a system lacking a well-established infrastructure, but also to highlight the connection between a system of management, accounting, auditing, technology and finally education, where practically the path of a future professional begins. Through all these aspects that helped to form the opinion of a specialist, it was demonstrated that Sarbanes-Oxley together with Section 404 was not just a new law but also a new business model.

Concluding on everything analysed, we can state that the process of implementing a SOX control is extensive, it is achieved over an extended period and it requires not only high costs but also qualified people. Since the employees of the companies do not hold all the required information, the companies are bound to allocate costs for their drawing up, fact which influences the figures of the amounts allocated for the implementation of internal controls.

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