

THE ISSUE OF AUDIT IN MULTINATIONAL COMPANIES

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Abstract

The main goal of the submitted paper is to define the Sarbanes-Oxley Act, specify costs which are connected with its implementation and to analyze costs of application of internal control based on rules defined in this act in a selected company. The paper consists of four main parts and Conclusion summarizing the results. The first part is focused on general characteristics of audit. In the second part the difference between internal and external audit is defined. The third part deals with the Sarbanes-Oxley Act, its form, benefits and costs. In the last part there is analysis of costs of implementation and testing of controls according to SOX controls in a selected company.

Introduction

Sarbanes-Oxley Act of 2002 is a very powerful but also a very controversial law that regulates the business environment in the USA. It deals with the transparency and accuracy of the accounts and financial statements, tightening of internal control systems, detection and sanctions against economic crime.

The aim of imposing this law was to create an environment in which the financial problems of companies would be nipped in the bud, in other words before they developed into large scandalous frauds, which in turn would adversely affect the economic environment. Thus, the main objective was to increase investors' confidence in the results published by companies trading on the American Stock Exchange. All companies listed on the American Stock Exchange, which also have the obligation to carry out their audits, shall keep accounts in accordance with this Act.

From the perspective of the Czech Republic, it usually concerns any entities with a parent company in the United States. This Act does not affect the accounting according to Czech accounting legislation, but has an effect on the process of recording individual accounting operations for the parent company in accordance with U.S. GAAP. Taking into account the globalization of the economy, all companies have to process their financial transactions in accordance with SOX. In order to achieve this state, it is necessary that their subsidiaries or affiliates respect the principles mentioned above, also outside the USA territory.

1 The issue of the audit

There are many definitions of an audit. Over the years this term has been defined by a large number of institutions and individuals. The particular conception of an audit as it is generally understood is that its scope means accounting, financial statements and annual report. Audit is mainly perceived in this way because it is a reflection of accounting that provides information about the management of a company. Thus, users of this information are interested whether financial statements have been prepared correctly and truthfully.

The definitions compiled by the Committee of the American Accounting Association is following: *“Auditing is the systematic process of objectively obtaining and evaluating evidence regarding assertions about economic activities and events to ascertain the degree of*

correspondence between the assertions and established criteria and communicate the results to interested users.” [8]

Domestically, the definition of the audit created by the Chamber of Auditors of the Czech Republic goes as follows: *“The mission and purpose of an audit of financial statements is to express an opinion of an independent qualified person on the veracity of financial statements published by the management. Auditor verifies that the information in the financial statements give a true and fair view of the financial position and results of operations and cash flows in accordance with the rules given by Czech or other accounting regulations, often with International Financial Reporting Standards (IFRS). Auditor’s opinion contains sufficient information entirely in conjunction with a complete set of financial statements, which the auditor expresses their opinion on. Auditor’s opinion which is out of context with specific accounts is confusing.” [3]*

In the Czech Republic, audit is legislatively modified as follows: *“Statutory audit means (§ 2, paragraph a) of Act No. 93/2009 Coll.) verification of the ordinary and extraordinary accounts or consolidated accounts, in case such verification requires a different legal regulation; possibly auditing interim financial statements, if such verification is required by another applicable law.” [12]*

1.1 Objectives and types of audit

From the above definitions the basic objective of the audit follows. It is defined by Králíček as *“the increase the credibility of financial information from companies that mandatorily publish their financial statements and annual reports”*. As another goal, its moral and protective effect against the occurrence of errors and fraud can be stated. Sedláček in his publication Basics of Audit also mentions its educational and advisory role, which, together with the auditor’s work and the work of the company’s employees, leads to a gradual and continuous improvement of the accounting system. General public tend to see audit as a means of revealing all errors and fraud in the audited company. [9] Auditor’s opinion, however, does not mean that the statements have been made absolutely correctly; the auditor should only express their professional and qualified opinion on whether the financial statements are made truthfully and faithfully. The aim of the audit is not:

- confirmation of the accuracy of accounting in business,
- investigation of possible fraud,
- affirmation of compliance with all legal norms by an entity,
- confirmation of the accuracy of tax returns,
- evaluating the effectiveness and soundness of business management,
- affirmation of viability of the entity in the future.

Audit should mainly benefit, whether economically or socially. Audit can be directed to different areas of human activity. There are several types of audits:

- **Audit of financial statements:** also called the audit of the financial closing, financial or external audit, which verifies the accuracy of the final reports and balance sheets and verifies the quality of the ongoing internal control of the company. It is performed by an independent external auditor and its primary mission is to enhance the credibility of financial statements of the company.
- **Internal audit:** focuses on business process and is provided by an internal auditor.
- **Audit of quality:** checks the quality of the management system in the company. Its task is to determine whether the company meets the requirements of international standards, including building a system of documentation. It usually results in being

granted a certificate within ISO standards; certificates are granted by specialized institutions.

- **Environmental audit:** is a systematic evaluation of the management and checking of enterprise processes that could have an impact on the environment.
- **Computer audit:** is used in control programmes of computer technologies and other components of information systems in the enterprise.

Further, audit can be divided according to who performs it into an internal audit and an external audit.

1.2 Audit legislation in the Czech Republic

Audit legislation is necessary for a number of reasons. One of the main reasons is the need or even the necessity to protect public interest. The auditor's results primarily do not serve those who pay the auditor and their service, but generally public who rely on them. Furthermore, it is necessary to state the reason of informational imbalance. Users of the information which arises from the audit and accounting are in most cases not able to assess themselves whether the audit has been conducted properly. It is necessary to modify audit legislation also due to the fact that there are high demands placed on auditors, both in terms of theoretical knowledge and practical experience. On the one hand, legislative regulations of the audit in the Czech Republic define operators and conditions of statutory audit, and on the other hand of course modify the audit itself.

Current legislation governing the work of auditors is given by Act 93/2009 Coll., of the auditors and the amendment of certain laws. This law defines the status and activities of auditors, audit firms and audit assistants, as well as the status and competence of the Chamber of Auditors of the Czech Republic and the Council for Public Audit Supervision. Another basic source of law governing audit is Act No. 563/1991 Coll., of accounting (including its implementing regulations and Czech accounting standards) and Act No. 90/2012 Coll., of commercial companies and cooperatives (Law of Business Corporations). Proper preparation of the audited financial statements of the company is then influenced by other laws, in particular:

- Act No. 586/1992 Coll., The Income Tax,
- Act No. 235/2004 Coll., The Value Added Tax,
- Act No. 262/2006 Coll., The Labour Code.

The auditor must also take into account the documents issued by the Chamber of Auditors of the Czech Republic, such as the Code of Ethics and Auditing Standards and International and various local accounting standards.

2 The issue of internal and external audit

Internal audit has the potential to become one of the most influential services with the greatest added value, which is the apex body of the company available. It has the ability to make a tangible contribution to the proper performance of the company management for efficient functioning and profitability of any organization, whether small or large, in both the private and the public sectors. In theory, management control is considered an essential part of the control systems. [9]

External audit, otherwise also known as the audit of the financial statements or the statutory audit, is focused on the individual and consolidated financial statements. It is made to order, usually by the entity's owners or holders of a group of companies, and submitted to an external auditor. This can then be either an individual (natural person) or an audit company

that provides these services through its employees. Statutory audit forms an important element of the protection of property rights.

2.1 Development of internal audit

Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control processes and corporate governance of the organization. [11]

In 1941 The Institute of Internal Auditors Inc. was established in the U.S.A. It currently brings together internal auditors from both the USA and all developed countries. Internal audit profession began to evolve in the U.S. after World War II. The value of internal audit was further increased, particularly in the USA, with the implementation of Sarbanes-Oxley Act in 2002. [7] In its early days, the internal audit addressed a majority of financial auditing and internal accounting control, but over time more functions were formed. First companies to establish internal audit units were banks and insurance companies at the turn of the 30ies and 40ies of the last century. About 40 years later, this step was taken by industrial and commercial enterprises as well. Regarding the size of these institutions, it differed and still differs by the type of an organization, size of the company and also the intricacy and the complexity of the implemented activities. [9]

In the Czech Republic, the internal audit was introduced quite recently. The beginnings of internal audit in this area are connected to the inputs of foreign companies on the Czech market, which introduced this profession to the country. Internal audit has been introduced mainly in banking institutions, insurance companies, etc. Thanks to Act No. 330/01 Coll., of financial control in public administration (Financial Control Act), which established the scope of internal audit in the public sector, this profession has seen significant development. At present, the internal audit is still most represented in financial institutions, large enterprises and multinational companies. In small and medium business its role is still quite unused. [2]

Internal auditors are currently focused on many areas in companies. One of them is the financial audit, which includes the prevention and detection of fraud. In companies, auditors also examine certain economic transactions, contracts (e.g. with investors or suppliers), business performance, perform quality audit and the impact on the environment audit within the audit frame. Internal auditors also focus on human resources, which means, for example, management audit, personnel development and corporate relations audit. Generally, they focus on internal accounting control, corporate compliance policies and procedures, laws, regulations and various regulations auditing.

2.2 Development of external audit

External audit can also be called a financial audit, and as far as verification of financial statements drawn up according to Czech accounting standards is concerned, we can talk about the audit of financial statements and also the legal or statutory audit. External audit can be defined as an independent audit of financial statements by an external auditor to such an extent that the auditor is able to express the opinion that the submitted accounts are true and fair and comply with the appropriate legislation. Its essence is to determine whether the audited financial statements (financial statements and appendix) give a true and fair view of the assets and financial position of the entity, that is to the dates the financial statements are made. These findings further become the content of the auditor's audit report. The mission of the audit of financial statements is to increase the credibility of financial statements that are

published by a corporate management. It is intended for all stakeholders, mainly the shareholders, but also other entities, such as tax authorities, banks, suppliers, customers and employees, who are also keen to make sure that the financial statements have been presented fairly, in correspondence with the company's performance and position on the market. External audit is not set up to prove the absolute accuracy and certainty. It is based on testing samples, not testing all transactions and balances. It is rather designed to reduce errors in the financial statements due to fraud or error. Subsidiary purpose of the audit is therefore taking action against errors and fraud. [6]

The external audit function has changed in the course of its development. In the beginning, the auditor had to express their opinion on the financial statements, and confirm that the accounting information contained within was true and accurate. Emphasis was put on the detection of errors, accounting errors, or embezzlement, which could occur in a given period and affect the reported facts. In the course of time, exploration of potential mistakes was pushed into the background and emphasis was placed on the reliability of the reported information, which was expressed by the statement "a true and fair view". The accounting scandals that happened at the end of the last century led to the re-expansion of the requirements for auditors. The current auditors should pay particular attention to any signs of crime.

Due to the globalization of the world economy and due to the growth of information technologies, trade and financial companies and efforts to expand to major international financial markets, a lot of pressure on accessible, comparable and accurate information has been exerted. And based on these phenomena, there is a growing role of audit, particularly in marketable equity companies, where the aim is to prove the veracity and reliability of the data necessary for both current and potential investors. Audited financial statements should be a reliable source of information for decision-making of all users of accounting information. These users can be potential investors, banks, strategic business partners, government institutions, stock exchange or internal users as boards of directors, supervisory boards, shareholders etc.

3 Sarbanes-Oxley Act

Sarbanes-Oxley (SOX) is a U.S. law that came into force in July 2002. Its official title is "An Act to reform the financial corporations and investor protection" (Public Company Accounting Reform and Investor Protection Act of 2002). This Act introduces major changes in corporate governance and financial practices of companies that are listed on the New York Stock Exchange. It does not adjust only American companies, but it also affects many other businesses and interest groups. This law was named after its main authors, senator Paul Sarbanes and U.S. representative Michael Oxley. The reasons which led to the creation and adoption of the Sarbanes Oxley can be seen back at the end of the 90ies of the twentieth century and early years of the twenty-first century. In this period there were a number of financial scandals that affected not only the United States but the whole world as well. Many entities did not comply with the principle of equitable and fair presentation of conditions and results of operations and deliberately distorted the information. Therefore assets and incomes of these companies used to be overestimated; underestimation of costs and liabilities took place. Due to overvalued information about the real state entities, users of financial information had poorly evaluated the situation of individual companies, which resulted in an almost continuous rise in the value of equity securities.

Obviously, this could not be sustainable for a long time. Thus, the situation eventually escalated into bankruptcy of some entities. Examples of incriminated companies include those of such names as Enron, MCI, WorldCom, Tyco International and many others. With these

machinations the Big Five audit firms were connected and the situation led to the bankruptcy of the audit firm Arthur Andersen, which had been involved in the audit of Enron. Therefore, this bad situation could not but lead to public distrust in the published financial information, which resulted in a deepening distrust in the financial markets. This fact caused considerable losses not only in the U.S. A. but also globally, as many incriminated companies ran business not only in the United States, but performed their activities in many other countries. The top supervisory and regulatory authorities in the USA were forced to intervene to stabilize the situation. Their efforts led to the creation and approval of the Sarbanes-Oxley Act, which was issued in July 2002. Its mission is to ensure the accuracy and transparency of financial information, with a focus on reporting these data in the financial statements. [4]

3.1 Direct and indirect costs associated with the implementation of Sarbanes-Oxley Act in the corporate environment

Rules adopted by Sarbanes-Oxley Act increased the costs of all of the companies affected. Costs arising from the strict monitoring of internal control provided for in section 404 of the Act are moderated by the fact that companies had been required – prior to the introduction of the Act – to have an adequate system of internal control by the Foreign Corrupt Practices Act (Foreign Corrupt Practices Act). Some companies had also (themselves and voluntarily) drawn reports on the effectiveness of internal control. Sarbanes-Oxley Act gives companies a range of costs, both direct and indirect. [5]

Sarbanes- Oxley Act is often criticized for its cost. There are high direct costs related to SOX, which are mainly due to the high expense of internal control. Securities and Exchange Commission (U.S. Securities and Exchange Commission, hereinafter SEC) had originally assumed that the direct costs of implementation and compliance with SOX would be averaged for each company at about \$ 91 000. Due to vastly increased costs, SEC provided an extended period of time to implement. Having originally planned the line to be drawn in September 2003, SEC postponed it until April 2005. Nevertheless, the costs associated in particular with Section 404 of the Act proved to be much higher after the first year. According to the research conducted by the Association of Financial Executives International (FEI hereinafter) with 224 companies with an average turnover of \$ 5 billion, the average cost of one company was around \$ 4,360,000. These high costs were primarily attributed to a sharp increase in hours that the auditors had to spend in companies. In subsequent years, auditors and company gained more experience and costs began to decline. Obviously, with the growth of corporate costs, the profit of audit firms increased. One of the key items for implementing SOX is the costs of upgrading information systems. Should these systems be in accordance with auditing and reporting requirements of SOX, the information parameters of the system must be altered. The system must be able to provide more detailed information, and archive more information for a longer period of time. This represents a complete replacement or a significant impact on the current system for some companies. [1]

According to many experts, the indirect costs associated with Sarbanes-Oxley are far greater than the direct ones. Perhaps most important, but largely unobservable costs are opportunity costs of managers whose time and attention are focused on the design, implementation, and ensuring compliance with the new internal control. The requirements of SOX call for hard work and attention, from top management to IT departments employees, accountants etc. Hence, the requirements of SOX thus distract managers from their standard work and also reduce overall profitability. CFOs do admit that projects such as internal staff development, capital expenditures, mergers and acquisitions have been suspended or even cancelled due to the implementation of a commitment to comply with Sarbanes-Oxley Act. Much research also shows that most CEOs developed greater aversion to taking risk.

According to PricewaterhouseCooper company research, in 2004 44% of U.S. CEO admitted that their companies were less risky projects oriented than for example ten years ago. 59% of U.S. CEO then considered excessive regulations given by SOX the biggest threat to the growth of their companies. According to several experts, the increase of personal responsibility of managers resulted in the fact that companies operated much more cautiously and tried to avoid risky operations after the implementation of SOX. And this is the result of the high amount of indirect costs. Many managers and directors, due to their fear of personal responsibility, may decide that it is better for a company to limit its growth and produce stable earnings than take the risks associated with trying to achieve a dominant market position and expand into new areas. But this approach inevitably stifles innovation and economic growth for the whole economy. Indirect costs are the sum of foregone investments and profits of all business activities, which corporate managers had not taken due to its more conservative investment strategy. [10]

4 Implementation of the Sarbanes-Oxley Act in an enterprise located in the Czech Republic

The aim of this chapter is to present the cost of implementation of the Sarbanes-Oxley Act in a company, which operates in the Czech Republic and is owned by the parent company in the USA. This particular company specializes in the production of automotive parts. Data presented here were provided on condition that the name of the company would be kept back.

4.1 The cost of implementing the Sarbanes-Oxley Act in the enterprise

Implementation of the rules and procedures under this Act was internal, using its own employees. The company did not globally quantify specific implementation cost of controls required by the Sarbanes-Oxley (SOX). It kept and still keeps only records on the time spent on implementation and compliance with this Act. The Finance Department estimates that the cost of implementing SOX in 2005 amounted to CZK 1,200,000.

There is a worker in charge dealing with SOX, and they must keep records of time spent on SOX in this company. The time spent on these issues is currently almost constant. The records for 2013 show that the average time spent on SOX during the test period is 23.5 hours per week. Outside the test period the time spent is obviously shorter; it is four hours a week. If we average the number of hours spent on SOX, multiply it by the number of test periods and the average wage of management staff the field of accounting and controlling in the Czech Republic, we get the cost of testing required by SOX for the given company. Acquired costs will again be wage costs only, as well as the quantification of the costs of implement, but even in this case, labour costs constitute the main component of the cost of such testing. The data are presented in Table 1.

Tab. 1: *The analyzed company total cost of testing according to SOX controls in CZK*

	During test period	Outside test period	Total
Average wage per hour (CZK)	328.20	328.20	-
Average number of hours per week	23.50	4.00	-
Average number of weeks spent on SOX in 2013	3.00	49.00	52.00
The total cost of testing according to SOX controls for 2013 (CZK)	23 138.10	64 327.20	87 465.30

Source: internal documents of the analyzed company

As apparent from Table 1, SOX testing costs for the year 2013 amount CZK 87,465. These costs, however, do not include the cost of the processes that are related to SOX, such as

checking various documents under this Act etc. These costs represent only the cost spent on the responsible person, who is in charge of SOX and performs tests of controls set by this Act.

Conclusion

The direct costs associated with implementation and compliance with SOX can be quantified and it is possible to enumerate at least some of the indirect costs of the transaction, however, if we focus on the benefits of this act, it quickly becomes apparent that the benefits are subjective in nature and that it is much more difficult to measure or quantify them. The first problem concerns the recognition and quantification of benefits. Numerous empirical studies and surveys have shown that SOX has improved the reliability of financial reporting, the effectiveness of corporate governance, liquidity, investors and companies and has resulted in a reduction of fraud relating to financial reporting.

The original intention of this act was to restore public confidence in financial statements compiled by public companies. One of the main objectives of internal control is to produce reliable financial information, because the more effective they are, the more reliable and true information will be reported. One of the requirements of SOX is to maintain effective internal controls, thus reliable information can be expected to be produced.

As the above analysis shows, in the case of the analyzed company the costs of implementing SOX and testing controls are appropriate; and based on the size of the business it is possible to state that these costs do not significantly affect the profitability of the given company.

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PROBLEMATIKA AUDITU V NADNÁRODNÍCH SPOLEČNOSTECH

Cílem předloženého článku je definovat zákon Sarbanes-Oxley Act, specifikovat náklady, které jsou spojené s jeho zavedením, a analyzovat nákladovost aplikace interních kontrol na základě pravidel definovaných tímto aktem ve vybrané společnosti. Článek je rozdělen do čtyř hlavních částí a závěru, ve kterém jsou shrnuty výsledky práce. První část je zaměřena na obecnou charakteristiku auditu. Ve druhé části je pak definován rozdíl mezi auditem interním a externím. Třetí část se věnuje samotnému zákonu Sarbanes-Oxley Act, je zde definována jeho podoba, přínosy i náklady, které přináší. V poslední části je analyzována nákladovost implementace a testování kontrol dle SOX ve vybrané společnosti.

DIE PROBLEMATIK DES AUDITS IN ÜBERNATIONALEN GESELLSCHAFTEN

Ziel des vorliegenden Artikels sind die Definition des Sarbanes-Oxley-Act-Gesetzes, die Spezifizierung der mit deren Einführungen verbundenen Kosten und die Analyse der Anwendung interner Kontrollen auf Grundlage der durch diesen Akt definierten Regeln in der ausgewählten Gesellschaft. Der Artikel ist in vier Hauptteile und einen Schlussteil gegliedert, worin die Ergebnisse der Arbeit zusammengefasst werden. Der erste Teil zielt auf eine allgemeine Charakteristik des Audits ab. Im zweiten Teil wird der Unterschied zwischen internem und externem Audit beleuchtet. Der dritte Teil geht auf das Sarbanes-Oxley-Act-Gesetzes ein. Dort werden dessen konkrete Gestalt, dessen Vorteile und auch die anfallenden Kosten definiert. Im letzten Teil werden die Kostenintensität der Implementierung und die Testverfahren gemäß SOX in der ausgewählten Gesellschaft analysiert.

ZAGADNIENIE AUDYTU W SPÓLKACH PONADNARODOWYCH

Niniejszy artykuł ma na celu przybliżenie ustawy Sarbanes-Oxley Act, wskazanie kosztów, które są związane z jej wdrożeniem oraz przeprowadzenie analizy kosztochłonności zastosowania kontroli wewnętrznych w wybranej spółce w oparciu o zasady zdefiniowane w wymienionym akcie prawnym. Artykuł podzielony został na cztery podstawowe części i zakończenie, w którym podsumowano wyniki pracy. Pierwsza część poświęcona jest ogólnej charakterystyce audytu. W drugiej zdefiniowano różnicę pomiędzy audytem wewnętrznym a zewnętrznym. Trzecia część dotyczy ustawy Sarbanes-Oxley Act, jej formy, korzyści i kosztów, jakie są z nią związane. W ostatniej części przeanalizowano kosztochłonność wdrożenia i testowania kontroli wg SOX w wybranej spółce.