The Changing Public Reports by Management and The Auditors Of Publicly Held Corporations: An Updated Comparative Study Of General Motors Corporation And Ford Motor Company

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EXECUTIVE SUMMARY

As a result of the Enron debacle and based on a wave of revelation of accounting irregularities and securities fraud inter linked to Adelphia, Tyco and WorldCom, Congress passed the Sarbanes-Oxley Act (SOX) in June 2002. This was the most significant securities law change since passage of the original Federal Securities Law in 1933 and 1934. This paper provides background information on sections 302 and 404 of the Act. Based on that information, The Internal Controls Report of management and the Independent Auditor's Report of General Motors Corporation and Ford Motor Company from the years 2002 through 2008 are summarized, analyzed, and compared.

Keywords: Financial reporting, Auditors, Management, Internal controls, Sarbanes-Oxley Act.

INTRODUCTION

In response to numerous accounting scandals that rocked corporate America at the turn of the 21st century, the US Government passed the Sarbanes-Oxley Act of 2002 (SOX). Scandals affecting corporations such as Tyco International, Enron, WorldCom, HealthSouth, and Adelphia resulted not only in the loss of millions of dollars in shareholdings and thousands of jobs, but also in the decline of public trust in financial accounting and reporting.

BACKGROUND

Accordingly, SOX established standards for all public company boards, management, and public accounting firms in the United States and thus giving publicly traded companies a much greater understanding of internal controls and the need for such controls. These standards require corporations to evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting as well as the Independent Auditor's Report attesting to such disclosure. In addition, SOX requires that any material weaknesses in a corporation's financial reporting be disclosed in the annual and quarterly filings, and that the CEOs and CFOs verify financial reports. This paper focuses on the internal control reporting format and content as well as the Independent Auditor's Report.

This complex and wide ranging statute deserves section-by-section analysis. The provisions include accounting reforms, the SEC, financial reporting, corporate governance, Wall Street practices, securities fraud, officer conduct, document destruction, whistleblowers, attorneys, and internal ramifications. The focus in this paper is on financial reporting. After addressing auditor's shortcomings, Congress turned directly to the corporations themselves and set forth a broad range of rules addressing corporate disclosure, the responsibility of officers and directors, and corporate governance reforms. The Sections 302 and 404 of the Act are considered applicable for corporate reporting.

The problem, solution, implications and consequences for those two sections are clearly stated by Robert Prentice in his Student Guide Booklet on the Act. His presentation includes:

SECTION 302

The Problem

Corporate management has the primary responsibility for the presentation of financial statements and the creation of processes and systems of control to ensure that accurate information finds its way into those statements. That theoretical responsibility notwithstanding, in the white hot competition and excitement of the dot.com bubble, many corporate executives seemed to believe that it was their job to not produce accurate financial statements for the auditors to certify, but to bully the auditors into certifying as aggressive a set of financial statements as possible. Accuracy was not an important consideration if the auditor's certification could be obtained to "CY" the company's "A." In litigation, CEOs occasionally disclaimed any responsibility at all for financial statements, even though they had signed them.

The Solution

Section 302 requires each public company's CEO and CFO to certify that they have reviewed the quarterly and annual reports filed with the SEC, that based on their knowledge the reports do not contain any materially untrue statements or half-truths, and that based on their knowledge the financial information is fairly presented.

The CEO and CFO must also certify that they are responsible for establishing and maintaining their company's internal financial controls, that they have designed such controls to ensure that relevant material information is made known to them, that they recently evaluated the effectiveness of the internal controls, and that they have presented in the annual report their conclusions about the controls' effectiveness.

The CEO and CFO must additionally certify that they have reported to the auditors and the audit committee all significant deficiencies and material weaknesses in the controls and any fraud, whether or not material, involving management or other employees playing a significant role in the internal controls. Finally, the CEO and CFO must indicate whether or not there have been any significant post-evaluation changes in the controls that could significantly affect the controls.

Implications and Consequences

Many pre-SOX financial statements were signed by CEOs who meant to signify nothing more than "these financial statements may not be accurate, but they're not so bad that I couldn't talk my auditor into signing off on them." Since SOX, CEOs and CFOs risk considerable personal difficulties if they do not believe that the filings they sign are accurate and have not put into place reliable internal financial controls so that they can reasonably have some faith in their own beliefs. SOX returns to these internal financial controls in Section 404.

It is likely no coincidence that when Section 302 provision and Section 906 (which sets forth criminal penalties for false certification of financial statements in these filings) first applied to large public companies in August of 2002, HealthSouth's CFO resigned rather than certify the accuracy of HealthSouth's financial statements. His resignation tipped over the first domino, starting the process that within six months or so led to the uncovering of one of America's largest financial frauds. By August 2003, the SEC had nailed its first CEO and CFO for certifying reports without good faith.

SECTION 404

The Problem

In Section 404, Congress again addressed the problem of the accuracy and reliability of public companies' financial statements. Section 302 requires CEOs and CFOs to certify that to their knowledge the reports their companies file with the SEC are accurate. But how are they to know that the information upon which they predicate their beliefs is reliable?

Perhaps more to the point, company executives, notably Jeff Skilling, former CEO of Enron, testified before Congress that they just had no idea that their companies' financial statements were off by *billions* of dollars. Congress sought to deprive these executives of plausible deniability.

The Solution

Complementing Section 302, Section 404 requires each annual report to contain an "internal control report" stating that it is the responsibility of management for establishing and maintaining an adequate internal control structure so that accurate financial statements could be produced and also containing an assessment, as of the end of the most recent fiscal years, of the effectiveness of the internal control structure and procedures. Section 404 also requires auditors to audit the internal control assessment of the company as well as the financial statements.

Implications and Consequences

Section 404 is the most controversial of all the provisions of Sarbanes-Oxley. During the Watergate era, when scandals led to the passage of the Foreign Corrupt Practices Act, many top executives of leading companies testified before Congress that they had no idea how low-level underlings had laid their hands on millions of dollars of company assets in order to pay bribes to foreign government officials. The FCPA addressed this issue by requiring public companies to institute effective internal controls to stop the bribes and to make executives accountable. Section 404 goes further, but has similar goals.

Section 404 focuses on internal financial controls, so that information used to produce financial statements is reliable. "Best practices" may include:

- A disclosure committee to review procedures and processes
- A disclosure coordinator, to be the one person anyone in the organization can go to with a question and who tries to keep everyone on the same page
- A time line and responsibility chart
- Subcertifications, where lower level employees certify the accuracy of the information they send up the line
- Codes of conduct for all accounting and financial employees
- Lots of consultation with internal audit and outside advisors (many consultants are currently specializing in helping companies set up effective internal controls), and
- Established documentation procedures

Many companies have indicated that Section 404 is no problem for them. They are well managed and already have such controls in place so that they can know where they are making money and where they are losing money. For example, Dell Computer expected to spend only $250,000, mostly documenting already existing controls. Other companies, however, have found it quite expensive to set up, document, and evaluate such controls. General Electric claims it spent $30 million in so doing, and one study found an average cost of $3.1 million for 224 public companies surveyed. Much of this expense, of course, is a one time only cost to set up and document the controls. But ongoing maintenance and evaluation will not be cheap. Also, there is a cost for outside auditors to audit these controls, perhaps 20-100 percent of the pre-404 audit fees, although one estimate is that the average public company audit fees before SOX were only 1/20th of 1 percent of company revenues.

Even companies that have found Section 404 to be expensive to implement have often realized large cost savings because the new controls revealed inefficiencies or frauds that were previously undetectable. Some controllers of public companies have used Section 404's mandates to gain permission and resources to institute changes that they had wanted to make for years. Some British companies coming within SOX's reach announced that they intended to gain efficiency by instituting the controls, although they expressed doubt that monetary savings would exceed costs of implementations.

ANNUAL REPORT INFORMATION

The annual reporting of General Motors Corporation and Ford Motor Company are considered and contrasted. The year 2002 is used as the base year for consideration and comparison with years 2003, 2004, 2005, 2006, 2007, and 2008. The focus is on the annual internal control report and the independent auditor's report. The year the SOX Act was passed resulted in Auditing Standard No. 2 (AS 2) from the US Public Company Accounting Oversight Board (PCAOB). The question remains whether the requirements for internal control effectiveness and deficiency reporting under the Act and AS 2 provide enough information to satisfy all the stakeholders that corporations have sound internal control, compliance, and governance frameworks and that such reliability of financial reporting is improving (McCunig, 2006).

This paper considers changes in the reporting over the years that tends to lead to better information, more disclosure and general reliability. Tables 1 and 2 document the changes.

INTERNAL CONTROLS REPORT

The General Motors Corporation 2002 internal controls report had five paragraphs consisting of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Unqualified certification
4. Independent audit in accordance with auditing standards
5. Audit committee responsibility

In 2003, the paragraphs continued with the addition of the Code of Ethics under SOX Section 406. The change was expected with the Act of 2002. In 2004, management filed two separate reports. The first report consolidated the information in the official paragraphs from 2002, added SOX Section 302 and added specific language on reporting and disclosure. A separate report addressed reforming and disclosure controls. 2005 seemed to follow the 2004 reporting format. In 2006, significant information was added concerning material weaknesses. Management concluded that their internal control over financial reporting was not effective as of December 31, 2006. The separate internal control report focused on disclosure and remediation of material weaknesses in the 2006 report. The 2007 and 2008 reports continued to state the material weaknesses previously identified at December 31, 2008. The controls over the period-end financial reporting process were not effective. Therefore, the result was a significant number and magnitude of out-of-period adjustments to their consolidated financial statements. Specifically, the 2008 report stated the controls were not effective to ensure accounting estimates and other adjustments were appropriately reviewed, analyzed, and monitored by competent accounting staff on a timely basis. Additionally, some of the adjustments that had been recorded related to account reconciliations not being performed effectively. Table 1 summarizes the paragraph comparisons year by year.

Ford Motor Company 2002 internal controls report had four paragraphs consisting of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Independent audit in accordance with auditing standards
4. Audit committee responsibilities

In 2003, the paragraphs were the same ignoring any reference to the SOX Act or sections of the Act. In 2004, the paragraphs took on a different wording and consolidation occurred such as the consolidation of the 2002 paragraphs on (1) responsibility and (2) internal controls. Also, information on the Treadway Commission was added as well as a separate paragraph on New York Exchange required disclosure, but no mention was made of the SOX Act.

In 2005, the report seemed to follow the 2004 reporting paragraph by paragraph. Again, no mention was made of the SOX Act. In 2006, Ford decided to break paragraph 3 as stated in the 2004 report concerning internal controls and the auditors into two paragraphs. The same reporting continued for years 2007 and 2008. None of the Ford reports mention the SOX Act. Table 2 summarizes the paragraph comparisons year by year.

Comparisons between GM and Ford seemed to convey in 2002 more specifics by GM with such information as the Securities Exchange Act of 1934, and the SOX Act of 2002. Also, GM had five officers sign the report whereas Ford had only two. In the later years, GM gave more specifics such as with Sections 302 and 406 of the SOX Act. Also, GM identified and detailed their material weaknesses including actions to address previously reported material weaknesses that no longer exist at December 31, 2008.

Table 1

General Motors Corporation							
Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
Managements responsibilities for Consolidated Financial Statement and Other Financial information							
1	√	√	√	√	-	-	-
2	√	√			-	-	-
3	√	√			-	-	-
4	√	√	√	√	-	-	-
5	√	√	√	√	-	-	-
6	-	Added: Code of Ethics SOX: Sec 406	√	√	-	-	-
7	-	-	Added: Corp responsibility for fin reports	√	-	-	-
8	-	-	paragraph 7 cont.	√	-	-	-
In 2004, added *Internal Controls Over Financial Reporting and Disclosure Controls*							
I	-	-	√	√	√	√	√
	-	-	-	-	Added new paragraph on Internal Control	√	√
	-	-	-	Added 2 paragraphs on material weakness	√ more detailed	√ more detailed	√ more detailed
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
	-	-	-	-	-	Added Remediation and Changes in Internal Controls	Added Remediation and Changes in Internal Controls
Report of Independent Registered Public Accounting Firm							
1	√	√	√	√	√	√	√
2	√	√	√	√	√	√	√
3	√	√	√	√	√	√	√
4	1 SFAS № 142 Goodwill and other Intangible Assets	1. FASB 46 Consolidation of Variable interest Entities 2. SFAS № 123 Accounting for Stock-Based Compensation 3. FASB № 142	1. FASB 46 2.SFAS 123	1. FASB № 47 Accounting for Conditional Asset Retirement Obligations 2.FASB 46 (R) 3.SFAS 123	1.SFAS № 158 Employers Accounting for Defined Benefit Pension 2.FASB №47	1.FASB 48 Accounting for Uncertainty in Income Taxes 2.SFAS № 158 3.FASB № 47	-
	-	-	-	-	Added paragraph on GMAC, LLC	√	-
5	-	-	Added Paragraph on Internal Control	√	√	√	-
In 2004, added *Report of Independent Public Accounting Firm on Internal Controls Over Financial Reporting*							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
	-	-	-	Added paragraph on material weakness	√ more detailed	√ less detailed	√ less detailed
	-	-	-	-	Paragraph on restatement of 2005 and 2004 reports	-	-
V	-	-	√	√	√	√	√
VI	-	-	√	√	√	√	√

Table 2

Ford Motor Company							
Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
1	√	√	-	-	-	-	-
2	√	√	-	-	-	-	-
3	√	√	-	-	-	-	-
4	√	√	-	-	-	-	-
In 2004, added Management's Report on Internal Controls Over financial reporting							
I			√	√	√	√	√
II	-	-	-	√	√	√	√
III	-	-	-	√	√	√	√
	-	-	-	-	1 more paragraph	√	√
IV	-	-	Added: Corp. responsibility for fin. Reports SOX: Sec. 302	√	√	√	√
Report of Independent Auditors							
1	√	√	√	√	√		
	-	-	-	Added a paragraph	√	√	√
2	1.SFAS № 142 Goodwill and other Intangible Assets 2.SFAS № 144 Acc. For the impairment or Disposal of Long-Lived Assets 3.SFAS № 133 Acc. For Derivative	1. SFAS № 148 Accounting for Stock-Based Compens.-Transition and Disclosure 2.FASB №46 Consolidation of Variable Interest Entities 3.SFAS №142 4.SFAS № 144	1. SFAS № 142 2.SFAS № 148 3.FASB №46	1.SFAS №46 2.FASB № 47 Acc. for Conditional Asset Retirement Obligations	1. SFAS № 142 2.FASB №47 3.FASB №46	1. SFAS № 142 2.FASB №47 3.FASB №46 4.FASB № 48 Acc. for Uncertain Tax Positions	1.FASB № 48
							Added a new paragraph about financial crisis in global economy
In 2004, added Internal Controls over Financial Reporting							
I	-	-	√	√	√	Combined with p.	Combined with p.
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√

INDEPENDENT AUDITOR'S REPORT

The independent auditor's report generally follows the format of the following paragraphs:

1. Introductory
2. Scope
3. Opinion

Historically, audit reports referred simply to Generally Accepted Auditing Standards and Generally Accepted Accounting Principles. GM's independent audit report by Deloitte & Touché LLP for 2002 added a disclosure paragraph after the opinion paragraph.

In 2004, GM's annual report contained a separate report on internal controls by Deloitte & Touché LLP. Also, their standard report addresses the standards of the Public Company Accounting Oversight Board, but did not mention the SOX Act. The auditors did relate to certain FASB Standards in their annual reporting. In the 2008 annual report filed with SEC, Deloitte & Touché LLP revealed doubt about their ability to generate sufficient cash flow to meet obligations and sustain its operations and thus continue as a going concern.

Ford's independent audit report by PricewaterhouseCoopers LLP combines the introduction, scope and opinion paragraphs as a single paragraph. Their second paragraph discusses notes to the financial statements. That format is followed in years 2003 and 2004. In 2004, the auditors added a section to their report dealing with internal controls that continued for years 2005-8. In 2005, the auditors added a paragraph that seemed redundant concerning their purpose of forming an opinion based on applying auditing procedures. The auditors did refer to FASB Standards in their annual reporting each year. In addition, in 2008 a paragraph was added concerning the global economy facing a financial crisis and severe recession that has lead to significant pressure on the Company and the automotive industry generally.

Deloitte & Touché LLP style of separate reports for auditing and internal controls seemed more detailed and inclusive. Both auditors mention the Public Company Accounting Oversight Board. This requires the auditors to plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material aspects. Both auditors, through their reporting, state specific standards and their application to the client's financial information. Tables 1and 2 summarize the paragraph comparisons year by year.

GM TAKES NEW DIRECTION

Historically, GM's problems can be traced back to its origins a century ago with the buying of 39 companies by 1920 and running them as separate entities. In 1923, narrowly avoiding bankruptcy and then imposing tight financial controls. Acceding deals with the UAW that included cost-of-living pay increase, free health-care coverage for life and generous pensions became an unsupportable burden. By the early 1980s it finally dawned on GM that the Japanese could not only make better cars but do so far efficiently. The competition implications will continue well into the future (Economist-Opinion, 2009).

General Motors Corporation kicked off a new era following its recent exit from bankruptcy protection. Chief Executive Frederick "Fritz" Henderson promised "the Company will put a premium on speed, accountability and risk taking, and root out the layers of management that had hobbled decision making" (Shankman, 2009). Hopefully, the accountability will include strengthening their internal controls. However, according to a recent statement "MLC (Motors Liquidation Company, the new name of the "Old GM") determined that its internal controls over financial reporting were not effective. The lack of effective internal controls could materially adversely affect their financial condition and ability to carry out their business plan. Translation: they didn't have a handle on things when the government started bailing them out, they still don't and they don't know when if ever they will." This will certainly affect their ability to be competitive in the long-run relative to efficiency, reliability, credit, and decision-making. (Tom Blumer, 2009, *NewsBusters*)

CONCLUSIONS

The Sarbanes-Oxley Act is a landmark piece of Federal Regulation that continues to be debated even by the current president and vice-president of the United States. It created a new Federal Agency (the PCAOB) that has forced corporations at home and abroad to revamp their governance practices. Also, changed the accounting industry, protected whistleblowers, created many new crimes (especially for document destruction), and increased punishment for violation of many existing ones. However, the immediate purpose of restoring confidence in the securities markets has been accomplished (Prentice, p.60).

The contribution of the independent auditor is to provide credibility to information by publicly submitting their report in the form of an opinion as to the fairness of the financial statements. Independent auditors have no material personal or financial interest in the business, therefore, their reports can be expected to be impartial and free from bias.

The changing format and information, as illustrated by the specific reports in the annual reports of General Motors Corporation and Ford Motor Company, has been prompted by the Sarbanes-Oxley Act. Corporations strive for full disclosure but the presentations will vary based on management's focus and priorities as well as their business practices.

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