

# **THE CHANGING PUBLIC REPORTS BY MANAGEMENT AND THE AUDITORS OF PUBLICLY HELD CORPORATIONS: AN UPDATED COMPARATIVE STUDY OF FIVE INDUSTRIES WITH SPECIFIC INTERNATIONAL IMPLICATIONS**

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## **ABSTRACT**

*As a result of the Enron debacle based in a wave of revelation of accounting irregularities and securities fraud interlinked 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 selected corporations in the auto, gaming, hotel, pharmaceuticals and retail industries from the years 2002 through 2008 are summarized, analyzed, and compared. Various differences are noted and implications including international are considered.*

## **INTRODUCTION**

In response to numerous accounting scandals that rocked corporate America at the turn of the 21<sup>st</sup> 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 wealth and thousands of jobs but also in the decline of the 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 thereby gave publicly-traded companies a much greater understanding of internal controls and their 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 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, responsibility of officers and directors, and corporate governance reforms. Sections 302 and 404 of the Act are considered applicable for corporate reporting.

The problem, solution, implication and consequence 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 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 not to 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 their companies file 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.

CEOs and CFOs 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 report their conclusions about the controls' effectiveness.

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

**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 responsibilities 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 also refers to these internal financial controls in Section 404.

It is likely no coincidence that this provision and Section 906 (which sets forth criminal penalties for false certification of financial statements) 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 the responsibility of management for establishing and maintaining an adequate internal control structure so that accurate financial statements could be produced and contained an assessment, as of the end of the most recent fiscal year, 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 the provisions of Sarbanes-Oxley. During the Watergate era when the scandals that led to passage of the Foreign Corrupt Practices Act (FCPA) erupted, 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 to pay bribes to foreign government officials in order to land contracts for the companies. The FCPA required 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
- Establishing 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 profitable and where they are incurring losses. 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. It also costs resources for outside auditors to audit these controls, perhaps 20-100% of the pre-404 audit fees, although one estimate is that average public company audit fees before SOX were only 1/20<sup>th</sup> of 1 percent of company revenues (Prentice, 2005).

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 the monetary savings would exceed costs of implementation (Spira and Gowthorpe, 2008).

### **OBSERVATIONS FROM THE FIELD**

A recent survey of 2,700 CPAs with a 20% response rate, indicated the shift from the AICPA's Auditing Standards Board (ASB) to the quasi governmental PCAOB was controversial, and, in general, not well received by the profession. For example, a manager at a Big Four Firm: "The section 302 certification by itself does not provide any benefits. However, some of the best practices that some companies have adopted, such as robust cross-functional disclosure committee meetings and 'subcertifications' or built-up representation letters from deeper in the organization, have improved financial reporting quality. The best companies were already doing these things". Also, a partner at a Big Four Firm: "The bulk of the cost of a good system of internal control is part of the cost of doing business responsibly and should not be attributed to SOX. Small companies have just as much responsibility to safeguard shareholder assets as do large ones. The rewards to management for good results are huge. The only way to have assurance that those results are real is to have a good system of internal control and a quality audit" (Hill, 2007).

Another survey of external auditors (ninety two sampled with thirty four responses from two of the Big Four Firms) examined factors that affect audit efforts as managers and auditors to try to meet the demands of section 404. It is in management's best interest to ensure that internal controls meet the rigorous standards of SOX before the external auditors begin their evaluation and therefore, companies should hire consultants independent of the external auditors to assist with section 404 compliance. The survey results indicated, perhaps not surprisingly: "traditional factors such as management integrity and the quality of the internal audit team are extremely important in auditor's budget decisions. More than 50% of the respondents labeled those factors as very important, while most of the other respondents referred to them as somewhat important" (Blaskovich, 2007).

The audit analytics database classifies material weaknesses into several categories, one is "senior management's competency, tone, or reliability." A study analyzed the material weakness in this category from 2005 through early 2008. The results indicated audit firms issued adverse internal control opinions to 93 large public companies because of weaknesses with senior management's competence, tone, or reliability while companies appeared in the sample twice had the same material weakness in two years and therefore, there were 79 unique companies represented. According to their data, 8 wholesale and retail companies had material weaknesses related to senior management as compared to 25 service companies. The top four types of weaknesses included;

1. Generally poor management tone
2. Management override of controls
3. Ineffective control environment
4. Lack of appropriate communications.

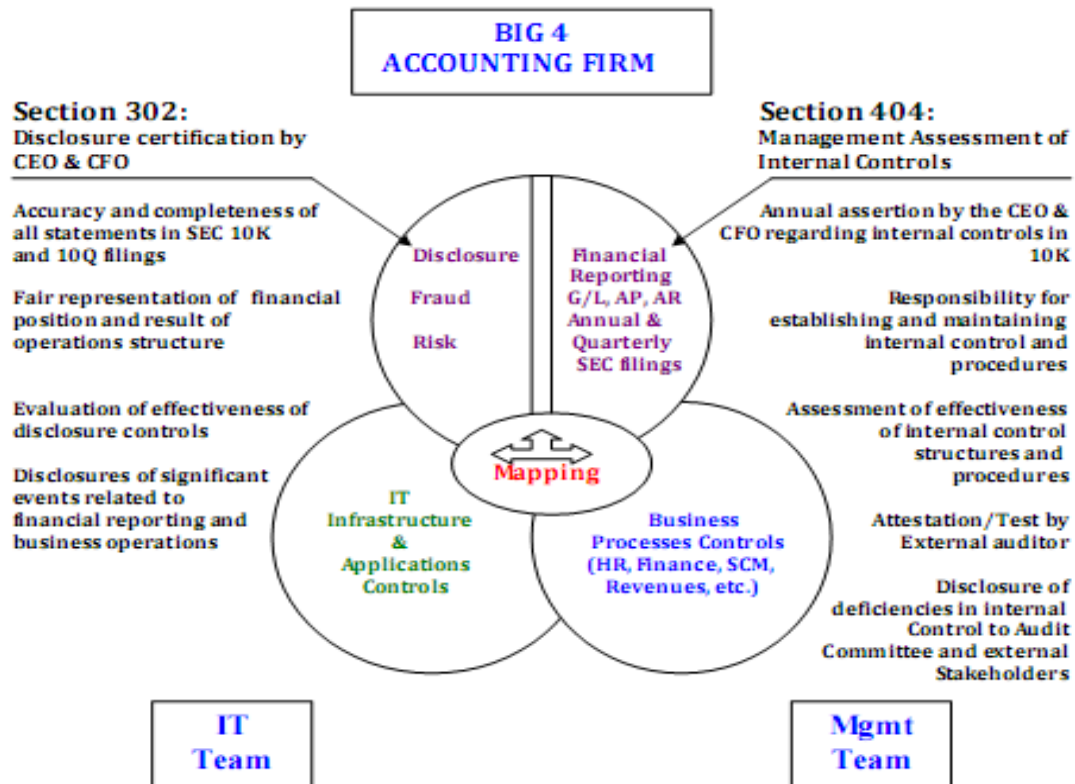
Their study indicated many of the companies with adverse internal control opinions from the auditors described in the management's report how the companies addressed the weaknesses (Hermanson, et. al.,

2008). The management and auditors reports reviewed in the retail and gaming industries did not indicate any hint of the types of weaknesses stated above.

A summary and diagram of sections 302 and 404 as it relates to the Big Four firms is illustrated in Exhibit A. The exhibit illustrates the interface of sections 302 and 404 relative to the outside auditors. For example, the outside auditors recommend full disclosure to minimize risk and avoid fraud. Those issues must be mapped out with the IT infrastructure and applications controls in relation to business processes controls. Management’s responsibilities are clearly laid out and the outside auditors must attest to the effectiveness of the internal control structures and procedures. The outside auditors must disclose any deficiencies in internal control to the corporation’s audit committee and external shareholders.

**Exhibit A**

**Sarbanes-Oxley (SOX) Compliance Project  
Discovery. Assessment, Remediation. Testing.**



Source: <http://www.iim-edu.org/corporategovernancesarbanesoxleybestpractices/index.htm>

**INTERNAL CONTROL ACCORDING TO COSO**

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) views internal control as a process affected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives. The reasonable assurance

relates to the categories of effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations and safeguarding of assets against unauthorized acquisition, use or disposition (Hayes, et. al., 2005).

### **ANNUAL REPORT INFORMATION**

The annual reports of the following corporations by industry are considered and contrasted for the years 2002 through 2008:

1. Auto: Ford Motor Company and General Motors Corporation
2. Gaming: Harrah Entertaining, Inc., MGM Mirage Casino, and Penn National Gaming, Inc.
3. Hotels: Choice Hotels International, Inc., Hilton Hotels Corporation, and Marriott International, Inc.
4. Pharmaceuticals: Eli Lilly, King, Merck, Mylan, Schering-Plough, and Watson
5. Retail: Kohl's Corporations, J.C.Penney Company, Inc., Sears, Roebuck and Company, Target Corporation and Wal-Mart Stores, Inc.

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 opinions and deficiency reporting under the Act and AS 2 provide enough information to satisfy all stakeholders that corporations have sound internal control, compliance, and governance frameworks and that such reliability of financial reporting is improving (McCuaig, 2006).

This paper considers changes in the reporting over the years that tends to lead to better information and general reliability. For all industries, as well as possible global organizations, accounting implications are based on an SEC idea of a single set of rules.

### **INTERNAL CONTROLS REPORT**

The 2002 internal control reports considering all 19 corporations had from none to six paragraphs consisting of various combinations of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Organizational alignment and communication policy
4. Statement of ethics
5. Unqualified certification
6. Independent audit in accordance with auditing standards
7. Audit committee responsibilities
8. Commitment to integrity and strong internal practices and policies.

For example, Ford Motor Company's 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 SOX Act or any sections of the Act. In 2004, the paragraphs took on a different wording and the consolidation of paragraphs such as the 2002 paragraphs on (1) responsibility and (2) internal controls. Also, information related to the Treadway Commission was added as well as a separate paragraph on the New York Stock Exchange required disclosure, but there was no mention made of the SOX Act.

In 2005, the report seemed to follow the 2004 report paragraph by paragraph. Again, no mention was made of the SOX Act. In 2006, Ford decided to break paragraph three of the 2004 report concerning internal controls and the auditors into two paragraphs. None of the Ford reports mention the SOX Act.

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.

The MGM Mirage Casino 2002 internal controls report had four paragraphs consisting of:

1. Management's responsibility
2. Objective of internal control
3. Management's evaluation
4. Report of independent registered public accounting firm

In 2005, the paragraph continued with the exclusion of Mandalay Resort Group because of such business representing only 47% of the company's total assets. This statement was not repeated in 2006.

Penn National Gaming, Inc. in 2004 established disclosure controls and procedures specified in the Rules and Forms of the SEC. As stated in 1 a. b. and c. below and the two paragraphs by management consisting of:

1. Evaluation of disclosure controls and procedures.
  - a. Established disclosure controls and procedures.
  - b. Reasonable assurance, judgment and cost-benefit relationship.
  - c. As defined in Rule 13(a)-15(e) under the Securities Exchange Act of 1934, the disclosure controls and procedures are effective.
2. Management is responsible for establishing and maintaining adequate internal control.
3. No significant changes in internal controls.

In 2005, the paragraphs were the same except in the management paragraph they excluded the operations of Argosy Gaming Company from their assessment of internal control because it was acquired by the company in a purchase business combination during fiscal year 2005. The exclusion was not repeated in 2006.

Harrah's Entertainment, Inc. 2002 internal control report had four paragraphs, excluding the disclosure controls and procedures, but including rules under the Securities Exchange Act of 1934, consisting of:

1. Reasonable assurance of reliability.
2. Evaluated effectiveness based on the Treadway Commission Framework.
3. Issuance of an attestation report on management's assessment by Deloitte and Touché LLP.
4. No changes in internal control over financial reporting.

In 2005, the corporation added a paragraph that included the acquisition of Caesars in June, 2005. In addition, the last paragraph again made mention of Caesars operations to be included in the first annual assessment to be reported as of December 31, 2006. In 2006, the corporation added a paragraph that included the acquisition of London Clubs International PLC during the fourth quarter of 2006. They excluded LCI from the scope of their annual report. In addition, the last paragraph again made mention of LCI being excluded.

Comparisons among the three corporations indicated that MGM Mirage was more specific as to significant elements of the company's internal control over financial reporting. For example:

- Hiring skilled accounting personnel and training them appropriately;

- Written accounting policies;
- Written documentation of accounting systems and procedures;
- Segregation of incompatible duties;
- Internal audit function to monitor the effectiveness of the system of internal control;
- Oversight by an independent Audit Committee of the Board of Directors.

Penn National Inc. and Harrah's Entertainment, Inc. included disclosure controls and procedures paragraphs to define controls more broadly. Also, they specifically stated any acquisitions and why such acquisitions were excluded in the current year of disclosure. None of the companies made any mention of the SOX Act of 2002. According to John Reanett, Vice President and Chief Financial Officer for majestic star, who owns four casinos "Gaming is already a highly regulated industry". In addition, he stated "section 404 is a rather broad and encompassing area and a lot of this stuff is pretty much in its infancy". His staff is working closely with their internal accountants and the SEC counsel to put procedures in place and fill in the gaps (Sears, 2008).

The hotel industry corporation's internal control reports have from none to three paragraphs for years 2002 and 2003 consisting of:

1. Integrity, objectivity, and a highly developed system.
2. Conformity with accounting principles generally accepted in the United States.
3. Audit Committee.

In 2004, Hilton Hotels Corporation added management's report on internal control over financial reporting consisting of:

1. Accordance with United States generally accepted accounting principles.
2. Framework based on the Treadway Commission's Report (COSO).
3. Independent registered public accounting firm's attestation report.
4. No changes that have a material affect.

In 2004, Marriott International, Inc. added four paragraphs consisting of:

1. Reporting supported by written policies and procedures.
2. May not prevent or detect misstatements.
3. Criteria based on the Treadway Commission's Report (COSO).
4. Independent registered public accounting firm's report appears in the annual report.

Marriott eliminated the audit committee paragraph and language referring to a highly developed system.

In 2004, Choice Hotels International, Inc. added management's report on internal control over financial reporting consisting of:

1. Accordance with generally accepted accounting principles.
2. Inherent limitations and risk.
3. Criteria based on the Treadway Commission's Report (COSO).
4. Auditing firm's report which appears herein.

For 2005 and 2006, the companies mention supervision by the Chief Executive Officer and Chief Financial Officer and any excluded assets. In particular, Marriott and Choice Hotels had very consistent language for both years.

The pharmaceutical industry companies internal control reports have from none to six paragraphs for years 2002 and 2003 consisting of:

1. Responsibility for fair presentation, accuracy and integrity.
2. Internal controls.



3. Code of conduct.
4. Independent audit in accordance with Generally Accepted Auditing Standards.
5. Audit Committee.
6. Commitment to integrity and strong internal practices and policies.

In 2004, Eli Lilly, King, Merck, Mylan, Schering-Plough, and Watson either added a paragraph on internal controls or changed the report from Financial Responsibility to Internal Control over Financial Reporting. For example, Eli Lilly specifically addressed the generally accepted auditing standards of the Public Company Accounting Oversight Board and evaluated management's assessment and evidence whether the internal control over financial reporting was designed and operating effectively. Schering-Plough under their new formatted report indicated the inherent limitations and expressed only reasonable assurance in the internal controls. The reports generally mention the integrated framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and the auditing standards of the Public Company Accounting Oversight Board.

The retail industry 2002 internal control reports had from four to six paragraphs consisting of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Organizational alignment and communication policy
4. Statement of ethics
5. Unqualified certification
6. Independent audit in accordance with auditing standards

The J.C. Penney report in 2002 specifically referred to the company's CEO and CFO signing certification statements as required by sections 302 and 906 of the Sarbanes-Oxley Act of 2002. These signed certifications were filed with the SEC as part of their 2002 Form 10-K.

In 2003, the paragraphs continued with Kohl's eliminating the paragraph related to internal controls and J.C. Penney combined the paragraphs on internal controls and communication policy. In 2004-2006, Wal-Mart eliminated the internal controls, organizational alignment and communication policy and statement of ethics paragraphs and changed the sequence of the paragraphs related to unqualified certification and independent audit in accordance with auditing standards. J.C. Penney and Sears had eliminated management's report but added management's report on internal control over financial reporting starting in 2004. Comparisons revealed more detail by J.C. Penney for years 2002 and 2003. However, Target, Wal-Mart, and Kohl's continued with the general format or a variation of the management's report. For example, Table 1 summarizes the paragraph comparisons year by year for the retail corporations. The same format was followed for the other industries.

### **COMPARISON OF INDUSTRIES**

A comparison of the industries revealed uniqueness by industry. However, Management's report on internal control over financial reporting by the pharmaceutical corporations was more detailed and specific. For example, the 2004 report of Eli Lilly addressed global financial policies. The second paragraph included critical areas in addition to internal controls, assurances, management's judgments relative to cost and expected benefits, and monitoring. In addition, another paragraph addressed a Code of Conduct (The Red Book) that applies to all employees worldwide. The paragraph statement did not mention SOX but addressed protection from discrimination or retaliation by the company over employees. In addition, Watson in 2004 addressed materiality as it related to internal control over financial reporting.

**Table 1: Management Internal Control Report  
Wal-Mart Stores, Inc.**

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
<b>Management's Report</b>							
1	√	√	√	√	√	√	√
2	√	√	-	-	-	-	-
3	√	√	-	-	-	-	-
4	√	√	-	-	-	-	-
5	√	√	√	√	√	√	√
6	√	√	√	√	√	√	√
			Added new paragraph about SEC and New York Stock Exchange	√	√	√	√
In 2004 added <i>Managements' Report on Internal Control Over Financial Reporting</i>							
I	-	-	√	√	√	√	√
II	-	-	-	√	√	√	√
In 2004 added <i>Evaluation of Disclosure Controls and Procedures</i>							
1	-	-	√	√	√	√	√
In 2004 added <i>Report on Ethical Standards</i>							
1	-	-	√	√	√	√	√
2	-	-	√	√	√	√	√

**Kohl's Corporation**

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
<b>Management's Report</b>							
1	√	√	√	√	√	√	-
2	√	-	-	-	Added new paragraph about SEC and New York Stock Exchange	√	-
3	√	√	√	√	√	√	-
4	√	√	√	√	√	√	-
In 2004 added <i>Managements' Report on Internal Control Over Financial Reporting</i>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√

### J.C. Penney Company, Inc.

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
<b>Management's Report</b>							
1	√	√	-	-	-	-	-
2	√	√	-	-	-	-	-
3	√	-	-	-	-	-	-
4	√	√	-	-	-	-	-
5	√	√	-	-	-	-	-
<i>In 2004 added Managements' Report on Internal Control Over Financial Reporting</i>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	-	√	√	√	√

### Sears

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
<b>Management's Report</b>							
1	√	√	-	-	-	-	-
2	√	√	-	-	-	-	-
3	√	√	-	-	-	-	-
4	√	√	-	-	-	-	-
<i>In 2004 added Managements' Report on Internal Control Over Financial Reporting</i>							
I	-	-	√	-	-	-	-
II	-	-	√	-	√	√	√
III	-	-	√	-	√	√	√
IV	-	-	√	√	√	√	√
	-	-	-	Added new paragraph	√	√	√
V	-	-	√	√	√	√	√

#### 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, GM in their standard report addressed 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 report.

Ford's independent audit report by PricewaterhouseCoopers LLP combined the introduction, scope and opinion paragraphs as a single paragraph. Their second paragraph discussed notes to the financial statements. That format was followed in years 2003 and 2004. In 2004, the auditors added a section to their report dealing with internal controls that continued starting with year 2005. In 2005, the auditors added a paragraph that seemed redundant concerning their purpose of forming an opinion based on applying auditing procedures. In 2006 that new paragraph introduced in 2005 was continued. The auditors did refer to FASB Standards in their annual report each year.

Deloitte & Touché LLP style of separate reports for auditing and internal controls seemed more detailed and inclusive. Both auditors mentioned the Public Company Accounting Oversight Board. This required 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, stated specific standards and their application to the client's financial information.

In 2002, Penn National Gaming, Inc.'s annual report added a paragraph on statement of Financial Accounting Standards No. 142. In 2004, a fourth paragraph addressed the standards of the Public Company Accounting Oversight Board and the Treadway Commission Framework relative to internal control. The same paragraph continued in 2005 and beyond.

In 2004, MGM Mirage annual report added a paragraph on internal control effectiveness based on the Standards of the Public Company Accounting Oversight Board and the Treadway Commission Framework. The same paragraph continued in 2005 and beyond.

Similarly, in 2004, Harrah's Entertainment, Inc. annual report added a paragraph similar to the one added by Penn National Gaming Inc. That same paragraph continued in 2005 and 2006. The auditors of all three companies recognized the importance of disclosing the PCAOB Standards and Treadway Commission Framework.

Hilton's auditors added additional paragraphs to address the reports of the prior auditors who had ceased operations. The financial statements had been revised to include necessary adjustments and to indicate no opinion or any form of assurance on 2001 or 2000 financial statements taken as a whole. In addition, in 2004-6, Hilton's auditors added a paragraph on criteria established by the Treadway Commission. For the same time period, Marriott's auditors added language relative to the Public Company Accounting Oversight Board. Marriott's auditors had added a paragraph on criteria established by the Treadway Commission but made no mention of the Public Company Accounting Oversight Board for the year 2005. At the same time, Choice Hotels' auditors had a combined report that included internal control over financial reporting. Hilton and Marriott had separate reports by their auditors relative to internal control over financial reporting.

Mylan added a fourth paragraph concerning its method of accounting for goodwill for fiscal years 2002-3 and 2003-4. In addition, in fiscal years 2004-5, 2005-6, and 2007-8 a fourth paragraph was added stating their accordance with the standards of the PCAOB and Treadway Commission Framework as to internal control. Also, a separate report was issued relative to internal controls. This procedure was followed by Ely Lilly, King, Merck, Schering-Plough, and Watson. For example, Watson included three detailed paragraphs on internal control as part of the independent auditor's report. The paragraph variations of all the companies do not detract from the completeness of the additional notes and the internal control over financial reporting. In 2004, separate reports by the independent public accounting firms over internal control were added by Eli Lilly, Mylan, and Schering-Plough.

Wal-Mart, Kohl's, J.C. Penney and Sears added a disclosure paragraph after the opinion paragraph. For example, Wal-Mart's independent audit report by Ernst and Young, LLP for 2002 added a disclosure paragraph relative to the company's adoption of provisions of Statement of Financial Accounting Standards No. 142, Goodwill and other intangible assets. Starting with 2004, Sears combined the report of the independent registered accounting firm with the report on internal control over financial reporting. For example, in 2004 the first paragraph stated the auditors have audited management's assessment that the company maintained effective internal control over financial reporting as of January 1, 2005. In the third paragraph, the auditors expanded on company's internal control including policies and procedures. In the fourth paragraph, the auditors discussed the inherent limitations of internal control. For example, the summary of the analysis is reported in Table 2 for the retail corporations. The same format was followed for the other industries.

**Table 2: Independent Auditors Report  
Target Corporation**

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
<b>Report of Independent Registered Accounting Firm</b>							
1	√	√	√	√	√	√	√
2	√	√	√	√	√	√	√
3	√	√	√	√	√	√	√
	-	-	1. SFAS No. 123 <i>Share-Based Payment</i>	-	1. SFAS No. 158 <i>Employers Accounting for Defined Benefit Pension</i>	1. SFAS No. 158 2. FASB No. 48 <i>Accounting for uncertainty in Income Taxes</i>	1. SFAS No. 158
	-	-	Added new paragraph about <i>Internal Control – Integrated Framework</i>	√	√	√	√
<b>In 2004 added: Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</b>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
V	-	-	√	√	√	√	√
VI	-	-	√	√	√	√	√
<b>Report of Audit Committee</b>							
1	√	√	√	√	-	-	-
2	√	√	√	√	-	-	-

## Wal-Mart Stores, Inc.

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
1	√	√	√	√	√	√	√
2	√	√	√	√	√	√	√
3	√	√	√	√	√	√	√
4	1. SFAS No. 142 <i>Goodwill and Other Intangible Assets</i>	1. SFAS No. 142 <i>Goodwill and Other Intangible Assets</i>	-	-	1. SFAS No. 158 <i>Employers Accounting for Defined Benefit Pension</i>	1. FASB No. 48 <i>Account ing for Uncertain ty in Income Taxes</i> 2. SFAS No. 158	1. FASB No. 48  2. SFAS No. 158
			Added new paragraph about <i>Internal Control – Integrated Framework</i>	√	√	√	√
<b>In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i></b>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
	-	-	-	Added new paragraph about <i>The Seiyu, Ltd., and Sonae Distribuciao Brasil S.A., acquired in 2006</i>	Added new paragraph about <i>Central American Retail Holding Company, acquired in 2007</i>	Added new paragraph about <i>Bounteous Company Ltd.</i>	Added new paragraph about <i>Distribuci on y Servicio D&amp;S S.A.</i>
V	-	-	√	√	√	√	√
VI	-	-	√	√	√	√	√

### Kohl's Corporation

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
1	√	√	√	√	√	√	√
2	√	√	√	√	√	√	√
3	√	√	√	√	√	√	√
4	1. SFAS No. 142 <i>Goodwill and Other Intangible Assets</i>	1. SFAS No. 142	<i>Restatement of financial statements for two previous years</i>	1. SFAS No. 123 <i>Share- Based Payment</i>	-	1. FASB No. 48 <i>Account ing for Uncertain ty in Income Taxes</i>	1. FASB No. 48
	-	-	<i>Added new paragraph about Internal Control – Integrated Framework</i>	√	√	√	√
<b>In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i></b>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
V	-	-	√	√	√	√	√
VI	-	-	√	√	√	√	√



## J.C. Penney Company, Inc.

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
1	√	√	√	√	√	√	√
2	√	√	√	√	√	√	√
3	√	√	√	√	√	√	√
4	1. SFAS No. 142 <i>Goodwill and other Intangible Assets</i>	1. SFAS No. 142 <i>Goodwill and other Intangible Assets</i>	-	1. SFAS No. 123 <i>Share-Based Payment</i>	1. SFAS No. 123  2. SFAS No. 158 <i>Employers Accounting for Defined Benefit Pension</i>	2. SFAS No. 158  1. FASB No. 48 <i>Accounting for Uncertainty in Income Taxes</i>	1. SFAS No. 157 <i>Fair Value Measurements</i>  2. FASB No. 48  3. SFAS No. 158
			Added new paragraph about <i>Internal Control – Integrated Framework</i>	√	√	√	√
<b><i>In 2004 added: Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i></b>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
V	-	-	√	√	√	√	√
VI	-	-	√	√	√	√	√

# Sears

Paragraph	2002 (base)	2003	2004	2005	2006	2007	2008
1	√	√	-	-	-	-	-
2	√	√	-	-	-	-	-
3	√	√	-	-	-	-	-
4	1. SFAS No. 142 <i>Goodwill and other Intangible Assets</i>	1. SFAS No. 142	-	-	-	-	-
<b>In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i></b>							
I	-	-	√	√	√	√	√
II	-	-	√	√	√	√	√
III	-	-	√	√	√	√	√
IV	-	-	√	√	√	√	√
V	-	-	√	√	√	√	√
VI	-	-	1. SFAS No. 142 <i>Goodwill and other Intangible Assets</i>  2. SFAS No. 158 <i>Employers Accounting for Defined Benefit Pension</i>	1. <i>Indirect buying, warehousing and distribution costs</i>	1. FASB No. 158 <i>Defined Benefit Pension and Other Post Retirement Plans</i>  2. <i>Indirect buying</i>	1. FASB No. 158  2. <i>Indirect buying</i>	1. FASB No. 158

**COMPARISON OF INDUSTRIES**

Within the pharmaceutical corporations, the independent auditors added a separate report on internal control over financial reporting. For example, Eli Lilly's March 31, 2005 report included an extensive paragraph on policies and procedures that pertain to records, assurance, and timely detection. The language is repeated in the reports of King, Merck, Mylan, Schering-Plough, and Watson.

Within the retail corporations, the independent auditors added a separate paragraph or report about the internal control-integrated framework. Wal-Mart had the most specific information in a separate report.

Differences existed among U.S. corporations within an industry, as well as between different industries, as demonstrated in this paper. Each industry had common language, issues, and reporting. All industries reported an explanatory trend in addressing internal control in detail. The primary focus is on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In addition, the report referred to the standards of the Public Company Accounting Oversight Board (United States).

### **INTERNATIONAL IMPLICATIONS**

The International Auditing and Assurance Standards Board (IAASB) is a standing committee of the council of IFAC which sets the international standards of auditing. The council's objective is to improve the degree of uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and attest functions. Since the Board's intent is voluntary, international acceptance of its guidelines, the international standards on auditing (ISAs), are not intended to override national regulations or pronouncements relating to audits of financial information. In the United States the authoritative body is the Public Company Accounting Oversight Board (PCAOB). ISA's became mandatory in Europe in 2005. Hopefully, other regions of the world including the U.S. will follow their lead (Hayes, et. al., 2005).

The Securities and Exchange Commission took an important step toward what many hope will eventually lead to global accounting standards and thus drop a requirement that non-U.S. companies with U.S. listings reconcile their results to U.S. rules. The single-audit theory is intended to benefit both investors and companies world-wide. However, there are differing views over who those rules are suppose to serve (investors, companies or governments), this could undermine global accounting rules (Reilly and Scannell, 2007).

In the United States and the United Kingdom markets are generally investor-driven. Thus, investor's needs generally take priority over those of companies and auditors. However, elsewhere in Europe, investor's needs take a back seat to corporate or political goals such as in China. Coming up with one set of standards is going to be difficult and enforcement would have to be different (Reilly and Scannell, 2007).

Many questions would need to be considered such as the role of the SOX Act, internal control enforcement and reporting, and the independent auditor's report. As stated in this paper, differences exist among U.S. companies within an industry as well as between different industries.

Let us now examine a few differences between U.S. and U.K. internal controls which are presented below in Exhibit B. Generally the U.S. has taken a legislative approach as compared to the U.K.'s voluntary codes based on principle of comply or explain. The outside auditors in the U.S. have more responsibilities for internal control reporting whereas; the U.K.'s definition of internal control is wider and more closely aligned to risk management procedures (Spira and Gowthorpe, 2008).

Adoption of international regulatory solutions may be ineffective without regard to the definition and interpretation of concepts such as internal control. Also national, historical and cultural contexts must be understood for successful harmonization of regulatory approaches (Spira and Gowthorpe, 2008).

**Exhibit B**

No.	Data	U.S. SOX Section 404	U.K. Turnbull Guidance
1	Responsibility	The responsibility for compliance lies with the management of the company	The responsibility is imposed on both, the board of directors and the management
2	Approach	U.S. takes a legislative approach	U.K. voluntary codes based on the principle of "comply or explain"
3	Disclosure	U.S disclosure process is oriented to defensive compliance rather than transparency	U.K. disclosure regime potentially leads to some transparency as companies describe their internal process
4	Relationship between internal control and risk management	U.S. is narrowly focused on internal financial controls	In U.K. internal control is broader and more closely linked to risk management

Source: Whittington, R. O., & Pany K. (2008). Principles of Auditing and Other Assurance Services. McGraw-Hill/Irwin, (16th ed.), New York, NY.

**CONCLUSION**

The Sarbanes-Oxley Act is a landmark piece of Federal Regulation that continues to be debated even by the 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. The Act 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 his or her report in the form of an opinion as to the fairness of the financial statements. Each independent auditor has no material personal or financial interest in the business, therefore, their report 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, has been prompted by the Sarbanes-Oxley Act. Corporations strive for full disclosure but the presentations, including the details, will vary based on management’s focus and priorities as well as their business practices.

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