

CASE 2.4

General Motors Company

As long as the unwritten rule stands that the best way to achieve success at GM is to be a good finance man, the bad habit of juggling numbers in order to present the picture people want to see cannot be broken.

Mary Ann Keller,
analyst for the automotive industry,
September 1990

The Great Depression dealt a devastating blow to Billy Durant. During the depths of the Depression in 1936, Durant, a high school dropout who was born a few months after the outbreak of the Civil War in 1861, was forced to declare bankruptcy. Like millions of Americans, the tough-minded and resilient Durant survived the Depression by becoming a jack-of-all-trades, a "job" that he had mastered as a young man. During his early twenties, the free-spirited Durant had worked as an itinerant salesman traveling from town to town peddling patent medicines. During the latter days of the Depression, Durant, who was in his late seventies by this time, made ends meet by managing a bowling alley. After suffering a stroke in 1942, he and his wife subsisted on a pension provided to him by a company that he had once managed. Durant died a few years later in 1947.

If one considered only the early and later years of Durant's life, his life story would not be particularly compelling. However, in the 50-year span between working as a traveling medicine man and managing a bowling alley, William C. "Billy" Durant created an organization that would become the United States' biggest corporation and have the largest workforce of any company worldwide.

Durant made a fortune in the late 1880s and 1890s manufacturing horse-drawn carriages, a business that he had launched in 1886 on \$3,000 of borrowed money. In the early days of the 20th century, Durant realized that the horseless carriage would soon supplant his company's product. Over the next few years, Durant invested much of his personal wealth in several automobile manufacturers, most notably the Buick Motor Company. In 1908, Durant merged those companies to create General Motors Corporation (GM).

For 77 years, from 1931 through 2008, GM reigned as the number one automobile manufacturer worldwide. Only a few months after that long run ended, GM, just like Billy Durant some seven decades earlier, filed for bankruptcy.¹ GM's bankruptcy filing in June 2009 had been foreshadowed by the going-concern audit opinion issued on its 2008 financial statements a few months earlier by Deloitte & Touche, its longtime audit firm.

Pensions & Panic

Similar to many companies, GM was victimized by the economic crisis triggered in late 2008 by collapsing housing prices and the implosion of the subprime sector of the mortgage industry. That crisis quickly spread to other sectors of the U.S. economy,

1. After losing control of General Motors in the early 1920s, Billy Durant became preoccupied with "playing" the stock market. The stock market crash of 1929 wiped out Durant's massive wealth and eventually forced him to file for bankruptcy.

including the large automotive industry. Panic and fear caused millions of distraught U.S. consumers to delay or cancel "big-ticket" discretionary expenditures, such as purchases of new automobiles.

Well before the economic crisis that gripped the country in 2008 and 2009, GM's financial condition had been deteriorating. The generous pensions that the company historically paid to its former workers and executives, such as Billy Durant, were a key factor that contributed to GM's declining health. Wage freezes implemented during World War II by the federal government had prompted many companies, including GM, to establish an employee pension plan—or expand an existing one—to give their employees a legal pay "raise." The retirement benefits provided by those pension plans became increasingly lucrative during the latter half of the twentieth century due largely to the effective negotiation skills of such labor unions as the United Auto Workers (UAW).

The large expenses stemming from GM's pension plan and other postretirement benefit plans added significantly to the company's cost of producing automobiles. Because foreign competitors such as Toyota paid more modest wages and provided their employees with less liberal pension and other postretirement benefits, they could produce automobiles more cheaply than GM. Over time, this economic disadvantage caused the annual sales of GM to shrink as car buyers gravitated to foreign models. In 2009, Toyota finally overtook GM as the world's largest automobile producer.

Easily one of the most controversial issues surrounding GM's financial problems in early 2009 was: What would happen to the company's huge and significantly underfunded pension plan if the company failed. Nearly 500,000 GM retirees or surviving spouses received monthly pension payments financed by the company. The majority of those individuals relied on their GM pension as the principal source of their retirement income. Likewise, the approximately 250,000 active GM employees had built their retirement plans around the pension benefits promised to them by their employer. What frightened GM's retirees and employees was that the present value of the liabilities associated with GM's pension plan were estimated to exceed \$100 billion while the pension plan had total assets of only \$85 billion. As the company tottered on the verge of bankruptcy, it was unclear how, or whether, the pension plan would be salvaged if the company filed for bankruptcy.

Pension Accounting: A Brief History

GM's impending bankruptcy in early 2009 refocused attention on longstanding allegations that top management manipulated the company's financial data to conceal its deteriorating financial condition and operating results. The company's critics included Maryann Keller, a longtime analyst of the automotive industry who two decades earlier had published a book entitled *Rude Awakening: The Rise, Fall, and Struggle for Recovery of General Motors* (HarperCollins, 1990). Keller suggested that GM management routinely "juggled" the company's accounting numbers to conceal its serious financial problems. Among the financial statement items that GM management allegedly distorted were the expenses and liabilities associated with the company's enormous pension plan.

In fairness to GM, a large number of companies have faced similar allegations, that is, charges that they "manage" their reported earnings and apparent financial condition by improperly accounting for their employee pension plans. In fact, accounting for pension-related financial statement items has long been one of the most complex and controversial issues facing the accounting profession.

Prior to the mid-1960s, most companies accounted for their pension plan expenses on a pay-as-you-go or cash basis. In addition to simply ignoring the long-term liabilities associated with pension plans, a major drawback to this accounting method was

that it allowed companies to readily and legally manipulate their reported earnings by varying the amounts they contributed each year to their pension plans. For example, if a company was having a poor year profit-wise, it could simply reduce its pension plan contribution and thus reduce its pension expense for the year.

Accounting for pension plan-related expenses and liabilities did not change dramatically until 1985 when the Financial Accounting Standards Board (FASB) adopted a new accounting standard that moved the profession toward accrual basis accounting for those items. However, this new standard, *Statement on Financial Accounting Standards No. 87 (SFAS No. 87)*, "Employers' Accounting for Pensions," still provided opportunities for companies to window-dress their financial statements.

SFAS No. 87 required companies for the first time to make several key assumptions in accounting for financial statement items associated with a defined-benefit pension plan, similar to the one that GM provided to its employees.² Critics of the new standard argued that since these assumptions were "discretionary," they could be easily "manipulated" by corporate executives hoping to make their company's financial statements more impressive.³ Among the most important of these assumptions was the discount rate used to determine the present value of a company's pension liability. This choice had important financial statement implications, particularly for labor-intensive companies with huge pension plans, such as GM. For example, a company could raise or lower—most likely the latter—the present value of its pension liability by varying the discount rate it applied to those liabilities.⁴

Rate Debates

In late 2002, GM faced an unpleasant predicament. Falling stock market prices were driving down the value of the assets held by its pension plan, while falling interest rates were increasing the present value of its pension liability. These two conditions were causing the unfunded portion of GM's pension liability and the company's projected pension expense under SFAS No. 87 to increase dramatically.

During the final few months of 2002, several GM executives, including the company's chief financial officer (CFO), chief accounting officer (CAO), and controller, agonized over the decision of which discount rate to apply to the company's pension liability. Those executives recognized that the choice of that discount rate would have a material impact on GM's reported operating results and financial condition. SFAS No. 87 obligated GM to choose the most reasonable discount rate to apply in computing the present value of its pension liability but did not specify how that discount rate was to be chosen. The mathematical method historically used by the company produced a discount rate of 6 percent. As in years past, the company also asked its actuarial firm to develop an independent estimate of the appropriate discount rate to apply to its pension liability. GM's actuarial firm reported that its mathematical modeling suggested that a 6.18 percent discount rate was appropriate.

2. Recognize that a company's pension plan is nearly always a legal entity independent of the company that created it. The issue in this context is not the actual accounting for a pension plan but rather the accounting for pension plan-related financial statement amounts of the given employer or "sponsor" of that plan.

3. Audit Integrity (www.auditintegrity.com), "Pension Liabilities: The Elephant in the Room," March 2009.

4. Addressing the specific features and requirements of pension accounting is beyond the scope of this case. Refer to any intermediate accounting text for a comprehensive treatment of that topic. In 2006, the FASB replaced SFAS No. 87 with SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." Following the issuance of SFAS No. 158, the FASB has continued to debate and consider additional modifications to its pension accounting guidelines and rules.

Instead of using either a 6.0 percent or 6.18 percent discount rate, GM's executives chose a discount rate of 6.75 percent to apply to the company's pension liability. This latter discount rate was not produced by a rigorous mathematical model but rather by simply averaging the interest rates on a relatively small sample of high-quality corporate bonds tracked by the Moody's investment service. In fact, the actual average interest rate of the sample used by the executives to arrive at the 6.75 percent discount rate was 6.63 percent. (When choosing a discount rate, GM "rounded" the given estimate of that rate to the nearest quarter of a percent.)

By the first week of January 2003, Deloitte's audit of GM's 2002 financial statements was well under way. On January 7, 2003, Deloitte auditors met with representatives of the GM department responsible for developing the discount rate to apply to the company's pension liability. At that meeting, the GM representatives presented the three-point estimates of the discount rate that had been considered and the source of each of those estimates. Their principal justification for choosing the 6.75 percent point estimate was that "most companies" were relying on the Moody's database of interest rates to choose the discount rate to apply to their pension liability. The Securities and Exchange Commission (SEC) subsequently challenged that assertion. The federal agency also maintained that GM officials had made no effort to determine whether the companies actually using the Moody's data were "demographically similar to GM" and thus a valid sample to use in supporting the company's decision to rely on that source.

Following the January 7, 2003, meeting, the Deloitte auditors informed client personnel that they would begin their review of the company's decision to apply the 6.75 percent discount rate. The auditors also informed the client that a second meeting to discuss the issue would be necessary. Finally, the auditors noted that their initial impression was that the 6.75 percent discount rate was too high.

A few days later, the Deloitte auditors asked to meet again with the client to discuss the 6.75 percent discount rate. Deloitte insisted that representatives of GM's actuarial firm attend this second meeting. GM's controller also attended this meeting. Following this second meeting, the controller told GM's CFO and CAO that the Deloitte auditors were "now resigned to our use of 6.75%."

GM personnel at this second meeting apparently convinced the Deloitte auditors to accept the 6.75 percent rate by pledging to include a "sensitivity analysis in the company's 2002 Form 10-K." This supplemental disclosure would supposedly illustrate the impact of an array of discount rates on GM's pension-related financial statement items. In an intercompany communication, GM's controller told the CFO and CAO that a Deloitte audit partner accepted this compromise as a "reasonable although imperfect solution or compromise to his concerns." Despite agreeing to the compromise solution proposed by GM, the Deloitte partner believed that a 6.50 percent discount rate would have been a "better choice." Deloitte subsequently issued an unqualified audit opinion on GM's 2002 financial statements.

GM filed its 2002 Form 10-K with the SEC on March 13, 2003. As the company had pledged to Deloitte, it included a sensitivity analysis in the 10-K, relevant to its choice of the 6.75 percent discount rate. That analysis disclosed what GM's pension expense and total pension liabilities would have been for both a 6.5 percent and 7 percent discount rate. If the 6.5 percent discount rate had been applied, the company's

5. The remaining quotes in this case were taken from the following source: *Securities and Exchange Commission v. General Motors Corporation*, Case 1:09-cv-00119, U.S. District Court for the District of Columbia, 22 January 2009.

pension expense for 2002 would have increased by \$120 million, which would have lowered its pre-tax earnings by approximately 6 percent. Likewise, the choice of a 6.5 percent discount rate would have increased GM's total pension liability reported on its balance sheet by approximately 10 percent or \$1.8 billion and would have reduced the company's stockholders' equity by approximately 16 percent or \$1.1 billion.⁶

In a subsequent complaint filed against GM by the SEC in January 2009, the federal agency maintained that the pension-related amounts and disclosures within the company's 2002 financial statements were "materially misleading." The SEC was particularly concerned by GM's lack of candor in the sensitivity analysis that it presented for its selected pension discount rate. Since that analysis disclosed the financial statement impacts of using 6.5 and 7.0 percent discount rates, it implied that the selected discount rate of 6.75 percent was near the midpoint of the discount rates that had been considered by the company, which was not true. The SEC also criticized GM for failing to disclose that an unconventional method had been used to select the 2002 discount rate.

EPILOGUE

In late January 2009, the SEC issued *Accounting and Auditing Enforcement Release No. 3033*, which disclosed a litany of accounting and financial reporting abuses by GM over the previous several years. The principal focus of that document was the improper decisions that the company had made in accounting for its pension-related expenses and liabilities. Without admitting or denying the charges, GM agreed to a consent decree under which the SEC enjoined the company from any future violations of federal securities laws. To date, the SEC has

not sanctioned Deloitte for its role in GM's pension accounting debacle.

Six months after being sanctioned by the SEC, GM emerged from bankruptcy as the "new" General Motors or "General Motors Company." Following GM's reorganization, the federal government was its largest stockholder as a result of investing nearly \$60 billion in the company through the Troubled Asset Relief Program (TARP).⁷ Fortunately for GM's retirees and workforce, the bankruptcy reorganization plan left the company's huge pension plan intact.

Questions

1. Auditing standards don't specifically discuss the audit procedures that should be applied to a client's pension-related financial statement amounts. Identify five audit procedures that would be relevant to those items. For each audit procedure that you list, identify the related audit objective.
2. Under what general circumstances should auditors retain outside experts to assist them in completing an audit? How could an expert be useful in auditing a client's pension-related financial statement items?

6. In its 2002 Form 10-K, GM reported total assets of \$370.8 billion, total liabilities of \$364 billion, and total stockholders' equity of \$6.8 billion.

7. On November 17, 2008, General Motors Company went public. On that day, trading in GM's stock accounted for nearly 10 percent of the trading volume on the New York Stock Exchange. Most financial analysts predict that the federal government will eventually recover the full amount of the nearly \$60 billion it invested in the company by selling the GM stock that it owns.

3. Do you believe that Deloitte behaved properly by accepting GM's decision to apply a 6.75 percent discount rate to its pension liabilities? What, if any, other steps or measures should Deloitte have taken under the circumstances?
4. Did the choice of the 6.75 percent discount rate in 2002 have a material impact on GM's financial statements? Defend your answer.

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