

Case 3.2

Waste Management: A Focus on Company Level Controls

Synopsis

In February 1998, Waste Management announced that it was restating the financial statements it had issued for the years 1993 through 1996. In its restatement, Waste Management said that it had materially overstated its reported pretax earnings by \$1.43 billion. After the announcement, the company's stock dropped by more than 33 percent and shareholders lost over \$6 billion.

The SEC brought charges against the company's founder Dean Buntrock and five other former top officers. The charges alleged that management had made repeated changes to depreciation-related estimates to reduce expenses and had employed several improper accounting practices related to capitalization policies, also designed to reduce expenses.¹⁴⁷

Upper Management Turnover

In the summer of 1996, Dean Buntrock, who founded Waste Management in 1968, retired as CEO, but he continued to serve as chairman of the Board of Directors. Buntrock was initially replaced as CEO by Phillip Rooney, who had started working at Waste Management in 1969. By early 1997, Rooney resigned as director and CEO because of mounting shareholder discontent.

After a new five-month search, Waste Management chose Ronald LeMay, the president and COO of Sprint, to assume its post of chairman and CEO. Surprisingly, just three months into his new role, LeMay quit to return to his former job at Sprint.

In addition, several other key executives who, unlike LeMay, had worked for Waste Management for several years—including CFO James Koenig, Corporate Controller Thomas Hau, and Vice President of Finance Bruce Tobecksen—also resigned by the end of 1997.

¹⁴⁷ SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

“Top-Side” Adjustments and Other Fraudulent Schemes

In February 1998, Waste Management announced it was restating the financial statements that it had previously issued for the years 1993 through 1996. While shareholders lost billions of dollars, management had already collected salaries and bonuses based on the inflated earnings and the resulting stock options. When the company’s improper accounting was revealed, the SEC described a fraudulent scheme that was perpetrated by several members of top management.

Specifically, the SEC brought charges against founder Buntrock and five other former top officers on charges of fraud. The SEC alleged that top management had made several “top-side” adjustments in the process of consolidating the results reported by each of their operating groups and intentionally hid these adjustments from the operating groups themselves. In addition, upper management had employed several other improper accounting practices designed to reduce expenses and artificially inflate earnings.¹⁴⁸

Specifically, to help conceal the intentional understatement of expenses, top management allegedly used a practice known as *netting*, whereby one-time gains realized on the sale or exchange of assets were used to eliminate unrelated current period operating expenses, as well as accounting misstatements that had accumulated from prior periods. In addition, it was also alleged that management made use of *geography* entries, which involved moving millions of dollars to different line items on the income statement. Essentially, these entries made it harder for auditors to compare operating results over time, a key audit procedure used by Arthur Andersen. Finally, top management allegedly made or authorized several false and misleading disclosures in financial statements.¹⁴⁹ The company’s auditor had proposed a series of action steps in early 1994 to help adjust their improper accounting. However, rather than following these steps, top management at Waste Management allegedly continued to manipulate their results in 1994, 1995, and 1996.

Senior Executives Charged with Fraudulent Activity

In March 1994, Executive Vice President and CFO James Koenig, who had worked as an auditor at Arthur Andersen

¹⁴⁸ SEC v. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen, Complaint No. 02C 2180 (Judge Manning).

¹⁴⁹ Ibid.

before joining Waste Management in 1977, allegedly instructed a purchasing agent to draft a memo that concluded it supported one of the company's salvage value estimates used to calculate depreciation expense. In fact, during November 1995, a study was initiated to determine the appropriate useful lives and salvage values of the company's vehicles, equipment, and containers. Koenig allegedly ordered the study be stopped after a memo was released in 1996 which apparently suggested that the company's salvage values should be reduced (which would have increased depreciation expense). Koenig also supposedly ordered the destruction of all copies of the memo and that the document be deleted from the author's hard drive. The memo was never provided to the company's auditors.

A complete profile of the accused senior executives is provided in Table 3.2.1. Top management profited from their fraudulent accounting, in at least two ways. First, through bonuses received that were based on the fraudulently inflated net income amounts. And second, through stock options which increased in value as the share price increased on the news of inflated net income amounts. In total, the SEC brought charges of fraud against six former top executives and calculated their ill-gotten gains, based on their bonuses, retirement benefits, trading, and charitable giving alone.

TABLE 3.2.1 Ill-Gotten Gains

Executive	Title	Profile	Alleged Ill-Gotten Gains
Dean Buntrock	Founder, chairman of the Board of Directors, and CEO	Founded Waste Management in 1968. In June 1996, retired as CEO, but continued to serve as chairman of the Board of Directors. Also served as CEO on an interim basis from February of 1997 until July 1997 and continued to serve on the Board until his resignation on December 31, 1997.	\$16,917,761
Phillip Rooney	President, COO, director, and CEO	Started working at Waste Management in March 1969 and first became an officer in 1971. Became chairman of Waste Management's largest subsidiary, Waste Management of North America, in October 1993. In June 1996, Rooney replaced Buntrock as CEO of the company. In February 1997, resigned as director and CEO.	\$9,286,124
James Koenig	Executive vice president and CFO of Waste Management	Began employment with the company in July 1977. Like every CFO who preceded him, Koenig worked as an auditor at Arthur Andersen. In January 1997, Koenig was fired from the CFO position because of shareholder discontent, but he continued to have responsibility for financial, accounting, and reporting matters.	\$951,005
Thomas Hau	Vice president, corporate controller, and CAO	Served as vice president, corporate controller and CAO from September 1990 to October 1997. Remained vice president until his	\$640,100

retirement on April 3, 1998. Like every CAO that preceded him, Hau worked as an auditor at Arthur Andersen, where he was a partner for 30 years. While at AA, Hau was the partner in charge of the Waste Management audit from 1976 to 1983 and, later, he became head of the AA audit division that handled the Waste Management account. Hau was again slotted to become engagement partner for the Waste Management audit in 1990, but he resigned from AA after Buntrock invited him to join Waste Management.

Herbert Getz	Senior vice president, general counsel, and secretary	Began employment with the company in 1983, Getz retired from the Company in late 1998. Prior to coming to Waste Management, Getz was a lawyer at the firm that had served as outside counsel to Waste Management and its officers since 1968.	\$472,500
Bruce Tobecksen	Vice president of finance	Vice president of finance until December of 1997, when he was asked to leave by the new CFO of Waste Management. Prior to holding that position, from 1987 to February 1993, Tobecksen was CFO of Chemical Waste Management, a subsidiary of Waste Management. Before joining Waste Management in 1979, Tobecksen worked as an audit manager at AA and, during a portion of that time, he worked on the Waste Management audit.	\$403,779

Case Questions

1. Three conditions are likely to be present when a fraud occurs. What are they? Based on your understanding of the Waste Management case, which of the three conditions appears to be most prevalent and why?
2. Briefly summarize what is meant by Paragraphs #76–78 of PCAOB Auditing Standard No. 2. Do you believe that the period-end financial reporting process deserves special attention from auditors? Why or why not?
3. Please consult Paragraphs #55–59 of PCAOB Auditing Standard No. 2 and Section 301 of SOX. What is the role of the audit committee in the financial reporting process? Do you believe that an audit committee can be effective in providing oversight of a management team such as that of Waste Management?
4. Consult Sections 302, 305, and Title IX of SOX. Do you believe that these new provisions will help to deter fraudulent financial reporting by a top management group such as that of Waste Management? Why or why not?