Case A.2

Waste Management

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.[350a]

The SEC also brought charges against Waste Management's auditor Arthur Andersen, alleging that it knowingly or recklessly issued materially false and misleading audit reports for the period 1993 through 1996. Andersen settled with the SEC for $7 million, the largest-ever civil penalty at the time, without admitting or denying any allegations or findings.[351]

History

In 1956, Dean Buntrock took over Ace Scavenger, a garbage collector owned by his then father-in-law who had recently died. After merging Ace with a number of other waste companies, Buntrock founded Waste Management in

[350a] 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).

[351] SEC, "Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More Than 20 Years and Largest-Ever Civil Penalty ($7 million) in SEC Enforcement Action against a Big Five Accounting Firm," Press Release 2001–62.

1968.[352] Under Buntrock's reign as its CEO, the company went public in 1971, and then expanded during the 1970s and 1980s though several acquisitions of local waste hauling companies and landfill operators. At one point, the company was performing close to 200 acquisitions a year.[353]

From 1971 to 1991, the company enjoyed 36 percent average annual growth in revenue and 36 percent annual growth in net income. By 1991, Waste Management had become the largest waste removal business in the world, with revenue of more than $7.5 billion.[354] Despite a recession, Buntrock and other executives at Waste Management continued to set aggressive goals for growth. For example, in 1992, the company forecasted that revenue and net income would increase by 26.1 percent and 16.5 percent, respectively, over 1991's figures.[355, 356, 357]

Waste Management's Core Operations

Waste Management's core solid waste management business in North America consisted of the following major processes: collection, transfer, and disposal.

Collection

Solid waste management collection to commercial and industrial customers was generally performed under one- to three-year service agreements. Most of its residential solid waste collection services were performed under contracts with—or franchises granted by—municipalities giving it exclusive rights to service all or a portion of the homes in

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[352] "Waste Management: Change with the Market or Die," *Fortune*, January 13, 1992.

[353] 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).

[354] 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).

[355] 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).

[356] 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).

[357] 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).

their respective jurisdictions. These contracts or franchises usually ranged in duration from one to five years. Factors that contributed to the determination for fees collected from industrial and commercial customers were market conditions, collection frequency, type of equipment furnished, length of service agreement, type and volume or weight of the waste collected, distance to the disposal facility, and cost of disposal. Similar factors determined the fees collected in the residential market.[358]

Transfer

As of 1995, Waste Management operated 151 solid waste transfer stations, facilities where solid waste was received from collection vehicles, and then transferred to trailers for transportation to disposal facilities. In most instances, several collection companies used the services of these facilities, which were provided to municipalities or counties. Market factors, the type and volume or weight of the waste transferred, the extent of processing of recyclable materials, the transport distance involved, and the cost of disposal were the major factors that contributed to the determination of fees collected.[359]

Disposal

As of 1995, Waste Management operated 133 solid waste sanitary landfill facilities, 103 of which were owned by the company. All of the sanitary landfill facilities were subject to governmental regulation aimed at limiting the possibility of water pollution. In addition to governmental regulation, land scarcity, and local resident opposition also conspired to make it difficult to obtain permission to operate and expand landfill facilities in certain areas. The development of a new facility also required significant up-front capital investment and a lengthy amount of time, with the added risk that the necessary permit might not be ultimately issued. In 1993, 1994, and 1995 approximately 52 percent, 55 percent, and 57 percent, respectively, of the solid waste collected by Waste Management was disposed of in sanitary landfill facilities operated by it. These facilities were typically also used by other companies and government agencies on a noncontract basis for fees determined by market factors, and the type and volume or weight of the waste.[360]

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[358] 1995 10-K.

[359] 1995 10-K.

[360] 1995 10-K.

Corporate Expansion

As the company grew, Waste Management expanded its international operations and into new industries, including hazardous waste management, waste-to-energy, and environmental engineering businesses. By the mid-1990s, Waste Management had five major business groups that provided the following services: solid waste management, hazardous waste management, engineering and industrial services, trash-to-energy, water treatment, and air quality services, and international waste management. (See Table 2.2.1 for a description of the primary services these groups provided and revenues in 1993, 1994, and 1995.)

Challenges

By the mid-1990s, the company's core North American solid waste business was suffering from intense competition and excess landfill capacity in some of its markets. New environmental regulations also added to the cost of operating a landfill, and they made it more difficult and expensive for Waste Management to obtain permits for constructing new landfills or expand old ones.[361]

TABLE 2.2.1 Waste Management's Major Business Groups

		Revenues ($000)		
Business Group	**Services**	**1993**	**1994**	**1995**
Solid waste management	Garbage collection, transfer, resource recovery, and disposal for commercial, industrial, municipal, and residential customers, as well as to other waste management companies. Included recycling of paper, glass, plastic and metal, removal of methane gas from sanitary landfill facilities for use in electricity generation, and medical and infectious waste management services to hospitals and other	4,702,166	5,117,871	5,117,871

[361] 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).

	health care and related facilities.			
Hazardous waste management	Chemical waste treatment, storage, disposal, and related services provided commercial and industrial customers, governmental entities, and other waste management companies by Waste Management and Chemical Waste Management (CWM), a wholly owned subsidiary; onsite integrated hazardous waste management services provided by Advanced Environmental Technical Services (AETS), a 60 percent-owned subsidiary; and low-level radioactive waste disposal services provided by subsidiary Chem-Nuclear Systems.	661,860	649,581	613,883
Engineering and industrial	Through Rust International, a 60 percent-owned subsidiary provides environmental and infrastructure engineering and consulting services, primarily to clients in government and in the chemical, petrochemical, nuclear, energy, utility, pulp and paper, manufacturing, environmental services, and other industries.	1,035,004	1,140,294	1,027,430
Trash-to-energy, water treatment, air quality	Through Wheelabrator Technologies Inc. (WTI), a 58 percent-owned subsidiary, develops, arranges financing for, operates, and owns facilities that dispose of trash and other waste materials by recycling them into electrical or steam energy. Also designs, fabricates, and installs technologically advanced air pollution control, and systems and equipment. WTI's clean water group is principally	1,142,219	1,324,567	1,451,675

	involved in design, manufacture, operation, and ownership of facilities and systems used to purify water, to treat municipal and industrial wastewater, and to recycle organic wastes into compost material useable for horticultural and agricultural purposes.			
International waste management	Solid and hazardous waste management and related environmental services in ten countries in Europe and in Argentina, Australia, Brazil, Brunei, Hong Kong, Indonesia, Israel, Malaysia, New Zealand, Taiwan, and Thailand. Also has 20 percent interest in Wessex Water Plc, an English publicly traded company providing water treatment, water distribution, wastewater treatment, and sewerage services.	1,411,211	1,710,862	1,865,081
Consolidated Revenue*		8,636,116	9,554,705	10,274,617

*Intercompany revenue eliminations in 1993, 1994, and 1995, respectively, were as follows: $(316,344), ($388,470), ($353,309).

Several of Waste Management's other businesses (including its hazardous waste management business and several international operations) were also performing poorly. After a strategic review that began in 1994, the company was reorganized into four global lines of business: waste services, clean energy, clean water, and environmental and infrastructure engineering and consulting.[362]

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 by Phillip Rooney, who had started working at Waste Management in 1969. In early 1997, Rooney resigned as director and CEO because of mounting shareholder discontent.

[362] 1995 10-K.

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.

Capitalization of Landfill Costs and Other Expenses[363]

Waste Management capitalized the costs related to obtaining the required permits to develop and expand its many landfills. It also capitalized interest on landfill construction costs, as well as costs related to systems development.

GAAP for Capitalizing Costs

Under GAAP, a cost can be capitalized if it provides economic benefits to be used or consumed in future operations. A company is required to write off, as a current period expense, any deferred costs at the time the company learns that the underlying assets have either been impaired or abandoned. Any costs to repair or return property to its original condition are required to be expensed when incurred. Finally, interest can be capitalized as part of the cost of acquiring assets for the period of time that it takes to put the asset in the condition required for its intended use. However, GAAP requires that the capitalization of interest must cease once the asset has become substantially ready for its intended use.

Capitalization of Landfill Permitting Costs

As part of its normal business operations, Waste Management allocated substantial resources toward the development of new landfills and the expansion of existing landfills. A significant part of the landfill development and expansion costs related to the process of obtaining required permits from the appropriate government authorities. Over the years, the company faced increased difficulty in obtaining the required landfill permits; it often was faced with having invested significantly in projects that had to be abandoned or materially impaired.

The company routinely capitalized the costs related to obtaining the required permits, so that it could defer

[363] 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), www.sec.gov/litigation/complaints/complr17435.htm.

recording expenses related to that landfills until they were put in productive use. However, instead of writing off the costs related to impaired and abandoned landfill projects, and disclosing the impact of such write-offs, management only disclosed the *risk* of future write-offs related to such projects.

The management team of Waste Management also allegedly engaged in transferring the costs of unsuccessful efforts to obtain permits for certain landfill sites to other sites that had received permits or other sites for which they were still seeking permits. In effect, they were commingling impaired or abandoned landfill project costs with the costs of a permitted site (a practice known as "basketing", which did not comply with GAAP). In addition to basketing, the company also allegedly engaged in transferring unamortized costs from landfill facilities that had closed earlier than expected to other facilities that were still in operation (a practice known as "bundling", which also did not comply with GAAP). Management never disclosed the use of bundling or basketing in its form 10K.

In 1994, after its auditor Arthur Andersen discovered these practices, management agreed to write off $40 million related to "dead" projects over a span of ten years; management also promised to write off future impairments and abandonments in a prompt manner. However, during 1994, 1995, 1996, and 1997, management effectively "buried" the write-offs related to abandoned and impaired projects by "netting" them against other gains, as opposed to identifying the costs separately.

Capitalization of Interest on Landfill Construction Costs

In accordance with GAAP, Waste Management was able to capitalize interest related to landfill development because of the relatively long period of time required to obtain permits, construct the landfill, and, ultimately, prepare it to receive waste. However, Waste Management utilized a method, referred to as the net book value (NBV) method that, essentially, enabled it to avoid GAAP's requirement that interest capitalization cease once the asset became substantially ready for its intended use. Waste Management's auditor, Arthur Andersen, advised the company from its first use of the NBV method (in 1989), that this method did not conform to GAAP.

Corporate controller Thomas Hau even admitted that the method was "technically inconsistent with FAS Statement No. 34 [the controlling GAAP pronouncement] because it included interest [capitalization] related to cells of landfills that were receiving waste." Yet, the company wrote in the footnotes to its financial statements that "[i]nterest has been capitalized on significant landfills, trash-to-energy plants, and other projects under development in accordance with FAS No. 34."

Ultimately, the company agreed to utilize a new method, one that conformed to GAAP, beginning January 1, 1994. Corporate controller Thomas Hau and CFO James Koenig allegedly determined that the new GAAP method would result in an increased annual interest expense of about $25 million and therefore, they chose to phase in the new method over a period of three years, beginning in 1995. However, the company appeared to still utilize the NBV method for interest capitalization as of 1997.

Capitalization of Other Costs

The company's management also chose to capitalize other costs, such as systems development costs, rather than record them as expenses in the period in which they were incurred. In fact, they allegedly used excessive amortization periods (10- and 20-year periods for the two largest systems) that did not recognize the impact of technological obsolescence on the useful lives of the underlying systems.

The company's auditor Arthur Andersen proposed several adjusting journal entries to write off the improperly deferred systems development costs. Andersen also repeatedly advised management to shorten the amortization periods. In 1994, management finally agreed to shorten the amortization periods and to write off financial statement misstatements resulting from improperly capitalized systems costs over a period of five years. During 1995, management changed the amortization periods and wrote off improperly capitalized systems costs by "netting" them against other gains.

Waste Management's Fixed Asset Accounting Process

The major fixed assets of Waste Management's North American business consisted of garbage trucks, containers, and equipment, which amounted to approximately $6 billion in assets. The second largest asset of the company (after vehicles, containers, and equipment) was land, in the form of the more than one hundred fully operational landfills that the company both owned and operated. Under GAAP, depreciation expense is determined by allocating the historical cost of tangible capital assets (less the salvage value), over the estimated useful life of the assets.

Unsupported Changes to the Estimated Useful Lives of Assets

From 1988 through 1996, management allegedly made numerous unsupported changes to the estimated useful lives and/or the salvage values of one or more categories of vehicles, containers, or equipment. Such changes had the effect of reducing the amount of depreciation expense recorded in particular periods. In addition, such changes were recorded as top-side adjustments, at the corporate level (detached from the operating unit level). Most often, the entries were made during the fourth quarter, and then improperly applied cumulatively from the beginning of the year. It appeared that management never disclosed the changes or their impact on profitability to their investors.[364]

Carrying Impaired Land at Cost

Because of the nature of landfills, GAAP also requires that a company compare a landfill's cost to its anticipated salvage value, with any difference depreciated over its estimated useful life. Waste Management disclosed in the footnotes to the financial statements in its annual reports that "[d]isposal sites are carried at cost and to the extent this exceeds end use realizable value, such excess is amortized over the estimated life of the disposal site." However it was later uncovered that Waste Management carried almost all of its landfills on the balance sheet at cost.[365]

Auditor Assessment[366]

In a letter to the management team dated May 29, 1992, Arthur Andersen's team wrote, "[i]n each of the past five years the Company added a new consolidating entry in the fourth quarter to increase salvage value and/or useful life of its trucks, machinery, equipment, or containers." Andersen recommended that the company conduct a "comprehensive, one-time study to evaluate the proper level of [WMNA's salvage value and useful lives," and then send these adjustments to the respective WMNA groups. Top management continued to change depreciation estimates at headquarters, however.

In March 1994, Executive Vice President and CFO James Koenig, who had worked as an auditor at Arthur Andersen before joining Waste Management in 1977, allegedly instructed a purchasing agent to draft a memo concluding that the agent supported one of the company's salvage value estimates. In November 1995, a study was initiated to determine the appropriate lives and salvage values of the company's vehicles, equipments, and containers. Koenig allegedly ordered the study to be stopped after he was informed that the interim results of the study revealed that the company's salvage values should be reduced. Koenig also was said to have ordered the destruction of all copies of the memo that released the study's interim results and that the document be deleted from

[364] 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), www.sec.gov/litigation/complaints/complr17435.htm.

[365] Ibid.

[366] Ibid.

the author’s hard drive. The memo was never provided to the company’s auditors.

Regarding the issue of Waste Management’s treatment of landfills on the balance sheet, Andersen issued a management letter to the Board of Directors recommending that the company conduct a “site by site analysis of its landfills to compare recorded land values with its anticipated net realizable value based on end use” after its 1988 audit. Andersen further instructed that any excess needed to be amortized over the “active site life” of the landfill. Andersen made similar demands after its audit in 1994. Despite this letter, management never conducted such a study and they also failed to reduce the carrying values of overvalued land, despite their commitment to do so after Andersen’s audit in 1994.

Top-Side Adjusting Journal Entries

Top-side adjusting journal entries are typically made by upper managers at the end of the reporting process, usually at corporate headquarters. Because these journal entries are typically not generated at the business process (e.g., internet sales) or the business unit level (e.g., the North American Division), they can be used as a way for upper managers to circumvent the internal control system and possibly perpetrate a fraud.

Waste Management seemed to use top-side adjusting entries when consolidating the results of several of its business units and entities in which the company had an interest, to prepare its annual and quarterly financial statements. Indeed, Waste Management’s use of several unbudgeted and unsupported top-side adjustments in the early 1990s caused observers (including Arthur Andersen) to question whether management had employed these adjustments as tools to help “manage” their reported earnings.

Waste Management set its earnings’ targets during an annual budget process. The company followed a “top down budgeting process,” whereby the CEO (Buntrock until 1996, Rooney from Buntrock’s retirement until early 1997) set goals for earnings growth and the operating units would, in turn, determine their budgets based on the goals set at the top. The budgets were then consolidated to arrive at the budgeted consolidated earnings. At this time, the upper managers also set budgets for the anticipated top-side adjustments, which were based on the existing accounting assumptions used.

As operating results were recorded by Waste Management’s operating units at the end of each quarter, upper management allegedly monitored the gap between the results and the goals and made a number of different types of unbudgeted top-side adjusting entries to “close the gap.” Management did not disclose to investors the impact of the top-side adjustments on the company's earnings. In fact, management did not inform its own internal operating units about the top-side adjusting entries that were made and their resulting expense reductions.

As early as 1992, the company's auditor Arthur Andersen advised management against its use of top-side adjusting entries as a tool to manage its earnings in a postaudit letter recommending accounting changes. Andersen auditors wrote that "individual decisions are not being evaluated on the true results of their operations" as a result of the extensive use of top-side adjustments. Andersen recommended that "all such corporate adjustments should be passed back to the respective" divisions. Yet, top management allegedly increased the budget for the top-side adjustments from 1992 to 1997, and, each year, the actual adjustments made exceeded the budgeted adjustments. From the first quarter of 1992 through the first quarter of 1997, top management used unsupported top-side adjustments in 14 of the 21 quarters to achieve reported results that ultimately fell within the range of the company's public earnings' projections or its internal budgeted earnings.

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 and that it had understated elements of its tax expense by $178 million. When the company's improper accounting was revealed, the stock dropped by more than 33 percent and shareholders lost over $6 billion.

Waste Management's Relationship with Independent Auditor Arthur Andersen

Even before Waste Management became a public company in 1971, Arthur Andersen served as the company's auditor. In the early nineties, Waste Management capped Andersen's corporate audit fees at the prior year's level, although it did allow the firm to earn additional fees for "special work." Between 1991 and 1997, Andersen billed Waste Management approximately $7.5 million in audit fees.[367] During this seven-year period, Andersen also billed Waste Management $11.8 million in fees related to the following services: $4.5 million for audit work under ERISA, special purpose letters (EPA), franchise audits and other reports, registration statements and comfort letters, International Public Offering, SFAS 106 and 109 adoption, accounting research/discussions and other (audit

[367] SEC Auditing and Enforcement Release No. 1410, June 19, 2001.

committee meetings); $4.5 million for various consulting services that included $450,000 for information systems consulting; and $1.1 million for miscellaneous other services.[368]

During the nineties, approximately 14 former Andersen employees worked for Waste Management.[369] While at Andersen, most of these individuals worked in the group responsible for auditing Waste Management's financial statements prior to 1991, and all but a few had left Andersen more than ten years before the 1993 financial statement audit commenced.[370]

In fact, until 1997, every cheif financial officer (CFO) and cheif accounting officer (CAO) at Waste Management since it became public had previously worked as an auditor at Andersen. Waste Management's CAO and corporate controller from September 1990 to October 1997, Thomas Hau, was a former Andersen audit engagement partner for the Waste Management account. At the time Hau left Andersen, he was the head of the division within Andersen responsible for conducting Waste Management's annual audit, but he was not the engagement partner at that time.[371]

Andersen's Engagement Partners on Waste Management Audit

In 1991, Andersen assigned Robert Allgyer, a partner at Andersen since 1976, to become the audit engagement partner for the Waste Management audit engagement. He held the title of "Partner-in-Charge of Client Service" and served as marketing director for Andersen's Chicago office. Among the reasons for Allgyer's selection as engagement partner: his "extensive experience in Europe" his "devotion to client service" and his "personal style that … fit well with the Waste Management officers."[372] In setting Allgyer's compensation, Andersen took into account fees for audit and nonaudit services.[373] Walter Cercavschi, who was a senior manager when he started working on the Waste Management engagement team in the late eighties, remained on the engagement after becoming partner in

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368 SEC Auditing and Enforcement Release No. 1405, June 19, 2001.

369 SEC Auditing and Enforcement Release No. 1410, June 19, 2001.

370 SEC Auditing and Enforcement Release No. 1405, June 19, 2001.

371 Ibid.

372 Ibid.

373 Ibid.

1994.

In 1993, Edward Maier became the concurring partner on the engagement. As concurring partner, Maier's duties included reading the financial statements; discussing significant accounting, auditing, or reporting issues with the engagement partner; reviewing certain working papers (such as the audit risk analysis, final engagement memoranda, summaries of proposed adjusting, and reclassifying entries); and inquiring about matters that could have a material effect on the financial statements or the auditor's report. Maier also served as the risk management partner for the Chicago office in charge of supervising such processes as client acceptance and retention decisions.[374]

Andersen's Proposed Adjusting Journal Entries

In early 1994, the Andersen engagement team quantified several current and prior period misstatements and prepared Proposed Adjusting Journal Entries (PAJEs) in the amount of $128 million for the company to record in 1993. If recorded, this amount would have reduced net income before special items by 12 percent. The engagement team also identified accounting practices that gave rise to other known and likely misstatements primarily resulting in the understatement of operating expenses.[375]

Allgyer and Maier consulted with Robert Kutsenda, the Practice Director responsible for Andersen's Chicago, Kansas City, Indianapolis, and Omaha offices. Kutsenda and the Audit Division head, who was also consulted, determined that the misstatements were not material and that Andersen could, therefore, issue an unqualified audit report on the 1993 financial statements. Nevertheless, they instructed Allgyer to inform management that Andersen expected the company to change its accounting practices and to reduce the cumulative amount of the PAJEs in the future.[376] After consulting with the Managing Partner of the firm, Allgyer proposed a "Summary of Action Steps" to reduce the cumulative amount of the PAJEs, going forward, and to change the accounting practices that gave rise to the PAJEs, and to the other known and likely misstatements.[377]

Although the company's management agreed to the Action Steps, the company allegedly continued to engage in

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[374] Ibid.

[375] Ibid.

[376] Ibid.

[377] Ibid.

the accounting practices that gave rise to the PAJEs, and the other misstatements. Nevertheless, Andersen's engagement team issued unqualified audit reports on Waste Management's financial statements, despite its failure to conform to GAAP. In fact, Waste Management's financial statements for the years 1993 through 1996 overstated the company's pre-tax income by more than $1 billion.[378]

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The SEC brought charges against founder Buntrock and five other former top officers on charges of earnings management fraud. The SEC's charges 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, top management had allegedly employed several other improper accounting practices to reduce expenses and artificially inflate earnings.[379]

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. Top management also allegedly made use of "geography entries", which involved moving millions of dollars to different line items on the income statement to make it harder to compare results across time. In addition, management allegedly made or authorized false and misleading disclosures in financial statements.[380]

Because the financial statements for the years 1993 through 1996 were not presented in conformity with GAAP, Waste Management's independent auditor, Arthur Andersen, came under fire for issuing unqualified opinions on these financial statements. The SEC filed suit against Andersen on charges that it knowingly or recklessly issued materially false and misleading audit reports for the period 1993 through 1996. Andersen settled with the SEC for $7

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[378] SEC, "Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More Than 20 Years and Largest-Ever Civil Penalty ($7 million) in SEC Enforcement Action against a Big Five Accounting Firm," Press Release 2001–62.

[379] 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).

[380] Ibid.

million, the largest-ever civil penalty at the time, without admitting or denying any allegations or findings.[381]

Three Andersen partners who worked on the Waste Management audit during the period 1993 through 1996 were implicated in the SEC's charges: Robert Allgyer, the partner responsible for the Waste Management engagement; Edward Maier, the concurring partner on the engagement and the risk management partner for Andersen's Chicago office; and Walter Cercavschi, a partner on the engagement. Allgyer, Maier, and Cercavschi agreed to pay a civil money penalty of $50,000, $40,000, and $30,000, respectively. Allgyer, Maier, and Cercavschi were also denied privileges of practicing before the SEC as an accountant, with the right to request reinstatement after five years, three years, and three years, respectively. A fourth Andersen partner, Robert Kutsenda, the Central Region Audit Practice Director responsible for Andersen's Chicago, Kansas City, Indianapolis, and Omaha offices, was also implicated in the SEC charges for improper conduct. Kutsenda was penalized by being denied the privilege of practicing before the SEC as a accountant. Kutsenda was given the right to request reinstatement after one year.[382]

Comprehensive List of Case Questions

1. Please consult Paragraph 32 of PCAOB Auditing Standard No. 2. In what ways was Arthur Andersen's independence, in fact or in appearance, potentially impacted on the Waste Management audit, if any?
2. Considering the example in the Waste Management case, please explain why a review by the Practice Director and the Audit Division Head is important in the operations of a CPA firm. In your opinion, was this review effective in the present context, at Waste Management? Why or why not?
3. Please explain what is meant by PAJEs. Do you believe that Andersen's final decision regarding the PAJE's was appropriate, under the circumstances? Would your opinion change if you knew that all of the adjustments were based on subjective differences (e.g., a difference in the estimate of the allowance for doubtful accounts), as compared to objective differences (e.g., a difference in the account receivable balance of their biggest customer)?

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[381] SEC, "Arthur Andersen LLP Agrees to Settlement Resulting in First Antifraud Injunction in More Than 20 Years and Largest-Ever Civil Penalty ($7 million) in SEC Enforcement Action against a Big Five Accounting Firm," Press Release 2001–62.

[382] SEC Auditing and Enforcement Release No. 1410, June 19, 2001.

4. Please refer to Section 203 and Section 206 of SOX. How would these sections of the law have impacted the Waste Management audit? Do you believe that these sections were needed? Why or why not?
5. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Waste Management that might cause you to elevate inherent risk. When identifying each factor, indicate the financial statement account that is likely to be most affected (and briefly discuss why it is most affected).
6. Consult Paragraphs #71–72 of the PCAOB Auditing Standard No. 2. Next, identify the types of revenue earned (a brief description will do) by Waste Management. Do you believe that any of the different types of revenue earned by Waste Management would have a "different level" of inherent risk? Why or why not?
7. Please consult Q39 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the different types of revenue earned (in Question #2) would influence the nature, timing, and extent of your audit work at Waste Management.
8. Please consult Paragraphs #24–25 of the PCAOB Auditing Standard No. 2. For one of Waste Management's revenue sources (choose one), please brainstorm about how a fraud might occur. Next, identify an internal control procedure that would prevent, detect, or deter such a fraudulent scheme.
9. In your own words, please explain what is meant by a "top-side" adjusting journal entry. If you were auditing Waste Management, what type of documentary evidence would you require to evaluate the propriety of a "top-side" journal entry?
10. Please consult Paragraph #16 of PCAOB Auditing Standard No. 2. Based on the case information, do you think this paragraph relates to the use of top-side adjusting journal entries at Waste Management? Why or why not?
11. Consult Paragraphs #76–78 of PCAOB Auditing Standard No. 2. Do you believe that the period-end financial reporting process should always be a significant process in an audit of internal control? Why or why not?
12. Please refer to Paragraphs #84–85 of PCAOB Auditing Standard No. 2. Identify one specific control procedure that could be designed to prevent the occurrence of or detect a misstatement related to a top-side adjusting entry.
13. Please describe why "basketing" and "bundling" are not appropriate under GAAP. As an auditor, what type of evidence would allow you to detect whether your client was engaging in "basketing" or "bundling"?
14. Describe why "netting" would be effective for Waste Management's management team when trying to cover up their fraud. As an auditor, what type of evidence would allow you to detect whether your client was using this

type of practice, designed to mask fraudulent behavior?

15. As an auditor, what type of evidence would you want to examine to determine whether Waste Management was inappropriately capitalizing interest expense and recording the amount as an addition to a fixed assets account?
16. Please consult Paragraph #60 and Paragraphs 68–70 of the PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the improper capitalization practices of Waste Management? Why?
17. Under what circumstances is a company allowed to change the useful lives and salvage values of its fixed assets under GAAP? As an auditor, what type of evidence would you want to examine to determine whether Waste Management's decision to change the useful lives and salvage values of its assets was appropriate under GAAP?
18. Please consult Paragraph #60 and Paragraphs #68–70 of PCAOB Auditing Standard No. 2. What is the most relevant financial statement assertion(s) about which financial statement account(s) related to the treatment of depreciation expense on fixed assets at Waste Management?
19. If you were auditing Waste Management in 1995 and you discovered that neither the Board of Directors nor the Management Team conducted a "site by site analysis" of the landfills that you had recommended the year before, what action, if any, would you take? Why?
20. Please consult Paragraph #84 of the PCAOB Auditing Standard No. 2. The paragraph states that "the auditor should clearly link individual controls with the significant accounts and assertions to which they relate." For the assertion identified in Question #2, please identify a specific internal control activity that would help to prevent or detect a misstatement related to depreciation expense at Waste Management.