Case 4.4 waste management

Waste Management, Inc. Waste Management, Inc. , incorporated in 1968, had become a leader in the industry of waste management services ranging from industrial operations to curbside collection. This company had become synonymous with many different kinds of disposal services that allowed for the company to grow and grow with a solid base over the course of twenty-eight years. Finally in 1996, the company reported total assets of almost $20 billion with net income close to $200 million. However, even with this growth and solid base, the company was feeling competitive pressures and net income was on the decline.

Everyone from local to national collection companies were now charging less to the customer and this was taking a major toll on the gross margins and net income of Waste Management. With a balance sheet that was heavily based on equipment and land Waste Management was beginning to see that the only way to keep the company growing was to use depreciation and salvage value manipulation to lower the direct hits of these expenses. Now that the issues were becoming large enough to notice, the SEC began stepping in to investigate the operations, assets and accounting methods that were being used.

Due to this, the company issued a release saying they would be amending and restating certain periods of their reporting and issuing new form 10-Ks and 10-Qs. Once the restatement occurred and a $3. 5 billion dollar loss was found the company’s incorrect accounting processes were finally exposed. This resulted in net losses for the company as well as debt and equity ratings dropping precipitously. The SEC now launched a formal investigation into the accounting processes and found many misstatements from avoiding depreciation to improper capitalization and failure to accrue to proper liabilities.

Many techniques were used and the end result was that many of the management team's members were named as defendants in this case as it was seen that they were the ones who were primarily responsible for the execution of this fraud. Through the investigation, it was found that Arthur Andersen helped to keep the fraud going by not demanding that PAJEs be undertaken to correct errors. Instead, Arthur Andersen, who viewed Waste Management as their " jewel" client, entered into an agreement with Waste Mangement to fix these errors in coming years.

This constituted an agreement to cover up fraud and Andersen was then sued for civil fraud by the SEC that carried a heavy price. The company stock plunged and Arthur Andersen's partners were fined and banned from the auditing of public companies for up to five years. This overall lack of internal control and greed in the company ultimately led to a downfall for many partners and managing members at both Andersen and Waste Management. Case Questions: 1) Three conditions are often present when fraud exists.

First, management or employees have an incentive or are under pressure, which provides them a reason to commit the fraud act. Second, circumstances exist – for example, absent or ineffective internal controls or the ability for management to override controls – that provide an opportunity for the fraud to be perpetrated. Third, those involved are able to rationalize the fraud as being consistent with their personal code of ethics. Some individuals possess an attitude, character, or set of ethical values that allows them to knowingly commit a fraudulent act.

Using hindsight, identify factors present at Waste Management that are indicative of each of the three fraud conditions: incentives, opportunities, and attitudes. Incentive Management teams of publicly traded companies are always under enormous pressure from shareholders to meet and exceed earnings expectations. Many shareholders view year over year growth, and performance vs. earnings as a sign of health of the company they've invested in. The pressure on management teams is compounded when poor results could easily spell the end of an executive's tenure with the company.

In the case of Waste Management during the 1990's, founder & CEO Dean Buntrock created and nurtured an entire culture of fraud. While Waste Management continued to produce false numbers to the public, Buntrock used company money to make charitable contributions and present himself as a decent, ethical person (Securities and Exchange Commission: 2002). He received large amounts of money while he perpetrated the fraud, and his executive team was incentivized for their role as well. Opportunity At the time the fraud existed, internal controls were almost non-existent.

The management team employed a number of improper accounting practices that did not comply with GAAP. As stated earlier, CEO Dean Buntrock not only allowed internal controls to be bypassed, he encouraged them to be ignored and shaped accounting policy with the sole purpose of making the targeted earnings numbers every year. The auditing firm, Arthur Andersen, LLP, was also shown to have complicity. The partners at Andersen knew that the company’s policies were not compliant so they provided Waste Management with proposed adjusting entries to their books.

Waste Management refused to make the adjustments so Andersen had Waste Management sign off on a list of 32 steps the company must do to change its practices. The document legally constituted an agreement among the two parties and clearly shows that Andersen was aware of fraud that Waste Management had covered up in the past. Furthermore, Andersen did not stand up to the company and continued to issue unqualified audit opinions. Andersen was motivated by greed, as they billed Waste Management over $25M in seven years.

Additionally, until 1997, Waste Management had never hired a CFO or CAO that had not worked for Andersen in the past. During the 1990’s when the fraud occurred, 14 former Andersen employees worked for Waste Management, many in key positions. The circumstances existed so that an outsider, who could wind up being a whistleblower, seemed to not be allowed into the inner circle where the fraud was happening. Waste Management could be ensured by the high fees it was paying Andersen that the company would have a steady stream of potential finance/accounting employees who understood the fraud and how to continue to perpetrate it.

Attitude One’s attitude and ethical beliefs shape how they perform under circumstances in life. The two main reasons why people choose to act unethically, like in the Waste Management case, are that their standards are different than society as a whole, or the person chooses to act in a selfish manner (Securities and Exchange Commission: 2002). Greed, praise and recognition can all be motivating factors for someone to behave unethically. Waste Management's Dean Buntrock possessed a set of ethics (or lack thereof) that allowed him to commit fraud.

He was clearly motivated by greed, was selfish, and had no issues with defrauding investors. He acquired almost $17M in personal wealth while investors lost billions of dollars of value in their shares of Waste Management. He also perhaps rationalized his behavior. He may have calculated that his odds of being detected were very low since he knew that the auditors at Arthur Andersen would issue an unqualified audit opinion regardless of how creative he got with his accounting fraud. The auditors also clearly acted unethically in their dealings with Waste Management.

Even though they were aware that fraud was occurring, as stated above, they continued to issue unqualified audit opinion and bend to the will of Waste Management executives. The auditors never stood up to the company, most likely out of fear of losing a client that paid them almost $25M a year in fees. Additionally, Waste Management had a track record of hiring Andersen auditors into high level position, so they were acting out of greed as well. 2) Review Waste Management's Consolidated Balance Sheet as of December 31, 1996.

Identify accounts whose balances were likely based on significant management estimation techniques. Describe the reasons why estimates were required for each of the accounts identified. Waste Management had several fixed/long-term asset accounts whose balances were based on estimation techniques. On the December 31, 1996 balance sheet, the

Vehicles and equipment account is grossly overstated. The company " avoided depreciation expenses on their garbage trucks by both assigning unsupported and inflated salvage values and extending their useful lives" (Arens: 2011).

In other words, company management inflated their " vehicles and equipment" account through estimation. With regards to the Land – disposal sites account, Waste Management also assigned random salvage values for many assets that had no salvage values at all. Estimates are required because there is no way to determine exactly what the resell value of a truck is 10 years from now. The accounting team must use their best judgment to estimate values based on past and present data.

The realm of value estimation is a significant gray area for accountants where fraud can be committed. To that end, accumulated depreciation is another account that is grossly understated on the December 31, 1996 balance sheet. Accountants must estimate depreciation values based on a particular method of depreciation, but they can lessen the effect of depreciation on the balance sheet by artificially increasing the salvage value of assets and/or by lengthening the estimated useful life of an asset.

Again, estimates are required because an accountant's assumption is necessary to determine the expected values because of the impossibility of predicting what will happen in the future. 3. Describe why accounts involving significant management estimation are generally viewed as inherently risky. a. When dealing with management estimations, many different factors always come into play which are not always easily understandable.

Management has the ability to use many different models, industry standards, and internally developed methods in order to properly or improperly state the item under estimation.

For this reason, auditors must always have some kind of backup to show both consistency and a clear line of numbers, methods and evaluations in order to arrive at an ending number of estimation. However, as easy as this may be to say, in the presence of fraud, numbers can be manipulated and tweaked to arrive at certain assumptions that can give the appearance of consistency while still not having a proper base. Along with this, auditors, while well versed and understanding of industries, do not have the time nor the knowledge to properly assess every single factor that may be used in the valuation of management estimates.

Management estimation techniques vary far and wide and when dealing with a client that uses techniques not akin to the industry, it can be very hard to truly feel comfortable about the numbers used and the valuations presented. 4. Review Auditing Standards (AU) Section 342, Auditing Accounting Estimates, and describe the auditor’s responsibilities for examining management-generated estimates. Also, AU Section 342 provides guidance to assist auditors in examining estimates. Describe the techniques commonly used by auditors to evaluate the reasonableness of management’s estimates. b.

According to the PCAOB, an auditor is responsible for considering all of the subjective and objective factors that go into the management estimates. The auditor must obtain sufficient evidence to reasonable agree that: i. All estimates that could be material to the notes have been developed ii. They are reasonable given the circumstances iii. The estimates are presented in conformity with applicable accounting principles and are properly disclosed (PCAOB US: 1989). There are, of course, a plethora of guidelines offered to the auditors relating to this inherently risky field of auditing management estimates.

However, these guidelines not only help to evaluate the actual estimates and their uses, but also help to look into the reasonability of the estimates and the need for them. In order to assess the reasonability of an estimate an auditor must have the information from prior years present and available so as to compare both the inputs and the outputs of all the estimates (PCAOB US: 1989). This allows for the auditor to see if there are any divergences or deviations from the usual historical outputs of the estimates.

This also can give the auditor the ability to see what inputs are able to be manipulated or subject to potential bias. This insight can prove very necessary when so many numbers and formulas are involved. Along with evaluating the historical inputs/outputs and the processes used, the auditor should have their own view on the estimates so as to agree upon the use of the estimate. In order to truly have one’s own view, the past is of course necessary but the future transactions and events can help to further enhance the reasonability of the estimate (or malign the use of it, if such be the case).

These subsequent events can help an auditor to decide if there should be other key factors used or if changes in the business and industry should become significant in the assumptions. The last idea, and offering, by these auditing standards is to hire a specialist (PCAOB US: 1989). Of course this is something should be done if, after review, the auditor determines that they need further expertise or analysis on the assumptions. At times, an industry can be some complex and calculations so convoluted that an auditor has no choice but to hire an industry professional to liaise with regarding the factors and computations. . The Waste Management fraud primarily centered on inappropriate estimates of salvage values and useful lives for property and equipment. Describe techniques Andersen auditors could have used to assess the reasonableness of those estimates used to create Waste Management's financial statements. Arthur Andersen auditors failed miserably on the audit inspection of waste management from 1992-1997. The auditors failed to realize the inappropriate salvage estimates and depreciation values of Waste Management's Equipment.

The first thing the auditors should have done was to check the accuracy of the estimates. The auditors should have checked every year in order to make sure the estimates were accurate. By checking the accuracy of the estimates Andersen Auditors would have seen in 1996 that Waste Management changed the salvage values of their equipment. Waste Management was allowed to change the salvage value, but the auditors should have made sure that it was a reasonable change, which is it was not. Next, the auditors would have been able to check these estimates on industry and governmental standards.

By checking against the governmental and industry standards the auditors would have once again been able to see that the salvage value was unreasonable. Another technique Andersen could have used was to get an independent estimate. By getting an independent estimate the auditors would have been able to compare the independent estimate to the salvage value that Waste Management was applying to their equipment. These numbers would have been able to be compared and evaluated to each other in order to figure out the proper salvage amount to use. The auditor is responsible for checking these numbers and they did not do their job.

Also, the auditors could have done some more research on the items being salvaged and applied the fair value to each one of the items. This way the auditors would be able to back up these different estimates when comparing them to the estimates given by Waste Management. Andersen should have also seen red flags when these new salvage numbers were given. They were not historically accurate and were completely off from prior years. Part of the reason Andersen did not do anything was due to former Andersen auditors working for Waste Management. Andersen needs to be independent and they were not.

By not being independent from Waste Management it caused them to " overlook" an estimate that caused stock holders to lose billions of dollars. 6. Several of the Waste Management accounting personnel were formerly employed by the company's auditor, Arthur Andersen. What are the risks associated with allowing former auditors to work for a client in key accounting positions? Research Section 206 of the Sarbanes? Oxley Act of 2002 and provide a brief summary of the restrictions related to the ability of a public company to hire accounting personnel who were formerly employed by the company's audit firm.

As stated in the case several of Waste Management accounting personnel use to work for Arthur Andersen as an auditors. This led to many problems for both companies. The auditor needs to remain independent because of two main reasons. One is to make sure the audit is done unbiased and to make sure the client is unable to trick the auditor. If the client knows what the auditor is looking for than they can manipulate the numbers in order to trick the auditor from catching these manipulations. The main risk with this practice is fraud. This can take place by the auditor or the client.

If the client use to work for the auditor, just like in this place, the client will know exactly how the audits are done and exactly what the auditor is looking for. This can cause a client to post fraudulent numbers to numerous documents. The client will be able to insert these fraudulent numbers in to documents that the auditor will not look at. Also, the auditor can cook the books as well so to speak. The auditor cannot check all of the documents due to being friends with the client, due to some of the former auditors working for the client now.

Also, the auditor can get a little lazy when it comes to doing the audit. What is meant by this is that the auditor might not do such a thorough job due to the fact that that a former auditor is doing the financial statements and they know exactly how to do them. According to the Sarbanes-Oxley Act of 2002 Section 206, the SEC has placed restrictions on former auditors working for a public company as accounting personnel. The section talks about conflict of interest in regards to this issue. SEC. 206. CONFLICTS OF INTEREST.

Section 10A of the Securities Exchange Act of 1934 (15 U. S. C. 78j–1), as amended by this Act, is amended by adding at the end the following: ‘‘(l) CONFLICTS OF INTEREST. —It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in H. R. 3763—31 ny capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit. ’’ (Sarbanes Oxley: 2002). Basically, section 206 states, that any public accounting firm cannot hire a CEO, Controller, CFO, Chief Accounting Officer that was a formerly employed by the auditor that is performing the audit for that publically traded company. That is the only restriction that is placed by section 206. As you can see on this case there are many risks and problems that are involved when a public traded company has formed audit members on their staff. 7.

Discuss possible reasons why the Andersen partners allegedly allowed Waste Management executives to avoid recording the identified accounting errors. How could accounting firms ensure that auditors do not succumb to similar pressures on other audit engagements? Waste Management was a “ crown jewel” client, and Arthur Andersen had been their auditor since before the company went public in 1971. Andersen and Waste Management had a long history of working together. Management officials at Waste Management were previous employees of Andersen and Anderson did not want to lose one of their most important clients.

From 1991 to 1997, Anderson received $7. 5 million in audit fees and $11. 8 million in fees for tax, attest work, regulatory issues, and consulting services. In addition, $6 million was billed to Waste Management's headquarters for non-audit fees. In order to please the client, and avoid losing them, certain fraudulent events occurred. Andersen advised Management to make " Proposed Adjusting Journal Entries (PAJEs) to adjust expense and income accounts in the financial statements. Management failed to comply with Andersen's advice and they entered into a secret agreement to write off the errors.

The agreement " Summary of Action Steps," contained incorrect accounting practices and listed 32 steps that the company must perform to correct the practices. It would allow Waste Management to cover up past frauds by committing future frauds. Andersen was hoping that this would benefit the company. However, the auditors did seem to ignore that refused to correct known accounting misstatements. Company auditors and management had personal relationships, so management was able to pressure auditors. Management knew what they were doing because they were former auditors.

Forcing the changes in accounting practices could result in an end to Waste Management as a company and Andersen would lose that income. In order to avoid these situations, Sarbanes Oxley introduced Section 203 that helps with issues that a firm might face. Section 203 includes partner rotation, which forces the audit partner on the assignment to rotate after 5 years. However, the rule has an exception to partner rotation for firms with no more than five public company audit clients and fewer than ten partners. These rules apply as of the first day of a company's first fiscal year beginning after May 6, 2003, with time served as the lead and concurring partners prior to May 6, 2003 being included in determining rotation periods" (Alali ; Romero: 2012). Audit firms can also give employee training on ethics so they are aware of company values. Bibliography Alali, F. , ; Romero, S. (2012). Auditor changes before, during, and post-section 203 of sarbanes-oxley act. Internal Auditing, 27(1), 25-30. Retrieved from http://bluehawk. monmouth. edu: 2048/? url=/docview/1009737322? accountid= 12532

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