Waste Management:

 Due Care Synopsis In February 1998 Waste Management announced that it was restating its financial statements 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 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.1 In its final judgment, the SEC permanently barred Buntrock and three other executives from acting as officers or directors of public companies and required payment from them of $30.8 million in penalties.2 Background Because the financial statements for the years 1993 through 1996 were not presented in conformity with Generally Accepted Accounting Principles (GAAP), Waste Management’s independent auditor, Arthur Andersen, came under scrutiny for issuing unqualified opinions on the financial statements for these years. 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 ultimately settled with the SEC for $7 million, the largest ever civil penalty at the time, without admitting or denying any allegations orfindings.3 Three Andersen partners who worked on the Waste Management audit during this period also received sanctions from the SEC. Waste Management’s Relationship with Arthur Andersen Even before Waste Management became a public company in 1971, Arthur Andersen served as the company’s auditor. In 1991 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 financial statement au- dit fees.4 During this seven-year period, Andersen also billed Waste Management $11.8 million in fees related to other professional services.5 During the 1990s, at least 14 former Andersen employees worked for Waste Management.6 While at Andersen, most of these individuals had worked in the group that was responsible for auditing Waste Management’s financial statements prior to 1991.7 In fact, until 1997 every chief financial officer (CFO) and chief 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. When 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.8 Andersen’s Partners on the 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. Allgyer held the title of partner-in-charge of client service, and he also served as the marketing director for Andersen’s Chicago office. Among the reasons for Allgyer’s selection as engagement partner were his “extensive experience in Europe,” his “devotion to client service,” and his “personal style that . . . fit well with the Waste Management officers.”9 In setting Allgyer’s compensation, 3 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. 4 SEC Auditing and Enforcement Release No. 1410, June 19, 2001. Andersen considered fees earned on the Waste Management account for audit and nonaudit services.10 Walter Cercavschi, who was a senior manager when he started working on the Waste Management engagement team in the late 1980s, also remained on the engagement after becoming a partner in 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 engage- ment partner; reviewing certain key workpapers (such as the audit risk analysis, final engagement memoranda, and summaries of proposed adjusting 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 the client acceptance and retention processes for the entire office.11 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 Waste Management to record in 1993. If recorded, this amount would have reduced net income before special items by 12 percent. The engagement team also identified other accounting practices that gave rise to other (known and likely) misstatements primarily resulting in the understatement of operating expenses.12 Allgyer and Maier consulted with Robert Kutsenda, the practice director responsible for Andersen’s Chicago, Kansas City, Indianapolis, and Omaha offices, about this issue. 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, the team did instruct 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.13 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, as well as to the other known and likely misstatements.14 Although Waste Management agreed to the summary of action steps, the company continued to engage in the accounting practices that gave rise to the PAJEs and the other misstatements. Despite Waste Management’s failure to make progress on the PAJEs, Andersen’s engagement team continued to issue unqualified audit reports on Waste Management’s financial statements.

1. What is auditor independence, and what is its significance to the audit profession? In what ways, if any, was Arthur Andersen’s independence potentially impacted on the Waste Management audit?

2. Consult Paragraphs 3–6 of Quality Control Standard No. 20 (QC 20). Considering the example in the Waste Management case, 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 at Waste Management? Why or why not?

3. Consult Paragraph 7 of PCAOB Auditing Standard No. 13. Do you believe that Andersen’s final decision regarding the PAJEs was appropriate under the circumstances? Would your opinion change if you knew that all of the adjustments were based on subjective differences (such as a difference in the estimate of the allowance for doubtful accounts) as compared to objective differences (such as a difference in the accounts receivable balance of the big- gest customer)?

 4. Refer to Sections 203 and 206 of SARBOX. 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?