Case 2.2

Waste Management: A Focus on Fraud and Inherent Risk Assessment

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.[82]

History

In 1956, Dean Buntrock took control of Ace Scavenger, a garbage collector that was owned by his then father-in-law who had recently died. After merging Ace with several waste companies, Buntrock founded Waste Management in 1968.[83] Under Buntrock's reign as its CEO, the company went public in 1971 and 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.[84]

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[82] 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).

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

[84] 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).

From 1971 to 1991, Waste Management enjoyed 36 percent average annual revenue growth and 36 percent average annual net income growth. By 1991, it had become the largest waste removal business in the world, with revenue of more than $7.5 billion.[85] 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.[86]

Waste Management's Core Operations

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

Collection

Solid waste collection to commercial and industrial customers were 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 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.[87]

Transfer

As of 1995, Waste Management operated 151 solid waste transfer stations, facilities where solid waste was received from collection vehicles, and was 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

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[87] Waste Management, 1995 10-K.

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.[88]

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 by the municipality or county. 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.[89]

Corporate Expansion

As the company grew, it 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. Table 2.2.1, on pages 36 and 37, describes the primary services these groups provided and revenues recorded 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

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[88] 1995 10-K.

[89] 1995 10-K.

operating a landfill and made it more difficult and expensive for Waste Management to obtain permits for constructing new landfills or to expand old ones.[90]

Several of its 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.[91]

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[90] 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).

[91] 1995 10-K.

TABLE 2.2.1 Waste Management's Major Business Groups

Business Group	Services	Revenues ($000)		
		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 health care and related facilities.	4,702,166	5,117,871	5,642,857
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	1,035,004	1,140,294	1,027,430

	paper, manufacturing, environmental services, and other industries.			
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 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.	1,142,219	1,324,567	1,451,675
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).

Case Questions

1. 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).
2. Consult Paragraphs #71–72 of 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?
3. 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.
4. Please consult Paragraphs #24–25 of 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?