

Case 3.9

Waste Management: A Focus on Top-Side Adjusting Entries

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.¹⁹⁶

Top-Side Adjusting Journal Entries

Top-side adjusting journal entries are typically made by upper managers at the very end of the reporting process, usually at corporate headquarters. Because these journal entries are typically not generated at the level of the business process (e.g., Internet sales) or at 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 perpetrate a fraud.

To help perpetrate its accounting fraud, management at Waste Management allegedly made use of top-side adjusting journal entries in the process of consolidating the results reported by their operating groups. Upper management allegedly employed a number of improper accounting practices (to reduce expenses, thereby inflating earnings) and used top-side adjusting journal entries to intentionally hide the fraud from both their operating groups and the investing public.

¹⁹⁶ 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).

It was not uncommon for Waste Management to make use of top-side adjusting entries when consolidating the results of several of its business units 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 and Rooney after 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.

Closing the Gap

As operating results were recorded by Waste Management's operating units at the end of each quarter, upper management monitored the gap between the results and the goals. Management then made a number of different types of unbudgeted top-side adjusting entries in the financial statements in an effort to "close the gap." For example, a top-side adjustment might have been used to: (1) reduce the allowance for doubtful accounts (or another reserve account); (2) extend the useful lives of trucks by two years; or (3) double the salvage values of trucks, depending on the nature and size of the budget 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 impact on reported net income.

As early as 1992, the company's auditor Arthur Andersen advised management against its use of top-side adjusting entries 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. Instead of following this recommendation, top management seemed to increase 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 allegedly used unsupported top-

side adjustments in 14 of the 21 quarters to achieve reported results within the range of the company's public earnings projections.

Case Questions

1. 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?
2. Please consult Paragraph #16 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?
3. 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?
4. 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.