Case 4.5

Waste Management: A Focus on Depreciation and Amortization

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.[236]

Fixed Asset 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 made numerous unsupported changes to the estimated useful lives and/or salvage values of one or more categories of vehicles, containers, or equipment. Such changes had the effect of

[236] 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).

reducing the amount of depreciation expense recorded in a particular period. 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. Management did not appear to disclose the changes or their impact on profitability to their investors.[237]

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 allegedly continued to change depreciation estimates at headquarters, however.

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 the difference depreciated over the estimated useful life of the landfill. 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, in reality, Waste Management allegedly carried almost all of its landfills on the balance sheet at cost.[238]

In response to this treatment of landfills on the balance sheet, after its 1988 audit, 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." 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. 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.

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[237] 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.

[238] Ibid.

Case Questions

1. Under what circumstances is a company allowed to change the useful life and salvage value 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 life and salvage value of its assets was appropriate under GAAP?
2. 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?
3. 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?
4. Please consult Paragraph #84 of 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.