Case #2.2 – Waste Management: Due Care

I. Technical Audit Guidance

To maximize a student's knowledge acquisition of this material, this book has been designed to be read in conjunction with the post–Sarbanes-Oxley technical audit guidance. All of the PCAOB Auditing Standards that are referenced in this book are available for free at http://pcaobus.org/STANDARDS/Pages/default.aspx. In addition, a summary of the provisions of the Sarbanes-Oxley Act of 2002 is available for free on the book's website at www.mhhe.com/thibodeau4e or at http://www.aicpa.org/Pages/Default.aspx.

II. Recommended Technical Knowledge

The Sarbanes-Oxley Act of 2002

Section 203
Section 206

PCAOB Quality Control Standard #20

Paragraphs #3-6

PCAOB Auditing Standard #13

Paragraph #7

III. Teaching Hints

This case provides students with the opportunity to understand what is meant by an audit firm exercising due care in completing the audit and the consequences associated with a failure to do so. In addition, the case provides a mechanism to illustrate auditor independence and why it is important to the audit profession. More specifically, the case provides students with an opportunity to understand how a lack of independence may impact the objectivity of auditors and potentially lead to biased professional judgments. Finally, the case provides a context to discuss what is meant by an adjusting journal entry proposed by an auditor. To meet these objectives, this case illuminates a number of relevant issues about the business relationship that existed between Arthur Andersen and Waste Management, the quality control review process at Arthur

Andersen and Waste Management's refusal to record adjusting journal entries proposed by Arthur Andersen.

We believe it is essential for students to carefully read over the recommended technical knowledge, along with this case reading. The educational psychology literature suggests that the acquisition of technical/factual type knowledge increases dramatically when such knowledge can be applied in a realistic context. Thus, we urge instructors to use this case as a mechanism to impart the relevant technical audit knowledge, as outlined above.

This case assignment will work best if it is scheduled to coincide with the auditors' professional responsibilities topic or the independence topic in the auditing course. The case can also be used in conjunction with a discussion of the importance of quality control at an audit firm. Alternatively, the case could be used when discussing the completion of the audit topic to illustrate the issues involved in forcing the clients to record adjusting journal entries.

Overall, we believe that it is helpful for students if instructors introduce the notion of an auditor's responsibility to financial statement users before discussing how a lack of independence can potentially bias an auditor's professional judgments. Specifically, we suggest that instructors do everything possible to illustrate the tension that auditor's face when attempting to maintain an attitude of independence during the financial statement audit. Students need to realize that the nature of the auditing process sometimes makes it difficult to remember that your primary responsibility when completing an audit is to financial statement users, not to client personnel.

We recommend that instructors spend time in class discussing the nature of the quality assurance at an audit firm. This discussion can be accomplished quite effectively while going over the response to question #2 in the case. In addition, depending on the point in the semester that this case is used, instructors should also consider spending class time explaining the nature of the adjusting journal entries proposed by auditors. Again, this can be accomplished quite effectively while going over the response to question #3 in the case. Finally, the subject of materiality can be raised in class when discussing whether Andersen should have forced Waste Management to record the adjusting journal entries.

Each of these points can also be used to help discuss the difficulties associated with professional judgments made by auditors and just how important it is to be unbiased in making all decisions. Indeed, what makes this tension more pronounced is the subjectivity that is inherent in many professional judgments made be auditors. The overriding objective of this discussion is to get students to think about the types of professional judgments that auditors make (e.g., requiring the client to record adjusting journal entries) and then to demonstrate how a lack of independence can impact the final professional judgment. To facilitate class discussion in this regard, it is useful to talk about the subjectivity that is inherent in an auditor's application of Generally Accepted Auditing Standards. In addition, it may also be useful to talk about the subjectivity inherent in the application of GAAP. Both aspects of subjectivity characterize the environment that auditors make decisions within and it is absolutely essential that auditors are independent in all areas.

IV. Assignment Questions & Suggested Answers

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?**

According to the second general standard of Generally Accepted Auditing Standards, "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." Unfortunately, the facts of the case reveal numerous issues that suggest that Andersen's independence may have been compromised on the Waste Management audit.

For example, at Andersen, the compensation of partners depended on their ability to cross-sell other services to its audit clients. More than half of the fees for Waste Management were charged for non-audit services. The size of the nonaudit fees would likely have made it hard for the Andersen partners to challenge Waste Management's team on the difficult accounting issues.

In addition, more than fourteen former Arthur Andersen accountants were working at Waste Management. Several were in senior executive positions, including Thomas Hau, the chief accounting officer. Another concern is how Robert Allgyer was chosen for the engagement. He was selected based on his personal style that fit well with the Waste Management officers.

Article IV of the AICPA Code of Conduct (Objectivity and Independence) states: “A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.” Close relationships might affect independence in appearance, even if independence in fact is maintained. Clearly there was cause for concern at Waste Management.

2. **Consult Paragraphs 3-6 of Quality Control Standard No. 20 (QC 20). Considering the example in the Waste Management case, please explain why a review by the practice director and 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?**

According to paragraph #3 of Quality Control Standard No. 20, “A firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm’s standards of quality.” A review by the Practice Director and Audit Division Head at a firm would serve as a quality control process for the audit firm as the work of the engagement partner and concurring partner is being subject to review. Since the practice director and audit division head are not directly involved with the engagement, each professional is in a position to provide an unbiased opinion on all work completed.

This type of review is important because of the specialized knowledge possessed by each professional. Thus, this review, if conducted effectively, can reduce the exposure of the firm to financial loss resulting from litigation, customer complaints and loss of reputation due to intentional or unintentional errors in an individual engagement. Indeed, an effective control of this type helps to ensure that individual partners conform to a firm's "best practices" and that GAAP was properly and consistently applied on the engagement.

In this case, the review does not appear to have been effective as Andersen issued an unqualified opinion on Waste Management when misstatements of $128 million, or 12% of net income, were not deemed material by Andersen.

3. **Consult Paragraph 7 of PCAOB Auditing Standard No. 13. Do you believe that Andersen's final decision regarding the PAJE's 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 account receivable balance of their biggest customer)?**

Paragraph #7 of PCAOB Auditing Standard No. 13 provides concrete guidance to an audit professional about how to exercise due care when completing the audit. The key is for auditors to always exercise professional skepticism in completing their work. Professional skepticism is defined in the standard as "an attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence. The auditor's responses to the assessed risks of material misstatement, particularly fraud risks, should involve the application of professional skepticism in gathering and evaluating audit evidence." The decision made by Andersen regarding the PAJEs was inappropriate under the circumstances because the differences would likely have mattered to financial statement users. Andersen partners had a high level of professional training and experience in adhering to professional standards. As a result, it is surprising that they did not require the adjustments to be recorded.

Because of the magnitude of the adjustments, taken together, it probably would not have mattered if the adjustments were based on subjective as compared to objective differences discovered by Andersen. It is important to point out that the PAJE's resulted in an overstatement of net income by 12 percent. So, regardless of subjective differences or objective differences, the proposed adjustments were material in nature and would have resulted in a change in earnings per share. It is however important to point out that the subjective differences often lead to negotiation between the auditors and the client, where the objective difference typically do not. And, it is during these negotiations where an auditor's independence is truly put to the test. This is a terrific opportunity to bring up this tension in class and illustrate the difficulties of maintaining an independent and objective mind as an auditor.

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?**

Section 203 of the Sarbanes-Oxley Act requires audit partners to rotate off an audit engagement after five years. Section 206 says that the CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period ("the cooling off period") proceeding the audit.

Many believe that this law goes far enough, and that the audit firm itself should not have to rotate off an audit engagement every five years. Arguments against the rotation of the audit firm suggest that forcing audit firm rotation every five years would be too chaotic and the costs for both audit firms and clients would be significant. Audit firms incur substantial costs in the first couple years of an audit engagement as they are acquiring information about the firm, its industry and its internal control system for the first time. Requiring audit firms to switch every five years would inflate audit costs as firms would constantly be in the process of performing due diligence and researching their clients. The inflated costs of performing the audit would undoubtedly be passed onto clients. Another argument against audit firm rotation is that requiring firms to switch may be counterproductive in that fraud may actually be harder to find as the new audit firm is not as familiar with the client's business processes, risks, and attitude of management.

Waste Management had several employees who were former employees of Arthur Andersen. In addition, every chief financial officer and chief accounting officer at Waste Management until 1997 was a former auditor of Andersen. Section 206 of SARBOX would have affected Waste Managements chief officers since the former Andersen employees would have had to wait at least one year before stepping into the position.

Arguments supporting section 203 and 206 believe these sections are needed in order to keep a respectable distance between the client and audit firm. Rotating partners every 5 years will make it harder for employees of the audit firm to create close relationships with employees at the client company. This distance helps create an image of independence. Section 206 also supports the argument of independence. By requiring former audit employees to wait one year before stepping into a senior executive accounting position, it helps to create an image of independence. The former employee can take time off the engagement and employees still on the engagement have time to make changes to procedures and such; this way the former employee does not know every procedure being done and is at a far enough distance to be "out of the loop." If the former employee stepped into the position right away he would know all of the audit procedures being used and could inform other members of management of how to hide fraud and other scandals from the auditors.

The key arguments against section 203 and 206 support the overarching belief that rotating partners is too costly. A student may argue that if partners are rotated every 5 years there will always be a learning curve which will slow down the audit, creating higher costs for clients and audit firms. A student may also argue that making a former employee wait at least one year before stepping into an influential position at the former client is costly to the client. In addition, a student may argue that it is better for the former audit employee to be in the position right away this way no current knowledge of the company is lost.