Case #1.1 – Waste Management: The Expense Recognition Principle

I. Technical 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

Conceptual Framework

The Expense Recognition Principle (sometimes referred to as the Matching Principle)

PCAOB Auditing Standard No. 5

Paragraph #2

PCAOB Auditing Standard No. 15

Paragraphs #5-6

III. Classroom Hints

This case provides students with an opportunity to appreciate the difficulty that can be associated with auditing the application of depreciation rules to different types of assets at an audit client. Since the computation of depreciation expense requires management to estimate the salvage value and the estimated useful life for each asset depreciated, an auditor is often forced to evaluate a number of subjective factors when completing his/her procedures. To properly do so, students are able to see that an auditor must first understand the true economic substance of management's estimates for both salvage value and the estimated useful life. After gaining this understanding, the auditor must then determine whether the client has properly calculated and recorded depreciation expense in accordance with the economically appropriate estimates. Of course, each of these judgments must be made based on sufficient and competent evidence. In addition, the case provides a mechanism to illustrate the importance of identifying relevant financial statement assertions and identifying the related control activities that are designed to prevent and/or detect fraud in the post-Sarbanes audit environment. Finally, the case provides an opportunity for instructors to highlight the responsibility of management and the board of directors for an effective internal control system in the post-Sarbanes audit environment.

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.

This case assignment will work best if it is used at the time when instructors cover the purchasing process, the fixed asset process or the audit of depreciation expense. Alternatively, the case can be used when instructors cover the audit evidence topic or when instructors discuss the ways in which a management team can perpetrate a fraud. Indeed, because of the subjectivity associated with the estimate of an asset's useful life and salvage value, the account can be used by management as a mechanism to help smooth earnings and/or perpetrate fraudulent activity. As a result, we recommend that instructors spend time in class reviewing the impact that an increase in salvage value and/or an increase in depreciable life can have on reported earnings. This discussion should help students conceptualize how the application of depreciation rules can be used as a mechanism to perpetrate fraudulent activity.

Importantly, the goal of the previous discussion is not necessarily to make sure that students are experts in auditing recorded depreciation expense at an audit client with significant investments in fixed assets. Rather, we believe that it is important to point out to students that they will encounter difficult financial statement accounts to audit in their role as an auditor.

Therefore, when such an account is encountered, students must take the time to fully understand the nature and economic substance of the account. The professional judgment that is involved in auditing a difficult financial statement account also provides an opportunity for instructors to remind students of the importance of being unbiased and objective when making their audit judgments. Indeed, we believe that it is helpful to consistently remind students of their responsibility to maintain an attitude of professional skepticism throughout the audit process. Indeed, one of the primary goals of the Sarbanes-Oxley Act of 2002 was to take steps to improve the independence and objectivity of the audit process (e.g., Section 201). As such, we encourage instructors to take this opportunity to remind students of their responsibility.

This case also provides an opportunity for instructors to highlight the increased responsibility that management now has for effective internal controls under the Sarbanes-Oxley Act of 2002 (SARBOX). Under Section 404 of SARBOX, management is responsible for establishing and maintaining an effective internal control system that is designed to support reliable financial statement reporting. In addition, management must undertake a process whereby they assess the effectiveness of their own internal control system each year. Given this increased responsibility, it is amazing for students to see that the management team and Board of Directors at Waste Management actually ignored the recommendation made by Arthur Andersen to conduct a site by site analysis of their landfills. In the post-Sarbanes environment, this is clearly a process that would have to be in place to insure reliable financial reporting.

Finally, this case provides an opportunity to highlight the importance of identifying the relevant financial statement assertions about a significant financial statement account, a critically important task in the post-Sarbanes environment. The discussion of student responses to question #3 provides instructors with an opportunity to discuss this point. In addition, the discussion of student responses to question #3 provides an opportunity for instructors to highlight the importance of being able to identify an internal control activity that is explicitly designed to support reliable financial statement reporting for a particular financial statement assertion. Once again, the knowledge required to link an internal control activity to the financial statement assertion is essential in the post-Sarbanes audit environment. Thus, we encourage instructors to take the time to make this linkage explicit for students in the present context.

IV. Assignment Questions & Suggested Answers

1. **Consider the principles, assumptions and constraints of Generally Accepted Accounting Principles (GAAP). Define the *expense recognition principle (sometimes referred to as matching principle)* and explain why it is important to users of financial statements.**

According to the expense recognition principle, costs need to be matched to the revenues that they helped to generate. A key point is that expenses should not necessarily be recognized when the work is completed or a product is produced. Rather, the costs should be recognized when the costs can be "matched" to revenue that has been recorded. If a connection cannot reasonably be made between a cost and revenue that has been recognized, an accountant still has a responsibility to try to determine whether there is some type of relationship between the cost and revenue generated. The absolute goal is to try as hard as possible for an accountant to provide the best measure of the profitability and performance of a company. As a result, accountants should attempt to identify as best as possible, how much it cost to generate revenue. This is the basis of the expense recognition principle.

2. **Based on the case information provided, describe specifically how Waste Management violated the expense recognition principle. In your description, please identify a journal entry that may have been used by Waste management to commit the fraud.**

GAAP requires that depreciation expense be determined by allocating the historical cost of assets over the useful life of the asset less the salvage value. When the management team at

Waste Management made changes to the estimated useful life and salvage value of several assets, they effectively reduced the depreciation expense, ultimately resulting in overstated income. The reduction of depreciation expense in the current year essentially defers depreciation expense to a future year. The expense recognition principle requires the depreciation expense of an asset to be recognized over its useful life so that the associated expense is recorded in the year in which related income is earned. The arbitrary changes made to the estimated useful lives and salvage values directly violated the matching principle because the depreciation expense recognized in future years would now be unrelated to the production of income in those related future years.

In essence, increases to the useful life of assets have the effect of writing up the value of an asset and reducing expenses. This change can have a material impact on the financial statements. These types of changes, that affect the way a user of financial statements values Waste Management, must be properly disclosed as required by GAAP under the full disclosure principle. This principle requires management to disclose sufficient information to allow the user to make a judgment about the financial position of Waste Management.

3. **Consult Paragraph 2 of PCAOB Auditing Standard No. 5. Do you believe that Waste Management had established an effective system of internal control over financial reporting related to the depreciation expense recorded in its financial statements? Why or why not?**

According to Paragraph #2 of PCAOB Auditing Standard No. 5, “effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.” Waste Management did not have an effective system of internal control over financial reporting related to the depreciation expense recorded in its financial statements. Stated simply, Waste Management’s internal control system did not provide reasonable assurance that the transactions were recorded fairly, accurately, and in accordance with GAAP.

4. **Consult Paragraphs 5–6 of PCAOB Auditing Standard No. 15. 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?**

A company is allowed to change the useful life and/or the salvage value of its fixed assets under GAAP if events or circumstances reveal additional information that indicates that a change to the useful life and/or salvage value will more accurately depict the current market situation. Stated simply, there should be a legitimate basis to make any changes to these variables. In addition, according to the SEC, changes to the variables used in estimating depreciation and the resulting impact to investors should be disclosed in the financial statements to be in accordance with GAAP.[1]

Paragraphs #5-6 of PCAOB Auditing Standard No. 15 specifically highlight that an auditor must obtain sufficient and appropriate evidence. Sufficiency "is the measure of the quantity of evidence" needed. The quantity of evidence needed will depend upon the risk of material misstatement and the quality of evidence obtained. The appropriateness of evidence refers to whether the evidence obtained by the auditor is both relevant and reliable "in providing support for the conclusions on which the auditor's opinion is based." In this situation, an auditor should examine relevant information about comparable useful lives used in the industry and monitor the company's actual experience for similar assets in the past to determine if the firm's decision to change the useful life and salvage value of its assets was appropriate under GAAP. Overall, the rationale for changes must be well supported and reasonable. In making this

[1] U.S. Securities and Exchange Commission. (26 March 2002). "Securities and Exchange Commission vs. Dean L. Buntrock, Phillip B. Rooney, James E. Koenig, Thomas C. Hau, Herbert A. Getz, and Bruce D. Tobecksen." *http://www.sec.gov/index.htm*.

determination, interviews with managers and other relevant personnel would be essential, as each of these estimates are subjective. Ultimately, the events or circumstances resulting in the need for the changes would have to be critically evaluated and corroborated with sufficient and competent evidence by the auditors. After considering all of the available evidence, if the auditors are still unsure about the decision, they could use an independent third party to evaluate the changes to the useful life and/or salvage value that are proposed.

5. **Visit the PCOAB website (i.e., www.pcaobus.org), search for the "tip and referral center" and review the guidelines. Can you report a violation to the PCAOB anonymously? Assuming that the employee knew that the consolidating entries in the fourth quarter recorded by upper management were fraudulent, do you believe that the employee had a responsibility to report the behavior to the audit committee? Why or why not?**

Yes, according to the website, the PCAOB does allow you to report a violation in an anonymous manner. However, according to the website, if you so wish to stay anonymous, the PCAOB asks "that you please contact us again, within 24 hours, so that we may ask any important follow-up questions in response to your tip or referral."

Clearly, there are a number of allowable answers to the second part of this question. The absolute key is for a student to try and justify his or her position. Consider the following acceptable sample answer from a student:

Yes, the employee should have reported the fraudulent behavior to the audit committee. Consistent with the notion that ethical behavior is that which conforms to moral rules and principles, the moral action to be taken would have been to report the fraudulent behavior. In fact, when an employee is thinking through his/her ethical decision process, he/she should realize that in the long run, they may be held responsible for their role in helping to prepare fraudulent financial statements. Clearly, the moral action is for the employee to tell the audit committee about the fraudulent entries.

Case #1.2 – WorldCom: The Revenue Recognition Principle

I. Technical 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

Conceptual Framework

The Revenue Recognition Principle

PCAOB Auditing Standard No. 5

Paragraph #25
Paragraph A5 (in Appendix A)

PCAOB Auditing Standard No. 12

Paragraph #68

PCAOB Auditing Standard No. 13

Paragraphs #6-7

PCAOB Ethics Rule 102

Paragraphs #1-2

III. Classroom Hints

This case provides students with an opportunity to understand what is meant by company level controls and recognize their importance in completing an audit of internal control over financial reporting as mandated by Section 404 of SARBOX. By providing details about WorldCom's upper management behavior, including their use of "top-side" adjusting journal entries in the period-end financial reporting process, students are able to see the relationship between an audit client's "tone at the top" and their audit testing strategy. In addition, this case provides students with an opportunity to see the potential adverse impact that a CEO can have (i.e., tone at the top) by fostering a culture of "meeting the numbers" at all costs. Finally, the case questions provide an opportunity to discuss the role of the internal control system in helping to prevent or detect material misstatements.

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 post-Sarbanes technical audit knowledge, outlined above.

This case assignment will work best if it is scheduled to coincide with the internal controls topic or at the beginning of an instructor's discussion of the audit of internal control over financial reporting as required by Section 404 of SARBOX. Importantly, in Auditing Standard No. 5, the PCAOB stressed the importance of identifying, understanding and evaluating the effectiveness of an audit client's entity level controls (e.g., tone at the top and period-end financial reporting process) as the first step in an audit of internal control over financial reporting. Because of their pervasiveness throughout the internal control system, the PCAOB believes it to be essential to carefully evaluate the entity level controls first in order to complete an effective and efficient audit of internal control. Thus, one of the ways that the PCAOB believes that the audit can be made more efficient (and effective) is to evaluate company level controls first as a way to provide a foundation towards the understanding of a client's system of internal control.

Since the concept of company level controls is likely to be new to students, we believe that instructors should allocate enough time to carefully explain this concept in class (see paragraphs #22-27 of Auditing Standard No. 5). In particular, we recommend that instructors spend ample time discussing the importance of the control environment and its importance to the system of internal control. In addition, we recommend that instructors take the time to explain the special importance of the period-end financial reporting process to students and the special risks presented by “top-side” adjusting journal entries. The bottom line is that the upper management team at WorldCom helped to perpetrate their fraud using "top-side" adjusting journal entries at the end of the reporting process. Since these journal entries are typically not generated at the business process level, they can often provide a mechanism for upper managers to circumvent the internal control system and possibly perpetrate a fraud. Thus, auditors must always pay close attention to these entries.

This case also provides an opportunity to focus on the auditor’s responsibility to help prevent and/or detect fraud in the post-Sarbanes audit environment. For example, we recommend that instructors point out that the PCAOB has made it clear that preventing and detecting fraud ***MUST*** be the focus of the audit process (the term “fraud” was mentioned 19 times in their Auditing Standard No. 5).

IV. Assignment Questions & Suggested Answers

1. Consider the principles, assumptions and constraints of Generally Accepted Accounting Principles (GAAP). Define the *revenue recognition principle* and explain why it is important to users of financial statements.

The revenue recognition principle of GAAP states that revenue must be both earned and realized before it is recognized and is supported by the FASB Statement of Financial Concepts No. 5. For example, in order for revenue to be considered earned, the product must have been delivered or the services must have been provided to the customer. In addition, the amount of the sale needs to be fixed and determinable. Also, the recognition of revenue is dependent on an assumption that the cash will be collected from the customer in a timely manner.

2. **Provide one specific example of how WorldCom violated the revenue recognition principle in this situation.**

WorldCom violated the revenue recognition principle because they recorded revenue entries (with top-side adjusting journal entries) that had no valid economic activity underlying the entries. Rather, the entries were merely a tool to close the gap between the revenue forecast and the actual revenue earned. The principal tool used to generate the entries was the monthly revenue report ("MonRev") prepared and distributed by the revenue reporting and accounting group. The MonRev included dozens of spreadsheets detailing actual revenue data from all of the company's channels and segments.

WorldCom maintained a fairly automated process for closing and consolidating operational revenue numbers on the MonRev. By the tenth day after the end of the month, the revenue accounting group prepared a draft, referred to as the "Preliminary" MonRev. In general, this preliminary report was compared to the targeted revenue numbers and the difference was used as the basis for a top-side adjusting journal entry to close the gap. In essence, by booking revenue entries with no underlying business activity, WorldCom violated the revenue recognition principle.

3. **Consult Paragraph A5 (in Appendix A) of PCAOB Auditing Standard No. 5 and Paragraph 68 of PCAOB Auditing Standard No. 12. Do you believe that WorldCom had established an effective system of internal control over financial reporting related to the revenue recorded in its financial statements?**

According to Paragraph A5 (in Appendix A) of PCAOB Auditing Standard No. 5, the internal control system is a process that is ultimately designed to "provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP." The professional standards also place special emphasis on the risk of fraud related to revenue recognition in Paragraph #68 of PCAOB Auditing Standard No. 12. As a result, an auditor has to take great care to insure that the controls around the recognition of revenue are designed and operate effectively.

WorldCom did not have an effective system of internal control over financial reporting related to the recording of revenue in its financial statements. Rather, the system allowed top-side adjusting journal entries to be recorded without any underlying business activity. By allowing these invalid entries to occur, WorldCom's system of internal control was not effective. Overall, a key premise of this book is to help simplify the relationship between a company's internal control system and the financial statement account balances. Section 404 of SARBOX made clear that this relationship is paramount.

This case provides an opportunity to highlight the importance of being able to identify an internal control activity that is explicitly designed to support reliable financial statement reporting for a particular financial statement assertion. For example, one relevant financial statement assertion related to the revenue account for this activity is occurrence. It is relevant because there is some question as to whether there was real economic activity to support the revenue transactions that were recorded in the financial statements, especially those transactions recorded at the corporate level. It is important to highlight that this economic activity was booked at the corporate level as top-side adjustments, detached from the actual economic activity at the business process level. And, there was no control system in place to prevent such an entry from occurring.

4. **Consult Paragraph 25 of PCAOB Auditing Standard No. 5. Define what is meant by *control environment*. Next explain why the control environment is so important to effective internal control over financial reporting at an audit client like WorldCom.**

The control environment sets the tone for the organization and provides a platform or a foundation for the entire internal control system. The control environment is influenced heavily by a company's management team and is therefore often referred to as "the tone at the top". With respect to the control environment, the absolute key for management is to try and impact the attitudes towards internal controls throughout the organization by setting the proper example for the organization to follow. Paragraph #25 of Auditing Standard No. 5 outlines the auditor's responsibilities to understand the control environment. Indeed, "because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company."

Stated simply, the control environment has a "pervasive" effect on the reliability of financial reporting at WorldCom and all audit clients because it impacts ALL other components of an organization's internal control system. The lack of an appropriate control environment sends a message to all employees that management does not believe internal controls are important for efficiency and effectiveness of financial reporting.

While a complete evaluation of the control environment at WorldCom is not possible with only the case information, students should at least point out that Ebbers' compensation philosophy (with its focus on double digit revenue growth) should raise serious concerns about their control environment. In fact, the WorldCom case provides a terrific context to illustrate that an organization's compensation policy can also be used as a mechanism to foster an excellent control environment. However, it does not appear that WorldCom has taken advantage of this opportunity. Overall, by the end of class discussion, it should be clear that a proper control environment provides a foundation for the entire internal control system.

5. **Consult Paragraphs 6–7 of PCAOB Auditing Standard No. 13. If you were auditing WorldCom, what type of documentary evidence would you require to evaluate the validity and propriety of a top-side journal entry made to the revenue account?**

Top-side journal entries are adjustments that are typically made by top management at the corporate level. According to the AICPA, these adjustments are typically made at the end of the financial reporting period and are not always posted to the general ledger.[1] Often, these entries are not directly associated with actual economic activity as they do not emanate from the business operations of a division or a business unit. These types of entries have been used frequently in the past by upper managers as a manner in which to perpetrate fraud. As a result, they often result in a fraud risk that must be addressed in a skeptical manner by auditors. Indeed, Paragraph #7 of PCAOB Auditing Standard No. 13 explicitly states that 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."

In evaluating the propriety of a top-side journal entry, an auditor would want to first interview management and review any set policies and procedures related to top-side journal entries. The auditors would also want to vouch the supporting documentation for economic substance and ensure that it has been properly entered in the financial statements. If, for instance, the top-side entries resulted in decreased depreciation due to increasing the salvage value of the trucks, the auditor may want to obtain written confirmation from an appraiser, or other evidence from a third party. Students may discuss various examples and types of evidence that would be required to evaluate the propriety of a "top-side" journal entry. Students' answers

[1] AICPA. "Journal Entries and Other Adjustments." The CPA Letter/Public Accounting Firms. June 2003.

should support their examples as in the example above. The absolute key for the auditor is to evaluate the economic substance of the entry with sufficient and competent evidence.

6. **Consult Paragraphs 1–2 of Ethics Rule 102 (ET 102). Next, consider the roles of Ron Lomenzo and Lisa Taranto. Assume that these employees knew that the entries being proposed by Scott Sullivan were fraudulent; do you believe that Lomenzo and Taranto should have recorded the journal entries as directed by Sullivan? Why or why not?**

Ethics Rule 102 makes clear that a CPA must not "knowingly misrepresent facts" when completing his/her work. Indeed, according to Paragraph #1 of Ethics Rule 102 (ET 102), "in the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others." This rule extends to situations where the CPA knows another person is making the false journal entries. Consider that Paragraph #2 states that a "member shall be considered to have knowingly misrepresented facts" when he/she "makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records."

As a result, for CPAs, the standards are entirely clear. If Lomenzo and Taranto knew that the entries were fraudulent, the ethical decision would be to not record the entries. While the easier decision may be to follow Sullivan's orders, it is clearly not the right decision. The consequences of their actions in the long run would be far worse than the consequences of Lomenzo and Taranto refusing to enter the journal entries.