CONTEMPORARY AUDITING

12E

MICHAEL C.
KNAPP

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Contemporary Auditing
Real Issues and Cases

Twelfth Edition

Michael C. Knapp
University of Oklahoma

Australia • Brazil • Canada • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

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Michael C. Knapp

Senior Vice President,
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Erin Joyner

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Michael Schenk

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Intellectual Property Project Manager:
Arulkumaran Mayilnathan, Integra Software Services

Production Service:
Lumina Datamatics, Ltd.

Art Director and Cover Designer:
Chris Doughman

Cover Image:
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DEDICATION

To Emma, Kasen, Teagan, Warren, Natalie, and Arthur

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Case 1.1 Wells Fargo & Company 3

Wells Fargo's two founders launched the company in 1852 during the heyday of the California Gold Rush to provide banking and transportation services to the tens of thousands of fortune seekers who had overrun the San Francisco Bay Area. Unfortunately, the "Wild West" mindset that dominated the company's culture throughout most of its existence ultimately triggered a massive and high-profile fraud that left its reputation in tatters.

KEY TOPICS: nature and scope of internal controls over financial reporting, material weaknesses in internal control, illegal acts committed by audit clients, and impact of lengthy auditor tenure on audit quality.

Case 1.2 Weatherford International 19

Two Weatherford executives masterminded an innovative accounting and financial reporting fraud that grossly understated their company's reported income tax expense while, at the same time, ensuring that the company annually paid the proper amount of income taxes due to taxing authorities.

KEY TOPICS: audit objectives for a client's income tax expense and its related tax assets and liabilities, material weaknesses in internal control, coping with hostile and uncooperative client executives, and inadequate staffing of audit engagements.

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In the late 1990s, consultants from Caterpillar's audit firm designed a tax-avoidance plan that involved setting up a "ghost" subsidiary in Switzerland. For several years, Caterpillar diverted a sizable amount of its annual revenues to that subsidiary, resulting in tax savings of $2.4 billion. A partner of Caterpillar's audit firm warned a fellow partner in a private email that their firm needed to "create a story" to justify the existence of the ghost subsidiary.

KEY TOPICS: auditing tax-related financial statement amounts materially impacted by a tax-avoidance plan designed by consultants of the audit firm, auditing intercompany transactions, and public interest responsibility imposed on accounting professionals.

Case 1.4 Gemstar 45

In 2000, U.S. News and World Report *predicted that Henry Yuen, the chief executive of Gemstar-TV Guide International, would become the "Bill Gates of television" thanks to the innovative business model that he had developed for his company. When that business model went "bust," Yuen used several accounting gimmicks to embellish his company's reported operating results.*

KEY TOPICS: conditions commonly associated with "audit failures," revenue recognition issues, quantitative vs. qualitative materiality assessments, and "legal" vs. "ethical" conduct.

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Case 1.5 Enron Corporation 55

Arthur Edward Andersen established a simple motto that he required his subordinates and clients to invoke: "Think straight, talk straight." For decades, that motto served Arthur Andersen & Co. well. Unfortunately, the firm's association with one client, Enron Corporation, abruptly ended its long and proud history in the public accounting profession.

KEY TOPICS: history of the public accounting profession in the United States, scope of professional services provided to audit clients, auditor independence, and retention of audit workpapers.

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Wall Street was stunned in September 2008 when this iconic investment banking firm filed for bankruptcy. Lehman's bankruptcy examiner charged that the company had engaged in tens of billions of dollars of "accounting-motivated" transactions to enhance its apparent financial condition.

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KEY TOPICS: applying analytical procedures, identifying inherent risk and control risk factors, need for auditors to monitor key developments within the client's industry, assessing the health of a client's industry, and receivables confirmation procedures.

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KEY TOPICS: inventory audit procedures, auditor independence, content of audit workpapers, inherent risk factors, and auditors' civil liability under the federal securities laws.

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Paul Polishan, the former chief financial officer of The Leslie Fay Companies, received a nine-year prison sentence for fraudulently misrepresenting Leslie Fay's financial statements in the early 1990s. Among the defendants in a large class-action lawsuit stemming from the fraud was the company's audit firm, BDO Seidman.

KEY TOPICS: applying analytical procedures, need for auditors to assess the health of a client's industry, identifying fraud risk factors, control environment issues, and auditor independence.

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Gregory Podlucky founded Le-Nature's in 1989. Over the next 17 years, Le-Nature's consistently ranked among the most rapidly growing beverage companies in the nation. But Le-Nature's financial success was illusory, the product of what a Justice Department official described as a "financial mirage the likes of which I could never even dreamt could have been created."

KEY TOPICS: fraud triangle, COSO internal control framework, corporate governance, auditor changes, quarterly reviews, and forensic accounting.

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KEY TOPICS: PCAOB's regulatory responsibilities, auditor rotation, auditor independence, material internal control weaknesses, materiality, quality controls for audit firms, and auditors' civil liability.

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KEY TOPICS: identifying audit risk factors, the role and responsibilities of an audit engagement partner, criminal and civil liability of auditors, hiring of auditors by clients, substance-over-form concept, and due diligence investigations by auditors.

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KEY TOPICS: auditor changes, management integrity, inventory fraud, SEC regulatory responsibilities, financial reporting controls, materiality, related-party transactions, and audit committee responsibilities.

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Unknown to his colleagues, an individual assigned to the AmTrust audit engagement team was simultaneously serving as an FBI informant. For three years, the individual funneled information to the FBI by using a recording device disguised as a Starbucks gift card to capture conversations with colleagues on the audit team.

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On Antoine Deltour's final day as a Big Four auditor, he copied 30,000 pages of documents that he had discovered on his practice office's hard drive. He subsequently gave the file containing those documents to a journalist. In less than two years, Deltour was the subject of a criminal complaint filed by PwC, his former employer.

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Case 5.6 Cardillo Travel Systems, Inc. 457

Cardillo's chief executive pressured and manipulated three accountants—the company's controller and two audit engagement partners—to conceal the fraudulent nature of an accounting entry.

Case 5.7 American International Group, Inc. 463

AIG is best known for receiving more federal bailout funds than any other company during the economic crisis that engulfed the U.S. economy beginning in the fall of 2008. Several years earlier, AIG had been widely criticized for helping companies develop special purpose entities (SPEs) to "window dress" their financial statements. Surprisingly, Ernst & Young partnered with AIG in developing and marketing that SPE "service."

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Case 5.8 Caesars Entertainment Corporation 467

The advisory partner assigned to the Caesars audit engagement team "gambled" with his firm's independence when he borrowed funds on multiple occasions from a Caesars casino.

Case 5.9 IPOC International Growth Fund, Ltd. 471

In this case, a KPMG employee became an unwitting pawn in an international chess match of corporate espionage and murder involving a close associate of Vladimir Putin, the Russian president at the time.

Case 5.10 Le-Nature's Inc., Part II 477

An audit partner of a major accounting firm faced tax evasion charges after deducting fraudulent travel expenses on his federal income tax returns for three consecutive years.

Case 5.11 Richard Grimes, Staff Accountant 479

An entry-level auditor overhears a private conversation between two corporate executives who intend to withhold critical information from their company's audit team. What should the young auditor do?

SECTION 6 Professional Roles 481

Case 6.1 Kayleigh Caudell, Audit Senior 483

Kayleigh tells a "little white lie" to her immediate superior on an audit engagement and then attempts to goad—unsuccessfully—one of her subordinates on the same engagement team to "cover" for her.

Case 6.2 Brian Reynolds, Audit Senior 489

Fast-track auditors who have their sights set on making partner as quickly as possible may adopt an "anything goes" mindset. In this case, Brian attempts to further his career goal by taking improper credit for work done by one of his subordinates.

Case 6.3 Madison Wells, Audit Manager 493

Madison Wells discovers an error in a client's financial statements—three days after the client filed those financial statements with the SEC. That discovery prompts the audit engagement partner to verbally abuse Madison.

Case 6.4 Tillman Rollins, Office Managing Partner 501

Tillman Rollins oversees a small and remote practice office of a Big Four accounting firm. As OMP, the "buck" stops with Rollins when it comes to employment decisions for his office. In this case, the loss of a major client forces him to dismiss a well-liked and industrious staff accountant.

Case 6.5 Leigh Ann Walker, Staff Accountant 507

A staff accountant employed by a large accounting firm is dismissed after serious questions arise regarding her integrity.

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Case 6.6 Bill DeBurger, In-Charge Accountant 509

To "sign off" or "not sign off" was the issue Bill DeBurger wrestled with after he completed the audit procedures for a client's most important account. An angry confrontation with the audit engagement partner made Bill's decision even more difficult.

Case 6.7 Hamilton Wong, In-Charge Accountant 513

"Eating time," or underreporting time worked on audit engagements, has serious implications for the quality of audit services and for the quality of auditors' work environment. Hamilton Wong came face-to-face with these issues when a colleague insisted on understating the number of hours she had worked on her assignments.

Case 6.8 Tommy O'Connell, Audit Senior 517

A new audit senior is quickly exposed to the challenging responsibilities of his professional work role when he is assigned to supervise a difficult audit engagement. During the audit, the senior must deal with the possibility that a staff accountant is "signing off" on audit procedures that he has not completed.

Case 6.9 Avis Love, Staff Accountant 521

Auditors sometimes develop close friendships with client personnel. Such friendships can prove problematic for auditors, as demonstrated by this case.

Case 6.10 Charles Tollison, Audit Manager 525

Audit managers occupy an important role on audit engagements and are a critical link in the employment hierarchy of public accounting firms. Similar to most professional accountants occupying this position, Charles Tollison aspired to being promoted to partner.

SECTION 7 Professional Issues 529

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Ligand's auditor was the first Big Four firm sanctioned by the Public Company Accounting Oversight Board (PCAOB).

Case 7.2 Sarah Russell, Staff Accountant 537

Sexual harassment is a sensitive subject that many companies and professional firms have been forced to contend with in recent years. This case recounts the experiences of a staff accountant who was harassed by an audit partner.

Case 7.3 Washington Council Ernst & Young 541

In 2012, investigative reporters for Reuters, the London-based international news agency, discovered that a division of Ernst & Young had provided lobbying services to multiple audit clients of the Big Four accounting firm.

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Case 7.4 Internet Infamy 547

Email reigned as the first "killer app" of the Internet. Unfortunately, improper email etiquette can serve to "kill" or, at least, severely hamper the careers of accountants as proven by the anecdotes woven into this case.

Case 7.5 Fred Stern & Company, Inc. (*Ultramares Corporation v. Touche et al.*) 551

This 1931 legal case established the Ultramares Doctrine that, decades later, has a pervasive influence on auditors' civil liability under the common law.

Case 7.6 First Securities Company of Chicago (*Ernst & Ernst v. Hochfelder et al.*) 559

In this case, the Supreme Court defined the degree of auditor misconduct that must be present before a client can recover damages from an auditor in a lawsuit filed under the Securities Exchange Act of 1934.

Case 7.7 Texas Drug Warehouse 565

KPMG found itself a defendant in a lawsuit filed by a former client. Among other allegations, the former client charged that KPMG had engaged in "deceptive business practices" by failing to inform client management that it planned to change the scope and nature of its annual audit of the company.

Case 7.8 Frank Coleman, Staff Accountant 569

In recent years, the major international accounting firms have been confronted with huge class-action lawsuits alleging that they did not properly compensate certain employees for the overtime hours they had worked.

Case 7.9 Olivia Thomas, Audit Senior 573

Intra-office dating is a taboo topic in many, if not most, professional services firms. This case demonstrates how intra-office dating can impact the performance of independent audits and complicate the personal and professional lives of auditors.

Case 7.10 The Red Carpet 581

Two Big Four partners find themselves in the national spotlight, literally, and for the wrong reason. A gaffe by the partners resulted in the wrong film being announced for Hollywood's most prized award, namely, the Academy Award for Best Picture.

SECTION 8 International Cases 591

Case 8.1 Longtop Financial Technologies Limited 593

The Longtop fraud focused attention on an issue that had been simmering within the regulatory system of the U.S. capital markets for several years, namely, the refusal of the Chinese government to allow the PCAOB to inspect Chinese accounting firms that audit companies with securities traded on U.S. stock exchanges.

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Case 8.2 Kaset Thai Sugar Company 599

This case examines the 1999 murder of Michael Wansley, a partner with Deloitte Touche Tohmatsu. Wansley was supervising a debt-restructuring engagement in a remote region of Thailand when a professional assassin gunned him down.

Case 8.3 Republic of Somalia 603

PricewaterhouseCoopers (PwC) accepted a lucrative, unusual, and controversial engagement for the transitional government established for the Republic of Somalia by the United Nations. The case questions require students to consider the significant risks and thorny ethical issues that engagement posed for PwC.

Case 8.4 Republic of the Sudan 607

In 2004, the SEC began requiring domestic and foreign registrants to disclose any business operations within, or other relationships with, Sudan and other countries identified as state sponsors of terrorism. Three years later, the SEC included a webpage on its EDGAR website that listed all such companies. This SEC "blacklist" proved to be extremely controversial and triggered a contentious debate over the federal agency's regulatory mandate and its definition of "materiality."

Case 8.5 *Shari'a* 611

Islamic companies are prohibited from engaging in transactions that violate Shari'a, *that is, Islamic religious law. To ensure that they have complied with* Shari'a, *Islamic companies have their operations subjected to a* Shari'a *compliance audit each year. Recently, Big Four firms began offering* Shari'a *audit services.*

Case 8.6 Olympus Corporation 621

This case documents the long-running Olympus accounting fraud that shocked the Japanese business community. In addition to other issues, the case examines systemic weaknesses in Japan's independent audit function.

Case 8.7 Razia 631

Title VII of the Civil Rights Act of 1964 prohibits organizations with 15 or more employees—including professional organizations such as major international accounting firms—from making employment decisions based on race, color, religion, sex, or national origin.

Case 8.8 The Bank of Tokyo 635

To conceal money-laundering activities, one of the world's largest banks pressured its Big Four accounting firm to alter an "independent" report to be filed with a regulatory agency. The compliant accounting firm paid the price—in the form of a $25 million fine—for capitulating to the client.

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PREFACE

The past two decades have been a turbulent time for public accounting and the independent audit function. Shortly after the turn of the century, the Enron and WorldCom fiascoes focused the attention of the investing public, the press, Wall Street, and, eventually, Congress, on our profession. The Enron and WorldCom scandals resulted in the passage of the Sarbanes–Oxley Act of 2002 (SOX) and the creation of the Public Company Accounting Oversight Board (PCAOB). The SOX statute imposed a litany of new responsibilities and constraints on auditors of public companies, including the need to audit their clients' internal controls and prohibiting them from providing certain consulting services to their clients.

Next came the campaign to replace U.S. generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS). That campaign stalled when the subprime mortgage crisis in the United States caused global stock markets to implode and global credit markets to "freeze" during the fall of 2008. This economic downturn claimed many companies that had been stalwarts of the U.S. economy, the prime example being Lehman Brothers. Most of these companies, including Lehman Brothers, had received "clean" audit opinions on their financial statements one year or less before they collapsed.

As Congress and regulatory authorities struggled to revive the U.S. economy, news of the largest Ponzi scheme in world history grabbed the headlines in early 2009. Investors worldwide were shocked to learn that Bernie Madoff, the "wizard of Wall Street," was a fraud. Law enforcement authorities determined that billions of dollars of client investments supposedly being held by Madoff's company, Madoff Securities, did not exist. The business press was quick to report that for decades Madoff Securities' financial statements had received unqualified audit opinions each year from a New York accounting firm.

More recently, the aggressive regulatory stance taken by the PCAOB has resulted in public reprimands for several of the large accounting firms that dominate the auditing discipline. The enormous pressure imposed on those firms' audit partners by the PCAOB's annual inspection program led to a headline-grabbing scandal when KPMG announced that it had dismissed five of its partners. Apparently to lower their firm's annual "deficiency" rate, those individuals had obtained advance warnings from former or existing PCAOB employees of the KPMG audits that the PCAOB intended to inspect.

As academics, we have a responsibility to help shepherd our profession through these challenging times. Auditing instructors, in particular, have an obligation to help restore the credibility of the independent audit function that has been adversely impacted by recent events. To accomplish this latter goal, one strategy we can use is to adopt the reforms recommended years ago by the Accounting Education Change Commission (AECC), many of which have been embraced by the more recent

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Pathways Commission, a joint project of the American Institute of Certified Public Accountants and the American Accounting Association. Among the AECC's recommendations was that accounting educators employ a broader array of instructional resources, particularly experiential resources, designed to stimulate active learning by students. My casebook provides instructors with a source of such materials that can be used in both undergraduate and graduate auditing courses.

This casebook stresses the "people" aspect of independent audits. If you review a sample of recent "audit failures," you will find that problem audits seldom result from inadequate audit technology. Instead, deficient audits typically result from the presence of one, or both, of the following two conditions: client personnel who intentionally subvert an audit or auditors who fail to carry out the responsibilities assigned to them. Exposing students to problem audits will help them recognize the red flags that often accompany audit failures. An ability to recognize these red flags and the insight gained by discussing and dissecting problem audits will allow students to cope more effectively with the problematic situations they are certain to encounter in their own careers. In addition, this experiential approach provides students with context-specific situations that make it much easier for them to grasp the relevance of important auditing topics, concepts, and procedures.

The cases in this text also acquaint students with the work environment of auditors. After studying these cases, students will better appreciate how client pressure, peer pressure, time budgets, and related factors complicate the work roles of independent auditors. Also embedded in these cases is the ambiguity and lack of structure that auditors face each day. Aspects of the audit environment representing those two conditions that are woven into my cases include missing documents, conflicting audit evidence, auditors' dual obligation to the client and to financial statement users, and the lack of definitive professional standards for many situations.

The Twelfth Edition of my casebook contains the following eight sections of cases: Comprehensive Cases, Audits of High-Risk Accounts, Internal Control Issues, Ethical Responsibilities of Accountants, Ethical Responsibilities of Independent Auditors, Professional Roles, Professional Issues, and International Cases. This organizational structure helps adopters quickly identify the cases best suited for their particular needs.

My casebook can be used in several different ways. Adopters can use the casebook as a supplemental text for the undergraduate auditing course or as a primary text for a graduate-level seminar in auditing. The instructor's manual contains a syllabus for a graduate auditing course organized around this text. This casebook can also be used in the capstone professional practice course incorporated in many five-year accounting programs. Customized versions of this casebook are suitable for a wide range of accounting courses, as explained later.

In preparing this edition, I retained those cases that have been among the most widely used by adopters. These cases include, among others, Enron Corporation, Golden Bear Golf, Lehman Brothers, Leigh Ann Walker, Madoff Securities, The Trolley

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Dodgers, and ZZZZ Best Company. You will find that many of the "returning" cases have been updated for relevant circumstances and events that have occurred since the publication of the previous edition.

New To This Edition This edition features 15 new cases and three revised cases that have appeared in earlier editions. Four of the new or revised cases are included in Section 1, Comprehensive Cases, that historically has been very popular with adopters. The Wells Fargo & Company case examines the massive and high-profile scandal stemming from the company's aggressive sales practices that left the reputation of the prominent company in tatters. Critics questioned why Wells Fargo's independent auditors did not disclose the internal control deficiencies that allowed the questionable sales practices to go unchecked for years. The Weatherford International case documents arguably the most imaginative accounting fraud in recent memory. Two Weatherford executives conspired to inflate their company's earnings by significantly understating its reported income tax expense while, at the same time, ensuring that the company annually paid the proper amount of taxes owed to taxing authorities. The SEC fined Weatherford's audit firm $12 million and required the firm to implement a "Validation Plan" to enhance its income tax-related auditing procedures. Consultants of Caterpillar's Big Four audit firm designed a tax-avoidance plan that yielded $2.4 billion of tax savings for the large manufacturing company. The lynchpin of the tax-avoidance plan was a "ghost" subsidiary in Switzerland to which Caterpillar diverted a large portion of its annual revenues. Following a congressional investigation that focused on Caterpillar's "Swiss tax strategy," the company faced potential multi-billion fines. Caterpillar's audit firm also faced scathing criticism for sanctioning the questionable tax strategy designed by its consultants. The revised Gemstar case addresses a range of revenue recognition issues that the company's audit firm had to tackle. That audit firm ultimately agreed to an SEC settlement involving a $10 million fine and suspensions of three partners and a senior audit manager. The federal agency concluded that those individuals had failed to "exercise professional care and skepticism" while auditing what proved to be a large volume of fraudulent Gemstar revenues.

Hampton & Worley is the sole new case in Section 2, Audits of High-Risk Accounts. This new case revolves around an audit senior's questionable decision to downplay a possible contingent liability pending against an audit client at year-end. Blakely Markets, a revamped case, and Equifax Inc. are new to Section 3, Internal Control Issues. A rash of cash thefts that were apparently "inside jobs" had been plaguing a Blakely Markets grocery store. When another theft occurred, two of the store's employees—including the prime suspect—were asked to take lie detector tests. Because the requirements of a federal statute were not properly invoked, the administration of the lie detector tests resulted in a potential liability for Blakely Markets that was much larger than the cash thefts. More than likely, you were a victim of the cyberattack on Equifax's computer system that exposed the credit records and personal information of 150 million U.S. citizens. The enormous Equifax cyberattack raised the question of whether independent auditors should consider cybersecurity risks when auditing

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their clients' internal controls over financial reporting. The new case in Section 4, Ethical Responsibilities of Accountants, is the third and final revised case included in this edition. The Aaron Elrod case illustrates the challenges—ethical and otherwise—that sole practitioners may face. Unfortunately, Aaron Elrod "flunked" his ethics test and wound up receiving a multi-year prison sentence.

The Twelfth Edition includes five new cases in Section 5, Ethical Responsibilities of Independent Auditors. In the AmTrust case, unknown to his colleagues on the audit engagement team, a BDO Seidman auditor was serving as an FBI informant. To capture incriminating information regarding the client, the auditor used a high-tech recording device camouflaged as a Starbucks gift card. Scott London, an audit partner who headed up KPMG's Pacific Southwest audit practice, funneled confidential information regarding public company audit clients to a close friend. In a sting operation, the FBI recorded London accepting a $5,000 cash payment from that friend, which resulted in London receiving a prison sentence—and losing his job. Antoine Deltour, a young auditor with PwC's Luxembourg City practice office, became disillusioned with public accounting. On his final day with PwC, Antoine copied a computer file from the office's hard drive that contained 30,000 pages documenting aggressive tax-avoidance plans PwC had developed for hundreds of companies, including prominent U.S. firms. Deltour ultimately faced criminal charges after the journalist to whom he had given the computer file posted the tax-avoidance plans to the Internet. In the Universal American case, the SEC fined EY almost $5 million after discovering that two of the firm's audit partners had inappropriate relationships with client executives. Case 5.5, Zero Tolerance, recounts a headline-grabbing scandal involving the PCAOB and KPMG. In June 2019, the PCAOB fined KPMG $50 million after uncovering a scheme used by five KPMG partners to identify the firm's audits that would be inspected by the PCAOB.

Section 6, Professional Roles, includes two new cases in this edition. Kayleigh Caudell, an audit senior, finds herself knee-deep in a dilemma after politely asking her subordinate to do something that Kayleigh admits may be "marginally dishonest." In Case 6.2, Brian Reynolds, another audit senior, also becomes tangled in a conflict with a subordinate. Brian, a quintessential "fast tracker" in his practice office, treats his subordinates with disrespect while fawning on his superiors. Eventually, one of Brian's subordinates takes him to task for claiming credit for work that she had done. The Red Carpet is a new case in Section 7, Professional Issues. This case recounts the major-league gaffe that took place during the 2017 Academy Awards. Several minutes after the winner of the prestigious Academy Award for Best Picture was announced, chaos broke out on the stage of the glitzy Dolby Theatre, where the awards ceremony was being held. Why? Because of a monumental mistake made by one of the two PwC partners in charge of distributing the sealed envelopes containing the cards on which each winner's name or title was printed. Finally, Section 8, International Cases, presents two new cases. The Razia case addresses the sensitive subject of Title VII of the Civil Rights Act of 1964 that prohibits organizations—including public accounting firms—with 15 or more employees from making employment decisions predicated on race,

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color, religion, sex, or national origin. The Bank of Tokyo case involves a mandatory money-laundering investigation completed for that bank by PwC consultants. After being goaded by client officials, PwC altered the wording of the report summarizing the investigation before filing it with the relevant regulatory agency. That decision ultimately resulted in the regulatory agency fining PwC $25 million.

Casebook Organization Listed next are brief descriptions of the eight groups of cases included in this text. The casebook's Table of Contents presents an annotated description of each case.

Comprehensive Cases Most of these cases deal with highly publicized problem audits performed by the major international accounting firms. Among the clients involved in these audits are Enron Corporation, Lehman Brothers, The Leslie Fay Companies, Livent, Weatherford International, and ZZZZ Best Company. Each of these cases addresses a wide range of auditing, accounting, and ethical issues.

Audits of High-Risk Accounts In contrast to the cases in the prior section, these cases highlight contentious accounting and auditing issues posed by a single account or group of accounts. For example, the Jack Greenberg case focuses primarily on inventory audit procedures. The Take-Two Interactive Software case raises audit issues relevant to accounts receivable, while the Belot Enterprises case examines auditing issues pertinent to period-ending expense accruals.

Internal Control Issues The cases in this section introduce students to internal control topics relevant to the performance of independent audits. These topics are examined in a variety of different client contexts. For example, the Goodner Brothers case focuses on internal control issues for a wholesaler, the Howard Street Jewelers case provides students an opportunity to discuss control issues relevant to retail businesses, and the First Keystone Bank case highlights controls in a financial services environment.

Ethical Responsibilities of Accountants Integrating ethics into an auditing course requires much more than simply discussing the AICPA's *Code of Professional Conduct*. This section presents specific scenarios in which accountants have been forced to deal with perplexing ethical dilemmas. By requiring students to study actual situations in which important ethical issues have arisen, they will be better prepared to resolve similar situations in their own professional careers. Four of the cases in this section will "strike close to home" for your students since they involve accounting majors. For example, in the Wiley Jackson case, a soon-to-graduate accounting major must decide whether to disclose in a preemployment document a minor-in-possession charge that is pending against him.

Ethical Responsibilities of Independent Auditors The cases in this section highlight ethical dilemmas encountered by independent auditors. In the Cardillo Travel Systems case, two audit partners face an ethical dilemma that most audit practitioners will experience at some point during their careers. The partners must decide whether

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to accept implausible explanations for a suspicious client transaction fed to them by client executives or, alternatively, whether to "complicate" the given engagement by insisting on fully investigating the transaction. Client confidentiality is the focal topic in the AmTrust Financial Services case, dramatic auditor independence and conflict-of-interest issues are raised in the Universal American case, and the American International Group case examines the always sensitive "scope of services" issue that has far-reaching ethical implications for audit firms.

Professional Roles Cases in this section examine specific work roles in the auditing discipline. These cases explore the responsibilities associated with those roles and related challenges that professionals occupying them commonly encounter. The Tommy O'Connell case involves a young auditor recently promoted to audit senior. Shortly following his promotion, Tommy finds himself assigned to supervise a small but challenging audit. Tommy's sole subordinate on that engagement happens to be a young man whose integrity and work ethic have been questioned by seniors he has worked for previously. Two cases in this section, Leigh Ann Walker and Avis Love, spotlight the staff accountant work role, which many of your students will experience firsthand following graduation.

Professional Issues These cases address sensitive but important topics in the auditing domain. Two precedent-establishing litigation cases, Fred Stern and First Securities Company, help students understand the significant legal liability facing accounting firms in the present litigious environment. The amount of overtime worked by independent auditors, the controversial scope of services issue, and the quality control challenges accounting firms must address are among other topics dealt with by cases in this section. Among the most sensitive topics for freshly-minted public accountants—which many of your students will soon be—is intra-office dating. The Olivia Thomas case provides future public accountants with a vivid, and real-life, account of how intra-office dating can impact their work environments and their professional careers.

International Cases These cases provide your students with an introduction to important issues facing the global accounting profession and auditing discipline. Several of these cases document unique challenges that must be dealt with by auditors and accountants in certain countries or regions of the world. For example, the Kaset Thai Sugar Company case dramatically demonstrates that auditors and accountants may be forced to cope with hostile and sometimes dangerous working conditions in developing countries where their professional roles and responsibilities are not well understood or appreciated. Likewise, the Longtop Financial Technologies case documents how cultural differences across the globe may impact the performance of independent audits.

Customize Your Own Casebook To maximize your flexibility in using these cases, Cengage Learning has included *Contemporary Auditing: Real Issues and Cases* in its customized publishing program. Adopters have the option of creating a customized version of this casebook ideally suited for their specific needs. At the University of

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Oklahoma, a customized selection of my cases has been used to add an ethics component to the undergraduate managerial accounting course. In fact, since the cases in this text examine ethical issues across a wide swath of different contexts, adopters can develop a customized ethics casebook to supplement almost any accounting course.

Custom versions of this casebook would be ideally suited for the undergraduate auditing course. For example, auditing instructors who want to add a strong international component to their courses can develop a customized edition of this text that includes a series of international cases. Likewise, to enhance the coverage of ethical issues in the undergraduate auditing course, instructors could choose a series of cases from this text that highlight important ethical issues. The following are several examples of customized versions of this casebook that could be integrated into the undergraduate auditing course.

International Focus: Longtop Financial Technologies Limited (8.1), Kaset Thai Sugar Company (8.2), Republic of Somalia (8.3), Shari'a (8.5), Olympus Corporation (8.6). This custom casebook would provide your students with insight on some of the most important issues that major accounting firms face when they enter foreign markets.

Ethics Focus (I): Suzette Washington, Accounting Major (4.3), Wiley Jackson, Accounting Major (4.5), Arvel Smart, Accounting Major (4.6), Leigh Ann Walker, Staff Accountant (6.5), Hamilton Wong, In-Charge Accountant (6.7), Avis Love, Staff Accountant (6.9). The first three cases give students an opportunity to discuss and debate ethical issues directly pertinent to them as accounting majors. The final three cases expose students to important ethical issues they may encounter shortly after graduation if they choose to enter public accounting.

Ethics Focus (II): Creve Couer Pizza, Inc. (4.1), F&C International, Inc. (4.2), Antoine Deltour (5.3), Universal American Corporation (5.4), American International Group (5.7), Richard Grimes, Staff Accountant (5.11). This selection of cases is suitable for auditing instructors who have a particular interest in covering a variety of ethical topics relevant to the AICPA's *Code of Professional Conduct.*

Applied Focus: Weatherford International (1.2), Livent, Inc. (1.12), ZZZZ Best Company, Inc. (1.13), Belot Enterprises (2.8), Cardillo Travel Systems, Inc. (5.6), Caesars Entertainment Corporation (5.8). This series of cases will provide students with a broad-brush introduction to the real world of independent auditing. These cases raise a wide range of technical, professional, and ethical issues in a variety of client contexts.

Professional Roles Focus: Kayleigh Caudell, Audit Senior (6.1), Tillman Rollins, Office Managing Partner (6.4), Leigh Ann Walker, Staff Accountant (6.5), Bill DeBurger, In-Charge Accountant (6.6), Tommy O'Connell, Audit Senior (6.8), Avis Love, Staff Accountant (6.9), and Charles Tollison, Audit Manager (6.10). This custom casebook would be useful for auditing instructors who choose to rely on a standard textbook to cover key technical topics in auditing but who also want to expose their students to the everyday ethical and professional challenges faced by individuals occupying various levels of the employment hierarchy within auditing firms.

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> *High-Risk Accounts Focus:* Each of the cases in Section 2, Audits of High-Risk Accounts. This series of cases will provide your students with relatively intense homework assignments that focus almost exclusively on the financial statement line items that pose the greatest challenges for auditors.

Of course, realize that you are free to choose any "combination" of my cases to include in a customized casebook for an undergraduate auditing course or another accounting course that you teach. For more information on how to design your customized casebook, please contact your Cengage Learning sales representative or visit the textbook website: http://compose.cengage.com/content/home.

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Michael C. Knapp
Professor Emeritus of Accounting
University of Oklahoma

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SECTION 1

COMPREHENSIVE CASES

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CASE 1.1

Wells Fargo & Company

Henry Wells and William Fargo, two East Coast businessmen, recognized that the California Gold Rush in the Sierra Nevada Mountains east of San Francisco had created a wealth of lucrative business opportunities for investors willing to accept a high risk of failure. After raising $300,000 from friends and business associates, the two adventurous entrepreneurs established San Francisco-based Wells Fargo & Company in 1852. At the time, San Francisco was a rapidly growing and largely lawless boomtown populated by 35,000 residents, including a ragtag collection of con artists, hustlers, and other ne'er-do-wells with shady backgrounds. Just four years earlier, San Francisco had been a sleepy fishing village with fewer than 500 residents.

A Wild West Mindset

Henry Wells, William Fargo, and their partners decided the two business services most needed by San Franciscans were transportation and banking. After acquiring a building near the intersection of present-day California and Montgomery Streets, the new company plunged headfirst, if not blindly, into those lines of business. Despite the lack of considerable forethought—or a comprehensive business plan—hard work and ingenuity allowed Wells Fargo to thrive.

Wells Fargo initially made a name for itself in the San Francisco Bay Area by providing rapid and reliable freight, courier, and mail delivery services. In the late 1850s, the company's founders helped organize the famous Butterfield Overland Mail Route that connected San Francisco with St. Louis. In a little more than three weeks, the company's stagecoaches could deliver mail, freight, and bone-weary travelers from the banks of the Mississippi River to the City by the Bay. Prior to the development of the first intercontinental railroad in 1869, Wells Fargo's fleet of six-horse stagecoaches served as the largest and most important transportation network west of the Mississippi River. (In 1862, the business assumed control of the iconic but short-lived Pony Express.)

Wells Fargo's banking operations expanded more slowly than its transportation services. However, the federal government's decision to nationalize major interstate freight and transportation lines during World War I forced Wells Fargo to focus almost exclusively on the banking industry. An aggressive acquisition strategy and the success of other key strategic initiatives implemented by successive generations of opportunistic, if not freewheeling, senior executives made Wells Fargo the largest banking firm globally in terms of collective market value by 2015. At the time, the company operated nearly 9,000 retail branches in 35 countries and had over 70 million customers.

In addition to its impressive size and unparalleled growth in the banking industry, Wells Fargo ranked, until recently, among the most admired and respected companies in both the United States and around the globe. In 2015, for example, Wells Fargo placed seventh in *Barron's* annual survey of the world's most respected multinational companies. Disaster struck in late 2016 when a federal agency revealed Wells Fargo had been fined $185 million for "unfair, deceptive, and abusive" banking practices. The resulting headline-grabbing scandal caused Wells Fargo to plummet to the bottom of *Barron's* annual survey.

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Growth at All Costs

During the early years of the twenty-first century, two strategic initiatives contributed heavily to Well Fargo's dramatic growth: a continually expanding product line of financial services and the "cross-selling" of those services to the company's existing customers. In fact, cross-selling eventually became the lynchpin of Wells Fargo's industry-leading business model.

"Financial products per customer household" rates among the most important metrics in the retail banking industry. By 2013, Wells Fargo provided an average of 6.15 financial products to each of its customer households, four times greater than the industry average. A noted bank consultant reported that "Wells Fargo is the master of this . . . no other bank can touch them."[1] The bank's long product line of services for retail consumers included checking and savings accounts, credit card accounts, automobile loans, student loans, retirement accounts, mortgage services, investment portfolio management services, among others.

Wells Fargo's cross-selling of its products was particularly successful from 2000 through 2013 when the company's financial-products-per-customer-household measure rose by approximately 50 percent. During this time frame, published reports in the *Los Angeles Times* and various business publications suggested that intense pressure imposed by Wells Fargo's branch managers on lower-level employees to reach unrealistic sales quotas accounted for the company's cross-selling success. The branch managers, themselves, also faced heavy pressure from Wells Fargo's regional managers and senior executives to reach or surpass the sales goals for their operating units each reporting period.

A 2013 *Los Angeles Times* article entitled "Wells Fargo's Pressure-cooker Sales Culture Comes at a Cost" prompted federal and local regulatory officials to begin investigating the company's marketing tactics. A former Wells Fargo entry-level employee quoted in the article recalled how superiors had belittled subordinates who failed to reach their assigned sales quotas. "We were constantly told we would end up working for McDonald's. If we did not make the sales quotas . . . we had to stay for what felt like after-school detention, or report to a call session [to telephone customers] on Saturdays."[2] A former Wells Fargo branch manager reported that if his branch failed to reach its periodic sales goal, he was "severely chastised and embarrassed in front of 60-plus managers"[3] from his sales region.

Even more troubling was an allegation that the extreme pressure exerted by Wells Fargo management on the company's entry-level salespeople drove them to routinely sign up customers for unwanted services. In one case, a former Wells Fargo employee described how a homeless woman had been goaded into opening six accounts—those accounts produced $39 in monthly fees for the given Wells Fargo branch. Another former employee told a *Los Angeles Times* reporter she resigned her position rather than continuing to force "unneeded and unwanted" financial products on customers "to satisfy sales targets."[4]

A common deceptive practice used by Wells Fargo sales staff was transferring a modest amount of funds from an existing customer account, such as, a checking account, to a new, unauthorized account, a practice referred to internally as "simulated funding." This tactic helped employees reach their periodic sales quotas while also generating additional fees for Wells Fargo.

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1. E. S. Reckard, "Wells Fargo's Pressure-cooker Sales Culture Comes at a Cost," *Los Angeles Times* (online), 22 December 2013.
2. *Ibid.*
3. *Ibid.*
4. *Ibid.*

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The pressure on Wells Fargo salespeople to market additional financial services or products to customers was exacerbated by the company's incentive compensation program.[5] Employees in entry-level sales positions earned significant bonuses each year if they met or surpassed their assigned sales quotas. In turn, Wells Fargo's branch managers and the company's more senior managers and executives received large bonuses if their subordinates achieved their sales goals.

Inattentive customers who did not monitor their Wells Fargo accounts became unwilling accomplices of their bank's scheming employees. If customers complained about unauthorized accounts opened in their names, branch managers would typically step in and assuage their concerns with disingenuous explanations. "When customers complained about the unwanted credit cards [or other unauthorized accounts], the branch manager would blame a computer glitch or say the card had been requested by someone with a similar name."[6]

In early September 2016, the Consumer Financial Protection Bureau (CFPB), a federal watchdog agency created by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, announced Wells Fargo had been fined $185 million. That figure included a $35 million fine imposed by the Office of the Comptroller of the Currency and a $50 million fine levied by the County of Los Angeles. The fines stemmed from "illegal" business practices employed by the banking giant, principal among them signing up customers for financial services and products they had not requested. The CFPB sanctions required Wells Fargo to refund customer fees linked to the unauthorized accounts—the refunds were expected to be no more than $5 million. Wells Fargo was also required to hire an independent consultant to identify measures to prevent self-serving employees from taking unfair advantage of customers.

Wells Fargo's senior management responded to the CFPB announcement by revealing that the individuals who had created the unauthorized customer accounts had been fired. In total, the bank had dismissed 5,300 individuals involved in the scam—the company's workforce included more than 250,000 employees. Nearly all of the fired employees occupied entry-level positions in Wells Fargo branches. The company also announced it was discontinuing the controversial cross-selling policy as of January 1, 2017.

"Nothing Could Be Further from The Truth"

The CFPB reported that between 2011 and 2016, alone, Wells Fargo employees had issued 600,000 credit cards and established 1.5 million bank accounts for customers who had not requested them. Those figures shocked and enraged not only the Wells Fargo customers who had been directly impacted by the scandal but also elected officials and the general public.

The response of Wells Fargo's senior executives to the scandal further infuriated the company's critics. In the days and weeks following the CFPB's stunning announcement, company spokespeople rejected insinuations that the underhanded banking practices were attributable to a high-pressure sales culture cultivated by top management. Similar denials had been made in 2013 when the *Los Angeles Times* leveled accusations of misconduct against Wells Fargo's sales staff. The company's chief financial officer (CFO) at the time had bluntly claimed he was "not aware of any overbearing sales culture"[7] within the firm.

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5. To stress the importance of branch employees "selling" new services to customers, Wells Fargo began using the term "stores" rather than "branches" when referring to its operating units.

6. Reckard, "Wells Fargo's Pressure-cooker Sales Culture Comes at a Cost."

7. *Ibid.*

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John Stumpf, Wells Fargo's chief executive officer (CEO), angrily dismissed allegations that the deceptive banking practices emerged from a mercenary, if not corrupt, internal culture within the company. In one statement, he insisted those activities were not the result of an "orchestrated effort, or scheme as some have called it, by the company."[8] In responding to a 2015 lawsuit alleging improper sales practices by Wells Fargo's branches, Stumpf snapped, "Nothing could be further from the truth on forcing products on customers . . . Did some things go wrong – you bet and that is called life. This is not systemic."[9]

Following the announcement of the CFPB sanctions, a former Wells Fargo branch manager said he was "disgusted" by John Stumpf's effort to divert responsibility for the scandal from the company's senior management to the 5,300 lower-level employees fired by the company. "Corporate executives designed the sales quota systems and created the culture of harassment and fear when we did not meet them. When John Stumpf blamed the frontline workers for the unauthorized accounts, I was disgusted."[10]

Critics of John Stumpf were quick to point out that he had maligned the new banking regulations prompted by the massive financial crisis of 2008–2009 that had undercut the stability of the U.S. banking system. That crisis had been attributed, in part, to high-risk, if not reckless, policies implemented by the nation's largest banks, including Wells Fargo. While accepting the 2013 "Banker of the Year Award" from a major trade publication, Stumpf, the nation's highest-paid banker, denounced the "plethora of new banking regulations"[11] that he believed were inconsistent with a free market economy. Ironically, Stumpf had failed to criticize the federal government's decision a few years earlier to suspend free-market conditions by providing Wells Fargo with $25 billion in "bailout" funds to help it weather the enormous economic crisis.

As the controversy over Wells Fargo's unlawful banking practices continued to grow, the U.S. House Financial Services Committee and the U.S. Senate Banking Committee held hearings in late September 2016 to investigate the scandal. In his testimony before those committees, John Stumpf "stuck to the same script he had used throughout the crisis. The problem, he explained, was an ethical lapse limited to the 5,300 employees, most of them low-level bankers and tellers, who had been fired for their actions since 2011."[12]

Members of both political parties verbally battered Stumpf during the congressional hearings. His most relentless critic was U.S. Senator Elizabeth Warren. Senator Warren pointed out that in addition to the tens of millions of dollars in salary and other compensation benefits Stumpf had received during the time frame covered by the CFPB investigation, the value of his ownership interest in Wells Fargo had increased by $200 million during that five-year period. After telling Stumpf he should resign, Warren added angrily, "You should give back the money you took while this scam was going on, and you should be criminally investigated by the Department of Justice and the Securities and Exchange Commission."[13]

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8. M. Corkery, "Wells Fargo's John Stumpf Has His Wall Street Comeuppance," *New York Times* (online), 19 September 2016.

9. W. Frost and D. Giel, "Wells Fargo Board Slams Former CEO Stumpf and Tolstedt, Claws Back $75 Million," www.cnbc.com, 10 April 2017.

10. L. Shen, "Former Wells Fargo Employees to CEO John Stumpf: It's Not Our Fault," http://fortune.com, 19 September 2016.

11. Corkery, "Wells Fargo's John Stumpf Has His Wall Street Comeuppance."

12. S. Cowley, "Wells Fargo's Reaction to Scandal Fails to Satisfy Angry Lawmakers," *New York Times* (online), 29 September 2016.

13. J. Puzzanghera, "Sen. Elizabeth Warren Rips into Wells Fargo CEO's 'Gutless Leadership,'" *Los Angeles Times* (online), 20 September 2016.

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In early October 2016, shortly after he testified before Congress, John Stumpf resigned as Wells Fargo's CEO. A few months later, the company dismissed four other executives linked to the cross-selling scandal.

Senators Take Aim at KPMG

After berating John Stumpf, congressional investigators turned their attention to other parties associated with Wells Fargo, who they believed shared some measure of responsibility for the company's massive scandal. KPMG, Wells Fargo's independent audit firm since 1931, soon found itself in Congress's crosshairs.

Because independent auditors serve as the final line of defense against shortsighted corporate executives, legislative and regulatory authorities often examine the role auditors played—or failed to play—in high-profile financial scandals. In the decade prior to the Wells Fargo fiasco, the spectacular collapses of Enron and WorldCom within 12 months of each other cost investors and creditors $200 billion. Andersen & Co., which had served as the audit firm of both companies, faced fierce criticism from numerous parties, including Congress, for not warning the public of the criminal conduct that had undermined those two well-known companies.[14]

In the summer of 2002, public outrage stemming from the Enron and WorldCom disasters spurred Congress to hurriedly pass the Public Company Accounting Reform and Investor Protection Act, commonly referred to as the Sarbanes–Oxley (SOX) Act. Among other wide-ranging corporate reforms—including the creation of the Public Company Accounting Oversight Board (PCAOB)—SOX requires large public companies to have their internal control over financial reporting (ICFR) audited annually by their independent accounting firm.[15] The existence of one "material weakness" in a company's ICFR mandates the issuance of an "adverse" opinion on those controls. Congress expected that annual ICFR audits would discourage unscrupulous business practices such as those that had brought down Enron and WorldCom.

Beginning in 2004, when the SOX-mandated ICFR rules went into effect, KPMG issued an unqualified or "clean" opinion each year on the effectiveness of Wells Fargo's ICFR, including 2011–2015, the time period covered by the CFPB's investigation. Those unqualified ICFR opinions stood in stark contrast to harsh indictments of Wells Fargo's internal controls by other parties. The *New York Times* reported that the "widespread nature of the illegal behavior [within Wells Fargo's operations] showed that the bank lacked the necessary controls and oversight of its employees."[16] In an apparent reference to KPMG's reports on Wells Fargo's ICFR, a former federal regulator asked, "How does a bank that is supposed to have robust internal controls permit the creation of [a large number of] dummy accounts?"[17]

Wells Fargo's apparent internal control deficiencies caused several U.S. senators to demand KPMG explain why it had issued a clean opinion each year on the

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14. A criminal conviction stemming from the Enron bankruptcy effectively forced Andersen & Co. to cease operations. Although the U.S. Supreme Court subsequently overturned the conviction, the former Big Five firm's reputation had already been undermined.

15. SOX requires the management of each large public company to issue an annual report on the effectiveness of the organization's ICFR. Technically, auditors are required to then issue a report commenting on the accuracy of client management's ICFR assessment. Since the adoption of these requirements, the auditing profession has treated the latter mandate effectively as a requirement to "audit" a client's ICFR.

16. M. Corkery, "Wells Fargo Fined $185 Million for Fraudulently Opening Accounts," *New York Times* (online), 8 September 2016.

17. M. Egan, "5,300 Wells Fargo Employees Fired Over 2 Million Phony Accounts," www.cnn.com, 9 September 2016.

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company's ICFR while the CFPB was finding evidence of pervasive fraud. Those four senators, which included Senator Elizabeth Warren, sent a letter to KPMG's CEO in late October 2016—see Exhibit 1. In the letter's prologue, the senators suggested that KPMG's failure to report Wells Fargo's "illegal behavior" cast doubt on the "quality" of the firm's annual audits of the company's ICFR.

The senators asked KPMG to respond to five questions. The key issue raised by those questions was whether KPMG was "aware of any of the illegal sales practices committed by Wells Fargo employees." If KPMG had not been aware of those activities, the senators

EXHIBIT 1

October 27, 2016, Letter Sent by Members of U.S. Senate to KPMG Chairman

Lynne Doughtie
Chairman and Chief Executive Officer
KPMG U.S.
345 Park Avenue
New York, NY 10154

Dear Ms. Doughtie:

We are writing regarding KPMG's role as the independent auditor of Wells Fargo's financial statements from 2011-2015, years in which the company was unable to detect and prevent illegal sales practices by thousands of employees. Wells Fargo recently settled with federal regulators for the company's misbehavior in this massive fraud involving the creation of more than one million unauthorized deposit accounts and over 560,000 fraudulent credit card applications.

Wells Fargo dismissed 5,300 employees over a five-year period for these actions. But each year during what the Consumer Financial Protection Bureau's (CFPB) investigation concluded to be "fraudulent conduct . . . on a massive scale," KPMG conducted audits assessing Wells Fargo's internal control over its financial statements. These detailed audits were conducted by "obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk." But none of KPMG's audits identified any concerns with illegal behavior that resulted in the creation of over two million unauthorized accounts by thousands of employees – and that ultimately resulted in the resignation of Wells Fargo's CEO and a decline in the company's stock price of more than 10% in the days after the settlement with federal regulators. In fact, in each of your audits, your firm concluded that Wells Fargo "maintained . . . effective internal control over financial reporting."

The Sarbanes-Oxley Act of 2002 was passed into law in part to address the problem of companies like Enron whose internal auditors' lack of independence enabled them to produce unreliable public financial reports and obscure problems with their companies. That is why the Act requires financial statements of public companies to be audited by an independent accountant and filed with the Securities and Exchange Commission (SEC). But your firm's failure to identify the illegal behavior at Wells Fargo raises questions about the quality of your audits and the effectiveness of the implementation of these Sarbanes-Oxley requirements by the Public Company Accounting Oversight Board (PCAOB).

Therefore, we request answers to the following questions:

1) Was KPMG aware of any of the illegal sales practices committed by Wells Fargo employees from 2011-2015 and addressed in the CFPB settlement?
   If yes:
   a. Did KPMG communicate this knowledge with top executives at Wells Fargo? If so, please provide electronic or paper copies of any and all communications.

(*continued*)

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EXHIBIT 1—*continued*

OCTOBER 27, 2016, LETTER SENT BY MEMBERS OF U.S. SENATE TO KPMG CHAIRMAN

b. Did KPMG have any internal discussions about Wells Fargo's illegal sales practices and their potential impact on the company's financial statements and on the outcome of the annual audits? If so, please provide all electronic or paper documents relating to these discussions.

If no:

a. Please provide a detailed explanation of why KPMG failed to contemporaneously identify or otherwise learn of Wells Fargo's illegal activity during your audits.

b. Did you assess whether Wells Fargo had controls in place to prevent this illegal activity? What was your assessment about the quality of these controls and how well they were executed?

2) Did any employee of Wells Fargo mislead any employee of KPMG about the extent and impact of the unauthorized account creation addressed in the CFPB settlement during your audits?

3) Has KPMG conducted any internal reviews, reexaminations, or reassessments of its Wells Fargo audits in light of the information revealed in the settlement?

4) Has KPMG faced any disciplinary action or queries from the Public Company Accounting Oversight Board (PCAOB) in relation to your audits of Wells Fargo? If so, please provide details on these actions or queries.

5) Based on your present knowledge of the creation of unauthorized accounts at Wells Fargo, does your firm stand by its conclusions from 2011-2015 that "Wells Fargo maintained, in all material respects, effective internal control over financial reporting?"

Please provide complete answers to these questions by November 28, 2016. Thank you for your attention.

Sincerely,

U.S. Senator Elizabeth Warren — U.S. Senator Bernard Sanders

U.S. Senator Mazie K. Hirono — U.S. Senator Edward J. Markey

Note: The original letter from the U.S. senators included extensive footnotes identifying the sources of the quoted passages. Those footnotes can be found in the original version of the letter that is available online. (https://www.warren.senate.gov/files/documents/2016-10-27_Ltr_to_KPMG_re_Wells_Fargo_Audits_FINAL.pdf)

asked the firm to explain why its Wells Fargo auditors had "failed" to identify them. The senators' final question asked KPMG to indicate whether it stood by "its conclusions from 2011–2015" that Wells Fargo had "maintained, in all material respects, effective internal control over financial reporting" given the subsequent findings of the CFPB.

After multiple news services published the letter sent by the four U.S. senators to KPMG, several parties came to the accounting firm's defense. A *Forbes* article entitled "Elizabeth Warren Sends Misguided Letter to KPMG about Wells Fargo" insisted that Senator Warren, her colleagues, and certain elements of the press did not understand the nature and purpose of the independent auditor's ICFR-related responsibilities. The article took particular issue with a statement by CNN that "Each year, KPMG put a stamp of approval on the procedures that Wells Fargo had in place to guarantee the integrity of its financial statements."[18] Rather than "guaranteeing" the reliability of

18. R. Berger, "Elizabeth Warren Sends Misguided Letter to KPMG about Wells Fargo," www.forbes.com, 31 October 2016.

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