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# CONTEMPORARY AUDITING<sup>12E</sup>



MICHAEL C.  
KNAPP



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**Contemporary Auditing: Real Issues  
and Cases, Twelfth Edition**  
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# DEDICATION

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



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## SECTION 1 Comprehensive Cases 1

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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.

### Case 1.3 Caterpillar Inc. 35

*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.

**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.

**Case 1.6**    Lehman Brothers Holdings, Inc. 73

*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.*

**KEY TOPICS:** “accounting-motivated” transactions, materiality decisions by auditors, responsibility of auditors to investigate whistleblower allegations, auditors’ legal exposure, and communications with audit committee.

**Case 1.7**    Just For FEET, Inc. 89

*In the fall of 1999, just a few months after reporting a record profit for fiscal 1998, Just for FEET collapsed and filed for bankruptcy. Subsequent investigations by law enforcement authorities revealed a massive accounting fraud that had grossly misrepresented the company’s reported operating results. Key features of the fraud were improper accounting for “vendor allowances” and intentional understatements of the company’s inventory valuation allowance.*

**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.

**Case 1.8**    Health Management, Inc. 103

*The Private Securities Litigation Reform Act (PSLRA) of 1995 amended the Securities Exchange Act of 1934. This new federal statute was projected to have a major impact on auditors’ legal liability under the 1934 Act. The first major test of the PSLRA was triggered by a class-action lawsuit filed against BDO Seidman for its 1995 audit of Health Management, Inc., a New York-based pharmaceuticals distributor.*

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

**Case 1.9**    The Leslie Fay Companies 119

*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.

**Case 1.10** Le-Nature's Inc. 131

*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.

**Case 1.11** Navistar International Corporation 139

*The Navistar case resulted in the first formal investigation of a Big Four firm by the PCAOB and played a role in prompting that agency to consider implementing mandatory audit firm rotation. Prior to being dismissed in 2006, Deloitte had served as Navistar's auditor for 98 years.*

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

**Case 1.12** Livent, Inc. 153

*Garth Drabinsky built Livent, Inc., into a major force on Broadway during the 1990s. A string of successful Broadway productions resulted in numerous Tony Awards for the Canadian company. Despite Livent's theatrical success, its financial affairs were in disarray. Drabinsky and several of his top subordinates used abusive accounting practices to conceal Livent's financial problems from their independent auditors.*

**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.

**Case 1.13** ZZZZ Best Company, Inc. 167

*Barry Minkow, the "boy wonder" of Wall Street, created a \$200,000,000 company that existed only on paper.*

**KEY TOPICS:** identification of key management assertions, limitations of audit evidence, importance of candid predecessor–successor auditor communications, client confidentiality, and client-imposed audit scope limitations.

**Case 1.14** DHB Industries, Inc. 181

*"You can't make up a story like this," observed a senior legal analyst for CBS News who tracked and reported on this outrageous financial fraud that involved a freewheeling executive who covertly used funds from the company he founded to finance his horse-racing hobby.*

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

**Case 1.15** New Century Financial Corporation 197

*The collapse of New Century Financial Corporation in April 2007 signaled the beginning of the subprime mortgage crisis in the United States, a crisis that would destabilize securities and credit markets around the globe. New Century's independent auditors failed to provide advance warning of the mortgage company's demise.*

**KEY TOPICS:** auditing loan loss reserves, Section 404 audit procedures, material internal control weaknesses, auditor independence, and audit staffing issues.

**Case 1.16** Madoff Securities 215

*As an adolescent, Bernie Madoff dreamed of “making it big” on Wall Street. Madoff realized his dream by overseeing the world’s largest and possibly longest-running Ponzi scheme. Madoff’s auditor pleaded guilty to various criminal charges for his role in that fraud.*

**KEY TOPICS:** factors common to financial frauds, regulatory role of the SEC, nature and purpose of peer reviews, audit procedures for investments, and the importance of the independent audit function.

**Case 1.17** AA Capital Partners, Inc. 225

*The SEC held the AA Capital audit engagement partner and audit manager responsible for failing to uncover an embezzlement scheme masterminded by one of the company’s executives. A federal judge subsequently cleared the AA Capital audit partner—but not the audit manager.*

**KEY TOPICS:** related-party transactions, the division of responsibilities on audit engagement teams, the nature and purpose of subsequent period audit tests, reliance on a client’s internal controls, and quality control measures for audit firms.

**SECTION 2** Audits of High-Risk Accounts 235

**Case 2.1** Jack Greenberg, Inc. 237

*A federal judge criticized Greenberg’s independent auditors for failing to realize the impact that pervasive internal control problems had on the reliability of the company’s inventory accounting records.*

**Case 2.2** Golden Bear Golf, Inc. 245

*Jack Nicklaus, the “Golden Bear,” endured public embarrassment and large financial losses when key subordinates intentionally misapplied the percentage-of-completion accounting method to numerous golf course development projects.*

**Case 2.3** Take-Two Interactive Software, Inc. 253

*Take-Two markets Grand Theft Auto, the fourth best-selling video game “franchise” of all time and easily one of the most controversial. In a span of a few years, Take-Two was forced to restate its financial statements three times after recording bogus sales and backdating stock options.*

**Case 2.4** General Motors Company 261

*In early 2009, the SEC released the results of a lengthy investigation of GM’s financial statements over the previous several years. A major focus of that investigation was GM’s questionable accounting decisions for its massive pension liabilities and expenses.*

**Case 2.5** Lipper Holdings, LLC 267

*Lipper’s auditors were criticized for failing to uncover a fraudulent scheme used by a portfolio manager to materially inflate the market values of investments owned by three of the company’s largest hedge funds.*

<b>Case 2.6</b>	<b>CBI Holding Company, Inc.</b>	<b>275</b>
	<i>This case focuses on audit procedures applied to accounts payable, including the search for unrecorded liabilities and the reconciliation of year-end vendor statements to recorded payables balances.</i>	
<b>Case 2.7</b>	<b>Bankrate, Inc.</b>	<b>281</b>
	<i>In late 2015, the SEC fined Bankrate \$15 million for a large-scale accounting scam that had allowed the company to surpass its consensus earnings forecast. Ironically, among the items that Bankrate improperly accounted for were company audit fees and expenditures incurred for control provisions mandated by the Sarbanes–Oxley Act.</i>	
<b>Case 2.8</b>	<b>Belot Enterprises</b>	<b>287</b>
	<i>Understating discretionary expense accruals is a common method used by self-interested corporate executives to enhance their company’s financial statements. In this case, Belot “juggled” the period-ending balances of five major expense accruals to achieve an earnings goal established by the company’s new chief operating officer.</i>	
<b>Case 2.9</b>	<b>Powder River Petroleum International, Inc.</b>	<b>293</b>
	<i>A new management team implemented a successful turnaround strategy for Powder River. Unfortunately, the lynchpin of that strategy was an international Ponzi scheme involving the sale of “working interests” in Powder River’s oil and gas properties.</i>	
<b>Case 2.10</b>	<b>LocatePlus Holdings Corporation</b>	<b>303</b>
	<i>The New Age business model of LocatePlus revolved around a huge database that contained information profiles for 98 percent of all U.S. citizens. In contrast, LocatePlus executives used an old-fashioned fraud scheme to inflate the company’s reported revenues.</i>	
<b>Case 2.11</b>	<b>Overstock.com, Inc.</b>	<b>309</b>
	<i>Patrick Byrne, a bon vivant and protégé of Warren Buffet, founded Overstock in 1999. A decade later, a questionable gain contingency recorded by Overstock sparked a dispute between Byrne and his company’s audit firm. That dispute spawned a series of public and contentious exchanges between the two parties.</i>	
<b>Case 2.12</b>	<b>Parker-Halsey Corporation</b>	<b>317</b>
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<b>Case 2.13</b>	<b>Hampton &amp; Worley</b>	<b>331</b>
	<i>During the wrap-up phase of an audit, an audit senior neglects to inform her superiors of a potential problem in the client’s financial statements. Why? Because an extension of the audit would disrupt her post-audit vacation plans.</i>	
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	<i>Control deficiencies in the Dodgers’ payroll transaction cycle allowed an accounting manager to embezzle several hundred thousand dollars.</i>	

- Case 3.2** Howard Street Jewelers, Inc. 343  
*Given the susceptibility of cash to theft, retail companies typically establish rigorous internal controls for their cash processing functions. This case documents the high price of failing to implement such controls.*
- Case 3.3** Avon Products, Inc. 345  
*In December 2014, the SEC levied almost \$135 million of fines against Avon for violating the bribery and internal control provisions of the Foreign Corrupt Practices Act. The scandal also cost five senior Avon executives their jobs, including CEO Andrea Jung, one of the most influential women in Corporate America.*
- Case 3.4** First Keystone Bank 353  
*Three tellers of a First Keystone Bank branch embezzled more than \$100,000 from the branch's ATM. The district attorney who prosecuted the tellers commented on the need for businesses to not only establish internal controls to protect their assets but also on the importance of ensuring that those controls are operational.*
- Case 3.5** Goodner Brothers, Inc. 357  
*An employee of this tire wholesaler found himself in serious financial trouble. To remedy this problem, the employee took advantage of his employer's weak internal controls by stealing a large amount of inventory, which he then sold to other parties.*
- Case 3.6** Buranello's Ristorante 365  
*The general manager of Buranello's set up a "sting" operation—with the owner's approval—to test the honesty of the employee who he believed was stealing from the business. But the plan backfired and Buranello's found itself on the wrong end of a "malicious prosecution" lawsuit.*
- Case 3.7** Saks Fifth Avenue 369  
*A sales clerk tested Saks' "zero tolerance" policy for employee theft in this case. After being dismissed, the employee tested Saks again by suing the firm for wrongful termination.*
- Case 3.8** The Boeing Company 373  
*Two Boeing internal auditors disclosed information regarding alleged problems in their employer's internal controls to a newspaper reporter. After being fired, the two individuals filed lawsuits against Boeing under the whistleblowing provisions embedded in the Sarbanes–Oxley Act.*
- Case 3.9** Walmart de Mexico 379  
*A Pulitzer Prize-winning article in the New York Times charged that Walmart became Mexico's dominant mass merchandiser by routinely bribing government officials.*
- Case 3.10** Blakely Markets 383  
*An important but commonly overlooked internal control objective is ensuring compliance with applicable laws and regulations. The management of Blakely Markets violated the provisions of a federal statute, imposing a heavy monetary cost on the company in the process.*



<b>Case 3.11</b>	<b>Equifax Inc.</b>	<b>389</b>
	<i>A breach of Equifax’s computer system exposed the credit histories of almost 150 million U.S. citizens. Critics subsequently questioned why Equifax’s auditors discounted the company’s significant cybersecurity risks while auditing its internal controls over financial reporting.</i>	
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<b>Case 4.1</b>	<b>Creve Couer Pizza, Inc.</b>	<b>397</b>
	<i>Intrigue and espionage seem far removed from accounting . . . but not in this case. Creve Couer’s CPA was actually a double agent. While providing accounting services to his client, the CPA also supplied incriminating evidence regarding the client to the IRS.</i>	
<b>Case 4.2</b>	<b>F&amp;C International, Inc.</b>	<b>401</b>
	<i>A financial fraud spelled the end of a company with a proud history and tested the ethics of several of its key management and accounting personnel.</i>	
<b>Case 4.3</b>	<b>Suzette Washington, Accounting Major</b>	<b>405</b>
	<i>Suzette Washington, a college senior, majoring in accounting, faces an ethical dilemma. Since accounting majors are entering a profession with a rigorous code of ethics, do they have a greater responsibility than other students to behave ethically?</i>	
<b>Case 4.4</b>	<b>Aaron Elrod, Sole Practitioner</b>	<b>407</b>
	<i>A CPA in public practice faces a prison sentence after a dishonest client goads him into participating in a money-laundering scheme.</i>	
<b>Case 4.5</b>	<b>Wiley Jackson, Accounting Major</b>	<b>413</b>
	<i>“To tell or not to tell” was the gist of an ethical dilemma faced by Wiley Jackson while completing a preemployment document for his future employer, a major accounting firm.</i>	
<b>Case 4.6</b>	<b>Arvel Smart, Accounting Major</b>	<b>415</b>
	<i>Should an accounting major accept an internship position offered to him by a prospective employer when he has already decided to accept a job offer for a permanent position with another firm following graduation?</i>	
<b>Case 4.7</b>	<b>Zane Corbin, Accounting Major</b>	<b>417</b>
	<i>In recent years, “resume padding” has been costly to many politicians and other public officials. In this case, Zane Corbin faces an academic misconduct charge for allegedly embellishing the vita he submitted to a faculty awards committee after he was nominated for a prestigious undergraduate honor.</i>	
<b>Case 4.8</b>	<b>Dell Inc.</b>	<b>423</b>
	<i>This case explores ethical issues raised by a pervasive earnings management scheme masterminded by Dell executives, including Michael Dell.</i>	

**SECTION 5 Ethical Responsibilities of Independent Auditors 427****Case 5.1 AmTrust Financial Services, Inc. 429**

*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.*

**Case 5.2 Herbalife International 433**

*In early 2013, the FBI carried out a sting operation to snare an auditor who was feeding confidential “inside” information regarding a public company audit client to a friend. At the time, the auditor, a longtime Big Four partner, headed up his firm’s Pacific Southwest audit practice, a role in which he supervised more than 500 other audit professionals.*

**Case 5.3 Antoine Deltour 441**

*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.*

**Case 5.4 Universal American Corporation 447**

*The profession’s Code of Professional Conduct requires auditors to maintain their independence from audit clients. In this case, the SEC fined a Big Four firm almost \$5 million after discovering that two of the firm’s partners had established close personal relationships with client executives.*

**Case 5.5 Zero Tolerance 453**

*Each year, the Big Four firms anxiously await the “deficiency” rates published for them by the PCAOB. To improve (lower) their firm’s deficiency rates, several KPMG partners used covert means to identify the KPMG audits to be inspected by the PCAOB.*

**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.”*

<b>Case 5.8</b>	<b>Caesars Entertainment Corporation</b>	<b>467</b>
	<i>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.</i>	
<b>Case 5.9</b>	<b>IPOC International Growth Fund, Ltd.</b>	<b>471</b>
	<i>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.</i>	
<b>Case 5.10</b>	<b>Le-Nature’s Inc., Part II</b>	<b>477</b>
	<i>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.</i>	
<b>Case 5.11</b>	<b>Richard Grimes, Staff Accountant</b>	<b>479</b>
	<i>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?</i>	
<b>SECTION 6</b>	<b>Professional Roles</b>	<b>481</b>
<b>Case 6.1</b>	<b>Kayleigh Caudell, Audit Senior</b>	<b>483</b>
	<i>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.</i>	
<b>Case 6.2</b>	<b>Brian Reynolds, Audit Senior</b>	<b>489</b>
	<i>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.</i>	
<b>Case 6.3</b>	<b>Madison Wells, Audit Manager</b>	<b>493</b>
	<i>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.</i>	
<b>Case 6.4</b>	<b>Tillman Rollins, Office Managing Partner</b>	<b>501</b>
	<i>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.</i>	
<b>Case 6.5</b>	<b>Leigh Ann Walker, Staff Accountant</b>	<b>507</b>
	<i>A staff accountant employed by a large accounting firm is dismissed after serious questions arise regarding her integrity.</i>	

**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**

**Case 7.1** Ligand Pharmaceuticals **531**

*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.*

<b>Case 7.4</b>	<b>Internet Infamy</b>	<b>547</b>
	<i>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.</i>	
<b>Case 7.5</b>	<b>Fred Stern &amp; Company, Inc. (Ultramares Corporation v. Touche et al.)</b>	<b>551</b>
	<i>This 1931 legal case established the Ultramares Doctrine that, decades later, has a pervasive influence on auditors’ civil liability under the common law.</i>	
<b>Case 7.6</b>	<b>First Securities Company of Chicago (Ernst &amp; Ernst v. Hochfelder et al.)</b>	<b>559</b>
	<i>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.</i>	
<b>Case 7.7</b>	<b>Texas Drug Warehouse</b>	<b>565</b>
	<i>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.</i>	
<b>Case 7.8</b>	<b>Frank Coleman, Staff Accountant</b>	<b>569</b>
	<i>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.</i>	
<b>Case 7.9</b>	<b>Olivia Thomas, Audit Senior</b>	<b>573</b>
	<i>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.</i>	
<b>Case 7.10</b>	<b>The Red Carpet</b>	<b>581</b>
	<i>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.</i>	
<b>SECTION 8</b>	<b>International Cases</b>	<b>591</b>
<b>Case 8.1</b>	<b>Longtop Financial Technologies Limited</b>	<b>593</b>
	<i>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.</i>	

<b>Case 8.2</b>	<b>Kaset Thai Sugar Company</b>	<b>599</b>
	<i>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.</i>	
<b>Case 8.3</b>	<b>Republic of Somalia</b>	<b>603</b>
	<i>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.</i>	
<b>Case 8.4</b>	<b>Republic of the Sudan</b>	<b>607</b>
	<i>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.”</i>	
<b>Case 8.5</b>	<b>Shari’a</b>	<b>611</b>
	<i>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.</i>	
<b>Case 8.6</b>	<b>Olympus Corporation</b>	<b>621</b>
	<i>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.</i>	
<b>Case 8.7</b>	<b>Razia</b>	<b>631</b>
	<i>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.</i>	
<b>Case 8.8</b>	<b>The Bank of Tokyo</b>	<b>635</b>
	<i>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.</i>	
	<i>Index</i>	<b>639</b>
	<i>Summary of Topics by Case</i>	<b>651</b>
	<i>Summary of Cases by Topic</i>	<b>669</b>

# PREFACE

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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

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



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

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,

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

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

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.

*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  
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# SECTION 1

# 1

**Case 1.1**

**Case 1.2**

**Case 1.3**

**Case 1.4**

**Case 1.5**

**Case 1.6**

**Case 1.7**

**Case 1.8**

**Case 1.9**

**Case 1.10**

**Case 1.11**

**Case 1.12**

**Case 1.13**

**Case 1.14**

**Case 1.15**

**Case 1.16**

**Case 1.17**







## 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."<sup>1</sup> 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."<sup>2</sup> 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"<sup>3</sup> 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."<sup>4</sup>

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.*

The pressure on Wells Fargo salespeople to market additional financial services or products to customers was exacerbated by the company's incentive compensation program.<sup>5</sup> 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."<sup>6</sup>

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"<sup>7</sup> 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.*

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."<sup>8</sup> 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."<sup>9</sup>

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."<sup>10</sup>

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"<sup>11</sup> 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."<sup>12</sup>

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."<sup>13</sup>

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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](http://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. Puzanghera, "Sen. Elizabeth Warren Rips into Wells Fargo CEO's 'Gutless Leadership,'" *Los Angeles Times* (online), 20 September 2016.

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 short-sighted 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.<sup>14</sup>

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.<sup>15</sup> 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.”<sup>16</sup> 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?”<sup>17</sup>

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.

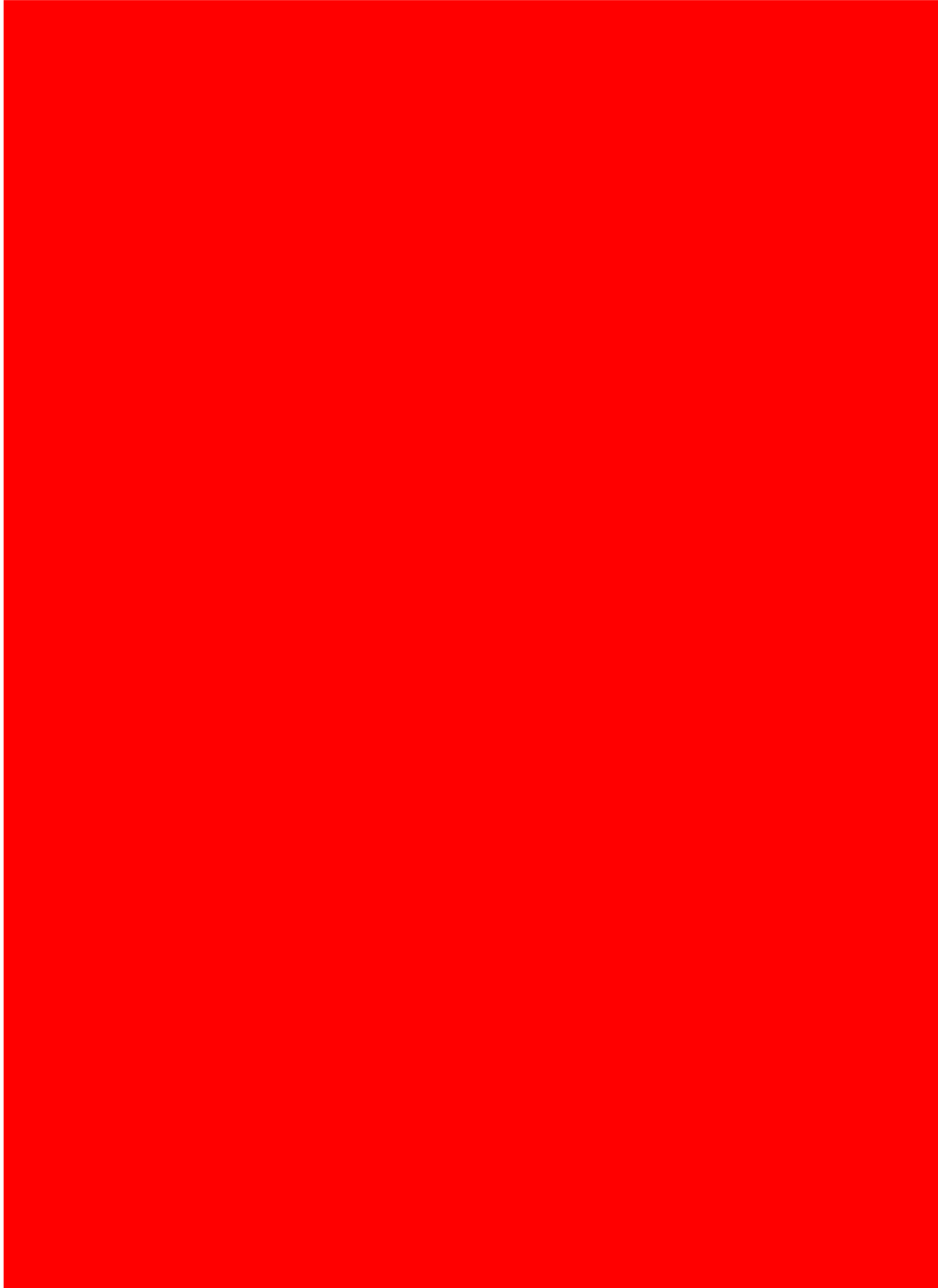
17. M. Egan, “5,300 Wells Fargo Employees Fired Over 2 Million Phony Accounts,” [www.cnn.com](http://www.cnn.com), 9 September 2016.

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



*(continued)*

**EXHIBIT 1—  
continued**

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



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.”<sup>18</sup> Rather than “guaranteeing” the reliability of

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18. R. Berger, “Elizabeth Warren Sends Misguided Letter to KPMG about Wells Fargo,” [www.forbes.com](http://www.forbes.com), 31 October 2016.

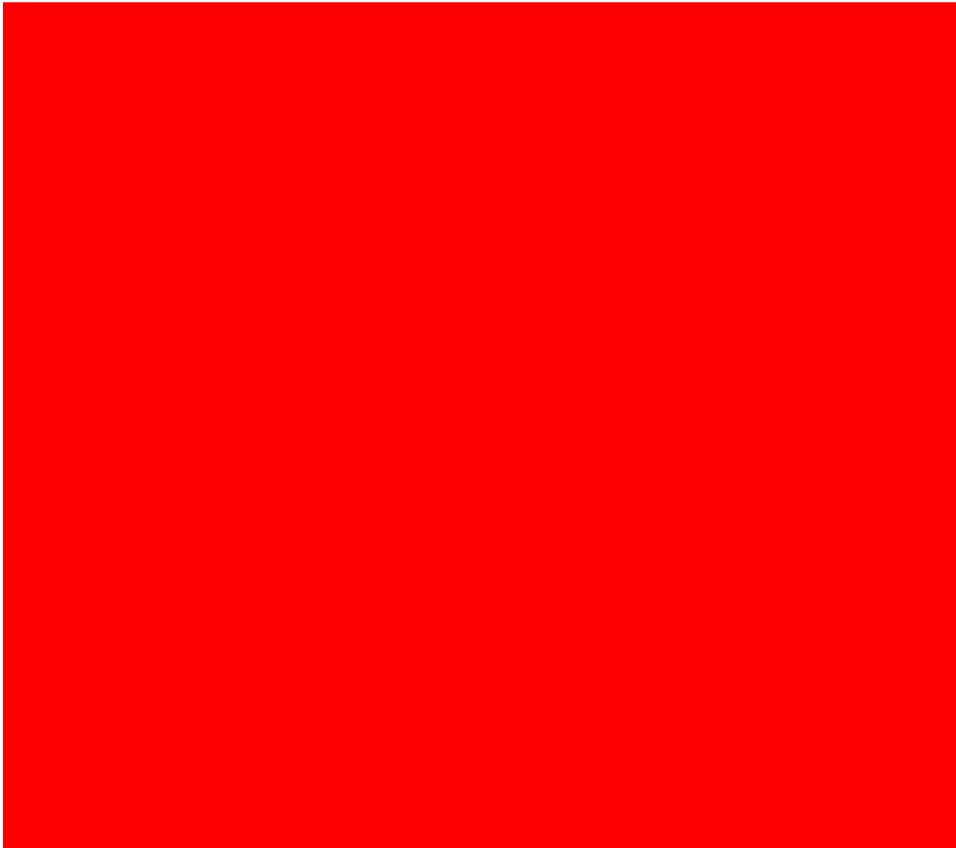
a client's financial statements, the *Forbes* article stressed that auditors only provide "reasonable assurance" that an entity's ICFR are operating effectively.

The *Forbes* article also rejected the premise that Wells Fargo's improper sales practices were *de facto* evidence of a material weakness in the company's ICFR. The financial statement impact of those activities, which the article implied was limited to the few million dollars of customer fees Wells Fargo was forced to refund, was clearly "not material" because it was "pocket change"<sup>19</sup> compared to the company's key financial benchmarks. Those benchmarks included the \$90 billion in revenues and the \$22.9 billion net income reported by the company for 2015. The article went on to reason that because Wells Fargo had fired 5,300 employees who engaged in the illicit sales practices, the company's internal controls, in fact, appeared to have been "effective," as reported by KPMG.

KPMG responded to Senator Warren and her colleagues in a letter dated November 28, 2016—see Exhibit 2. In that letter's opening paragraph, KPMG stressed its commitment to "audit quality" and assured the senators it took "very seriously its role as independent auditor of Wells Fargo's financial statements and internal controls over financial reporting." KPMG then made an important observation that was reinforced later in the letter: "At the outset, it is important to emphasize that not every illegal act has a meaningful impact on a company's financial statements or its system of internal controls over financial reporting."

**EXHIBIT 2**

NOVEMBER 28,  
2016, LETTER SENT  
TO MEMBERS OF  
U.S. SENATE BY  
KPMG CHAIRMAN



(continued)

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19. *Ibid.*



**EXHIBIT 2—  
continued**

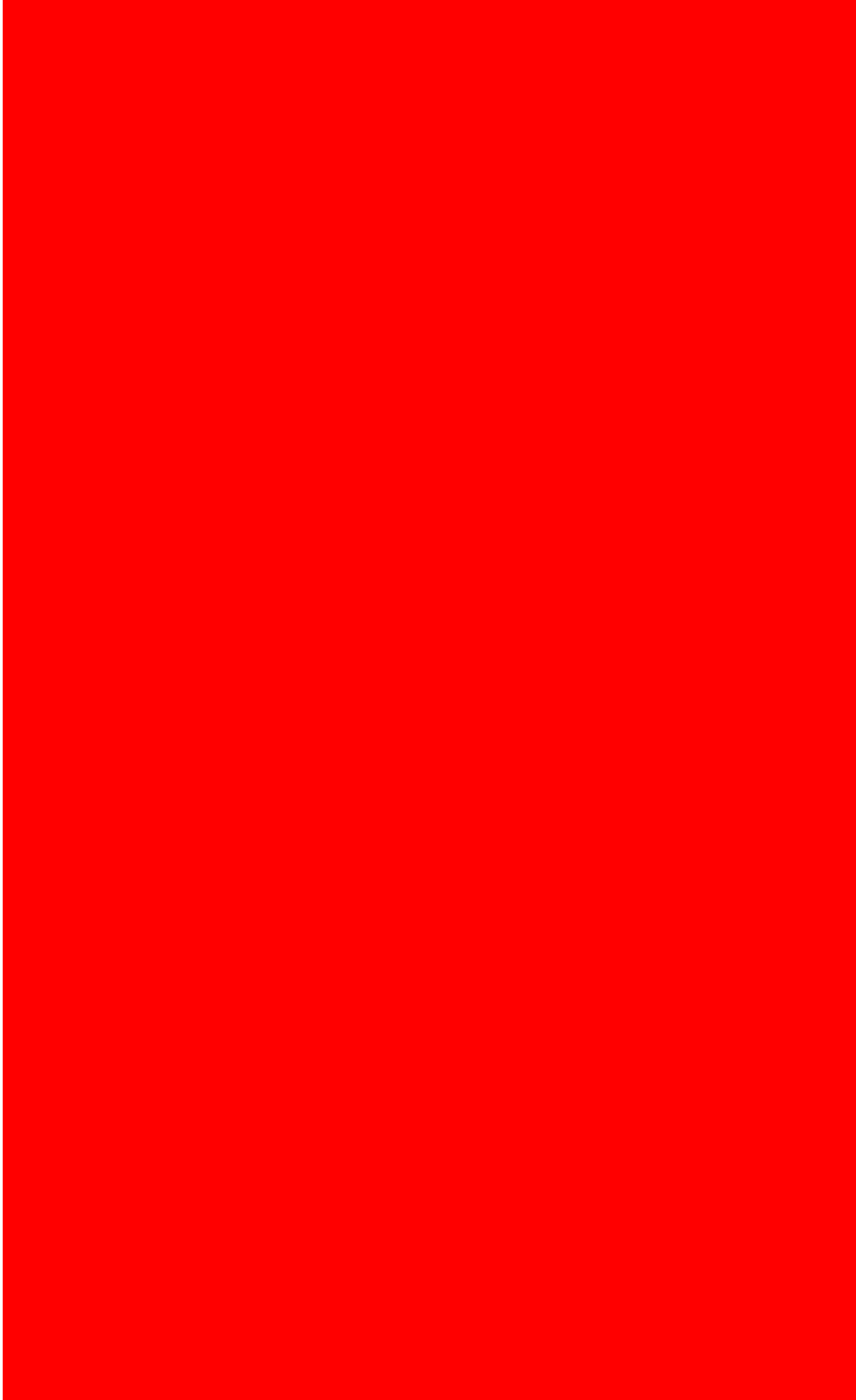
NOVEMBER 28,  
2016, LETTER SENT  
TO MEMBERS OF  
U.S. SENATE BY  
KPMG CHAIRMAN



*(continued)*

**EXHIBIT 2—  
continued**

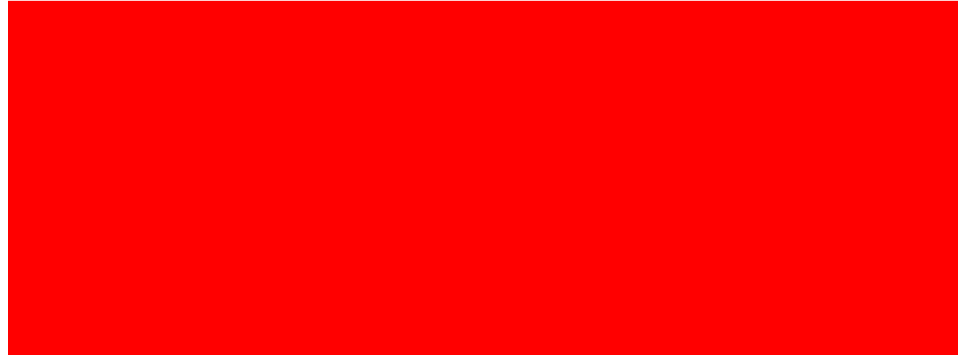
NOVEMBER 28,  
2016, LETTER SENT  
TO MEMBERS OF  
U.S. SENATE BY  
KPMG CHAIRMAN



*(continued)*

**EXHIBIT 2—  
continued**

NOVEMBER 28,  
2016, LETTER SENT  
TO MEMBERS OF  
U.S. SENATE BY  
KPMG CHAIRMAN



In the November 2016 letter, KPMG revealed that its Wells Fargo auditors had learned of “instances of unethical and illegal conduct” within the company involving “improper sales practices.” The auditors had also been aware of an internal investigation of “simulated funding” that had resulted in the dismissal of several employees. The auditors did not report those matters to Wells Fargo’s senior management because they determined that the executives had already obtained the relevant information via “internal [company] processes” and from related disclosures “widely reported in the press.”

KPMG explained in the letter that the improper sales practices identified by the CFPB and other parties did not involve key financial reporting controls and thus were not relevant to the annual ICFR audits performed for Wells Fargo. To support this argument, the audit firm pointed out that none of the employees involved in those activities “worked in financial reporting or had the ability to influence the financial reporting process.” KPMG also maintained that the financial statement impact of the unauthorized sales practices had been insignificant, meaning that they were not a source of material errors in the company’s financial statements.

The final question that had been posed to KPMG by the group of U.S. senators was whether the firm continued to stand by its conclusions that Wells Fargo had maintained effective ICFR from 2011 through 2015. The firm responded definitively to that question in the November 28, 2016, letter.

*Yes. Accordingly, KPMG has not withdrawn its reports on the bank’s financial statements or management’s assessment of the effectiveness of its internal controls over financial reporting. As detailed above, the facts developed thus far with respect to the improper sales practices do not implicate the effectiveness of internal controls over financial reporting.*

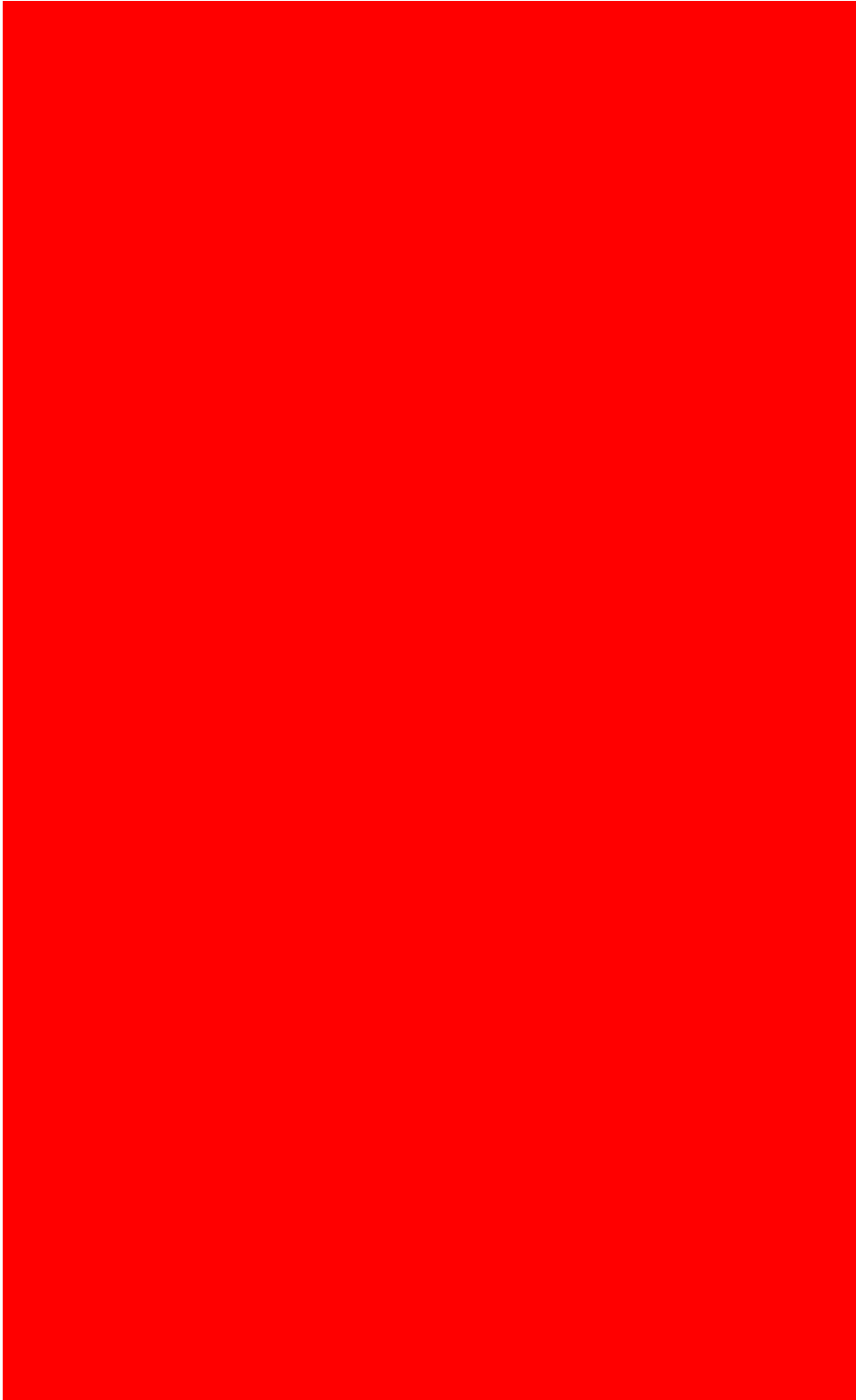
### **Senators Encourage PCAOB to Investigate KPMG**

In April 2017, five months after receiving the KPMG letter shown in Exhibit 2, Senator Elizabeth Warren and Senator Edward Markey wrote a letter to the PCAOB encouraging the federal agency to examine KPMG’s role in the Wells Fargo scandal—see Exhibit 3. The senators reminded the PCAOB chairman that his organization had been created “to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.” They suggested that “KPMG’s failure” to publicly report Wells Fargo’s illegal sales practices raised “significant questions” about the conduct of the Big Four firm as well as the “PCAOB’s role as overseer of public company auditors.”

In their letter to the PCAOB, the two senators characterized as “troubling” much of the information conveyed to them by KPMG, including the firm’s awareness “for several years” of the ongoing “illegal activity” by a large number of Wells Fargo employees.

**EXHIBIT 3**

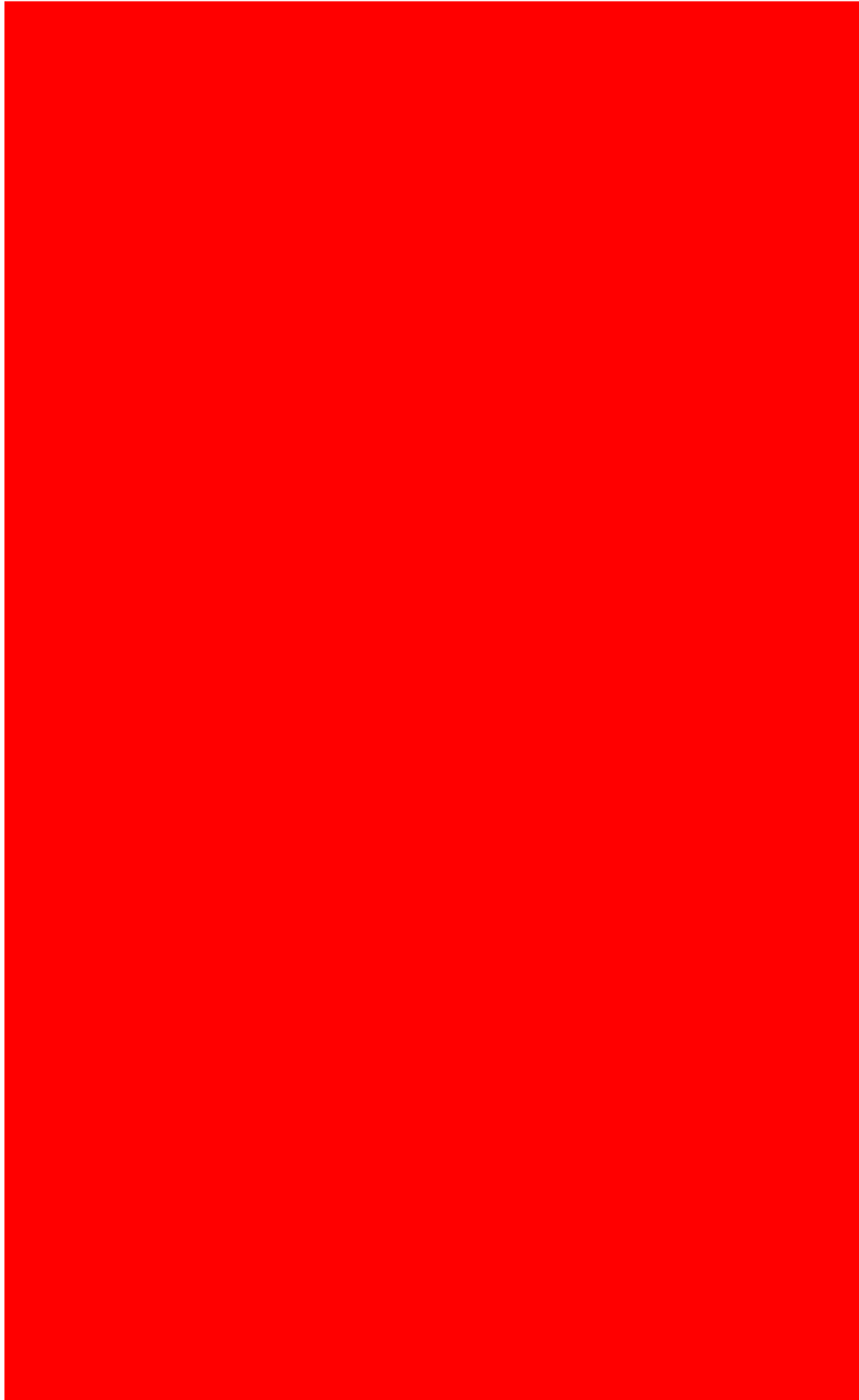
APRIL 25, 2017,  
LETTER SENT BY  
MEMBERS OF U.S.  
SENATE TO PCAOB  
CHAIRMAN



*(continued)*

**EXHIBIT 3—  
continued**

APRIL 25, 2017,  
LETTER SENT BY  
MEMBERS OF U.S.  
SENATE TO PCAOB  
CHAIRMAN



*(continued)*

**EXHIBIT 3—  
continued**

APRIL 25, 2017,  
LETTER SENT BY  
MEMBERS OF U.S.  
SENATE TO PCAOB  
CHAIRMAN



Given that knowledge, the senators were clearly dismayed by the clean opinions KPMG had issued on Wells Fargo's ICFR and by the firm's declaration in its November 2016 letter that it continued to stand by those opinions.

Senators Warren and Markey found it "difficult to comprehend" KPMG's contention that the Wells Fargo scandal did not involve or "implicate" the company's internal control over financial reporting. The senators used several metrics to support their position that the failure of Wells Fargo and KPMG to report the illegal sales practices had concealed critical information from third parties relying on the company's financial statements and accompanying disclosures. After the CFPB sanctions were announced, for example, the senators reported that Wells Fargo's credit card applications and new checking accounts had plummeted by 40 percent. Even more compelling were the results of an independent study by a consulting firm that projected the scandal would ultimately cost Wells Fargo \$99 billion in deposits, \$4 billion in revenues, and 30 percent of its customers.

The two senators also argued that KPMG's decision to not reference Wells Fargo's improper sales practices in its ICFR audit reports was inconsistent with a study released

by the independent members of the company's board of directors in early April 2017. Those directors found that a major cause of the scandal was Wells Fargo's "decentralized corporate structure," which undercut the company's "corporate control functions" and created a "culture" of "substantial deference" to Wells Fargo's branch managers. That deference or lack of rigorous oversight apparently gave the branch managers the freedom to alter the company's operating policies and procedures as they saw fit, including the use of the unauthorized sales practices. These conclusions by the independent directors suggested that Wells Fargo's flawed "corporate culture" impacted the effectiveness of its ICFR and the reliability of its periodic financial statements.

Senators Warren and Markey concluded their letter to the PCAOB by urging the federal agency to investigate KPMG's role in the Wells Fargo scandal. The senators asked the PCAOB to provide four items of information, including an indication of whether the agency had initiated an investigation of KPMG's "conclusions about Wells Fargo's financial reporting from 2011-2015." They also asked the PCAOB to review KPMG's decision to ignore, in its Wells Fargo financial statement audit and ICFR reports, the potential impact "of the fraud on the company's stock price," the "reputational harm" that might be inflicted on the company by the fraud, and the "flawed corporate structure" that the independent board members identified as a "root cause of the scandal."

The final item of information requested by Senators Warren and Markey from the PCAOB addressed arguably their most important concern. "Do PCAOB rules or guidance indicate whether auditors have a responsibility to publicly report or otherwise act on their knowledge of illegal or inappropriate activity by their clients?" No doubt, the senators would view a negative answer to that question as an indictment of the nature and scope of the independent audit function for public companies as well as the PCAOB's regulatory role in overseeing that function.

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## EPILOGUE

The PCAOB quickly acknowledged the receipt of the April 25, 2017, letter from Senators Warren and Markey shown in Exhibit 3. A PCAOB spokesperson noted that "We appreciate the Senators' continued interest in the important investor protection mission of the PCAOB's oversight of auditors of public companies."<sup>20</sup> The spokesperson implied that the PCAOB would respond to the senators' letter more completely in the future. To date, that response, if any, has not been released to the public.

More pressing matters may have interfered with the PCAOB's dialogue with the U.S. senators. On April 11, 2017, KPMG had shocked the business world and the accounting profession by announcing that it had dismissed five of its partners and one employee for failing to disclose confidential information obtained illicitly

from the PCAOB (see Case 5.5, "Zero Tolerance"). Subsequent reports would reveal that at least three individuals who were former or existing PCAOB employees—two of whom had been hired by KPMG—had conspired to provide three longtime KPMG partners with advance notice of the KPMG audits that would be included in the PCAOB's annual inspection program. At the time, KPMG had the highest audit deficiency rates among the Big Four firms—the PCAOB annually reports a deficiency rate for each of those firms. The intent of the KPMG partners involved in the scandal was, ostensibly, to lower their firm's annual deficiency rate. Several individuals involved in the scandal were either convicted or pled guilty to various criminal charges and received prison sentences. Those individuals included David Middendorf, KPMG's former

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20. M. Cohn, "Elizabeth Warren Questions PCAOB about KPMG Audits of Wells Fargo," [www.accountingtoday.com](http://www.accountingtoday.com), 27 April 2017.

National Managing Partner of Audit Quality & Professional Practice,<sup>21</sup> and three former PCAOB employees, including the two who had accepted positions with KPMG after leaving the PCAOB.

In December 2017, the SEC unexpectedly announced that it was replacing every PCAOB member, including the organization's chairman. In February 2020, President Donald Trump suggested that the PCAOB should be absorbed into the SEC, a move that would effectively make the organization an SEC operating unit and, apparently, eliminate the positions held by the PCAOB's five board members.

In August 2017, the Wells Fargo scandal was reignited when the company's new CEO reported that an additional 1.4 million unauthorized customer accounts had been discovered. The CEO also reported that more than 500,000 of the bank's customers had been

enrolled, without their permission, in an online bill payment service. When asked to comment on those new revelations, Senator Elizabeth Warren tersely responded, "Unbelievable."<sup>22</sup>

Wells Fargo officials negotiated settlements in late 2018 with all fifty states to end ongoing investigations and complaints involving the company's "retail sales practices."<sup>23</sup> The cost of those settlements was approximately \$640 million. Two years later, in February 2020, the U.S. Department of Justice announced that it had reached a similar agreement with Wells Fargo. The total cost of that settlement for the company, including reparations to be paid to affected third parties, was \$3 billion. Wells Fargo's 2019 Form 10-K released in February 2020 revealed that the company still faced numerous pending civil lawsuits prompted by its improper business practices.

## Questions

1. Identify the different types or classes of internal controls. How do internal controls over financial reporting (ICFR) differ from the other types or classes of internal controls?
2. Do you agree with KPMG's position that Wells Fargo's improper sales practices did not involve the company's ICFR? Defend your answer.
3. How does the AICPA's Auditing Standards Board define a material weakness in internal control? How does the PCAOB define a material weakness in ICFR? What factors should auditors consider in deciding whether an ICFR deficiency qualifies as a material weakness in ICFR?
4. Wells Fargo's independent board members concluded that the bank's "decentralized corporate structure" was "one root cause of the scandal." Do you believe the decentralized nature of Wells Fargo's corporate structure qualified as a "material weakness" in Wells Fargo's ICFR? Why or why not?
5. Does an audit firm of a public company have a responsibility to apply audit procedures intended to determine whether the client has committed illegal acts that don't directly impact its financial statements? Explain. What responsibility does an auditor of a public company have if the auditor discovers such illegal acts by the client?
6. While the Wells Fargo scandal was unfolding, several parties pointed out that KPMG had served as the company's audit firm since 1931. Explain how the length of an audit firm's tenure may influence its ICFR assessment for a public company client.

21. Despite an effort by certain Wells Fargo stockholders to convince the company's board to replace KPMG with another audit firm, in the spring of 2020, KPMG still served as Wells Fargo's auditor. The almost 90-year tenure of KPMG with Wells Fargo is among the longest in the auditing domain.

22. S. Cowley, "Wells Fargo Review Finds 1.4 Million More Suspect Accounts," *New York Times* (online), 31 August 2017.

23. The information in this paragraph was taken from "Note 17: Legal Actions" that accompanied Wells Fargo's financial statements in its 2019 Form 10-K and annual report.





individuals to carry out his “take-no-prisoners” approach to doing business. Duroc-Danner exerted such pervasive control over Weatherford that one observer suggested he served not as the company’s CEO but rather as its “absolute monarch.”<sup>4</sup> In 2008, Ernst & Young recognized Duroc-Danner’s skill as a corporate executive by presenting him with its “Entrepreneur of the Year Award.” That same year, Weatherford’s stock reached a split-adjusted record price of nearly \$50 per share, which was more than ten times higher than the company’s stock price in 1998.

Duroc-Danner relied heavily on Weatherford’s stock to finance the company’s worldwide acquisition spree. To keep the company’s stock price rising and attractive to potential takeover candidates, he recognized that he had to grow Weatherford’s earnings as well as its revenues. A strategic initiative the company implemented to achieve that goal was reducing one of its largest expense items, namely, income tax expense. To drive down Weatherford’s effective tax rate (ETR) and thus lower its income tax expense, the company’s executives began shifting revenues from relatively high-tax jurisdictions, such as the United States and Canada, to low-tax jurisdictions such as Bermuda, Hungary, Ireland, Luxembourg, and Switzerland.

To accelerate Weatherford’s revenue-shifting strategy, Duroc-Danner reincorporated the company in Bermuda in 2002. Over the next several years, Duroc-Danner reincorporated the company two more times when significant tax-reduction opportunities arose in other low-tax jurisdictions. In 2009, he made Switzerland the company’s corporate home base and then five years later transferred that home base to Ireland. Despite these legal maneuvers, Houston remained Weatherford’s *de facto* worldwide headquarters—following the 2009 relocation, the television news serial *60 Minutes* reported that Weatherford maintained “little more than a nondescript mail drop”<sup>5</sup> in Switzerland.

Another key feature of Weatherford’s revenue-shifting strategy was the use of “hybrid instruments.” According to the Securities and Exchange Commission (SEC), “hybrid instruments are structured to incorporate features of both debt and equity, such that an instrument typically qualifies as debt in one jurisdiction and equity in another.”<sup>6</sup> The SEC reported that Weatherford used hybrid instruments to “facilitate the movement of revenue” from high-tax jurisdictions to corporate tax havens. The “interest payments” on these securities would be deducted from taxable income by a Weatherford entity in a high-tax jurisdiction, while the “dividends receipts” on these same securities by another Weatherford entity in a low-tax jurisdiction would be either exempt from taxes or taxed at a very modest rate.

The aggressive taxation strategies employed by Weatherford during Bernard Duroc-Danner’s early years as CEO significantly reduced the company’s annual income tax expense and increased its reported profits. From 2001 to 2006, those strategies lowered the company’s ETR from approximately 36 percent to 25 percent. The company’s taxation strategies were so successful that they became a focal point of Weatherford’s quarterly earnings conferences with financial analysts tracking the company. In April 2007, a Bear Stearns analyst noted that the company exceeded its consensus earnings forecast for the first quarter of 2007 “primarily” because it lowered its ETR.<sup>7</sup> Frequent

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4. D. Blankenhorn, “Why Does No One Ask Hard Questions of Weatherford International?” [www.seekingalpha.com](http://www.seekingalpha.com), 21 November 2012.

5. *In Re Weatherford International Securities Litigation*, “Amended Complaint for Violation of the Federal Securities Laws.”

6. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3806*, 27 September 2016.

7. *In Re Weatherford International Securities Litigation*, “Amended Complaint for Violation of the Federal Securities Laws.”

statements by Weatherford executives that the company's ETR would continue to decline prompted financial analysts to issue favorable earnings forecasts for the company and raise their target price for the company's stock.

In early 2008, as Weatherford prepared to file its 2007 Form 10-K with the SEC, two senior members of the company's tax department discovered that Weatherford's ETR for fiscal 2007 was considerably higher than the estimated ETR that had been communicated to the company's financial analysts earlier in the year. The tax officials realized that the unexpectedly high ETR would come as an unpleasant surprise to those financial analysts and, more importantly, to their superiors, particularly Bernard Duroc-Danner. The unsettling discovery panicked the two men and sent them in search of a solution.

### Tax Fix, Tax Fiasco

In 2002, Andrew Becnel, an attorney in his early thirties, joined Weatherford and was given the title Associate General Counsel. The ambitious Becnel moved rapidly up Weatherford's corporate hierarchy. In 2005, he became the company's Vice President of Finance, and the following year added the title of Chief Financial Officer (CFO). After assuming the CFO position, Becnel reorganized the departments under his control. The reorganization included making Weatherford's tax department a "finance function . . . focused on tax strategy and planning, and not tax accounting."<sup>8</sup> Under this new organizational scheme, the tax department operated independently of the company's accounting and financial reporting functions.

*Thus, beginning in October 2006 . . . Weatherford's tax department no longer reported directly to Weatherford's accounting department or to senior management with sufficient knowledge or experience to assess whether Weatherford's income tax accounting was being fairly and accurately presented in accordance with GAAP. As a result, the tax department had virtually no accounting oversight.<sup>9</sup>*

James Hudgins served as Weatherford's Vice President of Tax from 2000 through March 2012, although he was not officially elevated to true "officer status" within the company until February 2009. Hudgins' principal subordinate in Weatherford's tax department was Darryl Kitay, who successively held the titles of Tax Manager, Senior Manager, and Tax Director during his tenure with the company. Both men were CPAs, although Kitay allowed his Texas CPA license to expire in 2004. In a 2016 enforcement release, the SEC provided the following summary of Hudgins' and Kitay's principal responsibilities.

*As the then Vice President of Tax, Hudgins was the architect of Weatherford's tax structure, tax planning, and was responsible for executing tax strategies designed to reduce Weatherford's ETR and tax expense. Hudgins was also responsible for ensuring that Weatherford's consolidated income tax accounts were properly maintained and that the consolidated tax provisions, underlying expenses, and related financial disclosures were accurately and fairly presented in all material respects in accordance with GAAP. Kitay, who reported to Hudgins, was responsible for preparing and reviewing Weatherford's consolidated income tax accounts and underlying expenses that were reported in Weatherford's financial statements.<sup>10</sup>*

The SEC determined that the work environment within Weatherford's tax department under James Hudgins was less than ideal. In addition to the department being "perpetually understaffed," its employees were overworked: "Hudgins pressed his

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8. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3806*.

9. *Ibid.*

10. *Ibid.*

employees to work long hours to make Weatherford's tax structure extremely competitive."<sup>11</sup> Hudgins also "quickly gained a reputation with the company's external auditor as . . . challenging and demanding" and "for taking aggressive accounting positions."<sup>12</sup>

Through 2007, Weatherford accounting employees within the company's operating units used Microsoft Excel spreadsheets to prepare year-end income tax data, which they then forwarded to the company's Houston-based tax department. Hudgins' subordinates reviewed these data and then compiled them to arrive at a consolidated year-end income tax provision for the company.<sup>13</sup> At the same time, those subordinates determined the appropriate year-end balances for the company's current and deferred income tax assets and liabilities.

Fiscal 2007 was a troubling year for the company financially. Throughout that year, "emails among senior management reflected that the company was under pressure to meet Wall Street expectations and to offset shortfalls in its quarterly earnings targets by lowering its ETR."<sup>14</sup> In late February 2008, just days before the company filed its 2007 Form 10-K with the SEC, Hudgins and Kitay reviewed the year-end tax data that had been collected and consolidated a short time earlier by their subordinates for the purpose of incorporating it in Weatherford's 2007 financial statements. Those data shocked Hudgins and Kitay because the company's ETR for the year was much higher than previously estimated. That estimate had been conveyed to financial analysts and investors during Weatherford's quarterly earnings conferences. To bring Weatherford's ETR for 2007 more closely in line with the previous estimate, Hudgins and Kitay made a bogus post-closing adjustment to the company's accounting records.

*Faced with what they considered to be an immovable deadline for reporting earnings, Hudgins and Kitay falsified the year-end consolidated tax provision by making an unsubstantiated manual \$439.7 million post-closing "plug" adjustment to two different Weatherford Luxembourg entities . . . To do so, they intentionally reversed accounting data that had been correctly input to Weatherford's consolidated tax provision via the company's accounting system.<sup>15</sup>*

This unauthorized "plug" adjustment produced a \$154 million bogus tax benefit for Weatherford—neither Hudgins nor Kitay disclosed the true reason for this adjustment to anyone outside of the company's tax department. The \$154 million tax benefit, along with several smaller misstatements, inflated the company's net income for 2007 from \$941 million to \$1.07 billion, an increase of approximately 14 percent. More importantly, the post-closing adjustment, which Hudgins and Kitay referred to as a "dividend exclusion" adjustment, allowed the company to surpass its consensus Wall Street earnings forecast for 2007.<sup>16</sup> (Despite understating its

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11. *Ibid.*

12. *Ibid.*

13. The SEC reported that Weatherford applied the appropriate financial accounting standards to determine its quarterly and year-end income tax provisions and current and deferred tax assets and liabilities. To estimate Weatherford's quarterly income tax provisions, the company's tax accountants applied *FASB Interpretation No. 18*, "Accounting for Income Taxes in Interim Periods." To determine Weatherford's year-end income tax provision, the accountants applied *Financial Accounting Standard No. 109*, "Accounting for Income Taxes." In the FASB's Accounting Standards Codification, those two pronouncements are now embedded in ASC Topic 740.

14. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3806*.

15. *Ibid.*

16. The bogus "plug" or "dividend exclusion" adjustment was made in the subsidiary accounting record known as the "Eliminations Region" that contained the company's extensive intercompany accounts. Because Weatherford had several hundred subsidiaries scattered across the globe, the intercompany accounting records were extremely complex, if not convoluted, and thus difficult to comprehend.

income tax expense for financial reporting purposes, Weatherford paid the appropriate amount of income taxes.)

On February 21, 2008, Weatherford filed its 2007 Form 10-K with the SEC. In that document, the company's senior management drew attention to the decrease in Weatherford's ETR from 26 percent in 2006 to 23 percent in 2007. "The decrease in our effective tax rate during 2007 as compared to 2006 was due to benefits realized from the refinement of our international tax structure and changes in geographic earnings mix."<sup>17</sup> Of course, the decline in Weatherford's ETR was primarily due to the undisclosed post-closing accounting adjustment made by Hudgins and Kitay. Several financial analysts complimented Weatherford for the impressive 2007 earnings report. An analyst with Morgan Stanley commented on the company's "truly remarkable"<sup>18</sup> earnings growth while another analyst congratulated the company for once more topping Wall Street's consensus earnings forecast.

In 2008, Weatherford changed its income tax accounting procedures by acquiring tax software that "automatically populated" or "mapped" the quarterly and year-end income tax amounts to the company's accounting records. This new software provided for more uniformity in the tax calculations across the company's operating units by eliminating the Microsoft Excel spreadsheets previously prepared by tax personnel within those units. During the fourth quarter of each fiscal year, Hudgins required his headquarters tax department staff to perform a "pretend hard close" to determine that the tax software was properly functioning.

*The purpose of the pretend hard close was to ensure that Weatherford's tax accounting controls were in place for the end of the year. Essentially, the pretend hard close was a 'dry run' of all the steps Weatherford would later perform to finalize its consolidated tax provision at year-end. Accordingly, the pretend hard close process would provide information regarding the effectiveness of Weatherford's ICFR [internal controls over financial reporting] for the accounting of income taxes, but the results themselves would not be incorporated into Weatherford's financial statements.<sup>19</sup>*

Weatherford's senior management suggested, in fiscal 2008 quarterly earnings conferences with financial analysts, that the company's ETR for the year would be in the range of 17 to 18 percent, sharply lower than the 23 percent ETR achieved in fiscal 2007. However, the pretend hard close in late 2008 revealed that Weatherford's projected ETR was between 22 and 23 percent. To align the projected ETR for 2008 with senior management's prior reported estimate for the year, Hudgins and Kitay directed certain of their subordinates to "override" the new income tax software and manually reduce the income tax expense yielded by the pretend hard close. This manual override resulted in an ETR of between 17 and 18 percent for the year-to-date period.

In January 2009, the company's tax department used the new income tax software to determine the actual ETR and income tax expense for the entire year. Again, that ETR "far exceeded" the estimate previously communicated by senior management to analysts and the investing public. Faced with the prospect of disappointing Weatherford's senior management, financial analysts, and investors, "Hudgins and Kitay opted to perpetuate the fraud."<sup>20</sup> The two men once more prepared a manual post-closing accounting adjustment to manufacture a bogus tax benefit for Weatherford. That

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17. *In Re Weatherford International Securities Litigation*, "Amended Complaint for Violation of the Federal Securities Laws."

18. *Ibid.*

19. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3806*.

20. *Ibid.*

\$106 million tax benefit lowered the company's ETR to 17.1 percent for fiscal 2008 and increased the company's net income by approximately 8 percent.

James Hudgins "actively lobbied" his superiors during 2008 "for officer status and the higher compensation it brought."<sup>21</sup> As the year-end approached, Hudgins sent the following email to Bernard Duroc-Danner: "I'm very upset that I'm not an officer yet. I achieved a 17% rate [ETR] this year, and all of you treat me like sh\_\_."<sup>22</sup> In early 2009, after Weatherford released its 2008 earnings and ETR to the public, Hudgins received his wish and was upgraded to officer status with the company.

During 2009 and 2010, Hudgins and Kitay continued to intentionally understate Weatherford's ETR and income tax expense. Exhibit 1 presents a table prepared by the SEC that summarizes the "unsupported manual entries" and resulting "plugged tax benefits" Hudgins and Kitay produced for Weatherford from 2007 through 2010. That exhibit also reports the net income amounts initially reported by Weatherford for each of the affected years, amounts inflated by the impact of the improper tax benefits.<sup>23</sup>

**EXHIBIT 1**

IMPROPER  
POST-CLOSING  
ADJUSTMENTS  
RECORDED IN  
WEATHERFORD  
INTERNATIONAL'S  
ACCOUNTING  
RECORDS



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21. *Ibid.*

22. *Ibid.*

23. In 2007, Weatherford had total assets of \$13.2 billion and total revenues of \$7.8 billion; the company's total assets rose to \$19.2 billion by 2010 while its total revenues reached \$10.2 billion that year. These amounts include the collective impact of the three financial restatements made by Weatherford in 2011 and 2012.

A pesky artifact of the tax accounting fraud for the two conspirators was the steadily increasing “phantom income tax receivable” that it produced. “This phantom income tax receivable occurred because the current income tax payable accounts annually recorded from the consolidated income tax provision were understated by the amount of each year’s fraudulent tax benefit.”<sup>24</sup> Consequently, when Weatherford made tax payments each year—throughout the accounting fraud, the company continued to pay the proper amount of income taxes that it owed—the amount debited to the income tax payable account exceeded the existing credit balance of that account, resulting in a steadily rising debit balance in the income tax payable account.

The total of the phantom tax receivable reached approximately \$460 million by late 2010. To obscure the nature of the receivable for financial reporting purposes, Weatherford reclassified it to a generic “Prepaid Other” account during the fourth quarter of 2009. Throughout the fraud, Hudgins and Kitay fabricated excuses to justify the tax receivable that was growing progressively larger. Hudgins told multiple parties, including the company’s auditors, that he was attempting to recover the overpaid tax amounts. Of course, Hudgins knew the receivable was completely fictitious and would never be collected.

In February 2011, a review of Weatherford’s intercompany accounts by Ernst & Young revealed that the large income tax receivable was a direct result of the annual post-closing adjustments prepared by Hudgins and Kitay—Ernst & Young had been aware of these adjustments since early 2008 but did not understand their purpose. At this point, Hudgins and Kitay admitted that those adjustments had misstated Weatherford’s income tax expense and related accounts over the period 2007–2010. However, the two men did not disclose the fraudulent nature of the adjustments to the Ernst & Young audit team or Weatherford’s senior management and instead maintained that they were simply accounting errors.

Weatherford’s senior management attributed the required restatement of the company’s 2007–2010 financial statements to “an error in determining the tax consequences of intercompany amounts over multiple years.”<sup>25</sup> That restatement—filed with the SEC on March 8, 2011—slashed Weatherford’s previously reported net income amounts by approximately \$500 million and drove down the company’s stock price by 11 percent, costing stockholders \$1.7 billion. The bulk of the restatement was necessary to eliminate the impact of Hudgins and Kitay’s bogus post-closing adjustments. The remaining portion corrected other errors discovered in Weatherford’s income tax accounts. Bernard Duroc-Danner and Andrew Becnel hosted a conference call on March 2, 2011, to disclose the coming restatement of Weatherford’s prior operating results. In the conference call, Becnel reassured financial analysts tracking the company’s stock that the accounting glitch that had made the restatement necessary was “nothing other than . . . an honest mistake.”<sup>26</sup>

Following the March 2011 restatement, Bernard Duroc-Danner placed James Hudgins in charge of a “large-scale effort” to revamp and improve Weatherford’s income tax accounting policies and procedures. During this “remediation” project, Hudgins and his subordinates discovered numerous overt deficiencies in Weatherford’s income tax accounting process. In late February 2012, Weatherford

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24. Securities and Exchange Commission, *Accounting and Auditing Enforcement Release No. 3806*.

25. *Ibid.*

26. *In Re Weatherford International Securities Litigation*, “Amended Complaint for Violation of the Federal Securities Laws.”