

## CASE 1.1

# WELLS FARGO & COMPANY

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### Synopsis

Wells Fargo & Company got its start in 1852 in the midst of the California Gold Rush. The company's two founders raised the capital to finance a new company to be based in the Wild West boomtown of San Francisco after realizing that the Bay Area provided a wealth of business opportunities for investors willing to accept a high risk of failure. The company's founders decided that transportation and banking services were desperately needed in San Francisco so they decided that Wells Fargo would pursue those two unrelated lines of business. The company initially made a "name" for itself by providing rapid and reliable freight, courier, and mail delivery services. But, when the federal government nationalized major freight and transportation lines during World War I, Wells Fargo's management shifted its focus almost exclusively to the banking industry.

Throughout much, if not most, of Wells Fargo's history successive generations of senior executives have embraced the high-risk, "Wild West" mindset around which the company was created. That mindset or company culture triggered a massive, high-profile scandal that surfaced in September 2016 when a federal agency announced that Wells Fargo had been fined nearly \$200 million for engaging in improper sales practices on an enormous scale.

Critics of Wells Fargo eventually turned their attention to the company's longtime audit firm, KPMG. Several U.S. senators, in particular, harshly criticized the prominent audit firm. The senators demanded that KPMG explain how it could issue a "clean" opinion each year on Wells Fargo's internal control over financial reporting (ICFR) while the company was involved in the massive fraud involving improper sales practices.

Central to this case are three lengthy letters that are included as exhibits. Exhibit 1 presents a letter sent by four U.S. senators to KPMG in which the senators demand that the audit firm respond to a series of questions including whether the Wells Fargo auditors were aware of the improper sales practices being applied by their client. The senators also demanded to know whether KPMG continued to stand by its opinions that Wells Fargo had maintained "effective internal control over financial reporting" during the timeframe that the sales fraud was ongoing. KPMG's letter in response to the senators is contained in Exhibit 2—in the letter KPMG indicated that it did, in fact, still stand by its earlier opinions that Wells Fargo had maintained effective ICFR. Finally, Exhibit 3 presents a letter that the senators sent to the PCAOB—the senators had been troubled by much of the information conveyed to them by the KPMG letter shown in Exhibit 2. In this final letter, the senators suggested that the PCAOB review KPMG's audits of Wells Fargo's ICFR and that the agency review its "rules and guidance" relevant to public company auditors' consideration of ICFR weaknesses and illegal acts perpetrated by their clients.

### **Wells Fargo & Company--Key Facts**

1. In 1852, Henry Wells and William Fargo organized Wells Fargo & Company because they were convinced that the California Gold Rush provided a wealth of business opportunities in the San Francisco Bay Area.
2. Banking and transportation services were the two lines of business Wells Fargo's founders decided their new company would pursue.
3. After the federal government nationalized major freight and transportation lines during World War I, Wells Fargo's executives focused the company's operations almost exclusively on the banking industry.
4. Beginning in the early twentieth century, successive generations of Wells Fargo senior executives relied on a relentless acquisition strategy and aggressive marketing initiatives to expand the company's banking operations.
5. By 2015, Wells Fargo was the largest global bank in terms of collective market value; at the time, the company operated nearly 9,000 retail branches in 35 countries and had over 70 million customers.
6. In addition to its impressive size, Wells Fargo consistently ranked among the most respected multinational companies in annual surveys by *Barron's*.
7. In September 2016, the Consumer Financial Protection Bureau (CFPB) announced that Wells Fargo had been fined \$185 million for improper sales practices between 2011 and 2016; those illegal activities had resulted in the creation of millions of unauthorized customer accounts.
8. In response to the widely-publicized scandal, Wells Fargo's executives typically attributed the illegal practices to self-interested lower-level employees.
9. KPMG, Wells Fargo's longtime audit firm, issued "clean" opinions on the company's internal control over financial reporting (ICFR) throughout the time frame in which the illegal sales practices were being applied.
10. In a letter sent to KPMG in late 2016, four U.S. senators posed a series of questions to the firm, including whether the Wells Fargo auditors had been aware of the illegal sales practices and whether the firm continued to stand by its prior opinions that the company had maintained effective ICFR.
11. KPMG responded to the senators by indicating that the Wells Fargo auditors had been aware of the illegal sales activities but had concluded that they did not involve the company's ICFR and did not have a significant impact on the company's financial statements.

12. After receiving the letter from KPMG, two of the senators wrote the PCAOB and asked the agency to review KPMG's audits of Wells Fargo's ICFR and its "rules and guidance" relevant to auditors' consideration of ICFR weaknesses and illegal acts perpetrated by their clients.

### **Instructional Objectives**

1. To identify the different types or classes of internal controls.
2. To identify the nature and scope of internal controls over financial reporting (ICFR).
3. To define a "material weakness in internal control" and to identify the factors auditors should consider when determining whether a deficiency in internal control qualifies as a material weakness.
4. To define a "material weakness in ICFR" and to identify the factors auditors should consider when determining whether a deficiency in ICFR qualifies as a material weakness in ICFR.
5. To examine the responsibility of public company auditors to search for illegal acts committed by their clients.
6. To identify public company auditors' responsibilities after determining that a client has engaged in an illegal act.
7. To consider how the length of an audit firm's tenure with a public company client may impact its ICFR assessment for that client.

### **Suggestions for Use**

Consider launching this case by requiring your students to either individually or in groups research and report on a recent ICFR material weakness reported by a public company. If you want to ensure that each individual or group reports on a unique material weakness, then use a Google search to identify a sample of material weaknesses to be used for this exercise. After the students have made these presentations, ask them to compare and contrast the material weaknesses they researched with the internal control deficiencies that were evident within Wells Fargo. After completing this exercise, students will be better equipped to provide an informed opinion on whether KPMG should have reported an ICFR material weakness for Wells Fargo.

### **Suggested Solutions to Case Questions**

1. Internal controls can be categorized several different ways. For example, we could classify internal controls by transactions cycles, by cost, or by complexity. The key scheme that the accounting profession has historically used to categorize internal controls is by their overarching objective. According to the COSO's internal control framework, an entity's internal control process is designed to achieve three broad classes of objectives. Those classes of objectives

include “reliability of financial reporting,” “effectiveness and efficiency of operations,” and “compliance with applicable laws and regulations.”

Obviously, the key distinction between internal controls over financial reporting (ICFR) and the other two types or classes of internal controls is the underlying intent or purpose of ICFR. The PCAOB notes that ICFR are intended to “provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance

with GAAP” [AS 2201.A5]. In this same context, the PCAOB auditing standards note that ICFR include those “policies and procedures that—

- (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.” [AS 2201.A5]

The other two classes of internal controls address differing control objectives. For example, the intent or objective of internal controls relating to “effectiveness and efficiency of operations” involve operational issues such as minimizing waste on a production line. An example of the final category of internal controls would be ensuring compliance with the Americans with Disabilities Act (ADA).

2. This is a question that has diametrically opposed answers, each of which could be supported with at least somewhat reasonable arguments. In its November 28, 2016, letter to the four U.S. senators, KPMG defended its position that the improper sales practices “did not involve key controls over financial reporting” by arguing that (1) those activities had no significant impact on the company’s financial statements and (2) none of the individuals involved in the improper sales practices “worked in financial reporting or had the ability to influence the financial reporting process.”

There is certainly a basis for countering KPMG’s argument. AS 2201.21 requires auditors to use a “top-down approach” in auditing a client’s ICFR: “A top-down approach begins at the financial statement level and with the auditor’s understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-wide controls and works down to significant accounts and disclosures . . .” (Note the reference to “disclosures.” One could certainly argue that Wells Fargo’s internal sales “fraud” was a significant disclosure item for users of the company’s financial statements.)

AS 2201.23 and 24 identify a variety of entity-wide controls “that are important to the auditor’s conclusion about whether the company has effective internal control over financial reporting” [paragraph 23]. One group of such controls are “controls related to the control environment” [paragraph 24]. Following is the complete text of AS 2201.25:

*“Control environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. As part of evaluating the control environment, the auditor should assess—

- Whether management’s philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

Given paragraph 25, a client’s overall control environment is linked directly to the entity’s ICFR. Now, recognize that the results of the study by Wells Fargo’s independent board members indicted or criticized the company’s control environment. That is, the overly “decentralized” nature of the company’s organizational structure was a direct consequence of a control environment that one could argue was inadequate, at a minimum. So, in summary, the improper sales practices were a consequence of the decentralized organizational structure which, in turn, was a consequence of the company’s poor control environment. Bottom line, one could certainly make an argument that Wells Fargo’s weak control environment was an issue that should have been considered in KPMG’s audit of the company’s ICFR because a company’s control environment has a major impact on the reliability or effectiveness of its ICFR.

3. Here is the definition of “material weakness” in internal control that is included in the AICPA’s professional auditing standards: **“Material weakness.** A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected, on a timely basis.” AU-C 265.07

AS 2201.98.A7 provides the following definition or description of a material weakness in ICFR. “A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.” AS 2201, paragraph 62 notes that “The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies, individually or in combination, are material weaknesses as of the date of management’s assessment.” The next several paragraphs then discuss factors that auditors should consider in making that determination. Those factors include, among many others, “the nature of the financial statement accounts, disclosures, and assertions involved;” “the susceptibility of the related asset or liability to loss or fraud;” and the “possible future consequences of the deficiency.” [Note: the last item was particularly relevant to the Wells Fargo situation.]

Auditors of public companies have struggled to apply the materiality concept in a new context, namely, in determining whether or not ICFR deficiencies rise to the level of “material.” This point was addressed several years ago in a speech made by a PCAOB board member.

“For ICFR purposes, the meanings of ‘reasonably possible’ and ‘material’ rely upon

established definitions of these same terms that exist with respect to accounting. However, experience gathered during the first year of implementing Section 404 and AS No. 2 demonstrate that auditors and companies both had a difficult time applying these terms in this new context. *Like the generally accepted accounting principles (GAAP) that govern the preparation of financial statements, there are no clear bright-line tests based solely on quantitative measures; qualitative measures must also be considered, and professional judgment is required.*” – emphasis added [K. Gillan, “A Layperson’s Guide to Internal Control Over Financial Reporting (ICFR),” [pcaobus.org/News/Speech/Pages/03312006\\_GillanCouncilInstitutionalInvestors.aspx](http://pcaobus.org/News/Speech/Pages/03312006_GillanCouncilInstitutionalInvestors.aspx), 31 March 2006.

Notice the emphasized text in this quote. In my view, given the nature of ICFR evaluations, one could reasonably argue that, in fact, qualitative considerations may be more important in this context than quantitative considerations. No doubt, applying qualitative benchmarks or criteria are more challenging than applying quantitative guidelines . . . meaning that assessing ICFR deficiencies can be particularly “messy.”

4. Notes: This question is closely linked to the two preceding ones. In addition, recognize that there is not a definitive answer to this question. So, instead of assessing the accuracy of a student’s answer, I instead evaluate the rigor of the supporting argument for it.

At some point in addressing this question, consider taking a poll of your students to determine whether they believe the decentralized corporate structure of Wells Fargo qualified as a material weakness in ICFR—my students typically vote overwhelmingly that it did. A common justification for a “yes” vote is the fact that the quality of a company’s overarching control environment—including how authority is delegated within the organization—has an enormous impact on all dimensions of an organization, particularly its accounting and financial reporting functions. Many of my students point to the metrics identified in Exhibit 3 by the senators to demonstrate how pervasive an impact Wells Fargo’s overall poor control environment—including its decentralized management structure—ultimately had on the company.

5. AS 2405, “Illegal Acts by Clients” defines the responsibilities of auditors vis-à-vis illegal acts committed by a public company client. As a sidebar, AS 2405.03 notes that “Whether an act is, in fact, illegal is a determination that is normally beyond the auditor’s professional competence.” Because of this reality, the paragraph goes on to note that auditors may ultimately have to rely on the “advice of an informed expert” before deciding whether a particular act is illegal.

The degree of responsibility that an audit firm assumes for detecting illegal acts by a public company client depends upon the nature of those acts as discussed by AS 2405. That section of the PCAOB’s auditing standards distinguishes between an audit firm’s responsibility to detect illegal acts that have a “direct and material” effect on a client’s financial statements and illegal acts that have a “material indirect” effect on a client’s financial statements.

AS 2405.05 notes that an auditor’s responsibility to detect and report “misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in AS 1001, *Responsibilities and Functions of the Independent Auditor.*” In turn, AS Section 1001.02

notes that an auditor “has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.”

Auditors generally have much less responsibility to detect illegal acts that have a material indirect effect on a client’s financial statements. AS 2405.06 observes that an auditor “ordinarily does not have sufficient basis for recognizing” such violations by clients. AS 2405.07 adds: “If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.”

When a public company auditor discovers an apparent illegal act that may have a material indirect impact on the client’s financial statements, one of his or her first responsibilities is to evaluate the materiality of that item. “In evaluating the materiality of an illegal act [having a potential material indirect effect on a client’s financial statements] that has come to his attention, the auditor should consider both the quantitative and qualitative materiality of the act. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue” [AS 2405.13]. Auditors also have a responsibility to assess the “adequacy of disclosure” of illegal acts that apparently have a material indirect impact on a public company’s financial statements. “The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity’s operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create unusual risks associated with material revenue or earnings, such as the loss of a significant business relationship, that information should be considered for disclosure” [AS 2405.15]. AS 2405.16 also notes that auditors “should consider the implication of an illegal act [having a potential material indirect effect on the client’s financial statements] in relation to other aspects of the audit . . .”

In terms of communication, AS 2405.17 notes that “the auditor should assure himself that the audit committee is adequately informed as soon as practicable” about an illegal act having a material indirect impact on the financial statements. Paragraphs 18-21 of AS 2405 discuss the impact of a “material indirect” illegal act on an auditor’s report. Paragraph 18 notes that such an act that “has not been properly accounted for or disclosed” may require the auditor to issue a qualified or an adverse opinion.

6. The key issue in this context is the trade-off between the level of knowledge that an auditor accrues as its tenure with a public company client lengthens versus the corresponding increase in the risk that an auditor may become too “cozy” with the client as the relationship “ages.” The existence of a learning curve effect in auditing a client and its ICFR is widely accepted, which means that the periodic rotation of public company auditors would have some clear-cut negative impact on the quality of those services. However, periodically rotating public company auditors would have a countervailing positive impact (at least theoretically) because the *de facto* independence of auditors under a rotation policy regime should be enhanced, that is, auditors who are aware that a client relationship is finite should be less inclined to curry favor with their clients by downplaying “problem” circumstances that they discover.