WELLS FARGO AND THE UNAUTHORIZED CUSTOMER ACCOUNTS: A CASE STUDY

TEACHING NOTE

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CASE DESCRIPTION

The case discusses the controversial sales practices at one of the largest financial institutions in the country that led to unprecedented penalties by the Federal Reserve. The case exposes students to corporate governance policies within an organization, especially the ethical responsibilities of those charged with governance. The case can be used in an undergraduate or advanced auditing class and students can utilize the Committee on Sponsoring Organization or COSO framework to formulate responses. The COSO framework defines internal control, including corporate governance, and provides a systematic approach to internal control evaluation and assessment. The case can also be used in a management course that discusses leadership and/or corporate governance issues. The case is designed to be taught in one class period and is expected to require approximately two hours of outside preparation by students. The case is based on real events as reported in various media outlets.

CASE SYNOPSIS

$185 million! This was the initial combined fine levied by the oversight bodies against Wells Fargo (the Bank). They alleged that the Bank engaged in improper activities by opening or applying for over 3.5 million bank accounts and credit cards without customers' knowledge or approval. This action was done using a customer intensity model in which the Bank aspired to be the market leader in the cross-selling of products and services to existing customers. Employees who noted inappropriate activities by their colleagues reported the issues to the Bank's ethics hotline and to those charged with governance. These employees faced retaliation for reporting the potential violations and were either demoted, resigned, or terminated. Facing mounting pressures from various regulators and Congress, the Bank acknowledged the controversial sales practices and agreed to discontinue their use. The Bank eventually reached an agreement with the Federal Reserve that imposed significant penalties and restricted it from future growth until risk management practices were addressed.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The objective of the case is to help students utilize critical thinking skills to assess an ongoing corporate scandal. The case is flexible and could be used in several courses. For instance, it could be used in the undergraduate auditing course (a) to help students understand internal control and fraud, and (b) as an experiential learning opportunity since students will be utilizing The Committee on Sponsoring Organization of the Treadway Commission (COSO) framework. The case could also be used as one of the cases in a graduate auditing course to achieve the same goals as the undergraduate course, and in a management course to discuss the importance of corporate governance.

The COSO framework is the existing tool used by organizations and accountants to assess internal controls. The framework defines internal controls and provides a systematic approach to internal control evaluation and assessment.

The case is best completed in groups either as an in-class or out-of-class graded assignment. The group size, grading scale, and assigned points are at the specific instructor's discretion. If the case is used as an in-class activity, the students should read the case prior to attending class and the discussion questions should be answered in class. Depending on usage, instructors should ensure that a discussion of internal controls focusing on the difference between the control design and its effectiveness, occurs prior to assigning the case. The internal control discussion should incorporate the COSO framework since it is widely used and is the foundation for any internal control discussion. As noted below, the assignment requires approximately 2-3 hours of student time and no advanced preparation time other than reading the case is required by the instructor.

Learning Outcomes

Students will be able to:

1. Learn about the COSO framework and be able to utilize it to assess a fraudulent situation
2. Understand the importance of an effective corporate governance process in an organization

Case Implementation and Effectiveness

The case was class tested in an undergraduate auditing class in the fall of 2017 (n=22). The case was assigned as a group project (groups of four members) and students reviewed the COSO framework (executive summary) prior to answering the discussion questions. The executive summary was made available to the students via the course management system.

The students reported that it took approximately 2-3 hours to complete the assignment. This was inclusive of the COSO reading, the actual reading of the case on an individual basis, and the group meeting to formulate cohesive solutions to the discussion questions.

Although they had heard about the events discussed in the case, the students were surprised at the extent of the problem and that management and the board claimed ignorance. Overall, they found the case interesting, easy to read, and thought it was appropriate for classroom use. Furthermore, they noted that the case was useful in helping them understand and apply the COSO framework, especially as it relates to the control environment component.

DISCUSSION QUESTIONS

1. *The "tone at the top" is considered a key component of an organization's corporate governance process. Use the fundamental principles within the control environment component of the Committee of Sponsoring Organizations of the Treadway Commission (or COSO) framework to discuss:*
    i. *The company's commitment to integrity and ethical values*
    ii. *The Board of Directors' independence from management*

iii. *The structures, reporting lines, and appropriate authorities and responsibilities established by management in the pursuit of objectives*
iv. *The organization's commitment to attract, develop, and retain competent individuals*
v. *The organization's ability to hold individuals accountable for their internal control responsibilities*

See Appendix A

2. *Comment on the effectiveness of the Bank's overall control environment*

The organization's control environment was effectively designed to address internal control issues. However, as noted in Appendix A, the control environment did not operate since management personnel suppressed internal control issues (e.g., controversial sales practices) identified by employees and brought to its attention. This suggests an overall poor "tone at the top" at the company.

3. *Comment on the effectiveness of the corporate governance process at the Bank and its ability to respond timely to* the controversial sales practices.

The controversial sales practices began in 2011 and management did not respond in a meaningful way until 2015. During this period, red flags such as reports to the ethics hotline and to senior management were ignored by the company and the reporting employees silenced (through reprimands and terminations). The prevailing corporate culture was to increase sales at any cost. This increase in sales and the resulting profits enriched management including the CEO [who was also chairman of the board of directors (BoD)]. One might assume that with increase in profit and the resulting increase in the company's share price, management and the board ignored the red flags. The board and management only responded to the business practice when faced with external threats (local prosecutors and regulators). These actions do not demonstrate effective governance at Wells Fargo and its leadership did not respond to the issues in a timely manner.

4. *Did the board of directors (BoD) adequately fulfill its oversight responsibilities?*

The BoD delegated day to day responsibilities for the organization to the executive leadership team. It also created various committees that included board and management personnel charged with addressing business risks and strategies. The BoD provided the executives with the autonomy and authority to perform its function. The company adopted a decentralized structure to allow business decisions to occur closer to its customers.

The BoD held regular meetings with management to facilitate open communication and to ensure the reporting and resolution of business issues in an efficient manner. In the case of Wells Fargo, the CEO (a management function) and the chairman (a board function) roles were performed by the same individual – a potential conflict of interest. It does appear that the CEO was aware of the sales practices but it's not clear from the case if the information was shared with the fellow board members (they deny any prior knowledge). The BoD has ultimate oversight responsivities and it did not adequately fulfill its role.

5. *Do you agree with the senator on the removal of the directors who were on the board during the scandal?*
[Instructors Note: This is an opinion-based question so expect some variation in students' responses]

We agree with the senator. The directors that were on the board during the scandal should be removed. The bank had several problems with its risk management practices, and the board did not take an active role in ensuring that those risks were mitigated. Although the board's independent review report placed the blame on the decentralized organizational structure, this was the structure created by management and supported by the board (since the structure was not changed). Ultimately, the board of directors is responsible for creating a tone that emphasizes the importance of a strong internal control environment and high ethical standards. Clearly, the tone was not properly established by the board and it bears responsibility for the resulting failure.

EPILOGUE

At the time of the case, Wells Fargo continued to face fallout from its account scandal and other governance issues. For instance, the company disclosed that it enrolled customers in auto insurance they did not need and that it paid a $142 million class action settlement. Because of the governance issues and the increased associated costs, the bank received a credit rating downgrade from a rating agency.

Meanwhile, a California district court judge ruled in October 2017 that two cases against the Bank's officers and directors could proceed to trial. The lawsuits were filed by shareholders seeking to recover losses sustained from the account opening scandal. The defendants in the separate lawsuits are 15 current and former board members, and four current or former officers.

On February 2, 2018, the Federal Reserve (the Fed) reached a settlement with Wells Fargo in which it imposed penalties on the Bank for years of misconduct and barred it from future growth until it fixed the problems. Flittler, Appelbaum & Enrich (2018) noted that "The settlement is an attempt by the Fed to impress upon banks that their boards of directors should be vigorous, independent watchdogs — and if they fail, there will be consequences." The Fed also sent letters to the former chief executive officer and board chairman in which it criticized their performance as an example of ineffective oversight which is inconsistent with an entity of the Bank's size and scope.

The settlement required the Bank to (a) replace four members of its 16-person board by the end of 2018, (b) submit a plan for improving its board oversight and risk management processes to the Fed within 60 days, (c) have third parties conduct reviews of the plans and their effectiveness, and (d) have another third-party review risk management processes after the Fed's limit on asset growth is removed. (Flittler, Applebaum & Crowley, 2018). In commenting on the need for such penalties, The Fed chair noted that "We cannot tolerate pervasive and persistent misconduct at any bank and the consumers harmed by Wells Fargo expect that robust and comprehensive reforms will be put in place to make certain that the abuses do not occur again," (Gara, 2018).

In April 2018, the Bank reported that it faced a potential $1 billion in fines from two more regulators to settle unrelated mortgage and auto loans and compliance risk management concerns. The Bank is still in negotiations on an appropriate amount with the regulators. In the meantime, the Bank is focusing its communication efforts on its customers to regain their trust.

DISCLAIMER

This critical incident and teaching note were prepared by the authors and are intended to be used for class discussion rather than determining either effective or ineffective handling of the situation. The case is based on real events as reported in various media outlets.

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Appendix A: The COSO Framework – Control Environment

COSO Component – Control Environment	Related Principle	Comment on the design or existence of this principle within the organization	Comment on the operating effectiveness of this principle within the organization
	i. The organization demonstrates a commitment to integrity and ethical values.	The organization has an ethics hotline and the process for reporting ethical issues was communicated to employees. This suggests that it was committed to an ethical environment	Employees who reported ethical issues to management were disciplined, including being terminated. Also, it appears that the hotline was not monitored by an independent party and employees had no whistle blower protection. These actions are not consistent with an organization that is committed to integrity and ethical values.
	ii. The board of directors (BoD) demonstrates independence from management and exercises oversight of the development and performance of internal control.	The BoD structure was designed to provide adequate oversight of the company. It operated through several committees including risk, which had risk mitigating (including internal control) responsivities	The CEO was also the chairmen of the BoD. So functionally, the board did not have adequate independence from management
	iii. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.	The organization had an Executive Leadership Team in place with responsibilities for the different business units. It also had a decentralized structure which gave business units the autonomy to pursue objectives. The leadership team reported to the BoD on a regular basis	The decentralized structure may have attributed to the scandal since decisions were made by a business unit that enriched unit personnel. Also, the Executive Leadership Team was not transparent in their interaction with the BoD
	iv. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives	The case did not specially address the company's hiring practices	The company rewarded those employees who were willing to engage in the misleading sales practices. Such employees received bonuses and promotions for 'looking the other way". Employees who balked at the engaging in

		the sales practices were demoted and/or terminated
v. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives	The CBD organizational structure had several layers of management personnel with responsibilities for specific activities. This structure suggests that these managers (e.g., branch, regional) also had internal control responsibilities	The CBD management team circumvented the internal control since they approved of the deceptive sales practices and encouraged personnel to "do what it takes' to achieve goals. They rewarded personnel who achieved the goals and punished who reported the matter to the ethics hotline.

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