

Case Study – Community Gone Awry

- Raven's Head Ranch (RHR), Private gated community of 300 scattered home on 1,800 mountainous acres located 5 mile from Boise Idaho
 - Self governed by community volunteers
 - RHR's members as a whole were fiscally conservative & tried to avoided large expenses
- Board oversight of finance committee
- Unethical actions
 - Moving forward after community rejected fire dept proposal and using funds not authorized for the fire dept.
 - Wrote out checks without proper approval
 - Cosign a blank check
 - Miscoding expenses to the wrong accounts



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Raven's Head Ranch gated community Volunteer Fire Dept – Discussion Questions



- What are the three elements of the fraud triangle?
- What internal controls were circumvented?
- How could the internal controls be improved?
- What should Mable have done?
- What is Jason's responsibility to the board and community?
- What responsibility does the board have?
- How can you maintain internal controls with limited number of members for segregation?
- What is a preferred way to let media and affecting members know about an unethical situation?

Community Gone Awry

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INTRODUCTION AND OPERATING BACKGROUND

Raven's Head Ranch (RHR) was a private, gated community of 300 scattered homes on 1,800 mountainous acres located approximately five miles to the northeast of Boise, ID. The main road to RHR extended eight miles to the top of the mountain and was the only way in and out of the ranch. Individual homes were situated along this main road or along the 24 miles of unpaved secondary and tertiary roads. RHR also had two small physical facilities: a small office and meeting room at the top of the community and the gatehouse, which was staffed by a part-time employee.

The community was self-governed by volunteers who served on a seven-member board of directors (BoD) and on the Finance, Maintenance, and Social committees. Community members approved the yearly budget and voted for new BoD members at the March meeting. RHR's members as a whole were fiscally conservative and tried to avoid large expenditures. The BoD oversaw RHR employees: Sam, a full-time community manager who also worked on and oversaw the road crew; Mable, a part-time volunteer office manager and bookkeeper; and a part-time employee at the gatehouse. Jason, who was a practicing certified public accountant (CPA) in a local accounting firm, was the head of the Finance committee and oversaw community financial matters.

Each year, two or three new members began three-year terms on the BoD. This ensured that there was always a majority of experienced BoD members to assure continuity. The BoD president was selected by BoD vote from the returning members at the first meeting after the March elections.

PROPOSAL FOR A VOLUNTEER FIRE DEPARTMENT

The community had fire protection through the Boise fire department, which was located three miles from the gatehouse—for which community members paid a yearly fee. The fee was collected through the Metropolitan District (locally referred to as the "Metro"), a governmental body organized by public election and subject to state and county statutes, regulations, and reporting and auditing requirements. All members of the Metro were volunteers.

In late 2007, two RHR BoD members—Preston, the sitting president, and Gerry—presented a proposal to the Metro to establish a supplementary RHR fire department. After studying the proposal, the Metro concluded that, "a Raven's Head Ranch fire department should not be pursued at this time for...(three) reasons." First the Metro cited the extremely high cost (approximately \$1.5 million) to cover payments for a salaried fire chief, a maintenance building, fire protection vehicles, and protective clothing and tools, but the cost wasn't realistic to raise from member dues and assessments. Second, the department would still require unpaid volunteers to serve as firefighters. Third, even with the establishment of a fire department, insurance premiums wouldn't be lowered, or the reduction would be relatively minor in comparison to the large increase required in dues.

In spite of this, five months later Preston and Gerry presented a revised plan to organize an RHR volunteer fire department (VFD), which proposed hiring a 30-hour per week paid fire chief and a paid deputy, purchasing and maintaining an emergency fire truck, and constructing a building to house the fire truck. Gerry would be the

fire chief, and Preston would be the deputy. The only substantive change in the plan was in specifically calling it a volunteer fire department. This proposal was submitted to RHR residents at the March annual election and was defeated by a vote of 63 to 20.

Despite the community's rejection of the proposal, Gerry, Preston, and a few other community members pressed forward in planning for a VFD. They decided that all fire department members would serve strictly as volunteers with no paid members. In June 2008 (three months after the annual meeting), Preston and Gerry called a special town hall meeting to again discuss the establishment of a VFD. With the current plan, the Metro encouraged RHR to consider the idea of a VFD as supplemental fire protection. No community vote was taken to approve what was presented as simply "a discussion."

Two months later, the BoD approved the purchase of emergency radios to support the unapproved and nonexistent VFD. The minutes from that meeting stated: "The Raven's Head Ranch BoD discussed the purchase of the emergency radios to support the volunteer fire department. A check was written to the Metro district from the Raven's Head Ranch [homeowner's association] in the amount of \$14,076.50 at the meeting." Concurrently, Preston announced at this meeting that the expanding Boise fire department had donated one of its smaller fire trucks to the RHR VFD. The fire truck was eight years old and was in very good shape.

Over the next several meetings, Preston and Gerry presented plans for a Shelter-in-Place (SiP) emergency structure to be built in the community that would be used as a temporary shelter by community members in the event of a wildfire, which might cut off the top of the community from rescue. It would also serve to house the donated fire truck. The SiP was to be constructed using volunteer labor and funding from the RHR community. Several times during these discussions Preston only gave the BoD materials and information to be voted on at the last minute with no time to read or study the documents. Many of these items were proposals for initiatives and purchases to support the VFD. Although some of the BoD members found these activities disturbing, other BoD members supported the idea of a VFD and Gerry and Preston's efforts. These initiatives that slowly and inexorably led to the de facto establishment of a VFD were never presented to or voted on by the community after the failed vote in spring 2008.

CONCERNS IN THE COMMUNITY OVER THE VOLUNTEER FIRE DEPARTMENT

As these events unfolded toward the end of 2008, community members were becoming increasingly concerned with the turn of events producing the unapproved VFD and its related expenditures. In spring 2009, Gerry, Preston, and a third supporter of the VFD had intended to run for re-election as their terms were expiring. Three other residents decided to run in opposition, which was the first time in which there were more candidates than available positions.

The three candidates, Luke, Rich, and Averill, posted and mailed flyers specifically pledging to support fiscal responsibility and restore transparent decision making. The 2009 annual election saw the largest turnout in RHR community history, with emotions running high; divisive factions had obviously emerged in the normally cooperative community. Luke, Rich, and Averill were all elected, replacing the pro-VFD candidates, and Lisa, who had been on the BoD for a year, was voted as president of the BoD.

As president, Lisa had access to documents and community records that she had never seen before. As she read through these documents, she found possible evidence of fiscal activities that were disturbing, possibly unethical, and potentially illegal. First, the office manager, Mable, who was responsible for writing checks for RHR purchases, had been instructed several times by Sam to write checks for unknown items and in amounts greater than she was authorized to write without additional approval. Sam wasn't a resident of RHR but was a full-time employee charged with community maintenance and supervision of all employees of the ranch. Preston had recently appointed Sam as a lieutenant in the VFD, a position Sam said he was "honored to have."

Second, Lisa uncovered records of many questionable purchases made over the past several years. As she began to ask questions about them, Jason, who had been serving as head of the Finance committee for the past five years, resigned, stating he "could not work with the new BoD." Lisa then appointed her husband Dave, a retired corporate auditor, as the new head of the Finance committee. After a cursory look at the books, Dave concluded that there was sufficient evidence to make it prudent to call for an external audit of the books for the past four years. After bids from and interviews with three independent auditing firms with experience in nonprofits, a local firm was selected and the engagement began soon thereafter in fall 2009. A timeline of events leading up to this point is presented in Table 1.

THE AUDIT

Following the completion of the audit, the auditors wrote a formal letter to the BoD outlining their findings and concerns. They concluded that RHR's governance and internal controls had a number of material weaknesses, as well as additional significant deficiencies. First, the list of material weaknesses began with significant conflicts of interest. The RHR BoD, the Metro, and the RHR VFD were all separate entities serving the same community. But several governing members of one entity were also governing members of one or both of the other entities with the authority to approve disbursements of funds. A number of these disbursements were made from RHR's accounts for the benefit of the Metro and the VFD. Table 2 illustrates the overlapping roles for several key individuals.

Second, the audit also uncovered frequent examples of management override of controls. The audit specifically cited instances in which the community's volunteer treasurer, Mable, a former bookkeeper, had signed a number of checks for goods and equipment for the benefit of the VFD that had not been recorded as VFD expenses; rather they had been assigned to other, standard community maintenance accounts. When questioned by the audit team, Mable had admitted that she didn't feel comfortable signing checks that appeared to be coded to the wrong account but was ordered to do so by Sam, the community manager to whom she reported.

Third, although RHR did have procedures to ensure that all disbursements were properly authorized and recorded, that process wasn't being followed. The approval process called for a four-step process for large checks (greater than \$1,000) with multiple approvals: (1) invoices or requests for checks more than \$1,000 had to be approved by a BoD member; (2) the invoice then had to be approved by the vice president of the BoD; (3) the bookkeeper received a copy of the invoice, verified the expense account to be charged, and prepared the check; and (4) the check was signed by two members of the BoD. Yet the process actually followed during the audit period varied in significant ways. First, the community manager maintained a separate checkbook for expenses less than \$250, which he could authorize, and for between \$251 and \$1,000, which required the treasurer as cosigner. But the audit team found a check written from this account for \$1,871.31 signed only by the community manager. Secondly, in practice RHR allowed the community manager to approve these checks, sign them, and designate the account to be charged without approval. There had been no attempt by the BoD or the head of the Finance committee to stop or correct the unauthorized approvals. Figure 1 illustrates the established procedures for

check writing and approval (panel A) and the actual process used (panel B).

Fourth, because so many checks were written and approved by the same person who designated the account to be charged, it was relatively easy to misappropriate funds from established RHR accounts to pay for expenses for unapproved projects, such as the VFD. The auditors noted that the VFD, although still not authorized by the RHR community and still lacking community approval for a budget, had been receiving funding from community accounts for the past three years. To determine how significant these misappropriated funds were, the scope of the audit was expanded, and the audit team examined all expenses recorded in the community's accounts for the 2007, 2008, and 2009 fiscal years. Fifty separate disbursements from the community's checking account that paid for goods and services for the benefit of the RHR VFD or the Metro were identified. None of these transactions were properly recorded as such in the financial statements but were instead charged to accounts such as telephone, repairs and maintenance, insurance, equipment, road maintenance, administration/overhead, social/recreation committee, and office expenses.

Many of these misappropriated expenditures were approved by the community manager, who had financial authority over both RHR and the VFD. Additionally, other misappropriated expenses were also approved by then-president of the BoD Preston, who was also the primary person driving the establishment of the VFD. The total amount misclassified over the three years totaled \$40,900. Because the approximate yearly income from dues for the RHR community was \$410,000, the misclassification was considered to be a material amount by the audit team. Table 3 compares reported with adjusted expenses.

Lastly, management override of controls, the failure to follow established procedure, and misappropriation of expenses were all enabled by a lack of segregation of duties. Due to the limited number of volunteers in the community, many critical duties were combined and assigned to the available volunteers/employees, without sufficient checks on the process. While this is not an uncommon problem in small, volunteer-run organizations, segregation of duties specifically for the receipt and disbursement of funds is especially critical to ensure individual integrity and to maintain the internal control system.

Lisa knew that news of an audit would lead to contention and confrontation in the community, so she tried to delay releasing the news until the audit was complete and until she had the report in hand. But she had only partial success

in this aim. When the news of the audit broke, Jason, the former head of the Finance committee, immediately flew back to town from vacation and contacted Mable to talk to her about the audit and what she had told the auditors.

DISCUSSION QUESTIONS

1. Segregation of duties functions as the primary preventive control by separating the four functional responsibilities of authorization, recordkeeping, custody, and reconciliation. This can be difficult for smaller, volunteer-driven organizations. How would you segregate duties at Raven's Head Ranch? What kind of compensatory controls might you use to reduce risk if you could not achieve full segregation among the four functional responsibilities?
2. Discuss the role and responsibilities of a board of directors in implementing an effective system of internal controls. Is the board of directors at Raven's Head Ranch functioning effectively? Why or why not?
3. Discuss the role and responsibilities of management in implementing an effective system of internal controls. Are the individual managers, officers, and committee heads at Raven's Head Ranch functioning effectively? Why or why not?
4. Discuss the role and responsibilities of external auditors in implementing an effective system of internal controls. Did the external auditors function effectively at Raven's Head Ranch? Why or why not?
5. How does conflict of interest undermine both governance and the control system?
6. The American Institute of Certified Public Accountants (AICPA) *Audit Risk and Materiality in Conducting an Audit* can be adapted to a system of internal controls by assessing inherent risk, control risk, and detection risk, with total risk being the product of these three measures. Use this model to assess total risk for Raven's Head Ranch.
7. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control – Integrated Framework* is widely accepted as the standard model for properly designed internal control systems. The Framework classifies the objectives of the control system into three categories: operations, reporting, and compliance. Does the current system of controls at Raven's Head Ranch address these objectives? How would you define these objectives for the ranch?
8. The COSO Framework conceptualizes internal control as having five components: (1) control activities, (2) risk assessment, (3) information and communication, (4) monitoring, and (5) the control environment. Explain these components and how they are present (or missing) at Raven's Head Ranch.

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Table 1: Timeline of Events

Quarter	Events Surrounding RHR VFD Establishment and Disbursements
Fall 2007	Proposal from Preston and Gerry to the Metro to establish a paid RHR fire department
Winter 2007-2008	The Metro rejects the plan as unworkable; suggests consideration of volunteer fire department (VFD)
Spring 2008	Proposal from Preston and Gerry for RHR VFD at annual community meeting; proposal is defeated by a wide margin
June 2008	Special town hall meeting called by Preston and Gerry to discuss establishment of VFD (no new vote conducted)
August 2008	Radios purchased for VFD; Preston announces he has accepted donation of a fire truck
Fall 2008	Gerry and Preston present plans for Shelter-in-Place building to house the donated fire truck and to serve as an emergency shelter in case of wildfires
Spring 2009	Lisa is elected to the board of directors at annual community meeting
Summer 2009	Lisa begins questioning past disbursements; Jason resigns from the Finance committee; Dave is appointed as the new head of the Finance committee and finds evidence of potential misappropriation of funds
Fall 2009	Lisa calls for an audit; the audit finds irregularities in the VFD disbursements and allocations as well as in bypassed internal controls; Jason rushes back from vacation and contacts Mable about the audit and its findings

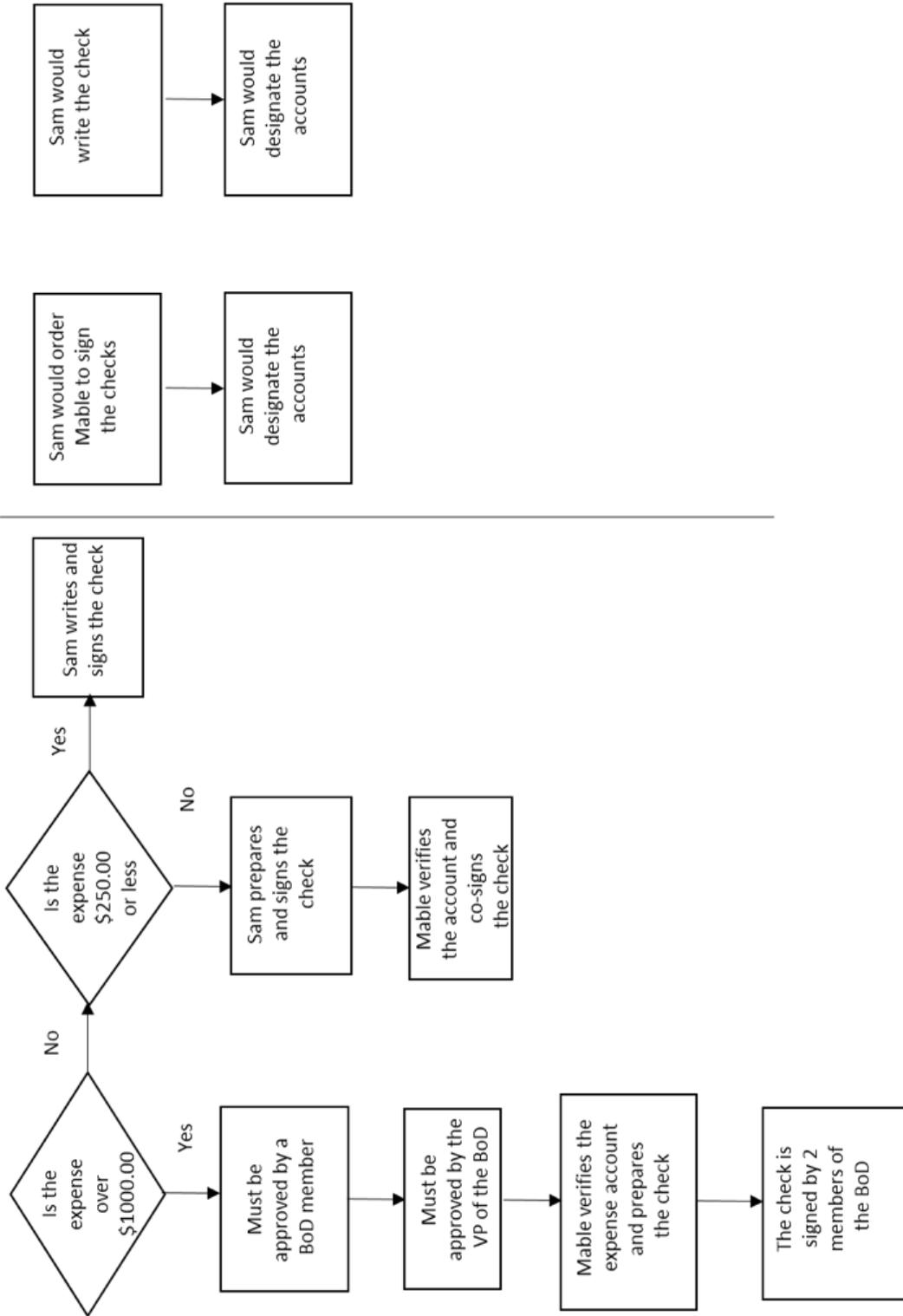
Table 2: Chart of Conflicts of Interest

	BoD	VFD	The Metro	Finance Committee	Community Employees
Preston	President	Deputy			
Mark		Member	Head of the Metro		
Gerry	Vice president	Chief			
Sam	Member	Lieutenant			Community manager
Jason			Member	Head of the Finance committee, reports to the BoD	

Table 3: Misallocation of Funds By Year

	2007	2008	2009	Total
VFD Reported Expenses	\$10,000	\$2,500	\$16,600	\$29,100
VFD Actual Adjusted Expenses	\$18,000	\$12,000	\$40,000	\$70,000
Misclassification	\$8,000	\$9,500	\$23,400	\$40,900

Figure 1: Check Writing and Approval at Raven's Head Ranch



Panel A: The Approved Procedure

Panel B: The Actual Process