

# Lexington Country Day School: Where Were The Internal Controls?

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***Abstract:** This case is loosely based on a real-world situation so the names of the key players are disguised. The case is flexible and could be used in a number of courses including internal auditing or financial auditing course (emphasizing corporate governance including COSO and internal controls), and in a nonprofit accounting or strategic management course (emphasizing internal controls and the responsibilities of the board of directors).*

## INTRODUCTION

May 20, 2007 started like a typical day for Mary Sunshine and her husband, Frank. They had breakfast with the children Mike, 14 and Freda, 16, while discussing the headline news of the day. They saw the children off to the bus stop on their last day of school for the year. Frank was late for work so he waved at Mary as he rushed to his BMW-SUV for the long drive to his insurance executive job. Mary followed shortly in her own BMW-SUV to her accounting job at a local pharmacy. As he drove to work, Frank thought of the children and how lucky he was to find Mary, his wife of 25 years. After all, he fell in love with her the moment he saw her walking into his accounting class during their junior year at Beattyville College. They dated for three years and married after Frank finished graduate school. Little did Frank know that his world was about to change, as his relationship with Mary would face its greatest challenge. As soon as Mary arrived at work, she was met by the local police and arrested for allegedly embezzling \$500,000 over a 10-year period from Lexington Country Day School her previous employer. How did all this happen?

## BACKGROUND OF LEXINGTON COUNTRY DAY SCHOOL

Lexington Country Day School, located in Coventry, Kentucky, is proudly celebrating its centennial after its humble beginning in 1907 as a day school for boys. It has expanded since this time and is now a coed institution with a pre-kindergarten (the lower school), a kindergarten through fifth (the middle school) and a school for grades six to twelve (the upper school). As a private institution, Lexington Country Day has one of the highest tuition rates in the state. Current annual tuition ranges from approximately \$27,000 for pre-kindergarten to approximately \$33,000 for the upper school. Tuition includes lunch, books, art supplies, most trips, laboratory fees, and equipment. However, transportation costs to and from school are not included in the tuition. As a result, Lexington Country Day attracts students from high-income families with most parents providing transportation for their children. Lexington Country Day's diversity initiative has resulted in the admission of more children from lower income families and it provides an alternative paid transportation service for those families.

Lexington Country Day prides itself on its small class sizes. This is reflected in a student-teacher ratio of 8:1. There are currently approximately 1,000 students enrolled at Lexington Country Day: 200 in the lower school, 300 in the middle school and 500 in the upper school. Another distinguishing feature of Lexington Country Day

is its qualified faculty, of whom approximately 70% have earned advanced degrees.

### **THE LEXINGTON COUNTRY DAY EXPERIENCE**

Lexington Country Day was founded on the belief that a quality education should be scholarly, including intimate teaching, rigorous academic standards, supported by state of the art facilities. As such, Lexington Country Day's mission is to offer students the foundations of a liberal arts education that will guide them to rewarding purposeful lives. This is achieved through the devotion of its faculty, the spirit and diversity of its students, the excellence of its facilities, and the atmosphere of its beautiful campus.

The Lexington Country Day experience begins with a thorough grounding in the fundamental skills of reading, calculation and clear expression, as well as a complete college preparatory curriculum. The arts, music and drama programs are also a fundamental part of the experience. Lexington Country Day also believes in stimulating the whole student so it offers a full range of intramural and interscholastic sports. These include baseball, basketball, fencing, lacrosse, field hockey, softball, track and field and swimming.

### **GOVERNANCE STRUCTURE**

#### **The School**

Lexington Country Day is "ruled" by a headmaster, Mr. Greg Fellows, who has been with the school for over 20 years. Mr. Fellows is a Lexington Country Day alumnus and has increased the academic rigor and athletic performance of the school during his long tenure. He is supported by the head of each school each of whom has some autonomy in leading the school within their charge. The

Bursar, Director of Admissions and Registrar provide administrative support for all three schools.

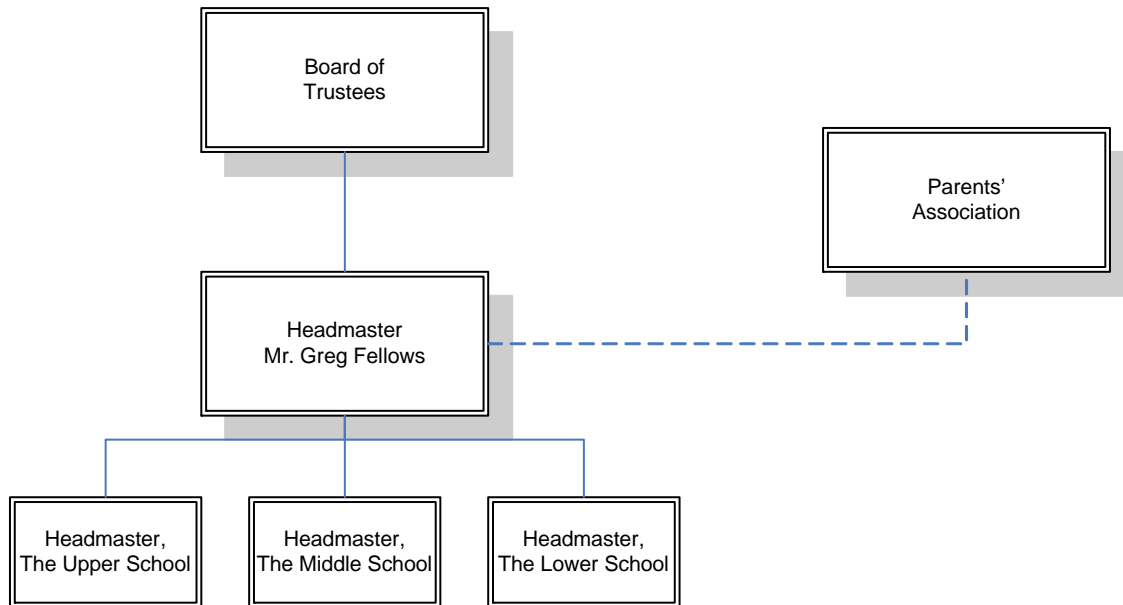
Weekly meetings are held by the administrators to discuss academic performance, faculty issues, and other Lexington Country Day business. The administrators include the headmaster, the head of each school and the Registrar, Bursar and Director of Admissions. A monthly meeting is held with the Student Advisory Council, a student group with representatives from each school, to ensure that student issues are fully addressed by the administration.

Monthly meetings are also held by the headmaster with the head of each department ("the Staff Council"). The Staff Council includes the Athletic Department, the Human Resources Director, the Controller, Directors of Facilities and Catering, and two faculty representatives (elected by the general faculty for a two year term). These meetings are meant to ensure that administrators, faculty and staff are all working to support the Lexington Country Day experience.

#### **The Board of Trustees**

A 41-member board of trustees, comprised of alumni and others, provides oversight of the school's activities. The board's officers, who are independent of the school, include a chairperson, vice chairperson, a secretary and treasurer. The board includes Mr. Fellows, as headmaster, along with 10 others with "Trustee Emeritus" status. Board of trustee meetings are held monthly and a quorum of active trustees is necessary for approval of significant actions. Mr. Fellows usually provides the board with information on enrollment trends, faculty issues such as resignations or the challenge of attracting qualified faculty. The board receives financial information on Lexington Country Day on a quarterly basis. Lexington Country Day's governance structure is depicted in Figure 1.

Figure 1: Organizational Diagram of Lincoln Country Day School



The primary role of the board is fundraising and board members are selected based on their ability to attract donations. Their achievements in this area are remarkable as noted in Lexington Country Day’s endowment of \$100 million, one of the largest such endowments in the nation for a school of its size. The endowment income allows Lexington Country Day to provide partial and full scholarships to families on a needs basis. The scholarships are part of Lexington Country Day’s efforts to increase diversity in its student ranks. The board recently announced a capital campaign for the next year with a stated goal of \$30 million. These funds are expected to be used to build a new science building and improve the school’s athletic facilities.

**The Parents’ Association**

Lexington Country Day benefits from a very active Parents’ Association (“the association”). This volunteer organization, with its own budget and elected officers, is dedicated to improving the Lexington Country Day experience. Meetings are held on a regular basis and all parents are welcome to participate fully in them. The association publishes a quarterly newsletter and calendar that is distributed to all families so that they are informed of upcoming events.

Among the events sponsored by the association are an annual fundraising benefit and the lower school spring carnival. Lexington Country Day’s accounting department manages all funds raised by the association. The association also provides other volunteer opportunities for parents. These include serving as chaperones on school trips; volunteering at art shows, concerts, plays and athletic events throughout the year; and assisting in the school libraries.

To support Lexington Country Day’s diversity initiative, the association created a Diversity Forum. The Forum, comprised of parents, faculty, administration, and staff, provides an opportunity for on-going dialogue and discussion on how to make its stakeholders (students, parents, faculty, administrations, alumnae, and staff) feel comfortable and welcome at Lexington Country Day.

**THE ACCOUNTING FUNCTION**

Like other organizations, Lexington Country Day has had a difficult time attracting a diverse candidate pool to fill its open faculty and staff positions. Working with the board and the

Parents Association, the Human Resources Department tried a number of different approaches to increase diversity in its ranks especially at the faculty and staff level. These efforts were beginning to pay off since two of the three head coaches and two of 10 faculty members recently hired were all members of underrepresented minority groups. However, finding qualified candidates for staff positions, especially at the professional level, was more challenging.

Lexington Country Day was excited to receive Mary Sunshine's resume in April 1996 for its unfilled accounting clerk position. Mary's resume showed that she had an accounting degree with four years of bookkeeping experience. Mary's resume also showed that she had not worked in the last nine months. Lexington Country Day included her on the list of candidates to interview and made a note to follow up on the gap in her work experience.

The interviews with Mary went better than even Lexington Country Day expected. She was quiet and shy and had a smile that "lit up the room" and seemed to have a good grasp of the basic accounting knowledge required by Lexington Country Day. John Smith, the Human Resources Director and Jane Flowers, Controller, quickly identified her as their number one candidate. During the interview, Mr. Smith discussed the lapse in her employment history with Mary. Mary responded that she was diagnosed with breast cancer a year earlier. After consulting with her doctor and her husband, she decided to quit her job so she could undergo treatment. "Thank goodness the treatment was successful," she said, "and now the cancer is in remission." With her improved health, she felt it was time to return to the work force. No additional follow-up was performed by Lexington Country Day and Mary was offered the job as accounting clerk. Mary joined the staff of Lexington Country Day on May 1, 1996, reporting directly to the controller.

Lexington Country Day operates with a lean staff and as such, staff persons performed multiple tasks. As the accounting clerk, in a two-person department, Mary was no exception. Her duties included receiving all funds regardless of source, including those relating to the association events, preparing and making the bank deposits, reconciling all bank accounts, receiving all approved disbursement vouchers from departments, preparing the cash disbursements, preparing monthly activity reports, and preparing and mailing donors' gift acknowledgements (i.e., gift receipts). It should be noted that cash receipts were not acknowledged until received by the accounting department.

Jane Flowers reviewed the monthly bank reconciliations and monthly reports prepared by Mary. Jane was also in charge of coordinating Lexington Country Day's fundraising efforts in addition to the accounting functions, but she did not have an accounting degree. Her background was in public relations and she took over the accounting department after the departure of the previous controller, which resulted in the merger of the accounting and public relations departments.

It was a very stressful job but Mary thoroughly enjoyed it and flourished in her role. She always received excellent annual evaluations along with outstanding raises from Jane Flowers. Mary was such a dedicated worker that she did not take much vacation time while at Lexington Country Day even though she was eligible for three weeks vacations each year. She occasionally took a Monday or Friday off so she could enjoy a long weekend with her family. As Jane was her only backup, Mary was afraid that the work would simply "pile up" in her absence plus she was paid at the end of the school year for any unused vacation time.

Over the years, the Parents' Association and other departments questioned the anticipated income versus the actual amounts shown on internal reports. These discrepancies were brought to Mary and Jane's attention. Mary was

always able to support the internal report balances and Jane fully agreed with and supported her explanations.

A major benefit for Lexington Country Day's employees was partial or full scholarships for their children to attend the school based on income levels. This benefit was effective after six months of employment. Mary obtained a full scholarship for her daughter Frieda to attend Lexington Country Day and she was initially enrolled in the middle school. Frieda is now an honors student in the upper school. Mother and daughter enjoyed the Lexington Country Day experience and were appreciative of their time together commuting and their weekly lunch in the students' cafeteria.

On the home front, Mary's family life was simply wonderful. Her husband was promoted to Vice President of Internet Marketing at his firm and her son was excelling in football and basketball at his junior high school. The family recently sold their home in one suburb and moved to a more upscale suburb into an \$800,000 home with an outdoor pool and a two-car garage. The two BMWs in the driveway were a physical testament to their success. In honor of Freda's recent sweet sixteen birthday party, a fabulous pool party was given in her honor. No expense was spared as evidence by the food, flowers and the live steel band at the party. Freda's classmates were still talking about the party a month after the event. They felt that this was the best sweet sixteen party so far for the girls in the class. Mary was quite pleased when Freda told her of the complements as she finally felt she was in the same league as the other wealthy Lexington Country Day parents.

Meanwhile, the workload continued to increase for Mary without any increase in manpower or salary adjustment and as a result, her stress level was also increasing. Mary was becoming more agitated and was becoming more difficult in her interaction with others. Jane noticed the change in Mary's demeanor and thought it was only temporary and would pass. Frank, her husband,

also noticed the change and was becoming concerned especially as Mary was not as attentive at home. Frank finally spoke with Mary and learned of her unhappiness at work especially with the increased workload and no additional assistance. Since the Christmas holidays were close, they both decided that Mary should quit her job, relax at home for the holidays and look for a new job in the New Year.

So in December 2006, Mary gave Lexington Country Day the required two weeks notice that she was leaving the school. This was a big blow to Lexington Country Day since it was losing a seasoned, well-respected employee. Jane tried to persuade Mary to stay by offering her more money, but this was not successful. John Smith, the Human Resources director, wanted to know the reason for Mary's resignation and she informed him that she was stressed and was afraid that her mood was affecting her marriage, and she was not willing to sacrifice her marriage for work. Lexington Country Day gave Mary the standard bon voyage package – a special luncheon and a Tiffany pen.

### **TRANSITION**

Kim Street was hired in January 2007 to replace Mary. Kim was an unlikely hire for the position since she was a CPA with five years of Big 4 accounting experience. In fact, she was asked multiple times in her interviews why she was interviewing for the accounting clerk position as she appeared overqualified. The answer was simple: Kim was a young mother with two children in Lexington Country Day's lower school and like many moms she simply wanted to spend more time with her children. Lexington Country Day was pleased to have someone with Kim's background on staff.

Because Mary was no longer on the job, all parties agreed that the best way for Kim to learn the job was to review the work done by Mary. With her background, Jane expected Kim to make a smooth transition. As Kim combed

through Mary's records she started noticing small discrepancies between the cash recorded in the bank and the school's general ledger versus those reported by the various outlets such as the cafeteria and the Parent's Association banquet. Individually, the amounts were not large - \$250, \$500, \$1,000 – but she brought it to Jane's attention expecting to receive a simple answer.

Jane became alarmed upon the news as she had not looked at detailed transactions in the past and simply relied on Mary's integrity. Clearly, she felt that Mr. Fellows, the headmaster, should be notified of the cash discrepancies. Mr. Fellows also notified the board of trustees' chairperson of the potential problem even though the extent of the damage was unknown. A meeting was held between Jane Flowers, Greg Fellows and the chairperson and they agreed that the best course of action was to hire a forensic accountant to work with Kim to review Mary's transactions for the last 10 years.

The investigation was conducted with speed and efficiency especially as Mary kept such immaculate records. It quickly revealed discrepancies of approximately \$500,000 between the amounts expected versus the amounts recorded in the general ledger for the last 10 years. The missing funds were from multiple outlets – tuition, fundraising events, the bookstore, and the cafeteria. The findings were discussed with the headmaster and chair of the board of trustees and turned over to the District Attorney's office for further investigation.

Mary was arrested by the local police on May 20, 2007 at her new workplace after the district attorney's investigation confirmed Lexington Country Day's findings. She was charged with one count of grand larceny in the second degree, one count of forgery in the second degree, and one count of criminal possession of a forged instrument in the second degree. Bail was set at \$250,000 and Mary had to relinquish her passport. No criminal charges were filed against Frank by the district attorney.

The news of Mary's arrest raged through the Lexington Country Day community and caught parents, administration, and staff by surprise. It quickly divided the community into different camps. Some felt a sense of betrayal, others felt that Mary was innocent and was clearly framed, and others were simply waiting for the criminal case to be resolved. Meanwhile, Lexington Country Day filed a civil complaint against Mary and Frank Sunshine in which they claimed that the misappropriated funds were used to acquire their home and cars. Lexington Country Day also obtained a lien on the Sunshine's assets including their bank accounts.

### **A CALL FOR ACTION**

This case raises a number of issues:

- Did Lexington Country Day have a good corporate governance process?
- Were there internal control weaknesses at Lexington Country Day?
- If so, what should Lexington Country Day have done to mitigate the control weaknesses identified?
- Was Lexington Country Day negligent by not uncovering the fraud sooner?
- What was Frank Sunshine's role in the fraud committed by his wife?

#### **Required:**

- Assume you are engaged to perform an internal control assessment at Lincoln Country Day School. Use the COSO framework to identify strengths and weaknesses in the control system and propose recommendations to management [see Appendix A].
- Communicate your findings and corrective actions to the board of trustees using the report format provided [See Appendix B].

**Appendix A: COSO Framework**

	<b>Identify Strengths in Internal Control</b>	<b>Identify Weaknesses in Internal Control</b>	<b>Propose Recommendations to address Weaknesses</b>
<b>Risk Assessment</b>			
<b>Control Activities</b>			
<b>Information and Communication</b>			
<b>Monitoring</b>			
<b>Control Environment</b>			

**Appendix B: Audit Report**

Date: (date fieldwork was substantially completed)  
 To: The Board of Trustees, Lexington Country Day School  
 From: Audit Manager  
 Cc: Executives of the business/unit audited

**Executive Summary**

**Audit Results:** The overall results of the audit are reported here (An optional report rating can also be added). This is a high level summary of the critical business issue(s) identified in the audit and its impact on the organization.

**Audit Scope:** This section identifies the period covered by the audit and provides a brief summary of the work performed. Management’s response to the findings is either provided with the issues or in a separate document (this requirement is outside the scope of this case).

**Issues and Recommendations** (begins on page 2 of the report)

This section provided details on each significant business issue noted in the audit and begins on page 2 of the report. The business issues are developed from the weaknesses noted in Appendix A and could be the combination of one or more findings. Each issue is described by five elements:

- The control condition or problem noted in the audit
- The criteria which renders the problem inappropriate
- The cause of the condition
- The effect or impact the condition may have on the organization
- The element that could eliminate or mitigate the condition

Management’s response to the issue (if applicable) is often included in the report.

*Teaching Note/Instructor Manual available from the Journal of Business Cases and Applications.*

