



Carolina Wilderness Outfitters Case Study (A)



CAROLINA WILDERNESS OUTFITTERS BOARD MEMBERS AND EMPLOYEES

BOARD OF DIRECTORS

Thomas Wilcox, *Chairman of the Board*

Ann Dawson, *CEO*

Robert Henderson, *Board Member*

Janice Quill, *Board Member*

Mark Sentor, *Audit Committee Chair*

Norton Bell, *Audit Committee Member*

George Li, *Audit Committee Member*

EXECUTIVE TEAM

Ann Dawson, *CEO*

Christine McCoy, *CFO*

Bud Stimson, *Head of Hunting Division*

Steve Bauer, *Head of Fishing Division*

Rocco Merli, *Head of Apparel Division*

Sue Ramos, *Head of Internal Audit*

OTHER EMPLOYEES

Mark Tomkin, *Head of Apparel, Texas Region*

Betty Koster, *Apparel Division Accounting Support Team, recently terminated*

Simon Peel, *Accounting Manger*



About this case study:

This case study was developed as a joint effort by the Center for Audit Quality, Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors. These four organizations have formed the Anti-Fraud Collaboration to actively engage in efforts to mitigate the risks of financial reporting fraud. The Collaboration's goal is to promote the deterrence and detection of financial reporting fraud through the development of education, programs, tools and other related resources.

For more information about the Anti-Fraud Collaboration and its resources please visit www.AntiFraudCollaboration.org.

Sue Ramos, head of internal audit at Carolina Wilderness Outfitters (CWO), found herself at a decision point. One month earlier, following an ex-employee's call to the company's ethics hotline, Ramos launched what had seemed like a routine investigation into a claim of improper termination. She had thought the investigation was winding down until last week, when it turned up a new allegation of possible accounting irregularities. The new allegation, however, was not well substantiated. Her instincts told her that she should pursue the matter further, but she also knew that it would be difficult to do so. She had little reason to believe the investigation would turn up something significant, and she had a full plate of work already and few resources she could assign to the task. A further concern was that CWO was one week away from its SEC filing date for its third quarter financial statements, and company management would be in no mood for a distraction without strong supporting data. Ramos considered her various options: should she notify management of her concerns, bring it to the attention of the audit committee, and/or alert the external auditor. Alternatively, she wondered whether she should just focus on her other high-priority work and not pursue what would, in all probability, not amount to anything material.

CAROLINA WILDERNESS OUTFITTERS (A)

Carolina Wilderness Outfitters was a publicly traded specialty retailer that sold gear and apparel to outdoor enthusiasts. Founded in North Carolina with just one small store in the 1930s, the company grew slowly for fifty years and attracted a loyal local following. In the 1980s, a small group of investors saw great potential in CWO and bought a majority stake in the business from one member of the founding family. Other members of this family continued to hold a 20 percent ownership stake. The new majority owners took the company public with a successful IPO and grew the business by building new and larger stores throughout the southern and eastern states. CWO now had 35 stores in six states. Texas, with 12 stores, and Pennsylvania, with eight stores, accounted for nearly two-thirds of the company's \$310 million in annual sales. Because of the importance of the fall hunting season to its business, a disproportionate share of its sales came in the late summer and early fall.

Headquartered in Hendersonville, North Carolina, CWO organized its divisions around its three main product groups: Hunting, Fishing, and Apparel. The Hunting division sold rifles, shotguns, air guns, ammunition, optics, hunting blinds, and other gun and hunting related gear. The Fishing division offered rods, reels, fishing tackle, lures, live bait, nets, canoes and small fishing boats, and boat accessories. The Apparel division sold hunting and fishing clothing, jackets, raingear, camouflage clothing, footwear, and other apparel for outdoor activities. The Apparel division

accounted for half of CWO sales, with the remaining sales approximately evenly split across Hunting and Fishing.

CWO carried both its own brands and a selection of leading national brands. It sourced a large majority of its products from major suppliers, but the company still manufactured a few apparel products, mostly camouflage clothing, in its own plant in Texas. CWO maintained a company website to promote its stores and provide general information about the company, but it had only recently begun exploring opening an internet channel to sell its products online.

COMPANY STRATEGY

CWO had built its reputation by offering quality products and superior service. It targeted mid- and upper-income consumers with enough disposable income to purchase that special item to complement their vacation or hobby experience. CWO sales associates were some of the best in the industry in terms of product knowledge, outdoor experience, and an ability to connect with customers. CWO located its stores in tourist towns close to fishable waters, in areas open to hunting, or areas with high levels of outdoor recreational activity where shoppers were ready to buy. For the past decade, CWO had pursued a strategy of steady, sustainable growth. It opened a new store every couple of years and company management focused on running each store profitably, increasing same-store-sales annually, and only opening a new store when it found a good location in the right area.

EXECUTIVE TEAM

Ann Dawson, CEO of CWO, had practically grown up in retail: beginning as a sales clerk in high school and becoming a part-time assistant manager in college. After earning her MBA, she became a buyer for a national sporting goods chain. Her confident leadership style, work ethic, and bias towards action soon led to executive-level positions in two different retail companies. Dawson had joined CWO as head of store operations five years earlier and, after two and a half years at CWO, she was named CEO.

Two factors that had led to Dawson's career success were her personality and her ability to set and achieve ambitious goals. One executive explained, "People like Ann. She is approachable, always projects a positive, can-do attitude, and is the kind of person people enjoy being around. At the same time, she is very focused on the business. When you see her working so hard and doing everything she can to improve the company, you feel like you never want to let her down."

Bud Stimson headed up CWO's Hunting division. He had joined CWO twelve years earlier and had been in his current position for five years. Stimson set his personal goals high and pushed his managers as much as he thought they could bear. Managers who thrived under pressure, wanted to advance their careers, or learn from one of the best, wanted to work for Stimson.

Steve Bauer and Rocco Merli headed the Fishing and Apparel divisions, respectively. Bauer was in some ways a holdover from an earlier generation. He joined CWO before it went public and worked in upper management at a time when many managers still considered themselves fishers and hunters. At executive meetings, he often prefaced his comments with, "What a fisher wants..."

Merli was the youngest member of the executive team and had been at CWO for two years. A graduate of a leading undergraduate college, Merli had been hired into an executive training program at a major retailer after earning an MBA from a top-tier business school. He had held a variety of retail management positions including a stint at a major consulting firm for the industry. Dawson hired Merli because she felt that he had been exposed to some of the most up-to-date thinking in the retail field. At CWO, Merli worked to prove he belonged on the top team. Though he often had more technical knowledge than his peers, he respected their experience and tried to learn from everyone. Merli followed the lead of Stimson by setting high targets for his Apparel team.

Dawson also hired CFO Christine McCoy, a CPA with whom she had worked earlier in her career. At CWO, McCoy was well regarded by other members of the top team. She tended to stick to her areas of expertise—finance and accounting—and stayed in the background on strategy and retailing issues. Her financial team mostly predated her at CWO. Its members had adequate experience for a company such as CWO, but McCoy believed she would have to invest in additional expertise as CWO continued to grow.

CWO had a small legal department. The general counsel provided legal advice and expertise to senior management and also served as the company's ethics officer.

All members of the executive team received a standard compensation package which included a base salary, stock option awards, and significant incentive compensation based on meeting individual and company targets. Dawson in particular had compensation heavily weighted towards company performance.

INTERNAL AUDIT

Sue Ramos had headed internal audit since she was hired by Dawson 18 months earlier. Like McCoy, Ramos was also a CPA, and additionally held the Certified Internal Auditor (CIA) designation. She had extensive internal auditing experience, having worked in the field for 25 years. Before CWO, she had held a similar position at a slightly larger firm. Dawson had wanted a new person in the position because she felt that while the department might have been strong a decade earlier, it had had little turnover in the past decade and had not kept up with the growth of CWO. Nor had the department been progressively evolving over that period. Ramos, however, did not completely fault her predecessor for the deficiencies in the department. It seemed that CWO had invested very little in systems, training, or new personnel in internal audit in recent years. Ramos had begun to take steps to rectify this situation, but her budget remained tighter than she had hoped when she took the job, limiting, in her view, an ability to transform the function as rapidly as she had initially envisioned.

Internal audit consisted of four members in addition to Ramos. The team evaluated risk exposures related to CWO's governance, risk management, and internal controls. It periodically evaluated risks for each division and region and selected sites for testing on a rotating basis. Internal controls at CWO seemed adequate, but were perhaps not as strong as they might be. Processes and controls were in place and regularly discussed.

Management generally took them seriously, but as one manager put it, “no one ever got promoted because they followed the rules.” Internal audit reported its findings to the audit committee; however, administratively, Ramos reported to CFO McCoy.

Ramos also handled special investigations and had some experience in this area. CWO’s previous internal audit head had typically hired outside experts to run any necessary investigations, but McCoy suspected that sometimes things simply did not get investigated unless they were deemed important enough to warrant bringing someone in. Because of this, McCoy wondered if there were other issues that may have been ignored or overlooked in the past. Consequently, McCoy wanted Ramos to run all investigations unless and until it was determined that outside help was required. Many such investigations originated with the company’s ethics hotline, which was also operated within the internal audit department.

Two other factors challenged internal audit. One of its staff members had gone out with a disability six months earlier. Initially it appeared that this employee, who helped test controls around obsolete inventory, would be out only a few months, so Ramos had delayed hiring a replacement. The disability, however, had lasted longer than expected, and Ramos would have to decide soon whether to hire someone new. While Ramos had asked about obtaining outside resources to provide assistance, it was not pursued because “it was not in the budget.” The second challenge was that other than the CFO, Ramos was the only manager at CWO who was a CPA. Dawson and other executives would occasionally drag Ramos into issues outside of internal audit to tap her expertise on accounting issues. While this did not take up a large amount of her time, and Ramos wanted to be helpful, she sometimes found this practice distracting.

EXTERNAL AUDIT

TK&R Partners had been auditing CWO’s financial statements since its IPO. TK&R had grown along with CWO, starting as a small regional firm and subsequently becoming one of the larger regional firms in the Eastern half of the United States. CWO executives generally felt TK&R was doing a good job. They also appreciated the firm’s willingness to build expertise in the sporting goods retail industry. TK&R had always issued unqualified audit opinions for CWO, and CWO had never missed a filing deadline or restated any financials. Historically, when TK&R proposed audit adjustments or questioned any accounting treatments, CWO was generally receptive.

CWO CULTURE

In its early days, the CWO culture was driven by individuals who lived and breathed hunting and fishing. It was difficult for them to draw a line between their personal and professional lives, as many of them left work to go fishing at the end of the day. Following the IPO, the leadership of CWO above the store level gradually took on a more professional feel. Many of the key leaders still enjoyed hunting and fishing, but they were executives first, doing their jobs to ensure the success of the company.

Dawson wanted to kick the professionalization trend up a notch and reinforce a performance culture. Her goal was to run a successful retail company that continued to grow and perform well for its shareholders. To this end, she held her executive team to high standards. She encouraged them, some would say pushed them, to set high goals for themselves and their teams. Accountability was also high on her list of important personal attributes. If one of her executives made a commitment, Dawson expected him or her to meet it. While Dawson believed that success was never guaranteed, she also believed it would never occur without ambition and holding people accountable.

Most executives and senior managers at CWO had competitive personalities. Like Dawson, they tended to work long hours and liked to show that their departments were functioning at high levels. None of them wanted to be seen as holding CWO back. While the performance culture had taken hold at the executive level, and to a lesser extent throughout headquarters and field staff, things were different in the stores. Store managers and their key sales staff saw working at CWO as a way to meld their love of the outdoors with their work, and CWO relied on them to provide that added bit of enthusiasm and expertise that attracted customers. While store staff could be relied upon to follow company initiatives, these employees tended not to think of themselves as sales people. They enjoyed talking with customers and showing products, but pursuing aggressive sales targets was generally not in their nature.

BOARD OF DIRECTORS

CWO’s board of directors had seven members including CEO Dawson. Thomas Wilcox had joined the board 10 years earlier when he was named Chairman and CEO. He relinquished the CEO title when he promoted Dawson to that role. He would likely retire next year, and he expected that Dawson would become board chair at that time and would retain her CEO title. Wilcox and

his family were friendly with members of the founding family, and that had played a small part in him becoming CEO years earlier. While he still had feelings of loyalty to the family, in reality he understood that the family's role in the business was diminishing as family-owned shares passed to younger generations that had never worked at the company.

One board member, Robert Henderson, was a descendant of the founding family, and with 6 percent of shares outstanding, he was the largest individual owner of CWO. Henderson was a capable director and he played an important buffer role with other family shareholders who sometimes demanded insight into what was happening at the company or otherwise criticized executive decisions. Henderson understood that these family members had no legal standing beyond that of any other shareholder, but because CWO was well-known in the community where it was founded and where many of the executives lived, "managing the family" was sometimes problematic.

The other four CWO board directors were all independent as defined by the NASDAQ exchange on which its shares traded. Two directors, Janice Quill and Mark Sentor, were North Carolina business leaders well-known in the state, and the two remaining directors, Norton Bell and George Li, each of whom had retail experience, were from New York. The board had three standing board committees—audit, compensation, and nominating/governance—each with three members. The audit committee was chaired by Sentor and included Bell and Li. Compensation was chaired by Quill and included Henderson and Li. Nominating and governance was chaired by Bell and included Dawson and Wilcox.

Sentor had been on CWO's board for six years and had been audit committee chair for the past three. Sentor was not a CPA, but he had an accounting degree, executive-level finance experience, an executive MBA, and was the board's designated audit committee financial expert. Bell was currently a CFO at a public company while Li was a retired banker. Sentor met quarterly with internal audit head Ramos, and Sentor made it known he was readily available to Ramos should she ever feel a need to reach out to him. In practice, however, neither Sentor nor Ramos, had reached out to the other beyond their quarterly meetings. Sentor was impressed with Ramos, and he believed she had the skills and ambition to do a great job at CWO. When Ramos described her plans for internal audit, Sentor's only concern was whether she would have the time or resources to do it all.

Board members received annual retainers for their service on the board. CEO Dawson, former CEO Wilcox, and family member Henderson all held significant shares in company stock. The remaining four directors did not.

BUILDING PRESSURE

CWO had done well in recent years and, with Dawson's ambitious plans for the company, performance expectations and the pressure to meet one's commitments only increased. Dawson and her team met weekly to discuss the latest revenue and expense numbers and to review market and promotion plans. In years past, these executive team meetings had been held monthly. Individual executives in turn increased their meeting times with their teams. Merli in particular, who headed Apparel, understood that because Apparel was the largest division, much of CWO's success would come down to him and his team. He spent significant time with his team driving home the performance message.

Starting with the executive team, the performance pressures trickled downward. CWO's buyers historically spent time looking for new and interesting products to attract customers. Their focus had historically been on ensuring that high-quality products were placed in the stores to maintain CWO's reputation. As performance expectations increased, the focus behind product selection gradually shifted as buyers were asked to work harder to get the lowest prices on products from their vendors to maintain or, where possible, increase margins. District managers also began pushing their store managers to take store sales targets more seriously.

Three regulatory shocks further increased the pressure on CWO managers. First, in Pennsylvania, the state's game commission shortened the hunting season by 30 days in some zones. This made it harder for hunters to schedule hunting trips and reduced their need for hunting supplies. Second, in Texas, the parks and wildlife commission added more hurdles to the process of obtaining a fishing license each year. Under the new rules, some part-time fishermen did not bother to renew their licenses. Finally, also in Texas, the game commission instituted new rules on hunting vests. In response to a hunting accident that received extensive media coverage, hunters were now required to wear orange-colored vests on public hunting lands. This reduced demand for the type of camouflage clothing manufactured at CWO's Texas plant.

THE HOTLINE

CWO introduced a hotline program in the 1990s. Following the passage of the Sarbanes-Oxley Act in 2002, CWO upgraded the hotline program. First, it hired an outside contractor, Tel & Tel Services, to receive calls 24 hours a day. Tel & Tel had trained operators who logged all calls, and the operator conducted a preliminary interview to get as much information as possible to help support an investigation, if necessary. Second, all call data was turned over to the head of internal audit. The hotline protocol specified that the head of internal audit determined appropriate next steps.

All employees were informed of the hotline when they were hired and during the annual process of reading and signing the firm's code of conduct. Dawson characterized the hotline as an important tool. Its existence let employees know that they could raise issues at any time, or alternatively, become the subject of a hotline call. The CWO hotline received a few dozen calls each year, most of which were easily addressed.

THE HOTLINE CALL

When Ramos received the Tel & Tel report, she noted right away the call from Betty Koster, an eight-year veteran of the Apparel division's accounting support team who had recently been terminated. In her experience, whenever ex-employees called the hotline, Ramos knew she would be conducting some type of investigation. Ex-employees were often bitter about something, but it was best to hear them out to potentially defuse a situation before it led to a lawsuit. The call notes indicated that Koster had been fired by her boss, Simon Peel, the accounting support team manager, and that Koster believed it was a case of age discrimination.

Ramos started her investigation by reviewing Koster's employment file and going to see Peel. Peel explained that improved software had left him with too many staff and that he needed to let someone go. He felt Koster did not fit in well with her coworkers, so he selected her for the layoff.

Ramos then called Koster and invited her in to talk about why she called the hotline. At the meeting, Koster explained that she was shocked at the firing because she had never been terminated from any job. She continued by indicating she had always liked working at CWO and thought she did a good job. "Eight years of good performance reviews ought to show that," she said. In the end, she concluded, it must be a case of age discrimination.

She was 58 years old and believed that everyone else in her group was under 45 and that most were under 35. "What else could it be?" she asked.

After the meeting, Ramos felt a need to think about what she had learned before making any decisions. She understood that age discrimination sometimes occurred, but just being the oldest person in a department and the only one fired did not prove the case. Over the next few weeks, while she struggled to stay on top of her regular work, she found time for a quick meeting with the head of human resources to get additional input.

Ramos decided to speak with Koster again, so she called her on the phone. Ramos wanted to explore one more time the question of whether Koster had any concrete evidence regarding her age discrimination claim. Koster did not have any specific proof, but she seemed more agitated about the situation than before and said she thought she should be compensated for what she had been put through.

In the course of the conversation, Koster demonstrated what initially appeared to be some of her alleged abrasive personality traits. She complained that people didn't like her because she did not mind speaking up when she saw things not being done right. Ramos asked for more detail. Koster continued, "There are rules in place that we are supposed to follow, and too often people want to take the easy way out to save time or to avoid questions from accounting or finance. When I say something, they ignore me." Ramos asked for examples, but Koster initially seemed unable to come up with any. Under further questioning, Koster appeared to be searching for something, and then finally stated, "That young man in Apparel, Mark Tomkin (Texas region Apparel head), has been sticking his nose into places he doesn't belong. Asking people to do things we are not supposed to do without the proper approvals. It seems like no big deal and people do it because he is nice, but it is not following procedure. Just last month he asked me to make some journal entries about a volume rebate he expected to receive, but he didn't have the right documentation, so I said 'no'. I don't think he liked that, but he never asked me again."

Red flags started going up for Ramos as Koster treaded into more dangerous territory than an isolated complaint of age discrimination. Ramos asked Koster if this had ever happened before. Koster indicated she was not comfortable getting into any more specifics, but remarked that she thought her accounting support colleagues had let themselves get too chummy with the sales staff. Ramos didn't get much more detail on the phone. Ramos

wondered whether Koster was blowing off steam because she was angry or whether she was trying to make a specific allegation. Whatever people's opinions of Koster might be, Ramos believed she was the type of person who had a good understanding of what the rules were and when they were not being followed. But could Koster identify a significant violation, or was she just being obstinate and a stickler for the letter of the law? Ramos wondered what she should make of what she had learned—was Koster mistaken about what Tomkin asked her to do, was this a one-time incident, or was this possibly the tip of something larger?

Ramos decided to call Tomkin. Tomkin answered the call but said that he only had a few minutes as he was running out to catch a flight to visit an important vendor and that he would be tied up for the next day and a half. Ramos asked Tomkin about the journal entry he had asked Koster to make. At first, Tomkin did not recall the specifics and he added, "I am in and out of the accounting support office all the time." When Ramos provided more details and asked specifically about the missing supporting documentation, Tomkin remembered. "I get verbal commitments from vendors that we have been doing business with for years," he explained. "Sometimes I receive the documentation, and sometimes I don't. When Koster requested it, I asked my vendor contacts if they could send me something. I planned to follow up with them when I got a chance, but I have to hang up now to get to the airport."

Ramos hung up her phone and worried. Suddenly an investigation with no particular time pressure had raised the possibility of some sort of accounting issue one week before the financial statements were due. Could she trust Tomkin? He had been around long enough to know he needed proper documentation for making journal entries.

Still, she understood verbal agreements were often made over the phone in the retail business and documentation caught up later. This was becoming a headache she did not need.

Did she need to investigate further? What might she do first? Who should she involve? Ramos also considered how Dawson might react to how she proceeded. Earlier in the year, Ramos was investigating a hotline call on a different matter. At the completion of the investigation Ramos presented her findings to the executive team, and Dawson complimented her on a job well done. However, Ramos also recalled Dawson's final comments, "Investigations should be handled internally if at all possible. Never involve the audit committee or the external auditors unless absolutely necessary. I have seen those investigations get out of hand. They become a distraction to management and impact shareholders." Ramos agreed with Dawson in principle but perhaps would not have stated it so definitively. Ramos believed that the audit committee and the external auditors had important roles to play, would expect to be informed of potentially serious matters on a timely basis, and should not be seen as adversaries.

Ramos had another option. Because the allegations were little more than just talk about not following the rules, too chummy relationships in the office, and chasing away someone who did not have proper documentation, maybe there was no financial statement problem. Rather than dig in and look for something improper now, Ramos could simply remind Tomkin that he should not rely on the support staff to make sure he had the right documentation. She could also schedule the accounting support function for a complete compliance review in the upcoming year. But would that, in Koster's words, be taking the easy way out?



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