BUSINESS MANAGEMENT

Internal controls for small business

2008 UPDATE

CPA AUSTRALIA

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First published 2007

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ISBN 978–1–876874–87–2

Internal controls

This guide is designed to help small business owners and operators understand the need for internal controls and develop simple systems to put in place in their businesses. Whether a business is a sole trader or has many employees, introducing internal controls will ensure that the business runs more efficiently, resources aren't lost and there are fewer unpleasant surprises.

Topics include:

- understanding the concept of internal controls
- the benefits/aims/objectives of internal controls
- limitations of internal controls
- consequences of not adhering to internal controls
- fraud protection
- identifying weak internal controls
- benefits of good internal controls

The guide also includes checklists covering various common procedures in a business:

- accounts payable
- payroll
- sales and accounts receivable
- cash and bank accounts
- non-current assets

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1. Introduction

Small businesses are the most vulnerable to fraud because they often don't have effective internal controls. You could also paralyse your business trying to cover every possible contingency. However, by removing opportunity and motivation for fraud and theft, and ensuring you have systems in place to discourage errors and identify mistakes and anomalies quickly, you are able to discourage fraud in the first place and, if that fails, you can take corrective action to minimise losses.

This guide will help small business owners look critically at their business and examine whether their procedures adequately minimise risks and promote best practice within the firm. A small business has limited resources, and the owner – you – must be active and vigilant in protecting those resources. Good internal controls help you manage resources and make sure operations are efficient and effective.

It may seem harsh but it has been stated that, when it comes to small business, all fraud starts with the owner. It happens if you have been too trustful or too distracted either chasing more business or enjoying success. Compared to large businesses, you have fewer staff to check the effectiveness of procedures and systems in your business and, usually, there are no auditors to do internal control checks for you.

Small businesses are known for having weak internal controls and this guide aims to focus owners' attention on what to look for when reviewing the business.

Owners/managers hold the key to the fight against internal control failures and must be attentive to the concept and issues of internal controls to maximise the business potential and minimise the risk of fraud, error and loss.

2. What is an internal control?

Internal controls are methods or procedures adopted in a business to:

- safeguard its assets;
- ensure financial information is accurate and reliable;
- ensure compliance with all financial and operational requirements; and
- generally assist in achieving the business's objectives.

The business culture

Your overall attitude to internal controls and their importance in the business create an environment or culture within your business. People are made aware of the environment through words and actions. This often starts with the vision and values of the business and the actions of the owners, also called 'tone at the top'.

Some business environments discourage poor reporting, carelessness and fraud, whereas others are ripe for mistakes and dishonesty to occur. Lack of attention to internal matters, no code of ethics, little respect for employees, few audit trails, lavish expenditure and general sloppiness in a business are all likely to create an environment that can be easily manipulated for gain. It is important that the owner treats the assets of the business in the same way that they would expect their employees; for example, don't just dip into the till when you need some money for lunch!

What is your assessment of the culture within your business? Ask your staff what they think about the culture with regard to internal controls. It may give you an insight in to the areas of weakness. Do they think controls are important? Are they aware of important controls? Do they always follow procedures?

Certain companies are recognised for having an *inadequate control culture*. OneTel was a highly visible company that fell over partly due to a lack of controls in all areas of the company. No one had a job title. No one had any accountability in his or her role.

Tone at the top

The next question you have to ask is how important are internal controls to you, the owner? If you do not think they are important then your staff won't.

Business owners have a critical influence on behaviour and the tone of the culture. If you don't care, your staff won't care. Enron was an extreme case of the management setting a risk-seeking tone and establishing a high-risk culture.

Information systems

Information systems are the methods and records you use to identify, assemble, analyse, calculate, classify, record and report transactions and other events that affect a business and to maintain accountability for assets, liabilities, revenue and expenditures. These systems are not just the computer systems but general accounting and office procedures, and also include other associated systems such as performance reviews, distribution systems and manufacturing systems.

It is important that your systems are able to identify leakages of funds or assets from your business.

> Try to list the systems you have in place in your business. Some of your systems may be hard to identify because they are often very informal. They include your computer email, as well as written records.

Control procedures

Control procedures are the policies and procedures that have been put in place to ensure that owners and managers can take the correct action to ensure the business achieves its objectives.

Procedures explain the how, why, what, where and when for any set of actions.

Some small business owners may think procedures are unnecessary. Nevertheless, written procedures help train new staff by explaining why they need to do what is asked of them. Written procedures reduce errors and help staff understand the business quickly. And, most importantly, it reduces the time taken to train new staff.

> Review procedures in your business. Do the procedures explain why and when you need them and who is responsible?

Many procedures are very detailed but forget to tell the reader why they are needed. Remember that internal controls are a process – a means to an end – not the end in itself.

3. Why have internal controls?

Internal controls filter through the whole business to:

- **Help align objectives of the business** – to ensure thorough reporting procedures and that the activities carried out by the business are in line with the business's objectives.
- **Safeguard assets** – ensuring the business's physical and monetary assets are protected from fraud, theft and errors.
- **Prevent and detect fraud and error** – ensuring the systems quickly identify errors and fraud if and when they occur.
- **Encourage good management** – allowing the manager to receive timely and relevant information on performance against targets, as well as key figures that can indicate variances from target.
- **Allow action to be taken against undesirable performance** – authorising a formal method of dealing with fraud, dishonesty or incompetence when detected.
- **Reduce exposure to risks** – minimising the chance of unexpected events.
- **Ensuring proper financial reporting** – maintaining accurate and complete reports required by legislation and management, and minimising time lost correcting errors and ensuring resources are correctly and efficiently allocated.

Each internal control procedure is designed to fulfil at least one of these eight criteria:

- **Completeness** – that all records and transactions are included in the reports of business.
- **Accuracy** – the right amounts are recorded in the correct accounts.
- **Authorisation** – the correct levels of authorisation are in place to cover such things as approval, payments, data entry and computer access.
- **Validity** - that the invoice is for work performed or products received and the business has incurred the liability properly.
- **Existence** – of assets and liabilities. Has a purchase been recorded for goods or services that have not yet been received? Do all assets on the books actually exist? Is there correct documentation to support the item?
- **Handling errors** – that errors in the system have been identified and processed.
- **Segregation of duties** – to ensure certain functions are kept separate. For example, the person taking cash receipts does not also do the banking.
- **Presentation and disclosure** – timely preparation of financial reports in conformity with generally accepted accounting principles.

All internal controls, whether administrative or accounting, are linked to a financial consequence. For example, keeping records for long service leave entitlements is an administrative control but it does ultimately have a financial consequence.

4. Types of internal controls

Different types of controls are used to meet different objectives. We look at the types of controls used under the four elements of the definition.

Controls to safeguard assets

These controls aim to protect physical and non-physical assets and minimise losses from both internal and external events. Physical assets include cash, stock and equipment, and non-physical assets could include debtors, intellectual property or customer lists.

Types of control techniques used to protect assets include:

- Physical security, such as locking premises, personal offices, filing cabinets and safes, etc.
- Using security cameras.
- Restricting access to areas and databases.
- Assigning and changing computer passwords, access codes and safe combinations regularly.
- Avoiding giving one employee total control over a key process.
- Making sure accounts payable are supported by properly raised (original) invoices.
- Making sure there is an independent check on processes and procedures.
- Having firewalls and protective devices on computer systems.
- Having clear guidelines on personal use of assets.
- Ensuring proper management supervision.

Example

It is quite common for companies to sell computer equipment that is outdated or excess to requirement. Often, there are cases of the buyers of this equipment finding that the information and/or programs on the computers has not been erased properly or at all. Imagine if your customer list was acquired by a competitor! What controls would you want to see in place to ensure this equipment had been ‘cleaned’ properly?

Controls to ensure financial information is accurate and reliable

Internal controls support the collection of correct information for management and financial reports. Many decisions are based on the information in these reports, so accurate information is crucial.

When financial reports are prepared and presented, users, including regulators, assume:

- All assets and liabilities actually exist.
- The records cover the whole story and are complete.
- All liabilities, rights and obligations are included.
- All entries have been allocated to the correct accounts.
- All relevant information has been disclosed.

The financial staying power of a business depends on reliable and timely reporting of both good and bad news

Types of controls used to ensure accurate and reliable financial information include:

- Assigning responsibility for who can create or alter financial records.
- Numbering documents, such as cheques, sequentially to avoid duplication.
- Regular reconciliation of accounts.
- Automated controls, such as valid date ranges or dollar value limits.
- Comparisons between budgeted and actual figures.
- Segregation of duties.
- Procedures for authorisation of payments.
- Independent checks.
- Validation checks.
- Exception reports.
- Approved authority levels.

Very small businesses may question the need for internal controls or consider them to be useful only in larger businesses, however, many controls can be modified for small businesses. Even a sole operator can regularly reconcile their bank statement and chequebook or check budgets against actual. Personal observation and routine checks can detect errors before they have an effect in another part of the business. Remember that every dollar lost or stolen is a dollar less in *your* pocket.

Controls to ensure compliance with financial and operational requirements

Businesses have many compliance obligations and need to ensure these are met. Some examples of controls used to ensure compliance include:

- Assigning responsibility to individuals for compliance with particular requirements, such as safety officer or fire warden.
- Physical controls to prevent accidents.
- Processing customer complaints fairly and in a timely manner.
- Staff feedback processes.
- Procedures that are well documented.
- Conduct of regular audits.

Controls to assist in achieving businesses objectives

Without accurate financial information, decision making becomes very difficult and the business will suffer. Internal controls help to ensure financial information is accurate and timely, so that managers and owners can take the correct action to meet the business's objectives and goals. Other internal controls also ensure the business meets its goals.

Some examples of human resource controls include:

- Undertaking reference checks on new staff to ensure they do have essential qualifications.
- Ensuring correct training for staff has been provided.
- Appropriate supervision of staff.
- Police and bankruptcy checks can be undertaken when the nature of the job requires it.

Examples of internal controls

The list below provides examples of techniques often used in small businesses to control procedures. Go through the list and see if you can identify one example of a control in your business that illustrates the listed technique. If not, consider whether using this particular technique would improve the accuracy or reliability of the information in your business or help to safeguard your assets.

- Document control – sequential numbering of documents (e.g. cheques).
- Batch totalling or reconciliation – totals added and cross-checked.
- Independent check – re-check totals, review spreadsheets.
- Automated controls – limit inputs to system, check dates.
- Validation checks – check amounts on invoices are signed off.
- Segregation of duties – receipting separate from banking cash.
- Exception routines – spot checks.
- Physical controls – limited access to equipment, petty cash.
- Rotation of duties – petty cash, receipting.
- Approval authority levels – purchasing authority levels for staff.
- Assignment of responsibility – clear lines of responsibility.
- Management supervision, monitoring and review – regular checks, review of personnel.
- Employee knowledge and skills – staff must be fully trained in their job.
- Compulsory annual leave – ensuring that all staff take their annual leave gives another staff member a chance to review what the person has been doing.

Depending on the importance of a control, a business may use a number of control processes in combination. For example, if the business has a large cash take every day, it might combine daily cash counts and reconciliations with segregation of duties and physical controls on access to the cash.

5. Setting up internal controls

The types of controls you need will vary with the different flows of goods and funds within your business. Some areas of the business are more at risk of loss or fraud and require more stringent controls. Go through each aspect of your business and review whether you have controls in place. The checklists below will help you to identify what controls you should have in place.

Financial controls

It is important for a small business owner to have a strong set of controls in place, especially when the business is growing and it is harder to stay in touch with what is going on at a grass-roots level. Effective controls and reporting of key financial information enables the owner to manage the business without getting bogged down in the detail.

Some points to consider are:

- Is a chart of accounts used?
- Is it detailed enough to give adequate management information and compliance, or indeed too long and complex?
- Is a double entry bookkeeping system used?
- Who approves journal entries and credits?
- Does the owner understand the form and contents of the financial statements?
- Does the owner use budgets and cash projections?
- Are they compared to actual results?
- Are major discrepancies investigated?
- Are comparative financial statements produced?
- Are the books and records kept up-to-date and balanced?
- Who is responsible for producing financial information?
- Are reasonable due dates imposed?
- Is staff cross-trained in accounting functions?
- Are storage facilities safe from fire or other physical peril?
- Is access to accounting records restricted where appropriate?
- Is insurance coverage reviewed regularly?
- Is there a records retention schedule used?

Non-current assets

Physical assets are easy to misplace and lose, if not kept secure. Assets can be taken from within the business by the staff or from external visitors to the business or from someone passing on the street. Consider all possibilities when setting up your environment.

- Laptop computers and data projectors are popular targets for theft, so lock them to a desk.
- If your office entrance is located near the street or a staircase ensure handbags and petty cash are well locked up at all times.

- Once any asset is purchased, it should be recorded on an asset register with all relevant details. (This helps with the accounting as well.)
- Allocate a staff member to be responsible for any expensive items, ensure the staff knows the location of the asset and lock it away when not in use.
- Establish an asset register. It is important that you maintain a proper asset register and that you review your physical assets regularly against this register, investigating any missing items. Make sure this is done irregularly – not just on 30 June.
- Ensure the same person is not responsible for ordering, recording and paying for purchases.
- If you run a retail business with a high shrinkage, make sure your staff discount is high enough to ensure staff purchase your goods and do not just take them.

Sales

Accurate sales figures are important to correctly estimate stock and revenue. You also want quick and reliable feedback of sales trends so you can respond quickly to changing circumstances. For example, you may need to purchase additional stock or discount old stock that is not selling. Ensure you have written procedures for cash, cheque and credit sales. Never ship goods out of your business without an accompanying invoice.

Make sure your staff knows how to handle returns and deal with customer complaints.

- Check sales figures from their individual source, such as invoices.
- If sales staff work on commission, ensure that their sales figures are valid and commissions are not paid until funds are received.
- Reconcile sales register with takings and credit card receipts.
- Make sure that goods are sent COD or with a tax invoice and obtain evidence of delivery.
- Is there a policy for credit approval?
- Are credit files kept current?
- Are credit checks done regularly?
- Are sales orders approved for:
  - price?
  - terms and conditions?
  - credit?
  - account balance limits?
- Are all sales orders recorded on pre-numbered forms and are all numbers accounted for?
- Are sales invoices compared to shipping documents?
- Are sales invoices recorded promptly?
- Are credit memos pre-numbered, accounted for and approved?
- Are monthly statements for outstanding balances reviewed by the owner? Are they mailed by the owner or a responsible employee other than the bookkeeper?
- Is the accounts receivable subsidiary ledger balanced monthly to control account?
- Is an ageing schedule of customers' accounts prepared monthly?
- Are write-offs and other adjustments (including cash back) to customer accounts authorised and reported on or reviewed?
- Are stocktakes conducted regularly and the results reconciled to the accounting information?

Accounts receivable

Accounts receivable is an important asset of the business. Delays or failure to collect due accounts can result in cash flow shortages and profit erosion.

- Ensure credit and collection policies are in writing.
- Conduct credit checks on new credit customers.
- Regularly age accounts and have an independent review of the report.
- Ensure credit purchases are recorded as soon as the transaction occurs.
- Separate the accounts receivable function and cash receipting.
- Have transactions, such as non-cash credits and write-off of bad debts, cross-checked.
- Have a well-documented and strict policy for the follow up of overdue accounts.
- Review credit balances on a regular basis.
- Have numerical or batch-processing controls over billing.
- Ensure cross-checking of early payment discounts and penalties on overdue accounts.
- Ensure mailing of accounts cannot be tampered with.
- Prepare trial balance of individual accounts receivable regularly.
- Reconcile trial balances with general ledger control accounts.

Cash receipts

The area of cash receipts is a common target for the employee to commit fraud. This is because of the ready and available nature of this method of payment, as well as the difficulty of matching the cash with a particular transaction. The points below need to be considered.

- Does the owner or a responsible employee other than the bookkeeper or person who maintains accounts receivable:
  - Open the mail and pre-list all cash receipts before turning them over to the bookkeeper?
  - Stamp all checks with restrictive endorsement 'for deposit only' before turning them over to the bookkeeper?
  - Compare daily pre-listing of cash receipts with the cash receipts journal and with the duplicate deposit slip?
- Are cash receipts deposited intact on a daily basis?
- Are cash receipts posted promptly?
- Are cash sales controlled by cash registers or pre-numbered cash receipts forms?
- If you have a cash register, is its access controlled?
- If you have a cash register, is it balanced regularly? Do you know which staff has access to each register? Who balances each register? Is that person different from the staff that has access to the register?

Purchases

Controls in the area of purchasing are important so that the physical assets of the business are protected (e.g. stock) and that goods properly purchased and received are properly paid and accounted for. Remember that controls should indicate to you errors and sloppy work practices, as well as outright fraud.

- Are supplier invoices:
  – matched with applicable purchasing orders?
  – matched with applicable receiving reports?
  – reviewed for correctness?
- Are all available discounts taken?
- Is there written evidence that invoices have been processed properly before payment (e.g. stamped or approved)?
- Are there procedures which provide that direct shipments to customers, if any, are properly billed to them?
- Does the owner verify that the trial balance of accounts payable agrees with the general ledger control account?
- Are expense reimbursement requests:
  – submitted properly?
  – adequately supported?
  – approved before payment?

Receiving goods

Receiving is another important component of the purchasing function and is an area in which the lack of controls can lead to significant financial loss. Stock is another area that is a common target for fraud and error. Would you know if you had received what you paid for, and would you know if it was in good condition?

- Are all materials inspected for condition and independently counted, measured or weighed when received? Are they also checked against any packing slips and purchase orders?
- Are receiving reports used and prepared promptly?
- Are receiving reports subjected to:
  – Pre-numbering and accounting for the sequence of all numbers?
  – Copies promptly provided to those who perform the purchasing and accounts payable function?
  – Controlled so that liability may be determined for materials received but not yet invoiced?
- Do you have a clear policy and set of procedures for the processing of customer returns?

Accounts payable

Many small businesses have found that mistakes made in their purchasing and accounts payable can be very costly to the business. This is an area that deserves careful attention and there should be many internal controls within the payments systems. Make sure that you have a clear and simple list of written procedures for purchases and accounts payable to ensure all staff knows the processes they are expected to follow.

Some important but simple controls to consider when reviewing payments are:

- Document all purchasing and accounts payable procedures.
- Ensure payments are on original invoices only – not copies or faxes, otherwise they may be paid more than once.
- After payment is made, stamp or perforate the original invoice to prevent reuse.
- Develop an exception report so payables over a certain amount are brought to your attention and, where practical, set authorisation levels so that the owner is the only one who can sign or commit the firm to certain amounts (such as those over $1000).

- Put in place controls to check for identical orders and/or payments.
- Ensure refund cheques from suppliers are handled by someone other than the person processing the invoices.
- Check invoices with only a post-office box address.
- Check invoices with company names consisting only of initials.
- Check unfamiliar vendors are in the phone book or check their ABN on the internet at www.abr.gov.au.
- Ensure the person who approves new vendors is different from the person responsible for the payment process.
- Check rapidly increasing purchases from one vendor.
- Check vendors' billings more than once a month.
- Check vendor addresses against employee addresses.
- Look out for large billings broken into multiple smaller invoices, each of which is for an amount that would not attract attention.
- Once a month select a type of vendor (such as all tradespersons) and review each line total and number of invoices for each vendor.
- Check out the competitors' prices if you rely heavily on one supplier.
- Investigate invoices for poorly defined services.

Cash disbursements

Once again, cash and the ease of access to it is the issue here. Effective controls will reduce the risk of misappropriation in this area and the following points should be considered.

- Are all disbursements except for petty cash made by cheque?
- Are cheques pre-numbered and all numbers accounted for?
- Are all cheques recorded when issued?
- Are all unused cheques safeguarded, with access limited? Is a mechanical cheque protector used to inscribe amounts as a precaution against alteration?
- Are voided cheques retained and mutilated?
- Are all cheques signed by the owner? How many cheque signatories are there? Are the people who raise most invoices also the cheque signatories?
- If a signature plate is used, is it under the sole control of the owner?
- Are supporting documents, processed invoices, receiving reports and purchase orders presented with the cheques and reviewed by the owner before he or she signs the cheques?
- Are supporting documents for cheques cancelled properly to avoid duplicate payment?
- Are cheques payable to cash prohibited?
- Are signed cheques mailed by someone other than the person who writes the cheques?
- Are bank statements and cancelled cheques:
  – received directly by the owner?
  – reviewed by the owner before they are given to the bookkeeper?
- Are bank reconciliations prepared:
  – monthly for all accounts?
  – by someone other than the person authorised to sign cheques or use a signature plate if they are other than the owner?

- Are bank reconciliations reviewed and adjustments of the cash accounts approved by the owner?
- Are all disbursements from petty cash funds supported by approved vouchers?
- Is there a predetermined maximum dollar limit on the amounts of individual petty cash disbursements?
- Are petty cash funds on an impress basis and:
  – kept in a safe place?
  – reasonable in amount so that the fund ordinarily requires reimbursement at least monthly?
  – controlled by one person?
  – periodically counted by someone other than the custodian?
- Beware of budget variations in payroll expense and investigate any variations.
- Maintain complete payroll records for holiday and sick leave.
- Use direct deposits for pays. Although not foolproof, this can cut down on payroll chicanery by eliminating paper paycheques and the possibility of alteration, forgery and most theft.
- Ensure that more than one person can process the payroll.
- Put in place checks on the rates, commissions and allowances paid to each staff to ensure they are consistent with the agreed rates.
- Put in place checks to ensure that the names on the payroll actually match real people who have been employed.

Cash and bank accounts

Businesses that deal mainly with cash often fall victim to fraud or loss since cash is easy to misappropriate, especially in a small business because controls are often weak.

Some common controls are:

- Never leave chequebooks or blank cheques lying around.
- Owners should review the cheques, cheque register, cash register totals and bank statements regularly but not at predictable intervals (e.g. not every Monday morning).
- Keep a tight reign on all cash, and balance tills daily or more regularly in businesses handling lots of cash (e.g. clubs, newsagencies or hotels).
- Have employees balance cash at the end of each shift if they are handing over to another employee.
- Reconcile bank accounts regularly.
- When possible, separate the opening of mail from the writing of deposit slips, and banking from bank statement reconciliation.
- Separate responsibility for cash disbursement and purchases from the approval process.
- Ensure the accountant does not forewarn staff before coming on to the premises to conduct an audit.
- Don’t reimburse petty cash or credit card receipts. Ask for tax invoices only.

Payroll

Many payrolls, even small ones, are now automated, so it is easier to commit fraud or errors if the internal controls are not tight and the procedures are not set or followed.

- If an electronic payroll is used, ensure supervisors change their password often.
- Ensure passwords are not handed to other staff members when the person is on holiday or sick.
- Ensure any payroll summaries are in the same typeface as the system’s printer to avoid possible fraud.
- Review bank account deposits to ensure that each pay goes to a different bank account.
- Where possible, segregate payroll preparation, disbursement and distribution functions.
- If possible, the payroll officer must not calculate their own pay.

Questions to ask yourself about your staff

- Are all employees hired by you?
- Are individual personnel files maintained?
- Is access to personnel files limited to you or a designated manager, who is independent of the payroll or cash functions?
- Are wages, salaries, commission and piece rates approved by you, the owner?
- Is proper authorisation obtained for payroll deductions?
- Is gross pay determined using authorised rates and:
  – adequate time records for employees paid by the hour?
  – piecework records for employees whose wages are based on production?
  – are piecework records reconciled with sales records?
  – are salespeople's commission records reconciled with sales records?
- If employees punch time clocks, are the clocks located so they may be watched by someone in authority or are there security cameras in the vicinity?
- Are time records for hourly employees approved by a supervisor?
- Would you be aware of the absence of any employee?
- Is the clerical accuracy of the payroll checked?
- Are payroll registers reviewed by you?
- Do you, the owner, approve, sign and distribute payroll cheques?
- If employees are paid in cash, do you compare the cash requisition to the net payroll?
- Do you maintain control over unclaimed payroll cheques?

Find out more about your employees

In a small business, you are very reliant on your employees. They are your representatives with customers, suppliers and competitors. Take the time to hire the right person for the job and your style of management, as the costs of hiring and training can be the equivalent to three months' wages. This is not an easy process.

Unfortunately, some people do falsify their employment records to get a good job – it is more common than you think.

- When taking on a new employee, always take the time to check their employment record, ring the previous employers and don't just rely on written references.
- Check out any claimed education credentials that are essential to the operation of the job/business.
- Undertake regular annual performance reviews with staff.
- Ensure adequate training is provided.
- Clearly outline responsibilities and expectations.
- Keep lines of communication open with employees:
  – Employee resentment increases when the owner enjoys success without passing it on to employees.
  – Be sensitive to employees' hopes and expectations.
- Don't misplace trust – one person in a small business usually bears an inordinate amount of financial responsibility. Review your office staff.
- Is annual leave required to be taken regularly?

Staff feedback

Finally, develop a process for staff to report breaches in internal controls and report suspicious behaviour. Ensure that staff know your door is always open and their concerns are welcome, not a nuisance. Most fraud is detected by staff tipping off the auditors, owners or accountants.

You can encourage this culture in your organisation by:

- Having in place a whistleblowing procedure.
- Protecting the identity of whistleblowers, if practicable.
- Protecting whistleblowers from being victimised.
- Investigating breaches as quickly as possible and taking firm disciplinary action when necessary.
- Rewarding staff for reporting breaches in internal controls or outright fraud (as well as for innovative ideas), perhaps with a gift voucher or similar, for every useable suggestion.

It is important that staff feel that it is their duty and responsibility to report such matters as it is their livelihood, as well as yours, that relies upon the financial integrity of the business.

Limitations of internal controls

No system is perfect. A business owner has to be aware of potential breakdowns at all times and be prepared to review all systems.

Here are some examples.

A data entry person inputs the date (15 February 2000) into the amount field of an account by error when entering a receipt, resulting in an amount of $1.522 million.

What internal control was missing? Could something like this happen in your business?

An invoice being paid twice is a very common problem in many businesses. How would you pick this up in your business? What internal control systems would help prevent this problem?

7. Why internal controls don't always work

Judgement error

Owners must constantly use their judgement in their business whether recruiting staff, dealing with customers or checking accounts.

Certain situations can even lead usually honest people to commit fraud because the opportunity is so irresistible. All businesses rely on a number of processes *and* honesty. Consider the consequences of 5 per cent of people not being honest. Owners must be thorough in checking procedures for new staff. Scrutinise potential employees' employment records and, if possible, ring and speak to previous employers personally. Financial stress, addiction and dissatisfaction can cause people to attempt to pervert the rules.

Unexpected transactions

Not all activities will be covered in the procedures manual. If the procedures manual properly explains the reason behind the activities it is describing, it is usually easier to handle an unexpected event. As an owner you can't oversee all transactions at all times, however, the right control framework and environment will help to ensure that your staff seek guidance when unexpected events occur. Reinforce to your staff that they should not let themselves be overridden or bullied into exceeding their authority or acting against your rules.

Collusion

This usually occurs when two or more people come together in an attempt to defraud. Collusion is hard to defeat in a small business. In such cases, the owner's presence, checking of key figures regularly and fear of being caught are deterrents.

Form over substance

You must not let the process become the point of the exercise. If the process does not fulfil an objective, then change or remove the process.

Management override

Management and staff can, at times, view internal controls as red tape, unnecessary and a waste of time. In a small business, the staff is often under tight budgets and will be tempted to cut corners. Surveys by KPMG regularly show that people who override internal controls may be doing so for their own benefit and may be attempting to defraud the business. Don't let people change your procedures without first discussing it with you.

Weak internal controls

A survey by KPMG found that 60 per cent of fraud was committed because a business had weak internal controls. Common fraud includes double payment of invoices sent twice and payments being made for work that has never been performed. These mistakes are a signal to the outside world that the internal controls are weak and the firm is a target for further abuse.

8. Consequences of poor internal controls

Fraud

Millions of dollars are lost every day in all business environments due to fraud. Fraud can be committed by an individual, a number of staff and/or external parties. But fraud doesn't happen in a vacuum, fraud occurs because of a perception that it is possible to avoid being caught.

Bad decisions for the business

Not reconciling bank accounts regularly may result in overspending and sudden cash shortfalls, which can even lead to bankruptcy or insolvency.

Wrong decisions are made by people ill equipped to deal with a situation

People without permission may authorise payment of petty cash without following procedures and end up disbursing cash for non-business expenses or not having appropriate receipts for tax purposes.

Not taking appropriate action in time to correct errors

An example of this is failure to take action to collect the funds when an invoice is paid twice.

Not allocating resources of the business correctly or most efficiently

Time is spent fixing problems that could have been avoided. If you think your internal controls are fine, consider how many mistakes are made in your business. Most usually could be avoided if the procedures were clearer or more thorough.

Can you think of examples of ineffective controls within your business?

When internal controls are breached, changing personnel is a waste of time if:

- Defective internal control policies remain the same.
- Management shies away from its responsibilities.
- Tough decisions are pushed further into the future.

When internal controls break down, what action should or could be taken in your business?

9. Fraud prevention

To reduce fraud, you as the business owner must remember that fraud requires two elements to succeed – opportunity and motivation. So, to prevent successful fraud we need to understand both of these elements. As a business owner you must accept that it can happen in your business if you are not vigilant.

Again, the culture and environment that you set up in your business is critical to reduce fraud.

Internal fraud

You must ensure that, where possible, you remove temptations – strong internal controls are fundamental to this.

Consider the:

- **Opportunity** for positive and negative feedback to and from your staff. Staff wish to feel that their opinion is of value and their hard work recognised.
- **Reward** staff fairly – disgruntled staff develop a stronger motivation to commit fraud if they feel they are being treated unfairly.
- **Check** all references and learn to see what is written 'between the lines' or seems to be omitted. Staff can repeat certain behaviours.
- **Segregation** of duty is important in all areas of your business – separate the custody of physical assets from the accounting for them.

External fraud

Again, strong internal controls will help prevent external fraud. Some examples of common small business fraud are shoplifting, credit card fraud, cheque fraud, scams and break-ins.

Internal controls should be visible and, where appropriate, visible to staff and customers (e.g. security cameras on the cash register).

Any offers that appear from an unknown supplier should be carefully checked. Be aware of fax-back offers and internet offers.

The checklists provided earlier are helpful reminders of areas in which your business procedures may be lacking.

The risk of fraud is not the only factor in defining internal control objectives. For example, management information and reporting requirements are important considerations as well. Nevertheless, each business must consider their acceptable level of risk, and the cost of implementing such controls will be a major factor to be considered, especially for small businesses.

Basic controls

A variety of basic controls exist in a typical system of internal controls. The most relevant basic controls are grouped into three categories: physical access, job descriptions, and accounting reconciliations and analyses.

1. Physical access

Most people would agree there is a need to control physical access to valuable assets, including intangible assets such as information. Measures to control physical access can include:

- The practise of locking doors, desks and filing cabinets so that unauthorised personnel, either within or outside the organisation, cannot gain access.
- Utilising employee IDs and passwords, computerised security systems (e.g. access cards that record time of entry and exit). Any system should provide the owner with audit reports of activity.
- Electronic surveillance systems, which should include as much new innovation, such as biometrics (including, for example, iris scans and voice recognition), that the business is able to afford.

As a general rule, organisations should restrict physical access to those who require it to perform their job function. Of course, controlling physical access in this way will not reduce the risk of fraud completely. Yet, it will help to reduce the risk in the following ways:

- Many frauds require that the perpetrator comes into physical contact with either the asset being misappropriated or the related asset records, in order to conceal the fraud. Reducing physical access reduces opportunity.
- Often, physical access controls are the most visible to potential perpetrators. Strong controls in this area send a powerful deterrent message *vis-à-vis* the other controls in the system. Conversely, loose physical controls.
- invite challenge.
- Effective access controls can assist in the fraud investigation process (e.g. warning of breaches, providing information so as to determine what actually happened and to reduce the number of suspects).

Example

Carefully screening who had access to cash receipts would have saved more than one small business. In one case, a temporary employee was stationed at the front desk to handle course applications, including collecting the necessary fees. The temp properly recorded and submitted for processing those applications paid for by cheque or money order. She pocketed any cash received and destroyed all evidence of the cash applications so that there was no record of the transaction. Not paying attention to controlling physical access led to several thousands of dollars in losses.

2. Job descriptions

Formal, specific job descriptions are a very effective fraud prevention tool. These descriptions should spell out exactly what is expected of each employee. Generally, employees should not perform duties outside their job description. Those who do represent a significant red flag.

Create job descriptions that reflect the important principle of division of duties. For example, employees with physical control over an asset should not also keep the records relating to that asset (as this will only make it easier for them to cover up the fraud). Segregate all other especially sensitive duties (e.g. purchasing and cheque signing).

The need for job descriptions goes beyond the widely recognised concept of segregating duties, although it is certainly one of the important consequences of job descriptions. Some cases may result in an entirely appropriate duplication of duties (e.g. double signing cheques). Specify in the job description that all employees must take annual leave regularly and not only in small chunks. (This is another well-known fraud prevention tool because an employer is more likely to discover perpetrators running an ongoing fraud scheme when they're removed from the scene.)

Thus, it is apparent that owners must approach the process of formulating job descriptions for their employees in an integrated manner. From the perspective of internal control and fraud prevention, different tasks performed by different individuals may be inter-related; therefore, a job description that is appropriate for one employee will often depend on the job descriptions of others, and vice versa.

Business owners often ignore or underestimate the need for formal job descriptions, writing them off as 'more useless paper'. At other times, owners create job descriptions but then ignore them. This attitude invites trouble. As one leading fraud investigator put it: 'When people begin to do things outside their job description, you have reason to be concerned. If it goes unrewarded, they begin to develop a justification to steal. It's very important that job descriptions are clear, agreed upon and adhered to.'

3. Accounting reconciliations and analyses

After access controls and job descriptions, accounting reconciliations and analyses are the third most important group of basic controls. An essential ingredient of a successful fraud is successful concealment. Regular, appropriately performed accounting reconciliations and analyses often make such concealment difficult or impossible.

Perform accounting reconciliations regularly (e.g. monthly), including:

- Bank reconciliations, for all accounts.
- Accounts receivable reconciliations (both month to month and general ledger to sub-ledger).
- Accounts payable reconciliations (again, both month to month and general ledger to sub-ledger).

The exact nature of the accounting analyses performed depends on the nature of the organisation's operations. Analyses relevant for most organisations include:

- Variance analysis of general ledger accounts (e.g. budget to actual, current year versus prior year).
- Vertical analysis of profit and loss accounts (i.e. calculation of expenses as a percentage of sales, and comparison of these percentages with historical standards or budgets or both).
- Detailed sales and major expense analyses (e.g. by product line or territory).

Of course, organisations often undertake accounting reconciliations and analyses with other purposes in mind, for example, to make management decisions or to ensure the accuracy of the accounting records or both. Nevertheless, this process also can highlight discrepancies that point to fraud.

Additional controls

1. Supervision

Supervision represents the second level of internal control. From the perspective of fraud prevention, strong supervision is vital, especially in small businesses that may have difficulty achieving segregation of duties.

Note that active supervision most definitely differs from supervisory or management override, whereby a manager or supervisor actually takes charge of or alters the work of a subordinate. In fact, override itself is a red flag, as it suggests that the manager or supervisor may be engaged in fraud or the concealment of one. Allow basic controls to operate as they were intended rather than to be circumvented by those at higher levels.

As a fraud prevention mechanism, good supervision consists of:

- fraud awareness
- approval, review, double-checking and re-doing

2. Fraud awareness

Fraud prevention specialists constantly emphasise the need for 'fraud awareness', to the point that the term has almost become a cliché. Yet, such awareness is, perhaps, the key prerequisite in building any effective fraud prevention strategy, and is especially important at the supervisory level.

Specifically, supervisors must be alert to the possibility of fraud whenever an unusual or exceptional situation occurs, such as complaints from suppliers or customers, discrepancies that don't make sense, or accounting reconciliations that don't balance. If a manager's mind is closed to the possibility of fraud during an unusual or exceptional situation, the risk of the fraud continuing unabated increases greatly.

Several businesses have had positive results in raising employees' awareness by publishing regular internal newsletters. In addition to reporting actual fraudulent activities, the newsletters relate the impact of fraud on both the employees and the bottom line.

3. Approval, review, double-checking and re-doing

In addition to awareness, fraud prevention demands that supervisors actually supervise. This means going beyond the typical approval function, such as initialling invoices or performing other duties of supervisors and managers. A more thorough review, double-checking employees' work and re-doing some tasks may be necessary and should be approached diligently.

For example, assign supervisors the responsibility of double-checking important procedures, such as the monthly bank reconciliation, that is, comparing the numbers on the bank reconciliations to those on the bank statements and in the general ledger, making certain that those numbers total correctly, test-checking outstanding items at the very least, and so on. To simply initial bank reconciliations in a habitual or reflex-like manner without really reviewing and actually re-doing them invites fraud.

Case study

The owner of a busy city restaurant used the following system of internal control for sales. Employees entered all pre-numbered customer bills into the cash register and, at least once each day, the bookkeeper batched the sales dockets, listed them on a deposit sheet and made the related bank deposit. The owner then matched the totals on the deposit sheet with the amounts shown in the stamped deposit book, and believed this to be adequate supervision.

The owner's supervision of the bookkeeper, however, was inadequate, especially because the bookkeeper was responsible for handling the cash (the bank deposit) and related records (customer bills, cash register tapes and deposit sheets). In fact, over a three-month period, the bookkeeper skimmed a portion of each day's cash receipts by omitting some of the cash sales bills and pocketing the corresponding amounts. The owner might have uncovered the fraud by using any one of these listed methods.

- *Segregating duties.* The owner rejected this method because he trusted the bookkeeper and did not want to incur the cost of an additional employee.
- *Accounting for all pre-numbered bills.* The owner opted not to use pre-numbered bills because it was too time-consuming. The bookkeeper intentionally did not list the bills in numbered order on the deposit sheet and pre-numbered books were issued out of sequence to waiters and waitresses.
- *Matching daily cash register tapes to the daily cash deposit.* The owner rejected this simplest and most appropriate method; not wanting to check his employee's work in this way because the tapes were a messy 'dog's breakfast' kept in a shoe box by the bookkeeper, entirely by design, of course, to cover up the fraud.

The owner eventually uncovered the fraud when the bookkeeper became too greedy and withheld a bit too much from what the owner knew was an especially good cash sales day, which raised his suspicions and led to an investigation.

This example illustrates the necessity of supervision – often it is the primary defence against ongoing frauds, such as the skimming of cash or the 'lapping' of accounts receivable. 'Lapping' refers to the process whereby funds are continually misapplied to conceal an original fraud and can usually occur only when there are no basic controls in place to independently record customer payments. The maximum opportunity level for the bookkeeper in the previous example should have been the outright theft of the day's cash receipts – typically less than half of a day's total receipts of about $10,000. However, inadequate supervision allowed a smaller amount of cash (about $700 a day) to be stolen over a period of three months, which amounted to a total loss of over $60,000.

10. Positive consequences of good internal controls

There are very positive consequences that flow from good internal controls. When reviewing your procedures, keep these positive benefits in mind and explain them to your staff. Internal controls should be used as a carrot, as well as a stick.

Good communication

Well-written documentation not only gets your message across but also builds a picture of the culture and processes that have been established to ensure the firm meets its aims.

Education

The existence of internal controls helps new employees learn the right way to do their job and the correct procedures needed to fulfil a task.

Error reduction

Good and clear internal control procedures minimise errors and save time and money. They help ensure business information is correct and that staff is accountable for their actions. For example, staff should know how to check their own work to ensure it is accurate.

Protection and authorisation

Internal controls give comfort to staff that they have protection if they have acted in the way prescribed by the internal controls and within their authorisation limits. The business cannot blame the staff if they have acted in good faith and within the guidelines specified.

Perceptions of detection

The existence of internal controls acts as a deterrent to those considering fraud, increasing the risk of detection. (See case study.)

Sale of the business

One of the extra benefits of good written procedures is the added value they give your business when it comes time to sell your going concern. Often, people want to buy ongoing businesses with a proven track record and a solid foundation. It is an added incentive to buy the procedures also, both manual and written. These procedures can give potential purchasers of your business added security as to the soundness of the business that they are paying you lots of money to buy.

Usually, franchises are a business that offers the newcomer to an industry well-established procedures and training. When you buy a franchise most new franchisees pay for the training, procedures and manuals as part of the costs. So, don’t wait until the day you want to sell your business – get writing those procedures now!

11. Responsibility for internal controls

Many small business people don't think of internal controls as something they are responsible for, but rather a function of an auditor or an accountant. Nevertheless, to be effective, someone in the business must take responsibility for introducing and monitoring internal controls.

Where do you see the responsibility for internal controls lying in your business?

It is the responsibility of all staff to ensure internal controls are operating properly. It takes time to explain the importance of internal controls to your employees but it will be time well spent as it will help staff understand and appreciate why things are done in a certain way. The 'tone' of a business is set from the top, so it is important that you behave in the same way as you expect your staff to behave and to lead by example. Staff can better accept controls if they are involved in the process of developing the controls for their area of the business.

Any breach in internal controls should be reported to you immediately. With good communication established between you and your employees, they should feel able to talk to you about these issues, as well as feeling that they are doing the right thing and not just 'dobbing in' a mate.

As the owner, you have ultimate responsibility and accountability for the working and effectiveness of internal controls.

12. Summary and case studies

Internal controls:

- Are needed to promote the efficient use of assets.
- Encompass the total business culture, structure and methods.
- Encourage positive behaviour.
- Protect staff and resources.
- Help promote the efficient use of the business's resources.
- Communicate and educate.

Valid internal controls have a positive and necessary place within a business and are the responsibility of everyone.

Case studies

Pam's parable

After leaving school, Pam got a job at a car wash station in the parking lot at a shopping centre. After two weeks of sitting alone in her small booth it occurred to Pam that no one was watching her. Since she was a little short of money she took $10. The next day she took $20. Several weeks went by and Pam continued to filch small amounts of money.

Then, one day, the firm's part-time accountant showed up at the booth unannounced. By counting her cash, the accountant quickly found Pam had stolen more than $500. When he confronted her, she confessed she had borrowed the money without authorisation. The accountant asked whether Pam knew someone would check her work. 'No', she replied. 'Until you walked in here, I didn't even know what an audit was.'

This case highlights two important concepts. Pam really didn't have an opportunity to commit and conceal her theft. She only thought she did because the owners didn't tell her they were planning to conduct a surprise audit. So, managers must point out to staff the controls and the risks of fraud. This will also deter people who have the opportunity to commit fraud.

Payment twice

How often do you overpay a supplier or pay an invoice twice?

Office Supplies Pty Ltd is a fast-growing new business. The owner, Bob, signs all cheques and keeps a tight reign on all parts of the business. He believes nothing could get past him!

Anita is the accounts payable person, receptionist and office manager all rolled into one. There are also several sales staff but they are usually on the road doing the deals.

One particular week, a number of suppliers started phoning, wanting their money as their accounts were overdue. Bob instructed Anita to stall them, as there wasn't enough cash in the bank.

Another week went by and three important suppliers were getting insistent, so Anita tried to get their invoices processed and give them to Bob to sign. But she could not find them anywhere. So she asked them to fax in another copy. They faxed in statements of the outstanding invoices. Bob finally agreed to sign them, as some cash had arrived in the bank account. Then, at the end of the following week, Bob turned up with a file of invoices that he had been sitting on. Anita madly processed them to get them out by the end of the month.

Anita ended up double paying the suppliers. The amounts didn't match because the statements were larger than the invoice accounts, so a simple check on similar amounts didn't match up.

Did the suppliers return the difference?

And, if they did, did reliable Anita bank the cheques into the business's bank account or did she get them endorsed over to her account?

And what would stop Anita adding another invoice? She could take a copy of an invoice for a small amount of money and send it through the system twice and pocket the refund when sent back from the supplier.

Anita has an inordinate amount of responsibility in the business. She is under great pressure to handle all her duties and, consequently, is not as thorough as she might think she is or would like to be.

Further learning

State governments offer short courses in this area, as does the Council of Adult Education and TAFE.

Some useful websites

Australia

www.business.vic.gov.au

www.smallbiz.nsw.gov.au

www.privacy.gov.au/business/small

www.sbc.vic.gov.au

www.smartsmallbusiness.qld.gov.au

www.australianbiz.com.au

www.business.act.gov.au

www.ausindustry.gov.au

www.businesswealth.com.au

Overseas

www.businessweek.com/smallbiz/index.html

www.entrepreneur.com

www.smallbusiness.com

www.smallbusiness.co.uk

www.visa.ca/smallbusiness/guide

www.toolkit.cch.com

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CPA75960 11/2007