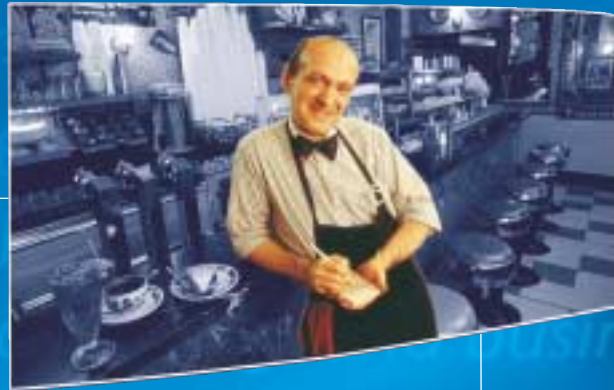


# Internal Controls for Small Business

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# Contents

Introduction	3
What is an internal control?	4
Why have internal controls?	5
Types of internal controls	6
Setting up internal controls	8
Limitations of internal controls	11
Why internal controls don't always work	12
Consequences of poor internal controls	13
Positive consequences of good internal controls	14
Responsibility for internal controls	15
Summary	15
Case studies	16

# Introduction

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 to protect 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 controls 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.



# 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 businesses' 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.

Some business environments discourage poor reporting, carelessness and fraud while others are ripe for mistakes and dishonesty. 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.

### ACTION

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. One Tel 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 roles.

## 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 other associated systems including performance reviews, distribution systems and manufacturing systems.

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

### ACTION

List the systems in your business. Some of your systems may be hard to identify as they are often very informal.

## 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 business achieves its objectives.

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

Some small business owners may think procedures are unnecessary, however 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. It reduces the time taken to train new staff.

### ACTION

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 internal controls are a process, a means to an end, not the end in itself.

# 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
- **Allow action to be taken against undesirable performance**  
Authorising a formal method of dealing with fraud or dishonesty if 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 correct accounts
- **Authorisation**  
the correct levels of authorisation, which cover such things as approval, payments, entry, computer access
- **Validity**  
that the invoice is for work performed and the business has properly incurred the liability.
- **Existence**  
of assets and liabilities. Has a purchase been recorded for goods or services that have not been yet received?
- **Error handling**  
that errors in the system have 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.

# 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 while 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, using security cameras, safes etc
- Restricting access to access codes
- Changing computer passwords regularly
- Avoiding giving one employee total control over a process
- 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.

## 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:

- Number 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 check
- Validation checks
- Exception reports
- Approved authority levels.

Very small businesses may question the need for internal controls, or consider they are only useful in larger businesses, however many controls can be modified for small businesses. Even sole operators can regularly reconcile bank statements and cheque books or check budgets against actuals. Personal observation and routine checks can detect errors before they have an effect in another part of the business.

## 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 for compliance with particular requirements such as 'safety officer, fire warden'
- Physical controls to prevent accidents
- Processing customer complaints
- Staff feedback processes
- Procedures well documented
- Conduct of audits.

## Controls to assist in achieving the businesses objectives

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

Some examples of types of controls used 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.

The following list provides examples of techniques often used in small businesses to control procedures.

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

### ACTION

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, cheques
- **Batch totalling or reconciliation**  
total added and cross checked
- **Independent check**  
recheck totals, review spreadsheets
- **Automated controls**  
limit inputs in system, check dates
- **Validation checks**  
check amounts on invoices 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 & review**  
regular checks, review of personnel
- **Employee knowledge & skills**  
staff must be fully trained in their job

# 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 following checklists will help you to identify what controls you should have in place.

## 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 take action 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 know 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.

## Accounts receivable

Accounts receivable are 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 noncash 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 tapered with
- Prepare trial balance of individual accounts receivable regularly
- Reconcile trial balances with general ledger control accounts.

## Cash and bank accounts

Heavy cash businesses often fall victim to fraud or loss since cash is easy to misappropriate, especially in a small business because controls are often weak.

- Never leave cheque books or blank cheques lying around
- Owners should review the cheques, cheque register, cash register totals and bank statements regularly but not at predictable intervals (for example not every Monday morning)
- Keep a tight rein on all cash, and balance tills daily or more regularly in businesses handling lots of cash (such as 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
- Where possible, separate mail-opening 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 the premises to conduct an audit
- Don't reimburse petty cash or credit card receipts, ask for tax invoices only.

## Purchases and accounts payable

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

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

- Document 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 where the owner is the only one who can sign or commit the firm to certain amounts (such as those over \$1,000)
  - Put in place controls to check for identical 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
  - 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 address that match 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



## Non current assets

Physical assets are as 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 off 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 hand bags 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 staff know the location of the asset and lock it away when not in use
- Review your physical assets regularly against your asset register and investigate 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

## Payroll

Many payrolls, even small ones, are now automated, so it is easier to commit fraud or make mistakes if the internal controls are not tight and 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 type face as the systems 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
- Beware of budget variations in payroll expense and investigate

- 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

## 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 is 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 out their employment record, ring the referees and don't just rely on written references
- Check out any education credentials that are essential to the operation of the business
- Undertake 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 of 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.

## 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 concerns are welcome, not a nuisance. Most fraud is detected by staff tipping off the auditors, owners or accountants. Reward staff for innovative ideas, perhaps a gift voucher for every useable suggestion.

# 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.

## Example A

A data entry person input 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.

### ACTION

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

## Example B

An invoice being paid twice is a very common problem in many businesses.

### ACTION

How would you pick this up in your business?  
What internal control systems would help this problem?



# Why Internal Controls Don't Always Work

## **Judgment error**

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

Certain situations can even lead normally 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% 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 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 this case the owner's presence 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 fulfill 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 staff are often under tight budgets and will be tempted to cut the corners. Research shows that people who override internal controls are often 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% 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.

# Consequences of Poor Internal Controls

Some of the results of poor internal controls include:

## **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 due to a perception that it is possible to avoid being caught.

## **Bad decisions for the business**

Not reconciling bank accounts regularly may result in over spending, 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**

Such as 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 could usually be avoided if the procedures were clearer or more thorough.

### **ACTION**

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 out into the future.

### **ACTION**

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

# 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 your mind and explain them to 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 help 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 controls procedures minimise errors and save time and money. It helps ensure business information is correct and that staff are 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 you if you have acted in good faith and within the guidelines specified. (Whistleblowers Act)

## **Perceptions of detection**

The existence of internal controls act as a deterrent for those considering fraud increasing the risk they will be detected (see case study).

# 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. However, to be effective, someone in the business must take responsibility for introducing and monitoring internal controls.

## ACTION

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 staff but it will be time well spent as it will help staff understand and appreciate why things are done in a certain way.

Any breach in internal controls should be reported to you immediately. With good communication established with your employees, they should feel able to talk to you about these issues.

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

## Summary

### 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 graduating from high school, Pam got a job at a car wash station in the parking lot at a small mall. 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 week a number of suppliers started ringing up wanting their money as their accounts were overdue and Bob told Anita to stall them, as there wasn't enough cash in the bank.

After 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 outstanding. 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 in 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.

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