

Internal Controls for Small Business Accounting

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Administrative Controls

Administrative controls are defined as those measures that control operations and transactions up to the point of authorization and that promote operational efficiency. Examples of administrative controls include establishing written codes of conduct for employees, developing personnel recruiting and hiring policies, and documenting an entity's organizational structure. Since I do not expect small business owners to begin developing written organization charts, job descriptions, and policy and procedure manuals any time soon, I will focus on controls that can be implemented through automated accounting systems. However, these do not give small businesses the maximum protection they need, and developing good administrative controls should not be ignored.

Accounting Controls

Accounting controls are designed to help ensure safeguarding of assets and reliability of financial records. Accounting controls also directly affect the transactions recorded in an accounting system. Accounting controls may be divided into two subcategories: general controls and application controls. Examples of general controls include computer access, backups, and security. Application controls are those that relate to a specific module of the accounting system. For example, when entering accounts payable invoices into an accounting software application, an application control would "validate" the invoice number field to help ensure that the invoice has not already been entered into the system. Many small businesses use off-the-shelf accounting software, such as Microsoft® Office Small Business Accounting 2006, which we will use for our examples of application controls.

Every small business owner should be constantly aware of important numbers that can be used to run their business. Many accounting solutions provide a digital dashboard as a one-stop snapshot of the business's financial health. In Figure 1, Office Small Business Accounting 2006 provides summary reminders (things that need to get done) such as Vendors to Pay Today, Overdue Customer Accounts, and Cash Flow.

While having strong internal controls procedures in place might be considered a requirement for medium and large businesses, it is no less important for small businesses. According to the 2004 Report to the Nation, issued by the Association of Certified Fraud Examiners (<http://www.acfe.com>), 48 percent of theft and fraud occurred in small businesses with fewer than 100 employees. The median loss was US\$98,000. Thirty-three percent of all fraud involved billing schemes, and 33 percent involved check tampering. Overall, nearly 93 percent of all frauds were related to asset misappropriation. With these kinds of numbers, don't you think small business owners should begin thinking more about internal controls?

The greatest hindrance to small business owners around achieving effective internal controls includes limited resources and time pressures that often force owners and managers into "putting out the hottest fire" and leaving little time for planning. However, in the absence of clearly defined entity objectives, the effectiveness of internal controls will be greatly limited. Accordingly, as a prerequisite for effective internal controls, it is incumbent on small business owners and key managers to clearly identify those objectives that warrant investment of company resources. Only after these objectives have been defined and documented can effective internal controls be developed to mitigate risks. A broad stroke identifies two types of controls: administrative controls and accounting controls.

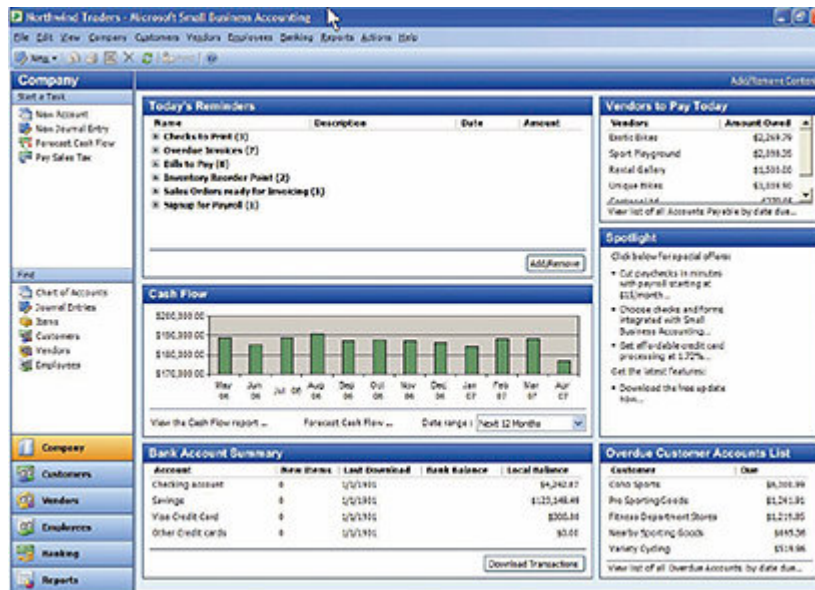


Figure 1

Application Controls Procedures

Transactions should carry management's general and specific authorization. Off-the-shelf packages, such as Small Business Accounting, use the following procedures to assist with authorization:

- User IDs and passwords restricting access to the applications and data.
- Prerecorded data input for fields such as credit limits, prices, and terms.
- Escalating approval levels for purchases.
- Using workflow tools.

Additionally, exception reports can be generated as control measures in most applications, indicating transactions which should have been subject to special forms of approval.

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User IDs and Passwords

One of the most fundamental internal controls procedures that should be employed by all organizations using accounting software applications is the assignment and use of unique user IDs and passwords. These should be employed at both the workstation level and the application level. Unfortunately, this most basic internal controls procedure is largely ignored by many small businesses. User IDs and passwords should be assigned so that employees have access to those areas within the application— and only those areas within the application— to which they need access to perform their job. All other areas within the application should be off-limits and restricted by the privileges assigned to the user ID. The integrity of user IDs and passwords should be maintained, and if ever compromised, IDs and passwords should be changed immediately.

A separate user ID and password can be assigned to each user, with rights that correspond to each user's job responsibilities. The process of assigning user IDs and passwords in Office Small Business Accounting 2006 is based on the concept of assigning each user to a predefined role, as shown in Figure 2.

Of course, the implication here is that proper management and maintenance of the roles is essential for the controls procedure to be effective.

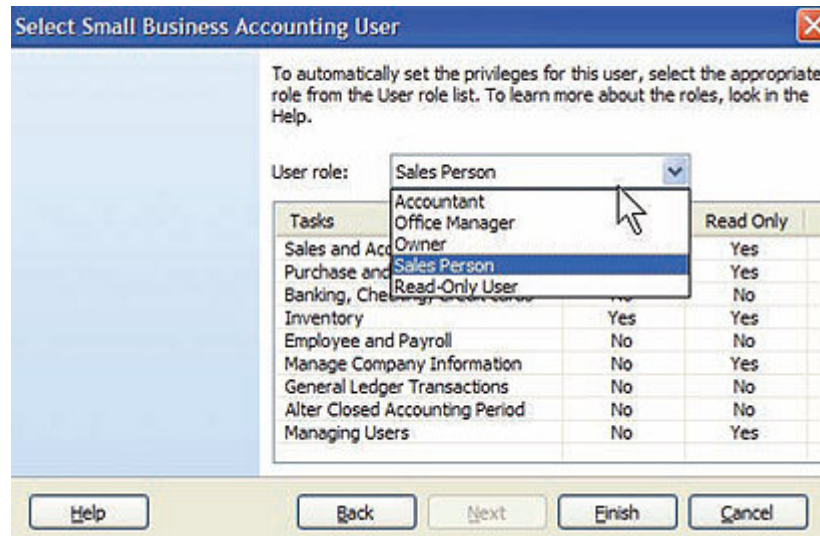


Figure 2

Prerecorded Data Input

The use of prerecorded data can be a very effective control in achieving authorization. For example, prices and price levels can be maintained to help ensure that items are sold to customers at prices in accordance with management's general and specific authorization. This enables users to apply authorized prices on a per-item and per-customer basis.

The use of price levels in Office Small Business Accounting 2006 is shown in Figure 3. Every customer who has been classified in the Customer Group as Retail (see Figure 4) will receive the pricing established for that group, in this case the base price. This is shown in the Sales price field for Adult Snowboard Bindings in Figure 3. By using prerecorded data in this fashion, business owners and managers are helping to ensure that selling prices are indeed authorized.

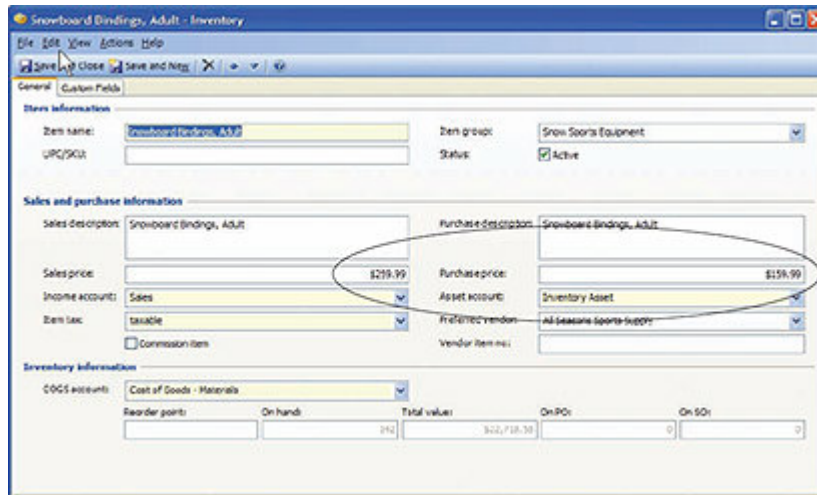


Figure 3

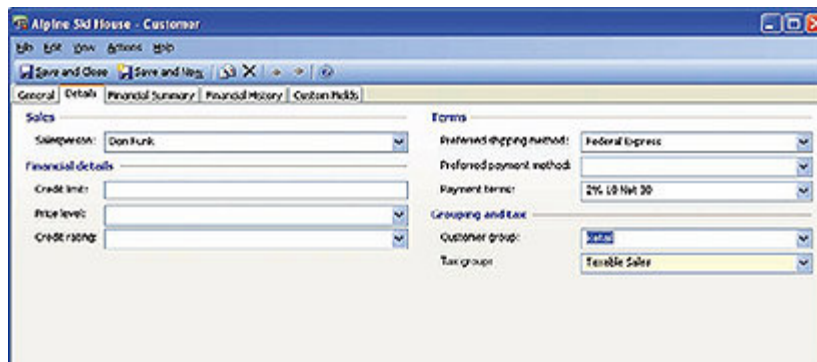


Figure 4

Approval Levels

Some applications also enable users to specify options for authorizing specific transactions. For example, purchase orders over US\$10,000 might have to be specifically authorized by a supervisor. Again, by using options such as this, business owners and managers can increase internal controls over authorization.

The purchase order information comes from the vendor file, and the business owner should watch carefully for changes made to ship-to addresses, as well as quantity and pricing, to detect and avoid fraud.

Workflow Tools

Most fraud occurs through the misappropriation of assets. To help ensure that each transaction is entered one time and one time only, most applications enable you to edit transaction numbers, such as invoice number. In Office Small Business Accounting 2006, for example, a preference can be established to not allow duplicate entry of the same document number for items such as an invoice or purchase order.

Prerecorded data is also used to increase the accuracy of transactions. Pricing information and default terms help to ensure accuracy of sales transactions. Also, establishing default accounts associated with each item helps with posting to the general ledger.

In Office Small Business Accounting 2006, default revenue, cost of goods sold, and inventory asset accounts are maintained for each item. These accounts are debited or credited, as appropriate, with each transaction for a particular item.

One of the areas of greatest concern to small business owners and managers in the revenue cycle is that of an employee stealing cash receipts.

Type	No.	Date	Qty.	Unit Price	Amount	Total
Inventory Items						
Basketball						
Vendor Bill	417	4/4/2006	20.00	14.99		299.80
Basketball Total						299.80
Bicycle - Red						
Vendor Bill	334	4/11/2006	40.00	43.99		1,760.60
Bicycle - Red Total						1,760.60
Bike Helmet - Children						
Vendor Bill	279	4/6/2006	20.00	14.99		299.80
Bike Helmet - Children Total						299.80
Fantastic Kites						
Vendor Bill	275	4/6/2006	36.00	12.79		460.44
Fantastic Kites Total						460.44
Fishing Tackle Box						
Vendor Bill	276	4/6/2006	40.00	43.79		2,551.60
Fishing Tackle Box Total						2,551.60
Hiking Boots						
Vendor Bill	241	4/11/2006	30.00	43.99		1,319.70
Hiking Boots Total						1,319.70
Hockey Glove/Pad Set						
Vendor Bill	273	4/6/2006	16.00	71.99		1,151.84

Figure 5

Of course, this is generally facilitated by the lack of segregation of duties. Guilty employees frequently attempt to cover their tracks by writing off the balance stolen through the issuance of a credit memo. Therefore, it is critical to control which employees have access to the credit memo function in the software program.

Reports can provide key controls in the expenditure cycle as well. For instance, the vendor Purchases by Item Detail report in Figure 5 provides small business owners and managers with key information regarding purchases, dates, quantity, and price sorted by vendor. This report could be useful in helping to identify undesirable purchasing activity.

One common controls procedure used by small businesses with inventory is a physical count of the inventory on hand. This count should be conducted periodically, and adjustments should be entered, as necessary, to the perpetual records. Again, virtually all packages support this function. The example in Figure 6 is presented from Office Small Business Accounting 2006.

After the count is completed, adjustments are often necessary so that the periodic records correspond to the physical count. Consideration should be given to which employees are allowed to access the inventory adjustment screens; otherwise, it could be quite easy for an employee to steal inventory and cover the theft by adjusting the inventory off the books. We also recommend that businesses consider modifying the standard Physical Inventory Worksheet so that quantity on hand does not print, as often the two end up being identical without proper investigation. In Office Small Business Accounting 2006 it is easy to select the Modify Report button on the report view screen, select Column from the modify task pane, and deselect the Quantity on Hand column.

Most packages provide a number of reports that can be useful for inventory control. Reports that show profitability by item and turnover by item are very useful in determining which generate desired profitability. Figure 7 shows an example of the Item Profitability report from Office Small Business Accounting 2006.

Item Name	Item Description	Qty. on Hand	Actual Count
Baseball gear			
Authentic Major League Baseball Bat	Authentic Major League B...	8.00	_____
Baseball Bat	Baseball Bat	7.00	_____
Baseball Glove	Baseball Glove	2.00	_____
Baseball Spikes	Baseball Spikes	7.00	_____
Baseball Uniform	Baseball Uniform	18.00	_____
Basketball gear			
Basketball	Basketball	43.00	_____
Basketball Hoop & Board	Basketball Hoop & Board	8.00	_____
Bikes			
Bicycle - Blue	Bicycle - Blue	8.00	_____
Bicycle - Red	Bicycle - Red	33.00	_____
Bicycle - Wild	Wild	(8.00)	_____
Bike - Adult Mountain	Adult Mountain Bike	0.00	_____
Bike - Super lightweight	Super lightweight bike	23.00	_____
Elite Bicycle	Elite Bicycle	4.00	_____
Specialty Unicycle	Specialty Unicycle	8.00	_____
Biking gear			
Swim Band	Swim Band	18.00	_____
Bike Helmet - Adult	Bike Helmet - Adult	(28.00)	_____
Bike Helmet - Children	Children's Bike Helmet	(26.00)	_____
Bike Replacement Chain	Bike Replacement Chain	18.00	_____
Football gear			
Autographed Football Jersey	Autographed Football Jer...	1.00	_____

Figure 6

Northwind Traders
Item Profitability
Date Range: January 1, 2006 - April 12, 2006
Item group: All, Item All
Vend Period: April 12, 2006

Item	Quantity Sold	Sales	Standard Cost	COGS	Adjustments
Inventory Items					
Baseball - Children	74.00	1,071.50			(1,181.00)
Base - Adult Mountain	20.00	2,637.80			(2,079.60)
Base Ball	42.00	11.34			(8.00)
Hiking Boots	15.00	1,198.85			(688.88)
Baseball Spikes	45.00	1,871.00			(1,519.68)
Football Spikes	27.00	1,460.73			(171.73)
Soccer Shoes	36.00	736.88			(643.66)
Football Jersey	20.00	1,479.80			(1,379.80)
Autographed Football Jersey	4.00	640.00			(600.00)
Baseball Uniform	98.00	2,579.48			(2,339.44)
Fishing Line	45.00	8.00			(4.50)
Fishing Lure	16.00	28.38			(24.78)
Hook	8.00	5.98			(5.50)
Leather Football	8.00	925.92			(834.00)
Football Kick Helmet	10.00	348.40			(183.60)
Baseball	18.00	596.82			(569.82)
Baseball Mop & Beard	17.58	529.83			(539.43)
Baseball Glove	42.00	1,408.80			(1,176.68)
Baseball Bat	19.00	400.82			(3,466.81)
Authentic Major League Baseball Bat	5.00	1,837.50			(1,126.00)
Soccer Ball	68.00	476.47			(197.02)
Volleyball Bat	22.00	1,247.78			(1,511.78)
Hockey Stick	27.00	798.75			(647.73)

Figure 7

To learn more about internal controls, I invite you to attend a K2 Enterprises seminar (www.k2e.com), or check with your state accounting society to see when a full day of Internal Controls for Office Small Business Accounting 2006 is offered in your area. To learn more about Small Business Accounting, please join the Microsoft Professional Accountants' Network (MPAN). MPAN is a free program offered to public accountants and provides free CPE credits for online Small Business Accounting training. Visit www.microsoft.com/mpan.

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