Internal Control Problems in Small Businesses

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Abstract
This paper will inform small businesses on the importance of internal control. Businesses will learn about the problems businesses have with internal controls and how employees are able to steal money from the company. Businesses will also learn precise internal control methods and how they can be installed into a business. This paper contains much of the information necessary to create a well-functioning work environment. Operating strategies for small businesses will not be discussed in this paper.

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Introduction

Problem
Many businesses worry about the condition of their company based on their sales. But one factor that some small businesses neglect is the factor of internal controls. Internal controls are simply measures that businesses take to detect any type of fraud, mistakes, or irregularities within their business. Small businesses are susceptible to embezzlement as they have employees working closely with record keeping and they may not have very many employees. Employees can become very comfortable with their work and learn weaknesses in the system. They then can find ways to steal from the business. Businesses with less than one-hundred million dollars in assets are more susceptible to losses from employees.¹ This is because employees play multiple roles in a smaller business.

Cases
A Credit Union executive in Texas embezzled over $1.1 million dollars over a four year period.\textsuperscript{2} The employee was writing small checks between $5,000 and $9,000 dollars to herself from the Credit Union’s own account. A woman at a Credit Union in Maryland stole over $500,000 dollars over a six year period. This employee was once honored as an outstanding Credit Union employee. The employee allegedly took money from friends and relatives’ accounts.\textsuperscript{3} A Credit Union accountant in Washington was arrested after allegedly stealing $200,000 dollars.

How Employees are Stealing
There are many ways in which employees can steal money from a business. The most popular ways include overpayment of salary, fictitious expenses, personal expenses charged to CU credit cards, double-payment of authorized expenses.\textsuperscript{4} In the recession and difficult economic times, the frequency of embezzlement has increased. It is very hard to detect embezzlement and many times the theft is investigated with an employee who grows suspicious of another employee’s activities. Many times these employees are long-term employees. Businesses are often caught off guard when they hear of these incidents. Businesses many times believe that these employees are well trusted.

Solution
The solution to internal control problems should create many redundancies. If processes are very deliberate and repetitive, embezzlement becomes much more difficult for employees as records will be passed through multiple employees. The main components for internal control includes

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control environment, risk assessment, control procedures, monitoring of controls and information system. Appendix A shows a comparison between two different control concepts.

**Control Environment**
The control environment refers to the high executives of the business. They must behave and stress the importance of internal controls. If they fail to do this, employees will fail to honor the system as well.

**Risk Assessment**
Businesses must identify their risks. Every business faces the threat of bankruptcy. But risks are individualized to the type of business. These risks can be anything that may harm the state of the company. These are important to identify because then a business can create measures to prevent these risks from occurring.

**Control Procedures**
Control procedures are used to help the business achieve its goals. The main parts of these internal control procedures are competent, reliable, and ethical personnel, assignment of responsibilities, separation of duties, audits, documents, electronic devices, and other controls.

**Competent, Reliable, and Ethical Personnel**
A business must have quality employees and paying good salaries will help attract the best employees. A business needs to train their employees accordingly and provide detailed information about their tasks within the business.

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Assignment of Responsibilities
Each employee should have certain responsibilities. Important tasks should always be addressed and made sure it is done correctly. Efficiency in the business can be achieved with clearly assigned duties.

Separation of Duties
Related duties should be divided between two or more people. This helps prevent fraud and will be beneficial towards the accuracy of a business’ records. Separation of duties can be divided into separate operations from accounting and separate custody of assets from accounting.

Separate Operations from Accounting
Accounting should be separate from operating departments. This helps ensure that qualified employees are recording important information.

Separate Custody of Assets from Accounting
Accountants should not have access to cash and cashiers should not have access to accounting records. If an employee has access to both the employee can easily steal money from the business.

Audits
Audits are used to help confirm the accuracy and validity of a business’ accounting records. These can also be used to ensure that employees are following company policies.
**Documents**
Documents provide details about business transactions.\textsuperscript{14} These will create a paper trail and help a business keep track of where the business’ money is going. This makes it more difficult for an employee to pass money to unknown accounts.

**Electronic Devices**
These devices help businesses keep track of large amounts of inventory digitally. These devices can be attached to products to help account for all inventory. These devices can help reduce theft by up to fifty percent.\textsuperscript{15}

**Other Controls**
These controls are measures taken to observe employees who may be in tempting positions to steal. These measures can be things such as security cameras and vaults.\textsuperscript{16} Businesses must train their employees to identify suspicious activity.

**Monitoring of Controls**
Businesses hire external auditors to help ensure the accuracy of their records and also to analyze the businesses controls.\textsuperscript{17} Monitoring is also used to help protect a business’ assets.

**Information System**
These are the software programs that a business may choose to use. These are important because businesses rely heavily on these to keep track of assets and measure profits and losses.\textsuperscript{18}

**Internal Control Solution Overview**
Small businesses should follow the provided internal control guidelines. These guidelines create a very structured business and prevent theft from employees. They provide better security to the

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businesses assets. These steps also make it extremely difficult for employees to steal assets because records are passed through several employees. These other employees will most likely be able to identify suspicious activity. Appendix B shows the method of initial detection of fraud within a business for the years 2006 and 2008.

**Conclusion**
The final step for a small business would be to install the internal control structure into its company. These controls help prevent theft and also create a more efficient work environment. These controls are very detailed and create a safe work environment that prevents many types of employee fraud.
## Appendix A: Comparison of Control Concepts

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<tr>
<th>Control Concept</th>
<th>Traditional Event-based Systems</th>
<th>BPMS</th>
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| **Authorization** | • Part of access control system  
• Assigned by activity type  
• Require *ad hoc* controls within applications | • Part of process rules and role definition  
• Assigned by various case factors  
• Complete authorization definition |
| **Segregation of duties** | • Time-consuming and costly management approval  
• Limited mechanism of assigning tasks for approval | • Speed up approval time and cost by workflow technology  
• Various models of task assignment for approval, to eliminate bottlenecks |
| **Application control** | • Menu-driven work  
• Potential of errors, such as selecting a wrong task, failure to perform a task or an object identification error | • Task-list-guided work  
• Include elimination of potential errors of tasks and object selection |
| **Auditability** | • Transaction-based system  
• Does not provide monitoring of process status  
• Require an *ad hoc* audit trail to link between transactions within a process | • Process-based system  
• Include built-in, continuous, visual process monitoring  
• Include a built-in process log |
Appendix B: Initial Detection of Fraud