PIPSO
Pacific Islands Private Sector Organisation

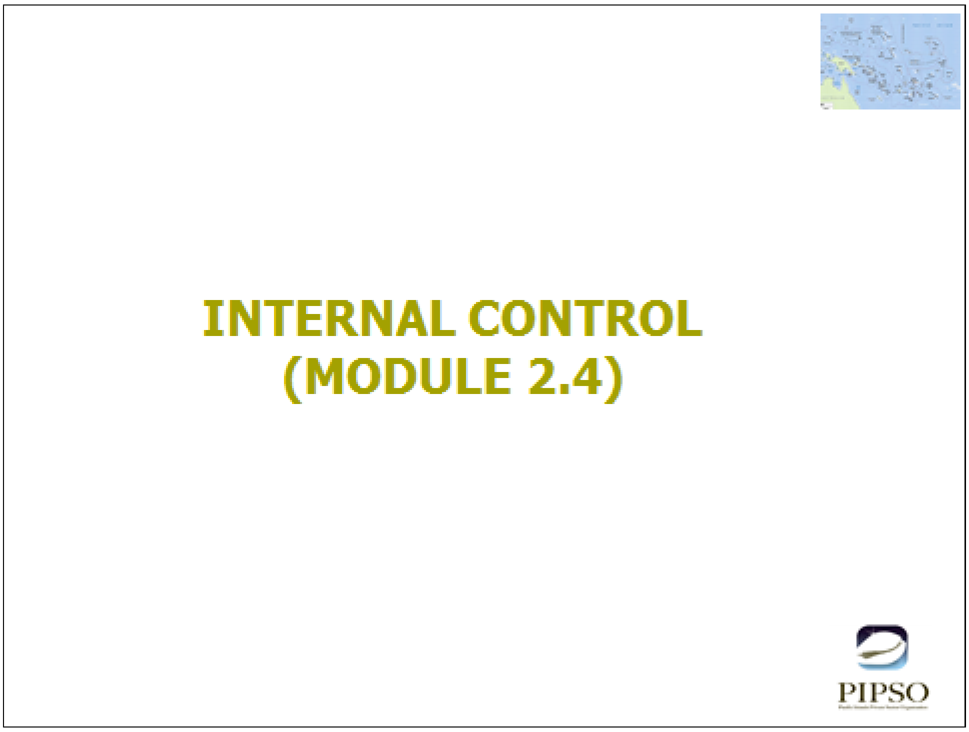
January 1

INTERNAL CONTROL

2014

This Module reviews the reasons for maintaining internal controls in the broad sense, not just as a means of detecting fraud, theft or errors. It looks at the types of controls for different situations & their limitations & benefits before illustrating relevant issues via case studies.

MODULE 2.4



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PURPOSE

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 & presented, users & regulators assume:

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

In this Module,we look at the positive benefits of simple internal control practices.

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 to ensure the accuracy, reliability & timeliness of financial & operational information.

Even sole operators can regularly reconcile bank statements & cheque books or check budgets against actuals. Personal observation & routine checks can detect errors before they have an effect in another part of the business. Simple actions can protect revenues & promote effective & efficient operations.

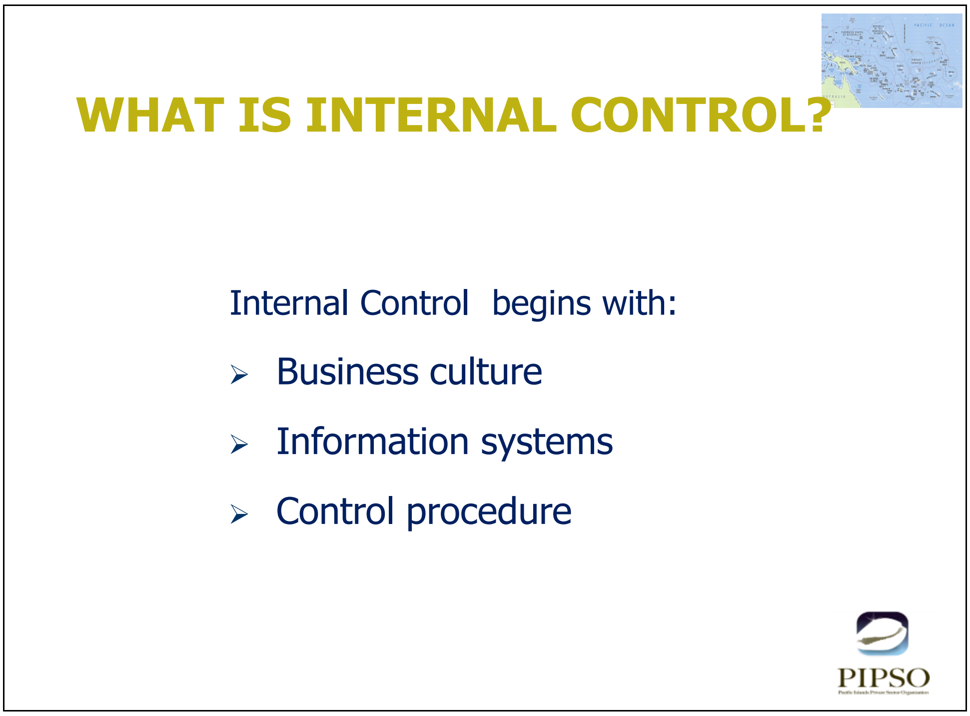
Participants will be introduced to a range of simple actions that will improve the security of assets & information, provide timely & accurate financial & operational information &provide staff with a clearly defined framework in which to operate in ways designed to meet the business objectives.

On completion of this Module participants should appreciate that internal control is not just about protecting a business from fraud, theft or other loss. Participants should be able to reconsider their own business with a view to implementing new &/or maintaining controls that improve efficiency & effectiveness as well as protect business revenues & assets.

While several sources were used, this Module is substantially based on the information provided in following publication:

Susan Campbell CPA and Judy Hartcher, “Internal Controlsfor Small Business” CPA Australia, Melbourne.

DEFINITION OF INTERNAL CONTROL



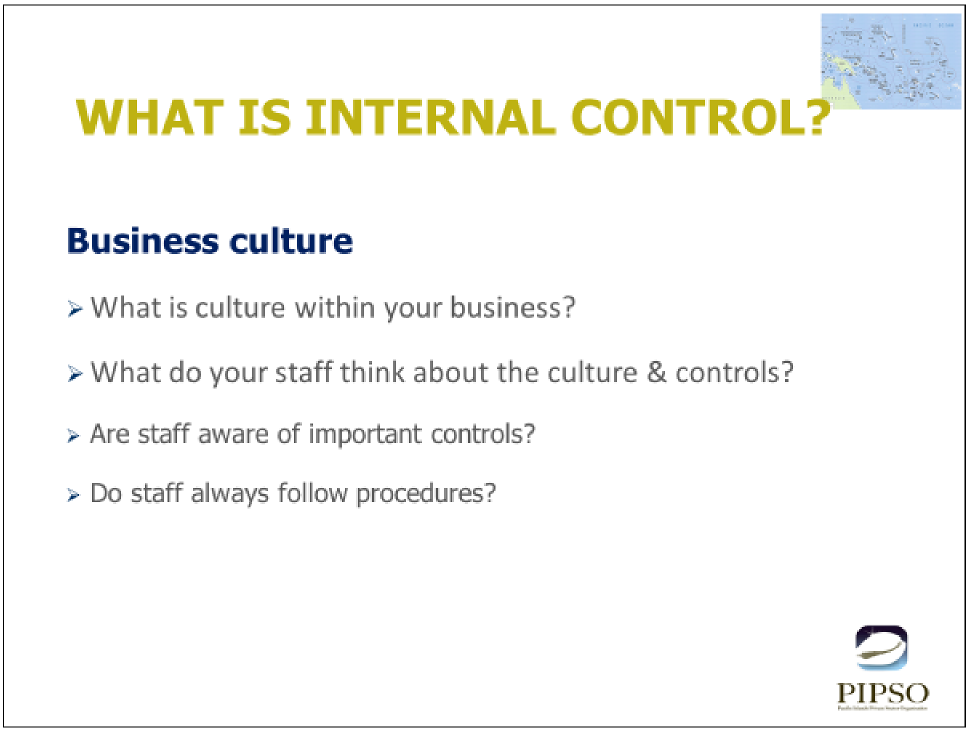
The business culture

The business's overall attitude to internal controls & their importance in the business create an environment or culture within your business. People are made aware of the environment through words & actions. This often starts with the vision & values of the business & the actions of the owners. Lack of attention to internal matters, no code of ethics, little respect for employees, few audit trails, lavish expenditure & general sloppiness in a business are all likely to create an environment that can be easily manipulated for gain.

Action required to assess your business

What is culture within your business? Ask your staff what they think about the culture & internal controls. It may expose areas of weakness. Do they value controls? Are they aware of important controls? Do they always follow procedures?

One Tel was a highly visible Australian 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.

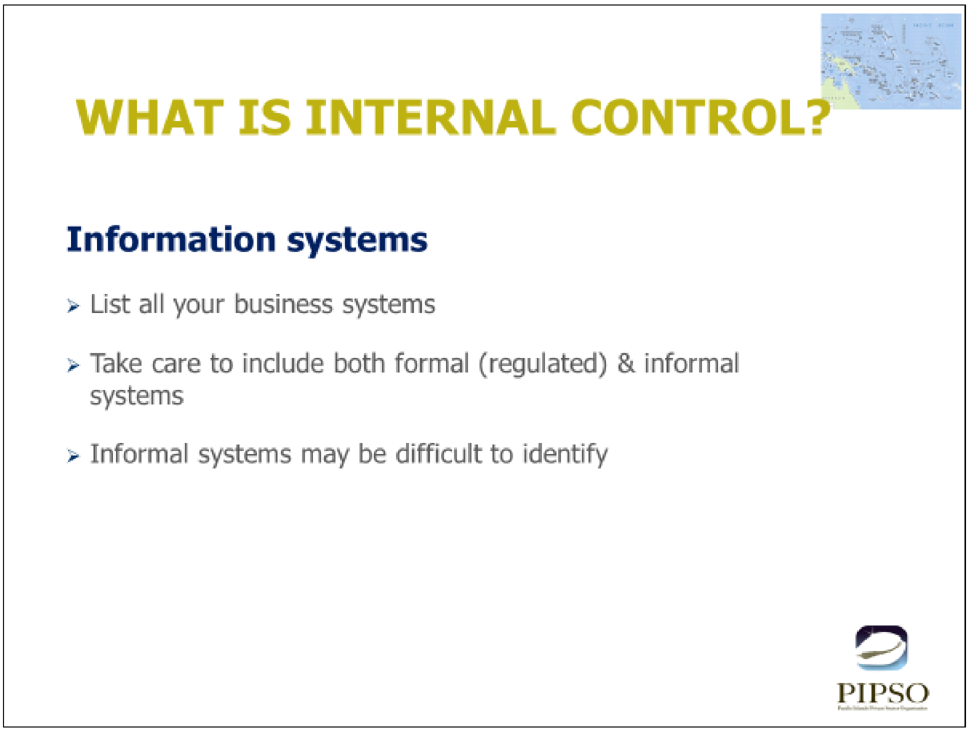


Information systems

Information systems are the methods & records you use to identify, assemble, analyse, calculate, classify, record & report transactions & other events that affect a business & to maintain accountability for assets, liabilities, revenue & expenditures. These systems include computer systems & all other associated systems including performance reviews, distribution systems & manufacturing systems. It is important that your systems are able to identify leakages of funds or assets from your business.

Action required to assess your business

List all your business systems, both formal (regulated) & informal. Some systems may be hard to identify as they are often informal.



Control procedures

Control procedures are in place to ensure that all staff take the correct action to meet business objectives. Procedures state how, why, what, where & when to act. Small business owners may think procedures are unnecessary, but written procedures help,& reduce the time, to train new staff by explaining why they need to do what is asked of them. Written procedures reduce errors & help staff understand the business quickly.

Action required to assess your business

Review procedures in your business. Do the procedures explain why & when you need them & who is responsible? Many very detailed procedures forget to tell the reader why they are needed. Note that internal controls are a process, a means to an end, not the end in itself. Nevertheless, they must have a purpose & it should remain relevant to the business.

WHAT IS INTERNAL CONTROL?

Control procedures

- Do the procedures explain why & when you need them?
- Do the procedures explain who is responsible?
- Informal systems may be difficult to identify
- Controls must have a purpose & remain relevant to the business

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Internal control is a part of business risk management. Applying sound internal controls reduces the risk of loss, errors, inefficiency & noncompliance. Refer the list that follows.

WHAT IS INTERNAL CONTROL?

Internal Control - the related methods and measures applied in a business to:

1. Promote operational efficiency & effectiveness
2. Provide reliable financial information
3. safeguard assets & records
4. Ensure adherence to policies & procedures
5. Comply with external regulatory requirements

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PURPOSE OF INTERNAL CONTROLS

Applying sound internal controls:

1. *Helps to align business activities & objectives*
   Through reporting procedures internal controls **keep the activities of the business in line with its objectives**&ensure it operates in an effective & efficient manner, e.g.:
   - Doing reference checks on new staff to ensurethey do have essential qualifications
   - Ensuring correct training for staff hasbeen provided
   - Appropriate supervision of staff.
2. *Encourages good management*
   Internal control practices require managers **to receive timely,accurate and reliable& relevant financial information** for comparison with performance targets & budgets. These control practices 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.

3. *Safeguards assets* (dealt with in more detail in Module 2.5)
   A key element of any internal control system is to ensure that **all physical & monetary assets are accounted for & protected against fraud, error & theft**.
4. *Prevents & detects fraud & error*
   Timely identification of fraud & errors, if, & when, they occur is central to sound internal control to minimize loss.
   Measures listed in 2 above are relevant to detection & prevention.
5. *Allows action against undesirable performance*
   An internal control system must include **a formal method of dealing with fraud or dishonesty, when detected**.This is anaction protocol for gathering information&evidence, reporting to management & police, if required, dealing with perpetrators, recording transactions in books of record & reporting events.
6. *Reduces exposure to risks*
   By following & internal control procedures &providing them for staff to read, management may**minimize the likelihood of unexpected events**. Risk management covers more than internal audit & requires specific & detailed attention based on a complete risk analysis. This will include such risks as workplace health & safety, production, project, commercial & other risks external to the business. The complete range of risks to be managed goes well beyond the scope of this Module.
7. *Ensures proper financial reporting*
   Fraud & theft aside, it is most important that management &**financial reports are accurate, complete & compliant** with internal & external (legislative) requirements & errors corrected promptly.
   Some examples of controls used to ensure compliance include:
   - Assigning responsibility for compliance with particular personnel such as 'safety officer, fire warden'
   - Physical controls to prevent accidents
   - Processing customer complaints
   - Staff feedback processes
   - Procedures well documented
   - Conduct of audits

   From your business are you able to identify examples of procedures that deal with any of the following issues, at least one per issue. There may be procedures that deal with more than one issue.

WHY HAVE INTERNAL CONTROLS?

Internal control procedures are designed to ensure each of the following:

1. That all records & transactions are included in business reports
2. The amounts recorded are correct
3. Officers, systems & transactions are authorised, e.g. approvals, payments, entry & computer access
4. Liability has been properly incurred & invoices for work performed are valid

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WHY HAVE INTERNAL CONTROLS?

Internal control procedures (cont.):

5. All purchases recorded have been received & that all recorded assets & liabilities exist
6. Errors in the system are identified & corrected
7. Wherever practical, key functions are performed by different persons, especially cash & creditors
8. Timely financial reports are prepared & compliant

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The special case for small business

The major issues for small business are theft & fraud. The lament of many small business owners/managers is, "**<u>We're too small for internal controls</u>**".

This complaint isn't true! Even a relatively small business can enforce certain internal controls that are very effective.

Among these are the following:

- The owner/manager should sign all checks, including payroll checks. This practice forces the owner/manager to keep a close watch on the expenditures of the business. Under no conditions should an accountant, a bookkeeper, or the Controller of the business be given check-signing authority. This person can easily conceal fraud if he or she has check-writing authority.

- In high-risk areas (generally cash receipts and disbursements, receivables, and inventory), require that employees working in these operating areas take vacations. Furthermore, make sure that another employee carries out their duties while there're on vacation. By doing the same job, the fill-in employee serves as a check on whether the regular employee is doing things correctly and according to the rules.

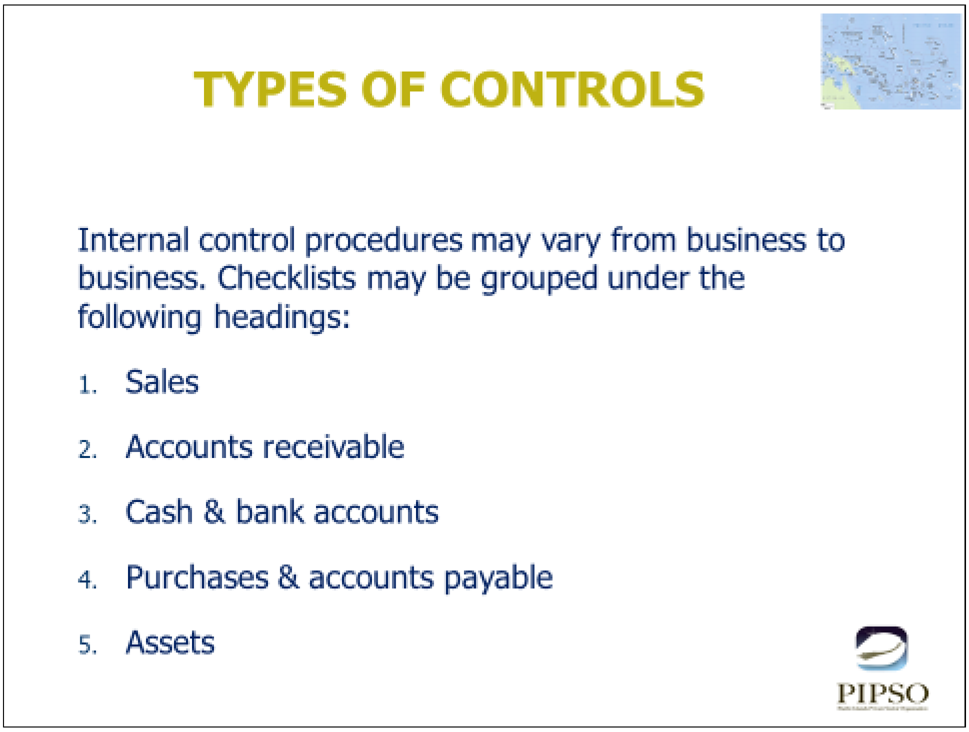
- Although separation of duties on a full-time basis may not be practical, consider the job-sharing approach. In job sharing, two or more employees are regularly assigned to one area of the business on alternate weeks or some other schedule. Each employee acts as a check on the other so that both use established methods and procedures. When a second employee shares the job, embezzlement is more difficult to conceal, unless the two persons collude.

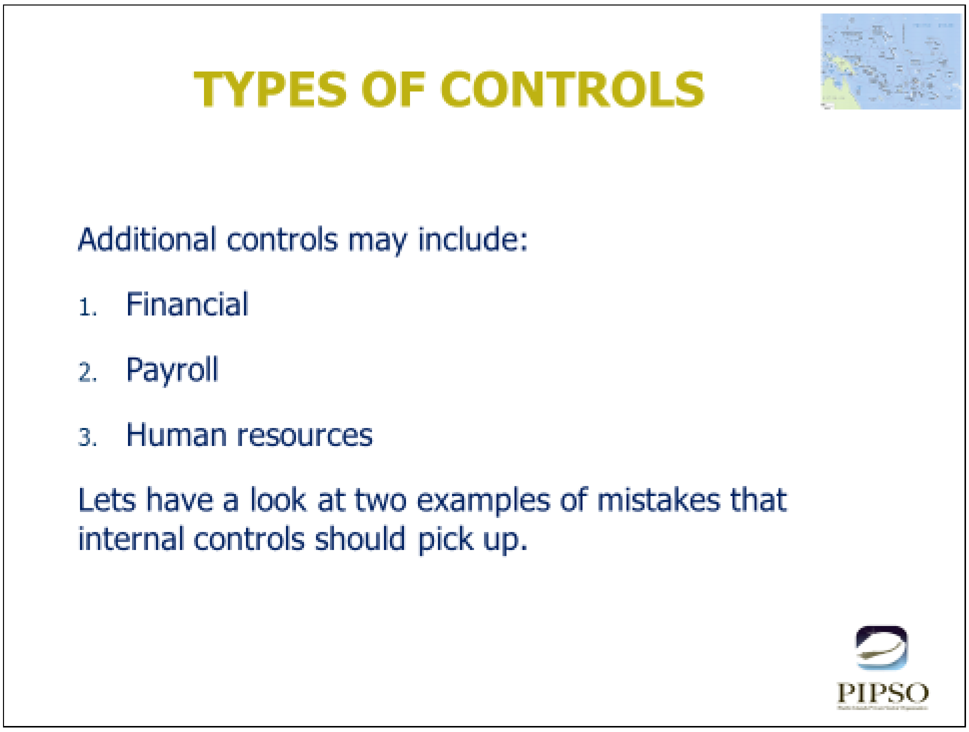
- Without violating their privacy, keep watch on the lifestyles of your employees. If your bookkeeper buys a new Mercedes every year and frequently is off to Monte Carlo, you may ask where the money is coming from. You know the salaries of your employees, so you should be able to estimate what sort of lifestyles they can afford.

Businesses should know that its employees and managers will sometimes have problems paying their bills on time, to say nothing about all the other financial pressures caused by divorce, health problems, medical emergencies, college-bound kids, drug addiction, and on and on. You can make a good argument that business is responsible for have good internal controls that prevent its employees and managers from committing fraud. Indeed, you can make a good case that a business has a social responsibility for exercising good internal controls.

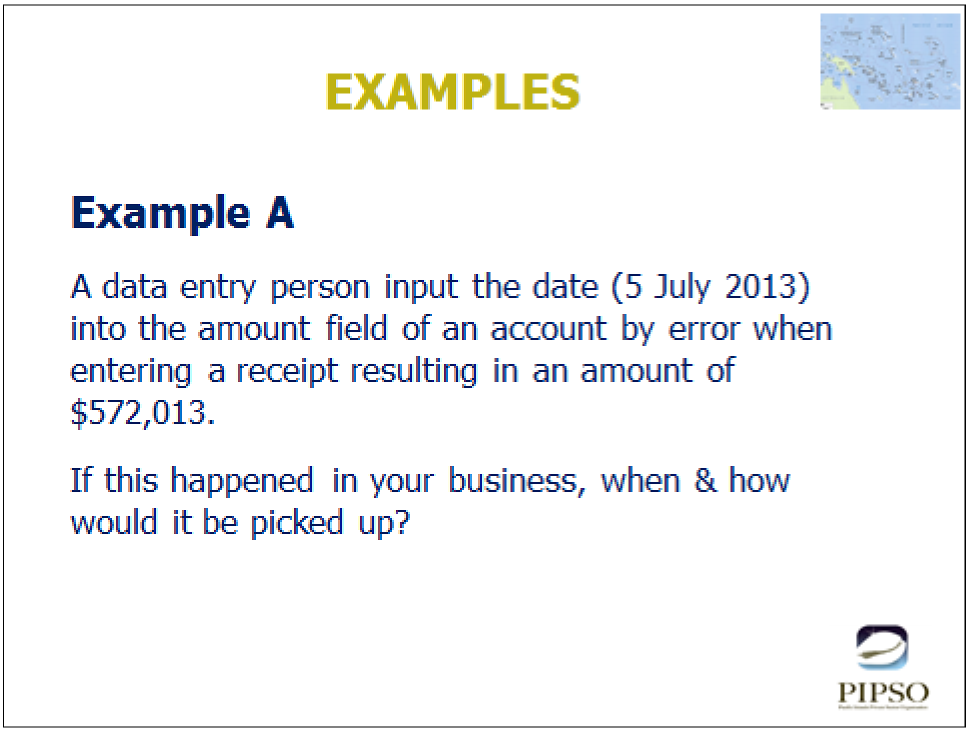
TYPES OF INTERNAL CONTROLS

Internal controls are frequently grouped under a range of relevant headings as follows.





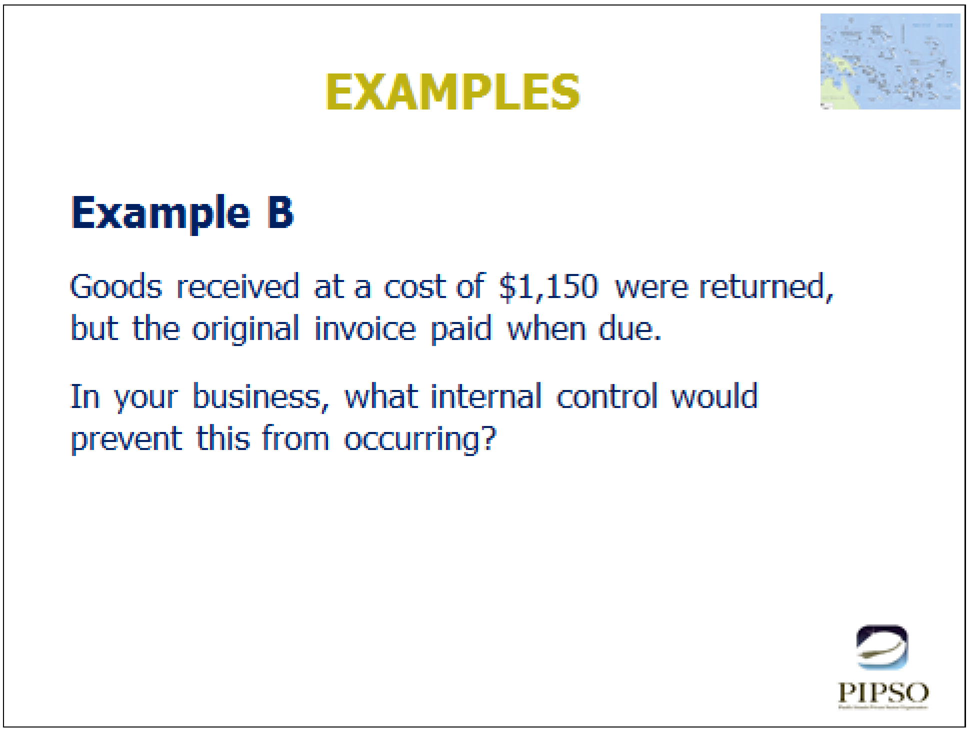
Now let's consider the following examples.



Would your internal control pick this up in a timely manner? If how? If not, what would you do in this situation?

NOTE FOR FACILITATOR
Possible answers include:

- An entry checker would pick it up
- A review of the cash book; depending on how often it I reviewed& by who
- A system alert of unusual amounts – to who?
- How timely would the identification of the error be?
- Add any sound alternatives offered by participants

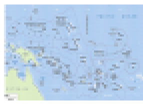


This should not happen. If, nevertheless, it did, how would it be discovered? By whom?When?

NOTE FOR FACILITATOR
Possible answers include:

- Prompt advice of return to accounts
- Direct input of returns into the system by warehouse
- Add any sound alternatives offered by participants

The following is a more detailed list of examples of the types of internal controls that may be used in business.



CONTROLS FOR SMALL BUSINESS

Activity 2.4.1 – Types of controls

Which of the following list of controls does your business apply?

Are there any others listed that you think you should apply?

Make a list & discuss.

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NOTE FOR TRAINER

In a workshop environment provide each group (table) with one heading &have the group prepare a lists of the controls that are used by one or more members of the group using butchers paper. Have each group elect a representative to present their controls in use to the entire audience.

Facilitate open discussion in the wider group to add to the list.

Hand out list as provide in the answer to this activity & thendiscuss those relevant to participants businesses from the controls listed. Discuss others that might be applicable to small business – they may not be all be on the list.

Seek active participant involvement to discuss participant examples where they have procedures in place to deal with the issues raised in the list.

LIMITATIONS OF INTERNAL CONTROLS

Errors of judgment

Owners must always use their judgment in theirbusiness whether recruiting staff, dealing with customersor checking accounts.

Certain situations can even lead normally honest people tocommit fraud because the opportunity is so irresistible.All businesses rely on a number of processes & honesty.Consider the consequences of 5% of people not beinghonest. Owners must be thorough in checking proceduresfor new staff. Check thoroughly potential employees' employmentrecords & if possible ring & speak to previous employerspersonally.

Financial stress, addiction & dissatisfaction maycause 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 reasonbehind the activities it is describing, it is usually easier tohandle an unexpected event. As an owner you can'toversee all transactions at all times, however the rightcontrol framework & environment will help to ensureyour staff seek guidance when unexpected events occur.

Reinforce to your staff that they should not let themselvesbe overridden or bullied into exceeding their authority oracting against your rules.

Collusion

This usually occurs when two or more people cometogether in an attempt to defraud. Collusion is hard todefeat in a small business. In this case the owner'spresence & fear of being caught are deterrents.

Form over substance

You must not let the process become the point of theexercise. If the process does not fulfill an objective, thenchange or remove the process.

Management override

Management & staff can at times view internal controlsas red tape, unnecessary & a waste of time. In a smallbusiness staff are often under tight budgets & will betempted to cut the corners. Research shows that peoplewho override internal controls are often doing so for theirown benefit & may be attempting to defraud thebusiness. Don't let people change your procedureswithout first discussing it with you.

Weak internal controls

A survey by KPMG found that 60% of fraud wascommitted because a business had weak internalcontrols. Common fraud includes double payment ofinvoices sent twice & payments being made for workthat has never been performed. These mistakes are asignal to the outside world that the internal controls areweak & the firm is a target for further abuse.

It is useful to consider the three aspects of the fraud triangle as follows in order to take protection action & implement reasonable internal control in a business.

1. Opportunities
2. Pressure/motivation
3. Rationalization

Ii is not possible to absolutely protect a business, small or large, entirely, but internal control measures should match the business risks.

Understanding the Psychology of Fraudsters

An easy and quick answer to why people commit fraud is for the money. However, this answer doesn't always get to the root causes why people commit fraud. How do they rationalize stealing money? Do they not think it's stealing? Do they need the money that bad? Don't they see the risks of getting caught? Don't they see the shame and dishonor getting caught will bring down on their family and their good name? Well, for one thing, many people seem to think that business is a fair target because businesses rip them off every day. Or, they may do it to get back at the owner of a business.

How do people that commit fraud rationalize or justify their actions in their minds? Fraud usually involves a variety of financial, personal, emotional, and other factors that can push even the most honest, hard-working person over the limit. Fraud driven by the need to survive probably is more commonplace and represents a much greater risk to the average business than fraud driven by greed alone. For example, we know of cases where a business owner went way over the line. The business owner viewed his company as a part of his family. The owner was willing do anything to ensure the survival of the business, which would be his legacy to his family.

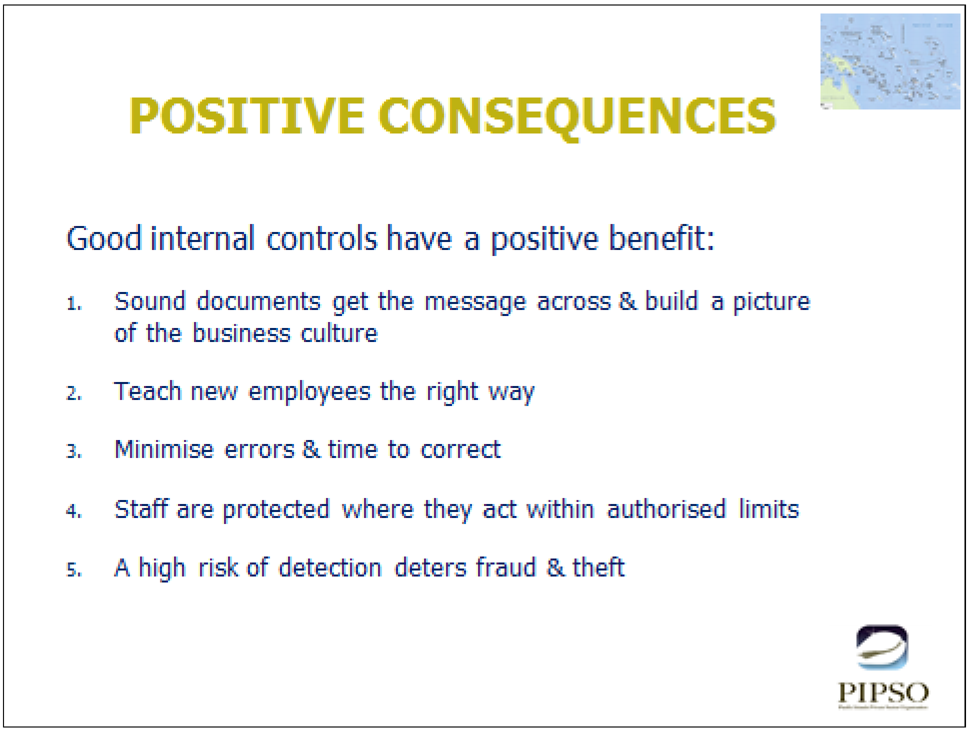
How are frauds found out?

Common ways for uncovering frauds include:

- Internal controls
- Internal audits

- Notification by an employee
- Accident
- Anonymous tip
- Notification by customer
- Notification by regulatory or law enforcement agency
- Notification by vendor
- External audit

BENEFITS OF INTERNAL CONTROLS



1. **Good communication**

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

2. **Education**

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

3. **Error reduction**

Good & clear internal controls procedures minimize errors & save time & money. It helps ensure business information is correct & that staff are accountable for their actions. For example, staff should know how to check their own work to ensure it is accurate.

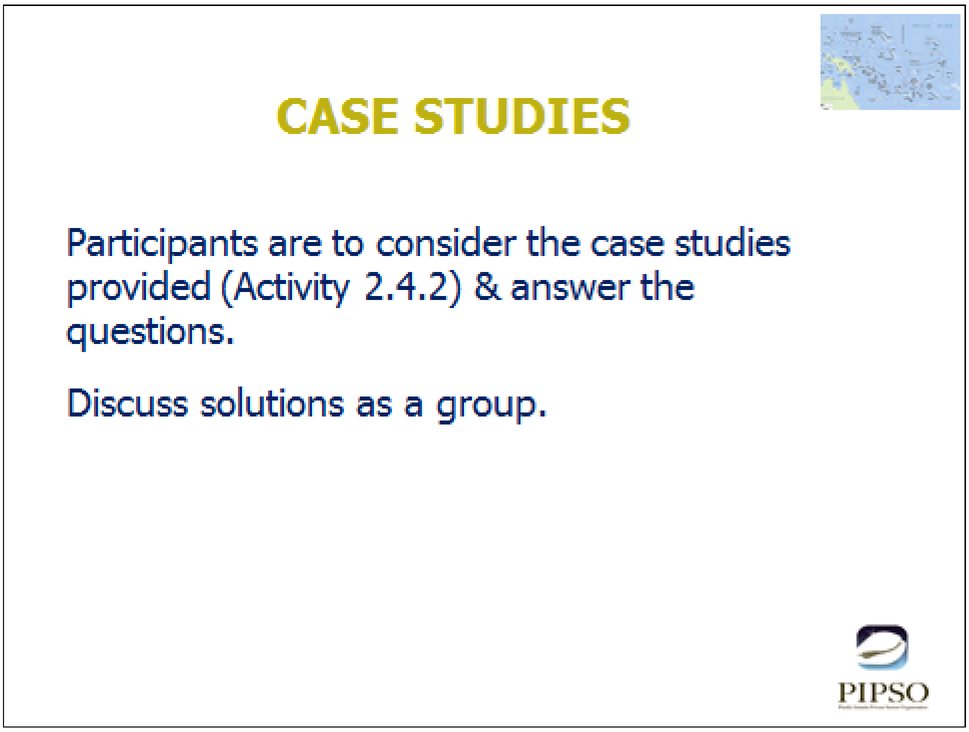
4. **Protection & authorisation**

Internal controls give comfort to staff that they have protection if they have acted in the way prescribed by the internal controls & within their authorisation limits.

5. **Perceptions of detection**

The existence of internal controls acts as a deterrent for those considering fraud increasing the risk they will be detected.

CASES STUDIES



ACTIVITY 2.4.2

CASE STUDIES

A. Wini’s parable

After graduating from high school, Wini 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 Wini 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 & Wini 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 Wini had stolen more than $500. When he confronted her, she confessed she had borrowed the money without authorisation. The accountant asked whether Wini knew someone would check her work. "No" she replied "until you walked in here I didn't even know what an audit was.”

Questions

1. How did the accountant know that Wini had been taking money?
2. In what ways did the internal control procedure fail?
3. What actions need to be taken to rectify the position?

B. Payment twice

Office Supplies Pty. Ltd is a fast growing new business. The owner Inoke signs all cheques & keeps a tight rein on all parts of the business. He believes nothing could get past him! Anita is the accounts payable person, receptionist & office manager all rolled into one. There is 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 & Inoke told Anita to stall them, as there wasn't enough cash in the bank.

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

Questions

1. What did Inoke get wrong & how will he know that suppliers return the difference?
2. Could Anita duplicate an invoice & pocket proceeds? If so, how would she do it?
3. How can Inoke improve his internal controls?

This exercise ends this Module.

ANSWERS TO ACTIVITIES

ACTIVITY 2.4.1

TYPES OF INTERNAL CONTROLS

Some areas of the business are more at risk of loss or fraud & require more stringent controls. The following checklists will help you to identify controls that you should have in place.

Sales

Accurate sales figures are important to correctly estimate stock & revenue. You also want quick & reliable feedback of sales trends so you can act 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 & credit sales. Never ship goods out without an accompanying invoice. Make sure your staff know how to handle returns & 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 & commissions are not paid until funds are received
- Reconcile sales register with takings & credit card receipts
- Make sure that goods are sent COD or with a tax invoice & obtain evidence of delivery.

Accounts receivable

Debtors are an important asset. Delays or failure to collect amounts due reduce cash flow & erode profit.

- Ensure credit & collection policies are in writing
- Conduct credit checks on new credit customers
- Regularly age accounts & have an independent review of the report
- Ensure credit purchases are recorded as soon as the transaction occurs
- Separate the accounts receivable function & cash receipting
- Have transactions such as noncash credits & write- off of bad debts cross-checked
- Have a well-documented & 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 & 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 & bank accounts

Businesses holding cash often fall victim to fraud or loss as 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 & bank statements regularly but not at predictable intervals (for example not every Monday morning)
- Keep a tight rein on all cash & 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
- If possible, separate mail-opening, writing of deposit slips & banking from bank reconciliation
- Separate responsibility for cash disbursement & 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 & accounts payable

Small businesses find mistakes in their purchasing & accounts payable costly. There should be internal controls within the billing & invoice payments. Have a clear & simple list of written procedures for purchases & accounts payable so staff know the process they are to follow. Some important but simple checks to consider when reviewing payments are:

- Document purchasing & accounts payable procedures
- Ensure payments on original invoices only – not copies or faxes otherwise they may be paid twice
- After payment is made, stamp or perforate the original invoice to prevent reuse
- Use an exception report so payables over a set amount come to owner’s attention & have an authorisation level where the owner only can sign or commit the business (such as over $1,000)
- Put in place controls to check for identical payments
- Ensure supplier refund cheques 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 not the person responsible for payments
- 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 that would not attract attention

- Monthly, select a vendor type, e.g. tradesmen, & review detail & number of invoices for all vendors
- Check out the competitors' prices if you rely heavily on one supplier
- Investigate invoices for poorly defined services

Physical assets

Physical assets present their own risk management issues as they are as easy to misplace, lose or steal. Assets can be borrowed by the staff or external visitors or take by passer-bys. Secure locked areas are the most common solution to physical security of:

- Laptop computers & data projectors
- hand bags & petty cash if your office entrance is located near the street or a staircase

Measures to protect physical assets include:

- Physical security such as locking up, using cameras, safes etc.
- Restrict access to access codes &change computer passwords regularly
- Avoid giving one employee total control over a process
- Having firewalls and protective devises on computer systems
- Recorded an asset in a register on purchase with all relevant details
- For any expensive items, have a staff member responsible for the asset's security & location
- Lock the asset away when not in use
- Stocktake physical assets regularly against your asset register & investigate any missing items
- separate responsibility for ordering, recording & paying for purchases
- For a retail business with a high shrinkage ensure your staff discount is sufficient to ensure staff purchase goods rather than take them
- Keep a list of "portable & attractive" items & include these in the asset stocktake
- Having clear guidelines on personal use of assets

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 & 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 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 & distribution functions.
- If possible, the payroll officer must not calculate their own pay.

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 & it is harder to stay in touch with what is going on at a grass-roots level. Effective controls & 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 sound management information & compliance, or too long & complex?
- Is a double entry bookkeeping system used?
- Who approves journal entries & credits?
- Does the owner understand the form & contents of the financial statements?
- Does the owner use budgets & cash projections?
- Are they compared to actual results?
- Are major discrepancies investigated?
- Are comparative financial statements produced?
- Are the books & records kept up-to-date & 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?

Human Resources

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 manager independent of the payroll or cash functions?
- Are wages, salaries, commission & piece rates approved by you, the owner?
- Is proper authorisation obtained for payroll deductions?
- Is gross pay determined using authorised rates plus:
    - 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 & 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 & competitors. Take time to hire the right person for the job & your style of management, as the costs of hiring

& training can be the equivalent to three months' wages. Unfortunately, people do falsify employment records to get good jobs – 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 & 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 & expectations.
- Keep lines of communication open with employees:
    - Employee resentment success when owner enjoys it without sharing it with employees.
    - Be sensitive to employees' hopes & expectations.
- Don't misplace trust - one person in a small business may bear too much financial responsibility.
- Is annual leave required to be taken regularly?

Staff feedback - Finally, develop a process for staff to report breaches in internal controls & report suspicious behaviour. Staff should feel that it is their responsibility to report such matters as it is their livelihood, as well as yours, that relies upon the financial integrity of the business. Most fraud is detected by staff tipping off the auditors, owners or accountants. You can encourage this culture 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 & 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.

ACTIVITY 2.4.2

CASE STUDIES

A. Wini's parable

After graduating from high school, Wini 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 Wini 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 & Wini 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 Wini had stolen more than $500. When he confronted her, she confessed she had borrowed the money without authorisation. The accountant asked whether Wini knew someone would check her work. "No" she replied "until you walked in here I didn't even know what an audit was."

Questions

1. How did the accountant know that Wini had been taking money?
2. In what ways did the internal control procedure fail?
3. What actions need to be taken to rectify the position?

Answer

1. Dockets/receipts issued on entry to customers were pre-numbered &/or automated, hence out of control of the exit operator, Wini, thereby acted as a control when compared to the cash received.
2. This case highlights two important concepts. Wini really didn't have an opportunity to commit & conceal her theft, she only thought she did it because the owners didn't tell her they were planning to conduct a surprise audit.
3. Corrective actions include:
    a. Require Wini is to repay money & warn or dismiss her. Call police?
    b. Managers must point out to staff the controls & the risks of fraud. Knowledge of this practice will deter people who have the opportunity to commit fraud.

B. Payment twice

Office Supplies Pty. Ltd is a fast growing new business. The owner Inoke signs all cheques & keeps a tight rein on all parts of the business. He believes nothing could get past him! Anita is the accounts payable person, receptionist & office manager all rolled into one. There is 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 & Inoke told Anita to stall them, as there wasn't enough cash in the bank.

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

Questions

1. What did Inoke get wrong & how will he know that suppliers return the difference?
2. Could Anita duplicate an invoice & pocket proceeds? If so, how would she do it?
3. How can Inoke improve his internal controls?

Answer

1. Inoke mad several errors, including:
    a. He took invoices away from office
    b. He signed payments from duplicate invoices
    c. He asked Anita to process invoices he had withheld & signed without reference to previous payments
    d. His system does not appear to cover a check on refunds from customers, anita could endorse over to her account
2. She could take a copy of an invoice for a small amount of money & send it through the system twice & pocket the refund when sent back from the supplier.
3. Inoke must:
    a. Recognize that he is lucky that Anita is honest & that she has an inordinate amount of responsibility in the business
    b. Understand that she is under great pressure to handle all her duties & consequently is not as thorough as she might think she is or would like to be
    c. Retain & pay on original invoice or, if not, check payments to creditor statements on a regular basis
    d. Reconcile creditor records to bank statements