Fitness Pedalers, Inc.
Where are the Controls?

As Mike was busy preparing for Fitness Pedaler’s grand opening, Mary took a day to attend a seminar on accounting and controls for small businesses offered by a local college. The major theme of the day was the importance of having adequate internal controls. Mary learned that a company’s control environment included the organizational structure, the methods used to communicate authority and responsibility, and the forms and procedures used to document transactions. Controls are not only safeguards against fraud and theft but also against “honest” mistakes. Many of the accounting controls are implemented to insure accurate financial reporting.

Some of the types of problems that could occur include:

- **Errors in recording transactions.** Errors are not intentional and should be corrected as soon as they are detected.
- **Fraud.** Fraud results from intentional errors. These errors might be in reporting or manipulation of transactions.

The seminar instructor noted that an effective way of evaluating the design of a control structure was to implement procedures that address the following five questions:

1. **Are controls and operating responsibilities appropriately segregated?**

   A good internal control structure would not give all control over a transaction to a single individual. No financial transaction should be handled by only one person (or only one department) from beginning to end. There are three functions that at a minimum should be handled by different individuals: (1) authorization of transactions, (2) the custody of assets, and (3) the recording and keeping of accounting records. If this were done, then the three individuals would have to collude in order to commit a fraud. For example, a baseball cap manufacturer had a large storeroom containing hundreds of hats ready for shipment. The employee in charge of the storeroom maintained records of the hats on hand. A shortage of a dozen hats developed because another employee acquired an unauthorized key to the storeroom. The employee responsible for the storeroom discovered the discrepancy between the stock on hand and his records. Fearing criticism of his record keeping, he changed the inventory records to agree with the quantities on hand. The thefts continued and large losses were sustained before the shortages were discovered. If the custody of the hats and the record keeping responsibilities had been separated, i.e. the responsibility of two different people, there would have been no opportunity to conceal a shortage by falsifying the records.

2. **Are all transactions being recorded by the accounting system?**

   Whenever business transactions occur, evidence that documents the occurrence of those transactions ought to be generated. For example when products are shipped to customers, an *invoice* (evidence – documentation – that the transaction occurred) should be generated to show what was shipped, the dollar amount owed and the payment terms. When the invoice is paid, it should be marked “paid,” with the date of payment noted, initials of the person handling the closing, and the check number used by the customer (a notation “cash” if no check was used). In our hat business, when a cash sale is made, a notation should be made as to what was sold and what was paid.

3. **Are there adequate physical safeguards to protect resources?**

   Banks use safes and armored cars. Most companies rely on locked doors to protect their inventory. Similarly, blank checks, blank sales forms, check signing machines, and, of course, cash should be physically protected. The handling of such resources should also be divided amongst more than one person.
4. **Has management established an environment for effective control?**

An effective control environment depends on how well management communicates its control policy. Employees will have a tendency to give priority to their operating duties in spite of the serious operating problems that can arise if control duties are not performed with due care and diligence. If management wants employees to carry out their control duties, then expectations must be explicitly communicated to employees and linked to the employee performance evaluation system.

5. **Are there adequate checks and balances?**

The cap manufacturer described above could have imposed other checks and balances to minimize the possibility of inventory losses. For example, the company could have had a numbered inventory requisition document, prepared in duplicate by another department, that authorized the movement of hats to and from the storeroom. Another employee could have been assigned the task of periodically reconciling those requisitions to ensure that there was no unauthorized movement of inventory and to reconcile the amount of inventory in the storeroom.

6. **Has operating efficiency been appropriately considered in the design and the evaluation of controls?**

Employees are more likely to carry out controls that do not inhibit operational efficiency. For example, a company might require that the assistant manager of the purchasing department approve all orders. However, if that manager travels a lot, there will be a large backlog of unprocessed orders. It would make more sense to ask a manager who does not travel but has the requisite knowledge and expertise to approve the orders. When an emphasis on both efficiency and effectiveness is combined with a performance evaluation system that penalizes those who circumvent control responsibilities, an effective control environment can be established.

During one of the breakout sessions during the afternoon, Mary and all the other attendees were asked, for each of the situations described below, to identify the control risks and recommend procedures to mitigate them.

a) Eight months of bank statements sit unopened in a filing cabinet.

b) The employee entrusted with the one set of keys to the safety deposit box containing marketable securities leaves those keys in the top drawer of her desk.

c) One of the two individuals required to sign all checks regularly signs blank checks in order to facilitate disbursements in a more timely fashion.

d) The clerk responsible for dispensing inventory and supplies encourages employees to take whatever they need and to fill out their own order form at the counter.

e) As cash disbursements are made, the cashier numbers the checks as they are issued, discards voided checks, and simply reuses the check number of any checks that have been voided.

f) A company does not use prenumbered sales invoices for over-the-counter sales.

g) The bookkeeper opens the mail, records cash receipts, and then forwards the cash to the cashier for deposit in the bank.

h) Steve works in the storeroom. He maintains the inventory records, counts the inventory, and has unlimited access to the storeroom.
At the end of the seminar, the instructor gave Mary and all the attendees the attached summary of the session.

**Discussion Questions:**

1. Consider the control risks present in the above scenarios and suggest remedies for them.
2. Identify potential areas for control problems in your business. What control procedures could you put in place to mitigate these problems?
Internal Controls for FME Businesses
By William H. Coyle
Associate Professor of Accounting

The key to internal controls is to ensure that all transactions are documented & recorded and all assets are safeguarded. If you have accomplished those two tasks, then your business is in pretty good shape with respect to internal controls.

Regarding documenting transactions, a way to start is to think about the typical types of transactions that will occur in your business. Examples might include:

- Purchases of supplies or raw materials
- Reimbursement of expenses
- Customer sales
- Operating expenses

There are many others examples that could be listed but this list is meant to get you started.

Each department should make a list of all the transactions in which it is involved. For example, the operations department might list inventory transactions. Naturally, a business might add to inventory when purchases are made and might decrease inventory when sales are made. Thus, the operations department should set up a ledger; that is, a way to keep track of these increases and decreases in inventory. This can readily be done using an Excel spreadsheet. You should then consider the documentation that would be associated with these transactions. A shipping document or invoice from the supplier should accompany all receipts of inventory. If inventory is moved out of a warehouse location to salespeople who will then sell it, paperwork must document that movement. For example, in a T-shirt Company, a document might show that salesperson Jones requisitioned 10 t-shirts on Feb. 15th. All documentation should be kept in files separated by type of transaction. So, the above-mentioned operations department would keep files containing invoices, shipping documents, and inventory requisitions.

With regard to safeguarding assets, the asset most in need of safeguarding is cash. Each department must identify the cash flows in which it is involved. How is the cash collected and how is the cash disbursed? The primary concern is to stop someone from collecting cash from customers and keeping the cash for him or herself. The other major concern is whether or not someone can disburse cash to him or herself. Therefore, internal controls need to be in place to protect the cash from being diverted from the business.

One effective means of internal control is to separate the person handling the cash from the person responsible for recording cash receipts and disbursements. For example, salesperson Jones returns to the accounting department after an evening selling t-shirts and states that she has sold 5 t-shirts. The accounting department employee should expect to receive the cash from those sales (5 shirts x selling price) and copies of 5 sales receipts. The controller would note the receipt of both, place the cash in a lockbox and file the copies of the sales receipts. At some point, sales receipts would have to be reconciled with inventory requisitions to make sure that unsold inventory does not remain in salespeople’s hands. Note that a cash register is ideal for recording cash receipts if the business has a single retail location. All cash receipts should be deposited in the business’s bank account daily. This procedure prevents unauthorized withdrawals.

On the cash disbursement side, all disbursements should be made via check. When a check is written, it should be supported by documentation. For example, if the operations department of the T-shirt Company receives an invoice from its supplier, a copy of this invoice should be forwarded to
the accounting department along with explanatory documentation. The accounting department would issue a check to the supplier, paying the invoice. There should be a very limited number of people authorized to sign checks.

Most businesses need to make small purchases fairly frequently. For example, the marketing department may need to make copies of flyers. Such expenditures can be handled through a petty cash system. The accounting department should keep a small amount of cash on hand in the lockbox for just such needs. It can issue cash for such purchases (or to reimburse employees if they use their own cash) as long as documentation is provided (receipts).

Of course, each business is unique. However, the general guidelines for effective internal controls are flexible enough to be applied in virtually all circumstances. Remember that the key is to have adequate documentation and recordkeeping of all transactions and to safeguard the business’ assets, especially cash.