

PROTECTING YOUR BUSINESS

**HOW INTERNAL
CONTROLS CAN
IMPROVE YOUR
BUSINESS AND
SAFEGUARD
ASSETS**

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ABOUT CURRIE & MCLAIN

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OBJECTIVES AND GOALS OF TODAY'S PRESENTATION

- Provide a framework to understand how organizational assets can be misappropriated
- Evaluate several types of fraud and how they could have been detected earlier or avoided altogether
- Identify effective internal controls for small companies
- Understand when it may be time to call in experts

INTERESTING FACTS

- White collar crime was first defined in 1939 but has been around for millennia
- Estimated that 28% of small businesses suffer some form of fraud
- Estimated losses are about \$500 BILLION per year
- 58% of affected businesses do not recover anything
- Typically committed by people in trusted positions
- Most business fraud goes undetected and unreported

- Source Wikipedia, acfe.com

INTERNAL CONTROLS

- A system or plan of accounting and financial organization within a business comprising all the methods and measures necessary for safeguarding its assets, checking the accuracy of its accounting data or otherwise substantiating its financial statements, and policing previously adopted rules, procedures, and policies as to compliance and effectiveness. *Merriam-Webster*
- It does not require lots of people or positions. It requires
- A system or Plan
- To identify all the methods and measures
- Necessary for safeguarding assets
- The Key:
- Strong ethical behavior from the top
- Do not act like a small business

A SAD STORY

- Mike started a cabinetry business in 2000. At first it was him doing the work and making sales. His wife handled the bookkeeping. Every year was the same thing: books were in disarray, there were no supporting schedules, QuickBooks constantly changed. The wife tried but finally by 2002 she'd had enough and he asked his accounting firm to help him hire a bookkeeper.
- Mike basically told the bookkeeper (Adam) to fix it and make it work. Mike gave him total control. By this time there were 8 employees. Everything appeared to be humming along.
- In 2004, Adam came in and asked for a raise. Mike said no. It is important to note – Mike's take home went from \$3,000 per month to almost \$10,000 per month since hiring Adam.
- In 2006, Adam was forced to resign. The CPA firm, while performing a review of the financial statements to support a line of credit, discovered that A/R was overstated by almost \$200,000. Mike refused to press charges.
- Mike's response to the entire event could be summed up as "I abdicated responsibility and he took advantage of me."
- Go figure

THEFT OF CASH

- Business Owner (Sarah) hires a bookkeeper (Bob). Sarah is frequently out of town so puts Bob on as an authorized signer. Bob also gets the mail and reconciles the bank statements. Bob works for Sarah for 3 years when Sarah gets a call from a vendor asking why they haven't been paid. Sarah asks Bob to look into it and forgets about it. A few weeks later Bob quits and Sarah hires a new bookkeeper. The new bookkeeper discovers that Bob had written close to \$100,000 worth of checks to himself.
- **What would you have been done differently?**
- Check signing authority should not be given to the bookkeeper
- Sarah should have reviewed the bank reconciliations
- Sarah should have either opened the bank statements on receipt or logged into the online account to review the statement

THEFT OF CASH

- Bill had a successful small manufacturing firm with 9 employees, including a bookkeeper. Bookkeeper did the invoicing in QuickBooks, handled the deposits and wrote checks but only Bill could sign. Bill reviewed the bank reconciliation report and ran a P&L monthly to verify his profit margins. Bill gets a phone call from a customer who asks if everything is alright because he hadn't seen a credit for some returned items. For the first time in 6 years Bill runs an Accounts Receivable ageing report to see if the credit memo was posted. It did not make any sense to him so he asked his bookkeeper to explain why customers had odd balances. The bookkeeper did not come to work the next day. Bill had his accounting firm look into it and discovered almost \$100,000 of missing deposits.
- What would you have done differently?
- Review the A/R ageing reports monthly.
- Personally follow-up with those over 30 days.
- Don't only focus on profit margins, look at your assets and liabilities as well.
- Have someone else do the bank deposit
- Have someone else do the invoicing

THEFT OF CASH

- Steve, an estimator for a construction company, was paid commission. The commission formula was very simple: 10% of gross profits on projects he bid. Adam, the construction company owner, kept his books in QuickBooks. He and his wife shared the accounting duties. Fewer than 25% of the projects they did had any form of job costing performed. Steve kept his own record of project revenues and costs and used these for the basis of commission. After filing bankruptcy, Adam was informed that he had overpaid Steve by about \$250,000 over 5 years.
- What would you have done differently
- Keep an appropriate accounting system – for a contractor use an effective job cost system
- Use a separate reporting system to verify accuracy of the reports provided
- Do not allow the same person to both initiate a transaction and report on it

THEFT OF CASH

- Sam was a part owner (25%) of a construction company. Sam gave all his employees a company credit card to help them be more efficient while working out of town. Sam refused to turn in an expense report and instead relied upon the bookkeeper to reconcile his (and everyone else's) credit card purchases. Needless to say, there were about 1,500 credit card transactions a month and only about 10% of purchases actually had receipts. The bookkeeper eventually gave up trying to keep it straight. During an IRS audit, it was discovered that Sam and 3 other employees had purchased close to \$1.0 Million of personal items on the Company card. This included cash withdrawals.
- What would you have done differently
- Make everyone, including owners, prepare their own expense reports
- Make sure that some purchases are examined by someone else to determine accuracy
- Be thoughtful about who has access to company resources and set reasonable limits
- Randomly examine some purchases to verify their accuracy
- Cash advances on credit cards should be forbidden

THEFT OF INVENTORY

- Adam loves shopping for a bargain. He would constantly go out to either Craigslist or E-Bay to look for parts to use in his business. He would brag to employees how much he was saving by buying through those sites instead of the manufacturer or distributor. One day, by accident, he noticed the shipping address on a box of items purchased on E-Bay were from his home town. He asked his bookkeeper to look up the address and she said it was one of the guys in the shop. Over the 3 year period he was employed he had sold about \$25,000 of parts back to the company.
- What would you have done differently
- Take a physical count at least annually
- Don't take short-cuts by buying "grey market" goods
- Require inventory move-reports or Routing sheets to help track inventory

THEFT OF INVENTORY

- Small coffee business with 4 locations was seeing increased traffic but profit margins were not improving. The margins for each store was evaluated and the margins were evaluated by shift. The lease profitable locations were all close to high schools and were least profitable during the morning shifts. When the owner worked a shift margins improved but would immediately drop when she was not there. The owner considered closing those stores due to poor performance.
- What would you have done differently
- Question things that don't make sense. Don't wait until a crisis develops
- Where dealing with lots of inventory make sure it is fully accounted for and spot counts are done on occasion
- The business implemented a “cup count” procedure where each shift reported the number of coffee cups at the beginning and end of their shifts and the store with the most accurate count would see a bonus of \$300 per employee. Margins went up 50% in one month at those troubled locations.

COMMON CONTROLS OVER CASH

- Authorized signer for bank accounts is not the bookkeeper or controller.
- Do not pre-sign checks
- Bank deposits should not be made by the bookkeeper or person collecting the money
- Do not sign checks to pay vendors without reviewing all the documentation
- Those with purchase and contract authority should not approve the vendor invoice or receipt of goods
- Any journal entry to the bank account should be reviewed
- Bank reconciliations should be prepared by someone other than the bookkeeper.
- If that is not possible, bank reconciliation should be reviewed by someone other than the bookkeeper.
- Randomly log into the online banking portal and review checks and deposits
- Set up a lock box with your bank for all deposits
- Set up paying by ACH/EFT and set authorization to finalize the transaction with someone other than the bookkeeper

COMMON CONTROLS OVER A/R

- Person invoicing sales should be separate from the person collecting and depositing funds
- All accounts receivable adjustments should be approved
- Review A/R ageing monthly and personally follow-up with the most significant balances
- Set up a lock box for payments
- Use a deposit pick-up service

COMMON CONTROLS OVER INVENTORY

- Know your inventory
- Person ordering goods should not be the person using the goods or responsible for warehousing or bookkeeper
- Set a policy of all items being recorded in inventory
- Buy only from approved vendor/supplier lists
- Review the inventory report monthly and have certain items counted to verify accuracy
- Establish cycle counting procedures or conduct a full count at least once a year
- Have someone other than the bookkeeper randomly verify prices
- Use a Kanban system to manage inventory

COMMON CONTROLS OVER EQUIPMENT

- Record serial numbers, purchase price, date of purchase and expected life of all assets purchased
- Once a year verify that the assets on the list still exist
- Require a sale/scrap report for any equipment taken out of service
- Require approval of purchases over a certain dollar amount. Track purchases by requesting employee
- Review the purchase request list to ensure that it is not excessive

COMMON FINANCIAL STATEMENT CONTROLS

- Review your full financial statements monthly.
- Compare actual gross profit to expected. Follow-up if it doesn't feel right
- Compare your accounts receivable to sales. It should be less than your standard terms. Follow-up as necessary.
- Compare your inventory to cost of goods sold. It should be reasonable for your industry and business needs.
- Review the detail of the plant and equipment accounts. Ask to see the purchase documents for new assets.
- Do your other asset accounts look reasonable? If you are unsure, review the detail of the account.
- Review your accounts payable ageing report. Follow up with any that are past due.

COMPREHENSIVE EXAMPLE

	12/31/20XX	Current Balance
Bank Account	6,500	2,500
Accounts Receivable	110,000	125,000
Inventory	105,000	90,000
Total Current Assets	221,500	217,500

Any past due?

Property Plant & Equipment

Leasehold Improvements	50,000	50,000
Shop Equipment	240,000	250,000
Office Equipment	25,000	25,000
Accumulated Depreciation	(45,000)	(50,000)
Total Property Plant & Equipment	270,000	275,000

Really bought?

Total Assets	491,500	492,500
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Accounts Payable	76,000	80,000
Line of Credit	98,000	50,000
Accrued Payroll	12,000	12,000
Accrued Payroll Taxes	2,000	2,000
Total Current Liabilities	188,000	144,000

Agree to stmt?

Long-Term Debt

Bank Loans	130,000	125,000
Shareholder Loans	50,000	50,000
Total Long-Term Debt	180,000	175,000

Common Stock	10,000	10,000
Retained Earnings	28,500	113,500
Current Year Earnings	85,000	50,000
Total Equity	123,500	173,500

Total Liabilities and Equity	491,500	492,500
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COMPREHENSIVE EXAMPLE

For Prior Year and the 3 months Ended March 31, 20XX

	Prior Year	3 months
Revenues	1,350,000	420,400
Cost of Goods Sold		
Materials	550,000	160,000
Labor	385,000	110,000
Total Cost of Goods Sold	935,000	270,000
Gross Profit	415,000	150,400
Overhead		
Marketing	40,000	12,000
Facility	128,000	40,000
Labor	117,000	37,500
General	40,000	10,000
Total Overhead	325,000	99,500
Interest Expense	4,500	900
Net Profit	85,500	50,000

Ratios

Days Sales in A/R	30.7	33.6
Days of Inventory	68.7	50.6
Days to Pay A/P	52.4	20.0
Gross Profit %	30.74%	35.78%
Net Profit %	6%	12%

Bank Balance **1,500**

Outstanding Deposits
 6/1/PY 5,000
 3/6/XX 1,800

Total Outstanding deposits **6,800**

Outstanding Checks
 2/22/XX #1499 5,000
 3/22/XX #1567 225
 3/24/XX #1569 350
 3/29/XX #1572 225

Total Outstanding Checks **5,800**

Reconciled Balance **2,500**

Balance per GL **2,500**

Why?

Why?

Does it
balance?

IN CONCLUSION

- White collar crime – fraud and theft – exist
- Effective plans can substantially reduce the risk of loss
- When in doubt, have someone else do part of the work
- Review your financial statements and ask questions when things don't make sense
- DO NOT rely upon your accountant catching things that might be wrong
- Not even an audit is going to catch all fraud or theft of assets
- Tax return engagements will likely never discover something happening
- Consider engaging your accountant to do special procedures to test your internal control program

THANK YOU FOR ATTENDING

- Questions?
- Additional Resources
- Feel free to contact me at johncaughell@currie-mclain.com
- Or by Skype [johncaughell@currie-mclain.com](https://www.skype.com/people/johncaughell@currie-mclain.com)
- PDF of this slideshow is available upon request and will also be posted at
- www.linkedin.com/in/johncaughellcpa

Our May Lunch and Learn is “Start-ups and Crowdfunding” If you are or know a business owner, controller, or advisor consider coming to learn more about the pro’s and con’s of using crowdfunding sources to expand your business.

may 17, 2017 11:30-1:30.

Also, a repeat of last month’s Lunch and Learn is being held in downtown Portland April 25, 2017