

PKF PERSPECTIVES

Best Practices: Internal Controls

When things are going well for a business, ownership and management could possibly have a false sense of well-being and become somewhat complacent. It is especially at these times when fraudulent activity could easily be hidden.

Although only public companies are subject to Section 404 (Management Assessment of Internal Controls) of the Sarbanes-Oxley Act of 2002, we believe it is prudent for all businesses to periodically step back and take a look at the controls in place to safeguard their assets and to ensure the accuracy and reliability of their financial reporting.

A business may engage independent auditors to specifically perform such a review of their internal controls and make recommendations if need be. During the course of an annual financial audit, independent auditors may test certain internal controls and bring apparent weaknesses to the attention of their client. Neither an internal control review, nor an annual audit, can absolutely guarantee that improprieties have not or will not be detected. Unfortunately, fraud can take place in any business at any time.

The following are some policies, procedures and practices which you may wish to consider when assessing internal controls in your business and their impact on fraud deterrence. They are by no means exhaustive.

Segregation of Duties

There are some job duties that are not compatible and do not ensure the integrity of the financial transaction. Ideally, different people should perform tasks related to elements of: accounts receivable, payroll, purchasing, accounts payable, financial reporting, etc.

For example, in the case of accounts receivable:

- The person generating an invoice should not be the same person to whom payment is directed.

- The person receiving and listing checks and cash on behalf of the company should not be a member of the accounting or finance department.
- A different person should prepare and make the bank deposit for such receipts.
- The person who lists the checks should be given the deposit receipt and compare it against the listing of checks and cash.

In the case of payroll:

- The person approving payroll should not be the same person preparing the payroll information for processing.
- The person receiving and distributing the pay checks should not be the same person who either approved the payroll or prepared the payroll input.

In the case of purchasing:

- All purchases should be made by Purchase Order with the purchasing agent's signed approval and documentation as to competitive bidding where warranted.
- A copy of the approved Purchase Order should be held by the accounts payable department and by the receiving department.
- When all material is received, the receipt copy of the Purchase Order should be sent by the receiving department to accounts payable.

In the case of accounts payable:

- The person who prepares the bank reconciliation should not be the person who processes the accounts payable, nor who signs the checks, nor who has access to a signature plate, nor who is authorized to add a vendor to the list of approved vendors, nor who mails the checks.

- The person who processes the accounts payable should not be authorized to add a vendor to the list of approved vendors.

In the case of financial reporting:

- A thorough review of financial statements should be made periodically by management, owners, board members or responsible individuals who are not part of the financial reporting process.
- The recording of journal entries outside the normal accounting process should be limited and should require approval by a responsible individual who does not have access to the original recording of financial transactions.

A mechanism for reporting any irregularities should be in place. There should be written procedures and any exceptions should be documented.

Compensating Controls

Not all businesses are able to support the number of qualified employees necessary to ensure that all phases of financial transactions are conducted by different individuals so that there are checks in-place to routinely uncover errors or wrong doing.

Therefore, to mitigate any areas where controls may be weak, consider:

- Hand signature of all checks by an officer of the corporation.
- Timely preparation of bank reconciliations which are then reviewed by an officer of the corporation.
- Requiring two sign-offs to add a person to the payroll or a vendor to the approved list of vendors or to wire funds: an officer and a member of management .
- Mandatory vacations for employees performing key control functions.
- Regularly sweep excess cash into investment or savings accounts where misappropriation is less likely.

You, with recommendations from your independent auditors, will be able to institute other compensating controls based on your knowledge of your business.

Other Safeguards

- Cash, blank checks, negotiable instruments and other important documents should be maintained in a fireproof cabinet under lock and key with limited access.
- Computer passwords should be maintained and access to sensitive information limited and monitored.
- Family connections and friendships can invalidate controls which are in place.
- Background checks should be done on all new employees with access to corporate assets.
- Treat employees fairly.

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Rather fail with honor than succeed by fraud.

Sophocles
BC 495-406, Greek Tragic Poet

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