

# BUSINESS SENSE

Next Level Tools for Entrepreneurs & Small Business Owners

## FINANCIAL LITERACY SERIES

### Purpose of Internal Controls

#### Why is this important?

A business establishes internal controls, or financial procedures and processes, as a measure against wrongdoing and as a tool to promote accountability, protect the company's interests and ensure the integrity of financial data. Strong internal controls can improve operational effectiveness and efficiencies while also ensuring accurate financial reporting during internal or external audits. It's important to remember that internal controls are unique to every business and designed according to the company's size and structure. Internal controls not only address risks to the company but also reduce incurrences of unnecessary cost or effort that wastes resources of any type.



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#### Internal Controls

Internal Controls may seem to some like a "corporate," not an entrepreneurial or small business thing. The truth is that Internal Control is essential in any business at any level. The complexity may be different, but the existence of controls is relevant no matter the size of your business.

In a nutshell, the primary purpose of internal controls is to minimize risks and protect assets, ensure the accuracy of records, promote operational efficiency, and encourage adherence to company policies, rules and laws governing the conduct of business.

#### *What are some typical examples of internal controls?*

**1. Separation of Duties** - Even in a small business it is important to divide accounting responsibilities between different people to reduce the risk of error and fraud as a basic control system. The person who prepares payroll checks should not sign payroll checks. The person who prepares financial reports does not

make cash deposits and/or purchases. In a small company where there are not enough people to adequately separate duties, a second person should review a transaction or posting as a form of check and balance to minimize risk.

**2. Access Control** - This is essentially who gets keys to the building, has access to different levels of accounting and/or Enterprise Resource Planning (ERP) software, has a credit card, as well as the locking file cabinets or closets for sensitive information and/or valuable raw materials or inventory. At a start-up or small business, these access controls may feel onerous when your culture is formed on trust and mutual respect. Access control is not about trust, but rather about disciplined business practices that maintain the value of your company.

**3. Required Approvals** - This relates to designating certain employees (preferably a manager or supervisor) who can authorize transactions daily or when you are away. Authorizations may be required for purchases above a certain dollar amount, or any expenditure.



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**4. Asset Audits** - Periodically auditing inventory levels is useful to make sure you have the raw materials and finished goods inventory needed for daily operation, and controls theft. Auditing petty cash or collections is also an important business practice, and demonstrates the importance of accuracy, diligence and rigor to all employees.

**5. Standardized Documentation** - If you have the same form for expense reimbursements, mileage reimbursements, invoices, purchasing, etc., it will be easier to track and understand exactly where the money goes. Standardizing forms and practices will help improve your overall operational efficiency, and enable your bookkeeper, accountant, or CPA to properly categorize expenses when creating your cost of good, and expense categories.

**6. Trial Balances** - Most accounting software allows for the creation of a trial balance. This simple accounting control makes an internal record of all debits and credits, and may help your bookkeeper or accountant identify errors or mis-categorized items in a timely manner

when the transaction is more easily recalled.

**7. Reconciliations** - Balancing your checking account, reconciling credit card charges, and properly classifying charges to the appropriate expense categories, and performing three-way matching are all examples of internal controls.

Three-way matching is simply taking the purchase order (or the decision to purchase), the invoice and receipt, and matching it to the product when it is received. Prior to online ordering this was a more structured process. Now when ordering from a variety of online vendors there isn't always the classic purchase order trail. For example, if you log on to Amazon and place an order you have essentially completed a purchase order and paid for it at the same time. However, if the ordered item doesn't get shipped or is delayed you may not realize it and order another. Three-way matching will avoid this.

**8. Data Back-Ups** - While you may choose not to back up your personal computer, it is essential that you back-up your business computers and accounting system. Technology does fail, fires do

happen. Backing up all computer files on a regular basis to the cloud ensures that you have a copy. Backing up your data should be done daily. Some companies choose to also back-up to an external hard drive that is stored off site on a weekly basis for added insurance.

None of these internal controls will matter unless you and your employees are prepared to act when you notice a problem or detect suspicious activity. Everyone should know who they can talk to when they suspect an error or malicious activity has occurred. While difficult in a small business, every effort to assure anonymity should be made.

When an error has occurred, the error may not be the only problem; it may be an indication that more training is needed. The important thing is that your internal controls caught the error. When malicious activity has taken place, you will have a decision to make on whether to terminate the employee. Every circumstance is different, but one thing is generally true ... the quicker you decide the better not only for the employee but for your business and the rest of your employees.

Business Sense is a no-fluff source of information that gets right to the heart of what small business owners need: essential tools and informational resources to help their businesses grow. Written by our team of business coaches, this series shares their decades of experience in areas such as financials, operations, sales and marketing, human resources, leadership, and governance. Business Sense is designed to provide entrepreneurs and small business owners in various sectors, including agriculture, forestry, waste management, renewable energy, and environmental technology, with recommendations and practical advice to help their businesses not only survive but thrive.

Our business management coaching and Business Sense Resource Guide are designed to accelerate the growth of the enterprises we work with and expand the leadership capacity of the entrepreneurs who own and manage these businesses.

### Let Us Help You and Your Business

The Vermont Sustainable Jobs Fund provides tailored business management coaching, entrepreneurial support, and training to position Vermont-based entrepreneurs and small business owners in our designated market sectors for growth and long-term success. We partner with state government, private sector businesses and nonprofit organizations to build a thriving economic, social and ecological future for Vermont. Learn more at [VSJF.org](https://www.vsjf.org)



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*Accelerating Sustainable Economic Development*

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