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Internal Control As It Relates To Small Business

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There is a delightful play now being shown on Broadway titled *How to Succeed in Business Without Really Trying.* I heartily recommend this play to you should you be in New York and should you be able to get tickets to it.

The play opens with the hero, center stage, reading from a book, following which he says fervently, "I can! I can! I can!" As the play develops it becomes clear that what he is saying is really, "I can succeed in business! I can succeed in business! I can succeed in business!"

Small business, like the lead in the Broadway play, can also say, "I can succeed in business! I can succeed in business!" Admittedly, this takes a lot of doing, for the mortality rate in small business is quite large. Now, small business is variously defined. The Small Business Administration has a definition that runs as follows:

> ...a wholesaler with annual sales of less than $5,000,000; a retailer, or dealer in service, with a volume of less than $1,000,000; a construction company whose annual receipts for the preceding three years have been less than $5,000,000; a manufacturer with 250 or fewer employees. Manufacturers with between 250 and 1,000 employees may be classed as large or small depending on the type of activity.

There are today somewhere between 4.5 and 5.0 million separate entities now engaged in conducting business on the American scene. Of these, between 95 per cent and 98 per cent are small as measured by the SBA's standards. The SBA estimates that small business accounts for at least 35 per cent of the total dollar volume of sales. Studies by Dun & Bradstreet bear out the general accuracy of this estimate.

Each new year brings a net increase of 50,000 or more units to the business population, the vast majority of which are small. An estimated increase during the next twenty years of a million new, mostly small, businesses seems a conservative estimate.

Strangely enough, the number of small business per dollar of gross national product has followed a very constant trend. I say strangely enough, since with the many mergers that have taken place in recent years one might think that the bigger business units are getting bigger and that the smaller business units are getting smaller —or disappearing entirely.

It is true that World War II disrupted the normal balance of the market enjoyed by small businesses as their individual owners went to war. In the post-war economy, however, the trend line returned to its normal place and has remained there.

Accordingly it appears that small business is here to stay.

Success for the individual small-business enterprise, however, is far from assured. Unfortunately, the mortality rate is quite high. During the four-year period from January 1, 1955 to December 31, 1958 the SBA estimates that about 1,650,000 business concerns started business and about 1,350,000 business concerns went out of business. In other words, for each 100 new businesses formed during this period approximately 82 ceased business.

This is most unfortunate as every failure weakens our economy to some extent. While in a competitive economy weaker units will continue to fall by the wayside it does seem that our national purposes would be better served if ways could be found of assisting small businesses to be more successful.

Several years ago the University of Pittsburgh made a very interesting study in which they compared a number of small businesses that had been successful with an equal number of small businesses that had failed. This study was published by the University of Pittsburgh Press under the title *Success and Failure in Small Manufacturing.* This study was in considerable depth and must have required a great deal of time in investigation and probing inquiry, searching for the reasons for success or failure.

As might be suspected, there are a number of reasons why the small businesses included in this study failed. Some of the more obvious reasons are lack of production skill, lack of an effective selling program, and lack of capital. However, there was one interesting fact of overriding significance disclosed by this study. This was that in *all* cases in which business failed there was a concurrent *absence* of effective accounting records.

I think this conclusion is of far more than passing interest. What this conclusion says is that business cannot succeed unless it is supplied with reliable financial data indicating where it has been, where it is now, and—desirably—where it is going. Good accounting records *are* necessary for success. I do not think I would be overstating the case to say that they are nearly indispensable.

I stress this point because to the uninformed, accounting is sometimes viewed as a burdensome overhead cost, a necessary evil; the implication is that accounting really doesn't contribute to the financial well-being of the company. The University of Pittsburgh study refutes this. In our competitive, free-enterprise system a business without effective accounting records has about as much chance of success as a prize-fighter would have entering the ring with a blindfold placed over his eyes.

So be not apologetic in stressing with small business the vital and indispensable rôle of good accounting records; I say small business both because that is our concern here today and because larger business better appreciates this fact anyway.

In connection with some work I am doing on the Long-Range Objectives Committee of the American Institute of Certified Public Accountants our Committee had occasion to spend a day with Dr. Ezra Solomon, a nationally known and nationally respected economist. We were exploring with him the impact of economic factors on the public accounting profession. In connection with our discussion Dr. Solomon made the statement that in his view the principal objective of business is maximization of long-run profit (Dr. Solomon prefers the expression *wealth* rather than *profit* but for our purpose today I think the expression *profit* may be better understood).

Strictly interpreted this means that business has no direct concern for social or any other non-economic objectives. To illustrate, if a business should be able to develop a new process by which it could create X output of gross national product with only two laborers, it should do so even if that should mean the disemployment of sixty million people.

Does this mean that business has no concern for social matters, that the disemployment of sixty million people is unimportant? Not at all!

In the first place, concern over social matters may well contribute to the long-run profit maximization of the business entity; and by and large, business entities have proven to be "good citizens" while at the same time striving to maximize their profit.

In the second place—and fundamentally more important—concentration by the business entity on profit maximization as its full direct responsibility is merely recognition of the respective rôles that should be played by business entities, by government, and by other entities.

Now if long-run maximization of profit is the principal objective of business then it follows that accounting records and the accounting system must be consistent with this test. This is to say that the accounting records and the accounting system must assist the enterprise in maximizing its profit. If the accounting records are inadequate and insufficient they fail to contribute their part to the profit maximization and, conversely, if the accounting records are too extensive and too costly they are equally subject to criticism because they equally impede achievement of the main objective.

The degree and effectiveness of internal control for small business, which is our main interest today, therefore should be considered in the light of this overriding principal purpose of business.

DEFINITION OF INTERNAL CONTROL

This seems like a good place to define internal control. The American Institute of Certified Public Accountants offers the following:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Such a system might include budgetary control, standard costs, periodic operating reports, statistical analyses and the dissemination thereof, a training program designed to aid personnel in meeting their responsibilities, and an internal audit staff to provide additional assurance to management as to the adequacy of its outlined procedures and the extent to which they are being effectively carried out. It properly comprehends activities in other fields as, for example, time and motion studies which are of an engineering nature, and use of quality controls through a system of inspection which fundamentally is a production function.

Montgomery's book on auditing makes a distinction between what is termed internal accounting control and internal check. This distinction may be useful in our discussion today.

Internal accounting control is defined by Montgomery as *controls which 'check the accuracy and reliability of accounting data' or controls which are designed to bring about accurate and suitable recording and summarization of authorized financial transactions.*

Internal check is defined by Montgomery as consisting of those accounting procedures or statistical, fiscal or other controls that safeguard assets against defalcations or other similar irregularities.

There is another definition, of a sort, of the function of internal control that I rather like which is that effective internal control represents the *quality control* contribution of the accounting system.

Now, we all recognize that in order for business to succeed it must produce a quality product or service at a competitive price. In order to make a quality product business must give attention to quality control of its production processes. In a large business this may be a highly formalized checking procedure. In a small business the quality control may be exercised by the owner-manager; but however done and by whomever done, quality control is an essential ingredient of a successful business, large or small. Viewed in this light the contribution of the accounting function is quality control of the financial data generated by the business. If properly designed and utilized, such control can enable the business better to realize its principal purpose of profit maximization.

I appreciate that all the foregoing is a rather general approach to the consideration of internal control as it affects small business. So now let us consider some of the specifics.

EFFECTIVE INTERNAL CONTROL

Fundamentally, of course, in establishing effective internal control we seek to have an adequate division of duties among the personnel. Essentially this means a division of duties among the personnel so that (a) no one person has complete control over any vital part of the operations, and (b) the work performed by any individual operates to check the work of other individuals. Obviously, the smaller the business entity the less feasible it becomes to have an adequate division of duties among employees. Therefore the owner-manager of the small business may become the key figure in the internal control system. He may have to be to his own business what the combined forces of the internal audit department, the controller, the treasurer, the president and the board of directors are to the large business. However, because of the owner-manager's intimate knowledge of the business, and because of his financial interest in the well-being of the business, he can be an effective internal-control mechanism.

Following are some suggestions that may be useful to small businesses in better control over their operations.

PHYSICAL LAYOUT

This may sound like a strange place to start, yet an orderly layout of the physical facilities can contribute to improved controls. An orderly flow of raw materials from the receiving dock through the stockroom, or other appropriate physical area, through production, inspection, and shipment, can contribute to better controls, both physical and accounting.

An orderly flow of work through the office also contributes to better controls.

Conversely, an operation that is physically disorganized, and slovenly in its housekeeping, is not apt to achieve effective, efficient controls. Pride in the personal appearance of a business really can contribute to better controls.

CASH

It is a good idea to create an imprest fund from which small disbursements may be made. With this device it is usually practicable, and highly advisable, to deposit all incoming receipts intact.

It is fundamental in the control of cash receipts that the accountability for incoming cash be established at as early a point in the procedure as possible.

Following this thought through, it may well be that the owner-manager should see the cash collections that come in daily in the mail. He may either do this himself or have his secretary do it. Such a simple device as running an adding-machine tape of the collections before they are turned over to other personnel for formal recordation and deposit can be an effective device. The important thing here is to make a record of the incoming cash as early in the procedure as possible. Such a record once made should be checked against the cash book to ascertain that the deposit has, in fact, been made.

Assuming that we have established adequate control over incoming cash, we should, of course, give consideration to the adequacy of control over outgoing cash, namely, over cash disbursements. This is not too difficult to do, for the owner-manager in a small business probably signs the checks himself. Double-signature checks are, of course, a common device used to assist in control of cash disbursements.

The use of purchase orders for materials or merchandise and the requirement for approval of the purchase orders by the owner-manager also assist in the control of cash disbursements.

Monthly reconcilements of bank accounts is, of course, in itself a good internal-control device. In the concept of separation of duties such reconcilements should desirably be made by someone who has had no part in the receipt, deposit, or recordation of the cash. In some cases it is feasible for the owner-manager to make the reconcilements, at least on a test basis.

RECEIVABLES

The owner-manager ought to review the monthly statements to customers prior to mailing and, desirably, should control their mailing.

Any accounts written off as uncollectible, or any other credits to accounts receivable other than for cash, should be approved by the owner-manager.

Just as with monthly bank reconcilements, there should, of course, be monthly reconcilements of accounts-receivable controls with underlying details.

INVENTORIES

Effective control of inventories is also a necessary control device for business. The nature and extent of the controls will vary with the type of business and the type of inventory.

Certain types of inventory should be subjected to fairly tight physical controls. This would be especially true if the inventory should be such as to be attractive to employees or any other persons having physical access to the storage area. Obviously, bulky items are less vulnerable and ordinarily do not warrant the same type of physical controls.

The movement of goods, both incoming and outgoing, should be subjected to controls. Prenumbered shipping and receiving documents are quite commonly employed and are useful.

As with bank reconcilements and agreement of accounts receivable controls with details, there should be a periodic ascertainment that the inventories recorded as on hand are actually on hand.

In some types of business it may be feasible, and may be desirable, to take monthly inventories. As a rule, however, inventories are not taken so frequently. Quite possibly quarterly, semi-annual, or even annual inventories may best aid in achievement of the over-all objective of profit maximization.

PROPERTY

The risk of loss of property items is ordinarily less severe than in the case of inventory items. This may not always be true, however, and consideration should be given to the need for physical and accounting control of property items.

Again, balance and judgment are needed as obviously a small portable calculating machine is more vulnerable to loss than a large milling machine anchored to the factory floor.

ACCOUNTING REPORTS

Monthly financial statements should be prepared promptly. Such reports should be reviewed critically by the owner-manager of the small business and should be used as a tool to achieve a better-running business.

Ideally, in my judgment, financial statements should make a comparison with prior-year figures and with budgeted figures for the current year. In addition, if industry statistics are available comparison should be made with them.

You will note I have stated that current operating data should be compared with this year's budget. You will also note that I did *not* say "if such budgets have been prepared."

This is a matter on which I have a fairly strong opinion, which is that no business, large or small, should attempt to operate without having some type of operating plan for an acceptable future period. *Operating plan* is a broad term but it embraces here the budget to which I am making reference.

Incidentally, at the recent Eighth International Congress of Accountants, Mr. F. G. Donner, Chairman of the Board and Chief Executive Officer of General Motors Corporation, who was one of the speakers, said that he spends far more time reviewing financial data prepared for forecast purposes than for historical purposes.

There are, of course, accepted techniques for the proper development of a budget and I would not decry their utilization. However, I feel that the value of a budget for a small business is so great that

I would rather see a small business develop a budget empirically, using short-cut procedures (if that be necessary), than have no budget at all.

Actually, the comparison of current financial data with budgeted figures is an excellent internal-control device. To illustrate, if a company had budgeted $1,000 for sales promotion in a given month and if the operating figures for that month showed that $2,000 had, in fact, been expended, the owner-manager is certainly alerted to the need to satisfy himself as to why the budget had been exceeded.

Again, for sake of emphasis because the matter is so important, if the accounting system is to contribute most effectively to profit maximization, it must produce reliable financial data on a timely basis —hence the need for prompt preparation and review of the financial statements. Fnancial data available only after undue delay simply will not be effective in this respect.

ACCOUNTING MACHINES

There are many good accounting machines on the market today, machines enabling businesses to perform all or a part of the accounting function with greater accuracy and lower cost than non-mechanized methods. Most of these machines have internal-check devices built into them. A review of any accounting system, and of the related controls, obviously should include a review of the adequacy of the accounting machines in use.

PEOPLE

One of the best methods of having a good accounting system and good internal control is to have good people. I think this factor is oftentimes overlooked.

This may be particularly true, I think, for small businesses. Many times a small business may feel that, because it is small, it cannot afford to employ competent personnel. As a consequence of this belief one oftentimes finds employees in small businesses who are substandard either in the skills they possess or in their performance.

I am about persuaded that the need for competent personnel is greater in a small organization than in a large one. The reason is that in the small organization a given person has to perform a greater variety of tasks. Furthermore, there must be enough versatility in the organization so that in the absence of one employee another one can temporarily perform his or her duties. Accordingly, I believe that in the development or review of an accounting system of a small business, greater attention should be given to the matter of personnel than is sometimes done.

CONCLUSION

In conclusion, if small business can develop a good product and can give the time and attention to its quality control, and to the quality control inherent in an effective accounting system, I believe it can say, as the lead in the Broadway play did say, "I can succeed in business! I can succeed in business!"