

Setting Up Internal Controls for Small Businesses

A robust internal control system protects your assets from fraud, ensures accurate financial records, and streamlines operations. Even with a small team, these steps can be scaled to fit your needs.

I. The Implementation Roadmap (Step-by-Step)

1. Establish the "Tone at the Top"

The owner's attitude toward ethics and accuracy dictates the company culture.

- **Action:** Create a written Code of Conduct.
- **Action:** Demonstrate that no one, including the owner, is above the rules (e.g., the owner should also submit receipts for reimbursement).

2. Conduct a Risk Assessment

Identify where your business is most vulnerable.

- **Financial Risk:** Where could cash go missing? (e.g., cash registers, petty cash).
- **Operational Risk:** Where could inventory be stolen or damaged?
- **Compliance Risk:** Are you meeting tax deadlines and payroll regulations?

3. Design Control Activities

Based on the risks identified, create policies to mitigate them. Controls are either **Preventive** (stopping the error before it happens) or **Detective** (finding the error after the fact).

4. Communication and Training

Controls only work if employees understand them.

- **Action:** Document procedures in a Standard Operating Procedure (SOP) manual.
- **Action:** Hold a brief training session to explain *why* these controls exist—not to "watch" employees, but to protect the business and their jobs.

5. Continuous Monitoring

Review your controls regularly to ensure they are still effective as the business grows.

- **Action:** Perform "surprise" counts of inventory or petty cash.
- **Action:** Review bank reconciliations monthly.

II. Essential Control Procedures

1. Segregation of Duties (The "ARC" Principle)

The most critical control. Ensure that no single person handles all three parts of a transaction:

- **Authorization** (Approving the purchase).
- **Recording** (Entering the transaction into accounting software).
- **Custody** (Having physical access to the cash or assets).
- **Small Business Tip:** If you only have one employee, the owner should perform the "Authorization" and "Review" steps.

2. Financial Controls

- **Dual Signatures:** Require two signatures for checks or electronic transfers over a certain amount (e.g., \$1,000).
- **Bank Reconciliations:** The person who records deposits should not be the one who reconciles the bank statement.
- **Direct Statement Delivery:** Have bank statements mailed or emailed directly to the owner unopened.

3. Physical & Digital Security

- **Asset Protection:** Keep high-value inventory in locked areas and use security cameras.
- **Access Controls:** Use unique logins for accounting software. Never share passwords.
- **Backup Data:** Ensure financial records are backed up to the cloud daily.

4. Documentation Standards

- **Standardized Forms:** Use pre-numbered invoices and receipts to ensure every transaction is accounted for.
- **No Receipt, No Reimbursement:** Enforce a strict policy that all expenses must have a corresponding receipt and management approval.

III. The Small Business "Compensating Controls"

If you don't have enough staff to fully segregate duties, use these "compensating" actions:

- **Owner Review:** The owner should personally review the "Audit Trail" report in the accounting software (like QuickBooks) to see if any transactions were deleted or altered.
- **External Review:** Hire an outside CPA to perform a quarterly review of the books.
- **Mandatory Vacations:** Require employees who handle money to take at least five consecutive days of vacation per year. Most fraud is discovered when the person committing it isn't there to hide the trail.