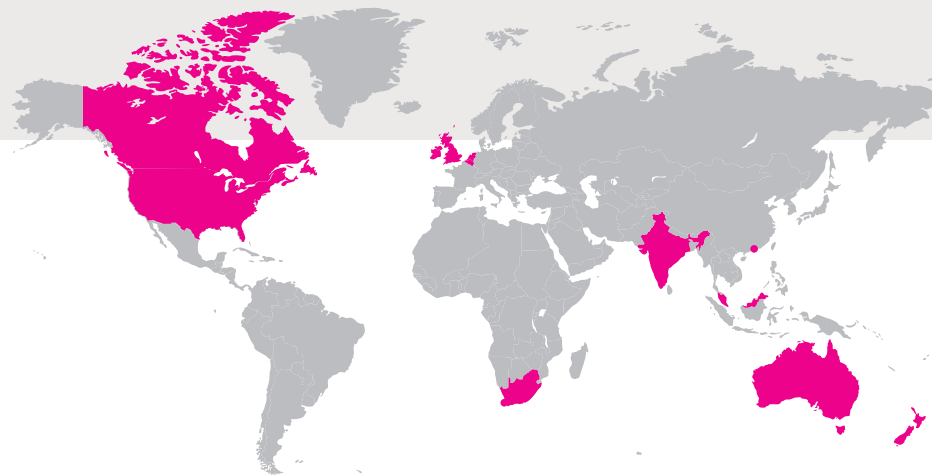




IS EVERYTHING
UNDER CONTROL?

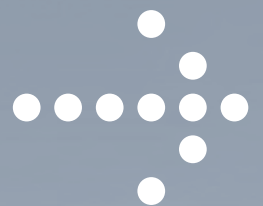
Establish
internal
controls





“Not only has our FD put financial systems and controls in place, they have also saved us a lot of money...”

Karen Howes, Taylor Howes



Executive summary

Internal controls are the procedures and methods used to help companies to achieve their performance and profitability targets and prevent the loss of resources/assets. They are also used to ensure financial reporting is accurate and reliable and that companies are compliant with regulations and laws.

In other words, internal controls can help your company achieves its goals, and limit the internal and external risks and threats you're likely to encounter. Every business will feel the pain of not being in control at some point in the growth cycle and, therefore, implementing internal controls in a measured and methodical manner will become essential at some stage.

It's better to establish internal controls now rather than continuing to trade without them. Not only do they give you more time and freedom but they enable you to manage and control the business rather than allowing the business to control you.

Highlights

- The essential elements of an internal control system
- The benefits of an internal control system
- The main reasons companies don't use internal controls
- How a part-time FD can create internal controls for you



Introduction

Many SME owners mistakenly believe that internal controls are the domain of publicly listed companies or government departments but they are just as critical for small to medium sized businesses too.

Michelle Long, author and financial consultant, says internal controls are necessary for SMEs to reduce the risk of fraud.

“Without any controls or oversight, it is like leaving the door unlocked with the cash register drawer open hoping that no one will steal any money,” she says in a report for Intuit.¹

“Even employees who are honest can be tempted when they see large sums of money right in front of them,” says Long. “This is especially true if the business owner has not implemented any access controls or set up shared control over the company finances.”

“Also, without internal controls, a business owner can never know if their information is complete, accurate, or reliable. Time should be taken to set-up, implement and review a policy of internal controls. Once the policy has been established, management should ensure that the controls are being followed.”

The need to have robust internal controls is highlighted by the case of the Royal Bank of Scotland (RBS), which fell victim to a rogue trader in Hong Kong.

In 2014, the RBS was fined £450,000 by Hong Kong financial regulators after “seriously inadequate” internal systems and controls failed to detect a rogue trader hiding losses worth tens of millions of pounds.²

The Hong Kong Securities and Futures Commission (SFC) fined the bank for “internal control failures” after unauthorised trades were recorded by an employee in its Emerging Markets Rates business.

The employer was found to have hidden losses of £24.4 million over a three-year period by regularly cancelling or amending transactions that had been entered into RBS’s internal trading systems.

A subsequent investigation by the SFC found that RBS’ risk management and internal controls at its bank’s Emerging Markets Rates business were “deficient and failed to prevent misconduct.”

The losses suffered by RBS are small however compared with the staggering £3.6 billion losses announced by French banking group Societe Generale (SocGen) in 2008. There too a rogue trader was found to have hidden enormous trading losses. The Paris-based trader used his “in-depth knowledge” of the bank’s fraud control systems to circumvent internal checks.³

¹ ‘Internal Controls for Small Businesses to Reduce the Risk of Fraud’, Long, CPA, MBA, Michelle L., Intuit, Intuit Inc., 2009

² ‘RBS reprimanded for systems failures following £25m trading losses: Hong Kong regulator fines bank £450,000’, Finnegan, Matthew, Computerworld UK, www.computerworlduk.com, Apr 22, 2014

³ ‘Rogue trader exploits tech knowledge to cost SocGen £3.6bn: Biggest fraud in investment banking history’, Chapman, Siobhan, ComputerWorld UK, www.computerworlduk.com, Jan 25 2008



This was a lone man who built a concealed enterprise within the company, using the tools of Societe Generale, and who had the intelligence to escape all control procedures.

DANIEL BOUTON, FORMER SOGGEN CHAIRMAN

He built up large positions and made unauthorised bets on stock index futures, and as his losses mounted, covered his tracks by using his knowledge of the bank's technology systems.

SocGen's Chairman at the time Daniel Bouton said: "This was a lone man who built a concealed enterprise within the company, using the tools of Societe Generale, and who had the intelligence to escape all control procedures."

It's not enough to create internal controls: they need to be regularly reviewed to ensure they are keeping pace with the company's growth. Pressure to create, develop and innovate means that old systems can quickly become redundant and need rethinking and rebuilding. This is really one of the biggest headaches a business owner faces. Creating products is easy by comparison.

You have probably experienced a shift from knowing every last detail about the inner workings of your business in the early days to losing a lot of control over the processes which allow the business to operate.

In other words, you have become removed from the day to day operating procedures. This means you probably can't see what is going on in the way that you would like to or, at least, you can't see as much as you would like to see. This can manifest in different ways. You might not realise that your customers are not paying since you don't have a system for alerting you to such occurrences. Or you might have several unproductive staff members but don't realise because you don't have the tools or time to do anything about it.

Instead, you are frustrated with your staff because you want them to fix the problem (using their own initiative). They, in turn, are frustrated with you for not providing them with clear job descriptions and responsibilities.

It may be that your cash flow is very poor or you are accumulating surplus stock. It may be that you are always turning up for meetings unprepared because the work it would take to uncover the information you need to run a good meeting would just take too long to collect.

You probably initiate a lot of the activity in the business (creating policies, signing HMRC documentation, sending off legal forms necessary for compliance) but you may not have the systems set up to manage these various projects going forward. This means that your head is full of concerns which rear their head at the very point at which you have the least time to deal with them. Usually, by then the problem has escalated.

All of this leads to a feeling of being disorganised and overwhelmed. If you were able to delegate the work and feel confident that your business had a stable framework, you would feel much happier about redoubling your growth efforts (a lot of business owners we work with hold themselves back because they instinctively know the business lacks the systems and structure to grow in a manageable way).

The essential elements of an internal control system

There are five key elements in a good internal control system:

- **Separation of duties.** Key duties and responsibilities in authorising, processing, recording, and reviewing transactions and events should be separated among individuals. This not only protects employees but prevents and detects both unintentional and intentional errors. It also encourages better job performance.
- **Authorisation.** Every transaction must be authorised and carried out by people acting within the scope of their authority. This will help prevent invalid transactions.
- **Documentation.** Every transaction (event or activity) must be documented. It helps ensure that assets are properly controlled. It also helps to ensure each transaction is accurate and complete.
- **Supervision.** Competent supervision must be provided to ensure the objectives of the internal controls are achieved.
- **Reconciliation.** This ensures the accuracy and validity of your records. It also means that discrepancies can be resolved quickly and that unauthorised changes don't occur.

To be effective, internal controls must be appropriate, must function consistently as planned, and must be cost-effective.

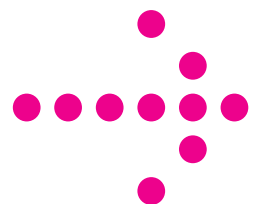
An effective control environment will ensure the following:

- The effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding of assets.

The benefits of an internal control system

Having an internal control system in your organisation will help:

- Prevent errors and irregularities from occurring. If they do occur, they will be detected quickly.
- Ensure that errors that do occur are minimised and resolved quickly
- Safeguard employees by clearly outlining their responsibilities and roles; by providing checks and balances; and from being accused of errors, irregularities, or fraud.



The main reasons companies don't use internal controls

The owners don't realise such controls are necessary

Forensic accounting expert Steve Dawson says placing your faith in people's honesty leaves you vulnerable to fraud.

"Believing you don't need internal controls because you don't have evil people working for you is irrelevant," he says.⁴

"Evil people don't represent the majority of fraud instances: desperate people do. Remember that 95 percent of those I have investigated are truly decent people who rationalize their fraud because of a severe financial crisis. They are able to take advantage of the company simply because their position has weak internal controls."

One of The FD Centre's part-time FD's recalls how one of her clients, was nearly sent to the wall because its CEO had stolen large amounts of money.

"I got involved immediately after they discovered the fraud. In the first 6 months, it was very doubtful whether the business had any future because of all the money which had been stolen. What I was able to do was give the different stakeholders enough confidence to be able to pull together something which secured its long term viability"

“

I immediately called the Revenue to explain who I was, what I was doing, and what I was going to do. I asked them to give me a few weeks to sort something out, during which I'd provide constant feedback to them.

THE FD CENTRE'S PART-TIME FD

"On my first day, we found out that the Inland Revenue were going to wind up the organisation in court because it had a large amount of PAYE which hadn't been paid over a long period".

"I immediately called the Revenue to explain who I was, what I was doing, and what I was going to do. I asked them to give me a few weeks to sort something out, during which I'd provide constant feedback to them".

"The combination of who I was, what I was doing, and how I was going to do it was enough to persuade them to give me some time".

⁴ *Internal Control/Anti-Fraud Program Design for the Small Business: A Guide for Companies NOT Subject to the Sarbanes-Oxley Act*, Dawson, Steve, (Wiley Corporate F&A), April 13, 2015

“The company had another equally large creditor who also wanted to be paid immediately.”

“I put a survival plan together, and luckily there was someone connected to the business who had funds. We persuaded that third party to provide the business with a long-term loan worth several hundred thousand pounds.”

“That allowed us to pay the Revenue, to pay the other creditor and to have some money to go forward so we could try to recover the money that had been stolen.”

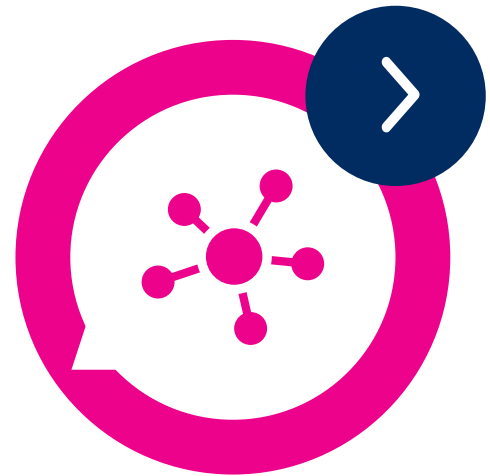
Lack of time

Creating internal controls does take time. The consequences of not investing energy into creating internal controls, however, are likely to be very damaging to the company concerned.

Philip Ratcliffe, an Internal Audit Consultant, says in a serious case the opportunity cost of the time that management will lose in attending to the consequences of an internal control breakdown can be massive.

“Strategic issues, tactical issues, business development – all these and many more normal concerns of senior management will have to take a back seat until the problem is resolved. Add to this the loss of reputation and of confidence, inside and outside the organisation, because news will inevitably leak out however carefully those involved try to prevent it.”⁵

⁵ ‘Engaging Senior Management in Internal Control’, Ratcliffe, Philip, QFinance, www.financepractitioner.com



It's too difficult

Creating internal business controls, which are the systems and frameworks that allow all departments of the business to keep up to speed with changes is plain hard work.

To some extent, this hard work is simply a part of building a fast growing business. That said, a lot of it can also be avoided by understanding business growth cycles and by designing an architecture which means your business is able to grow at a steady pace rather than allowing it periodically to outgrow itself (as you struggle to put out the fires).



Strategic issues, tactical issues, business development – all these and many more normal concerns of senior management will have to take a back seat until the problem is resolved.


PHILIP RATCLIFFE, INTERNAL AUDIT CONSULTANT

How a part-time FD can create internal controls for you

The FD Centre will provide you with a highly experienced senior FD with 'big business experience' for a fraction of the cost of a full-time FD. This means you will have:

- > One of the UK's leading FDs, working with you on a part-time basis
- > A local support team of the highest calibre FDs
- > A national and international collaborative team of the top FDs sharing best practice (the power of hundreds)
- > Access to our national and international network of clients and partners

With all that support and expertise at your fingertips, you will achieve better results, faster. It means you'll have more confidence and clarity when it comes to decision-making. After all, you'll have access to expert help and advice whenever you need it.



With all that support and expertise at your fingertips, you will achieve better results, faster.

In particular, your part-time FD will help you to create the necessary controls framework in your business. He or she will:

- > Explain what 'internal controls' are and how they will benefit the business going forward.
- > Share proposals about the delegation of duties and responsibilities to employees.
- > Build a plan which creates more time for you to devote to your strengths.
- > Work closely with you to suggest the most appropriate role/responsibilities for you to take on.
- > Create systems across the business for managing various procedures.
- > Install systems for monthly control accounts.
- > Establish monthly KPIs (Key Performance Indicators).
- > Establish processes for creating monthly management accounts.
- > Review computer systems and software to ensure that they are robust and will allow for growth in line with the plan.
- > Establish a system for expenditure and associated authorisation/sign-off.
- > Design systems for investment approval.
- > Design systems for new customer approval.
- > Implement control procedures to ensure customers are paying you correctly and on time.
- > Design systems for meetings, including board meetings.
- > Create reports for customer and product profitability analysis.
- > Create a system for cash flow forecasting and monitoring, including early warning system for peaks and troughs.
- > Establish and review budgeting forecasts.
- > Review government grants and incentives regularly.
- > Design a system for receiving quality advice from third parties regarding tax, Human Resources, IT and Health and Safety on a regular basis.
- > Review insurances to ensure best possible cover to limit risk.
- > Establish Human Resource systems.
- > Design and implement relevant Shareholders Agreement.
- > Design and implement credit control procedures.
- > Translate all figures and data in a way which makes sense to you.
- > Ensure brands and IP are protected.
- > Oversee the installation of new systems.



Conclusion

Putting the right systems in place allows you to see the business from a much clearer vantage point. Decisions to grow the business can be made in the knowledge that the underlying model is scalable and robust.

A part-time FD from the FD Centre will work with you to redesign your company's architecture and give you some space to move in. That will allow you to go from working in a job to managing a stable, healthy business.

REAL
IMPACT
BETTER
RESULTS
FASTER
CONFIDENCE
MONEY

Establish internal controls to protect your company now

Without internal controls, your company is vulnerable. A part-time FD can help you to create a strong internal control environment. Book your free one-to-one call with one of our part-time FDs now

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