

LAW OFFICE MANAGEMENT

Internal Controls: Who's Minding Your Store?

by Timothy O'Connell

It is estimated that more than \$600 billion is stolen each year through fraud and theft, sometimes by nice little old ladies you would never suspect of such an act. The following story emphasizes the importance of a good system of internal controls.

A nice grandmother who worked in a small lighting store was a long-time, trusted and valued employee. She handled the store's accounting, bookkeeping and banking, including making deposits, signing checks and reconciling the bank account. In her position, she had many opportunities to steal from her company, but she never took a dime, until one day, after working at the store for over 10 years, she started. Once she started, she found she couldn't stop. She ultimately ended up stealing over \$416,000. Here is how she did it: She would write a company check to herself and record it as voided. The next time she paid a vendor, she would add the amount she stole to the amount she recorded as the vendor payment. Doing this kept the account in balance. When the bank statement would come in with the canceled checks, she would destroy the one she wrote to herself. She was never caught. Eventually, her conscience would not let her continue, and she turned herself in.

The term "internal controls" refers to steps that may be taken to safeguard the assets of a firm and ensure the accuracy of accounting records. The goal is to safeguard the firm's assets from theft and robbery (internal and external), as well as from unauthorized use. The accuracy and reliability of accounting records is improved by reducing the risk of errors and irregularities. Errors are unintentional mistakes and irregularities are intentional misrepresentations.

There are six basic principles of internal control:

- Establishment of responsibility
- Segregation of duties
- Documentation procedures
- Physical, mechanical and electronic controls
- Independent internal verification
- Other controls

Before exploring these principles in detail, it is important to design a system of internal controls with the concept of reason-

able assurance in mind. This means controls should not cost more than the expected benefit. There is no need to hire an additional person (at \$40,000 plus benefits) to check for billing errors if it's estimated that only about \$10,000 in billing errors might be prevented. However, bills over a certain amount should be spot checked to ensure they were proper and complete. This limited review may be done by someone who has other full-time responsibilities. In this way, the cost would be minor and the anticipated benefit could be most of the \$10,000 that would be lost. Each of the following principles should be addressed with the concept of reasonable assurance in mind.

Establishment of Responsibility. This principle requires the assignment of a task to a specific person. What would happen if no one in particular was responsible to make the daily bank deposit, mail the client invoices or lock the door at the end of the day? It is likely that most days someone who knew these things had to be done would do them. It is just as likely that some days these things would not get done, because they are not anyone's responsibility.

Anything that needs to be done should be the responsibility of a specific person. The purpose of this principle is to ensure that each necessary procedure is done, to be able to trace a problem back to the person who made the error or caused the irregularity and to encourage a level of expertise and efficiency in the operation. For example, if the bank deposit was supposed to be prepared by the bookkeeper and brought to the bank by anyone in the administration department who might be going that way, what would happen? Because the task is not someone's specific responsibility, there may be times when the deposit sits around for days because no one is going toward the bank, or the weather is bad, or everyone is busy because of the holidays. What happens when a deposit is lost or stolen? Who was supposed to take it? What happened to it? Where do we even start to look? There is no way of knowing, because it was not someone's responsibility.

Segregation of Duties. The next principle requires that one person should not be responsible for every step of a process. No one should be in the position to authorize, approve and record a transaction. Take the stock room for example. A good system of internal controls would not allow the same person to order supplies, receive the supplies, approve invoices and pay the ven-

B dors. Ideally, one person is responsible for keeping the supply room stocked. When something is required, that person would requisition the item, and another person would place an order with the appropriate vendor. A third person would receive the order and document the quantity received. The order, the receiving documents and vendor invoice would be compared by an unrelated party so the payment can be processed. Payment would be approved by someone unrelated to any of the previous steps, and the bank reconciliation would be prepared by another unrelated party. This process would ensure that items ordered were needed, the correct price was paid to the correct vendor, and that the firm paid for what was received.

The problem with the system described above is that it would take six people to order a box of pencils! So what often happens is that the person who maintains the supplies also orders the supplies, receives the supplies and approves the invoice. In a small firm, there may be few options, but the process should be reviewed in an effort to get to the ideal process. There is usually someone who can be added into the process to ensure there is no one person in a position to initiate, approve and record a transaction. In a smaller organization, that means someone whose full-time responsibility is in one area may be responsible for approving or recording transactions in another area.

Documentation Procedures. This principle usually refers to the system a company uses to document the ordering, receipt and payment of goods or services purchased, and/or the documentation of the purchase and payment for goods or services delivered or rendered. Are the firm's purchases properly documented and approved? Many people may be happy to order things the firm needs, but there may be a reluctance to sign off or approve purchases in any formal way. In our industry, there seems to be a reluctance to approve a specific purchase. Instead of an

"ok to pay" with initials and a date, the person's name may be written on the envelope, which we have come to accept as meaning, "Here's a bill. Pay it."

This is clearly a weakness, because whether the bill is being sent by a person in a position to verify that the goods/services were received and invoiced at the agreed-upon rate, or the bill is being sent because the recipient has no idea of what it is all about and wants you to investigate, the documentation is often the same. Every firm must ask the following question: Are all transactions adequately documented from requisition to payment?

There is probably room for improvement in all firms in this area.

Physical, Mechanical and Electronic Controls. Whether it is a lock on the door, a surveillance system, keeping the petty cash secure at night, passwords on the computer, etc., every company has potential controls. These controls should be evaluated periodically to see if there are any weaknesses.

Some firms provide a wireless Internet connection for their clients. Others provide a wireless Internet connection that is separate from their network. This satisfies the client's need, and provides security for the network. Are the security features available from the online banking software being used to their full ability, or are they circumvented for ease of use? Is the check stock in a locked cabinet or in a box under the printer?

Independent Internal Verification. This principle requires that someone independent of the process review transactions for propriety. Firms should periodically review their records. An employee who is unrelated to the process should review the process, and any discrepancies and exceptions, errors or omissions should be reported to someone in management in a position to take action to fix the problem. Periodic spot checks by someone outside the department can bring to light basic flaws in how things are being done.

Often the questions of an unrelated

party get a professional to look at things in a different way. One does not have to be an expert to call attention to a basic flaw in someone else's process. Don't forget that Noah's ark was built by an amateur, and the Titanic was built by a professional. And even if the person reviewing transactions is not in a position to suggest improvements, just the fact that he or she is going to spot-check transactions will improve the performance of the people processing them.

Other Controls. This catch-all principle usually refers to all the other things that are done to compensate for weaknesses in other areas, or provide a level of confidence and make the other principles work better. For example, a company may perform background checks for new employees, drug screening, hire relatives or friends of the family, require vacations, rotate tasks, or take other steps that will enhance the system of internal control.

Conclusion

These six principles are basic to the system of internal controls for all companies. All industries use them to develop systems to safeguard their assets and improve the accuracy and reliability of their accounting records. Law firms may have developed processes and procedures that are inherently weak in certain areas. This may be because of size, proximity to the attorneys and partners, familiarity within the organization, time restraints, lack of staff, productivity expectations or any number of reasons that prevent the implementation of good control procedures. All that is required is a review of the basics, and the control procedures can be tightened and a layer of protection for the firm can be added, with little or no additional cost. ⚡

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