SMALL BUSINESS OWNERS' PERCEPTIONS OF INTERNAL CONTROL ISSUES

Richard T. Henage, Accounting Department, Utah Valley State College, 800 West University Parkway, Orem, UT 84058-5999, 801-863-6151, henageri@uvsc.edu
Jonathan R. Henage, Accounting Department, Utah Valley State College, 800 West University Parkway, Orem, UT 84058-5999, 801-489-1235, henagejo@uvsc.edu

ABSTRACT

Recent events have focused attention on the need for increased internal controls in the management of businesses. These events resulted in the Sarbanes-Oxley Act of 2002 (SOX). As a result of SOX, the Securities and Exchange Commission (SEC) requires that auditors evaluate the compliance of publicly-traded firms with a recognized control framework. While these rules are not mandated for privately-held companies, it might be assumed that they also need adequate internal controls. This paper surveys small business owners to determine their perceptions of internal control issues. The paper sets the stage for further studies on the adequacy of internal controls in small businesses.

INTRODUCTION

The news media had a field day in the late 1990's and early 2000's with numerous accounting frauds and business failures involving Enron, WorldCom, Tyco and others. In the aftermath of these events, congress passed the Sarbanes-Oxley Act of 2002. Among other things, this act requires publicly held companies to issue a report accompanying the financial statements stating that management is responsible for the internal control structure of the company. Further, management is required to assess the adequacy of internal control procedures and to reveal any significant defects or material noncompliance found during these internal control tests.

To help enforce the Sarbanes-Oxley act, the Securities and Exchange Commission (SEC) mandated that the internal control evaluation be based on a recognized internal control framework. The SEC has not identified the specific framework that is to be used, but has left that decision to management and the external auditors that certify the financial statements. To date, auditors have relied primarily on the framework developed by the Committee of Sponsoring Organizations (COSO). [1] In 2004, COSO expanded that framework from five to eight components of an internal control system, as well as adding two dimensions which define the types of objectives that must used to achieve company goals and the units of the organization that must be involved in the internal control process. [2] Due to the more comprehensive nature of the new framework, it should replace the older model as the standard for internal control over the years to come.

INTERNAL CONTROLS IN SMALL BUSINESSES

While the Sarbanes-Oxley Act applies only to publicly traded firms, the need for internal control is universal. When COSO developed their framework, the focus was clearly centered on large, publicly-traded organizations. Large corporations are owned by a multitude of shareholders, and management has a fiduciary duty to work in the interest of these same shareholders. To allow the owners to evaluate the stewardship of their management team, the shareholders require unbiased reports of financial performance. Internal controls protect against fraudulent financial reporting to shareholders. In contrast, most small businesses are operated by individuals who are both owners and managers. In most small businesses, fraudulent reporting should not be a concern.

The limited number of employees who participate in daily operations strongly affects the internal control structure of small. In many cases, this makes it impossible to develop an adequate level of segregation of duties. This may increase both the risk of inaccuracies in management reports and of employee fraud.

Another primary difference is related to the limited availability of resources for small businesses. Most small businesses cannot justify the employment of even one full-time internal auditor. It might be difficult for a small business to assign scarce resources to such processes as developing policy and procedures manuals, conducting formal performance evaluations, creating and monitoring budgets, creating adequate audit trails, and implementing adequate controls over computer systems.

The purposes of this paper are to investigate the primary internal control concerns of small business owners and to set a framework for further investigation of the internal control structure of small businesses.

METHODOLOGY

Owner/managers of small businesses were interviewed to determine their perception of risk on eight potential threats to their business. To meet the criteria of the study, the business had to have between 5 and 500 employees. Numerous businesses were contacted within a single geographic area and 29 interviews were completed.

The businesses in the sample had an average of 56 employees (standard deviation = 99.9), with a range of from 5 to 450 employees. The average number of employees involved in accounting functions (not including the owner) was 2.7 (standard deviation = 2.6), with a range of from 1 to 15. The majority of the businesses were corporations (21 out of 29, or 72%). There were four LLC's, two non-profits, and only one partnership and one sole proprietorship. It is notable that 27 of the 29 firms (93%) had chosen some type of organizational structure to limit the liability of the owners.

RESULTS

In an effort to determine the attitudes effecting risk assessment, the owner/managers were questioned regarding their concerns in eight areas. Each of the eight risks were evaluated on a 5-point Likert scale where 1 = little or no concern, and where 5 = extremely concerned. The results of the survey are presented in Table 1 below.

TABLE 1
Survey Results

Risk	Average	Std. Dev.
Employee theft of company assets (cash, inventory, etc.)	2.64	1.39
Theft of assets by third parties (customers, etc.)	2.50	1.13
Collection of fees or debts from customers	3.24	1.38
Inaccuracies or errors in accounting information	3.38	1.45
Potential of lawsuits from employees	2.00	1.16
Potential of lawsuits from customers	2.83	1.34
Potential of actions by tax or regulatory agencies	3.00	1.16
External calamities (fires, floods, earthquakes, etc.)	2.34	1.08

One of the surprising results of the interviews was that the largest concern of owner/managers was toward the potential for inaccuracies or errors in accounting information. The second highest concern had to due with collections. However, it should be pointed out that this result was affected by a number of firms that had little or no concern in this area. If these businesses were not included, this risk would have far surpassed all of the rest in magnitude (4.00).

A large concern of owner/managers is the risk of lawsuits from customers. While over 90% of the firms have limited liability structures, owners still recognize the potential of losing the business due to such lawsuits. The perception of this risk was largely dependent upon the industry. Some types of businesses tended to rank lawsuits by customers as their highest perceived risk (medical services, title insurance, etc.)

It is notable that the risk of lawsuits from employees was the lowest concern. Apparently, business owner/managers believe that the likelihood and magnitude of these events is even less than that of natural disasters (the second lowest concern.) A potential influence on this result is that the companies surveyed all are located in an "employee-at-will" state. Still, given the potential for lawsuits from discrimination, sexual harassment, worker's compensation claims, etc., the lack of concern in this area is surprising.

The purpose of this study was to lay the framework for an in-depth follow-up study. The follow-up study is to identify the types of internal controls that small business managers employ to meet the needs determined in their assessment of business risks.

REFERENCES

[1] COSO, The Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework*, American Institute of Certified Public Accountants, 1992.

[2] COSO, The Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management—Integrated Framework,* American Institute of Certified Public Accountants, 2004.