
CONTROLLING THE BOTTOM LINE

William E. Perry



CONTROLLING THE BOTTOM LINE

**(A guide for businesses who are more
concerned with increasing profits than sales)**

William E. Perry



An Inc./Van Nostrand Reinhold Publication

VAN NOSTRAND REINHOLD COMPANY
NEW YORK CINCINNATI TORONTO LONDON MELBOURNE

Copyright © 1984 by Inc. Publishing Corporation

Library of Congress Catalog Card Number: 83-21814

ISBN: 0-442-27380-0

All rights reserved. No part of this work covered by the copyright hereon may be reproduced or used in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, or information storage and retrieval systems—without permission of the publisher.

Manufactured in the United States of America

Published by Van Nostrand Reinhold Company Inc.
135 West 50th Street, New York, N.Y. 10020

Van Nostrand Reinhold
480 Latrobe Street
Melbourne, Victoria 3000, Australia

Van Nostrand Reinhold Company Limited
Molly Millars Lane
Wokingham, Berkshire, England

Macmillan of Canada
Division of Gage Publishing Limited
164 Commander Boulevard
Agincourt, Ontario M1S 3C7, Canada

15 14 13 12 11 10 9 8 7 6 5 4 3 2 1

Library of Congress Cataloging in Publication Data

Perry, William E.
Controlling the bottom line.

"An Inc./Van Nostrand Reinhold publication."

Includes index.

1. Industrial management. 2. Managerial accounting.

I. Title.

HD38.P439 1984 658.4'013 83-21814
ISBN 0-442-27380-0

preface

The giants of American industry in the early 1900s had little trouble controlling the bottom line. The story has been told of many of the founders of major U.S. corporations that they went into their accounting office at year end and said, "I want X percent or X dollars profit." The accountants then reworked the financial statements to produce the desired profit.

Entrepreneurs today have more difficulty in dictating the amount of profit that appears on the bottom line. Although accounting gives some leeway in controlling the amount of profit, the rules are much more stringent than they were fifty years ago. However, today's entrepreneurs still have many avenues open to them for controlling the profit on the bottom line.

Controlling the Bottom Line is a book about making money. Controls are one of the great misunderstood aids to profitability. The book suggests that controls are not for accountants but rather are the friend of management; in fact, they make things happen. It is through controls that honest people remain honest, workers provide a fair day's work for a fair day's pay, and management acquires the proper information to make effective decisions.

The objective of this book is to demystify how and what to control in the business. The suggestions are based on the experiences of many organizations. The concepts work. My thanks go to the businesses that have taught me these concepts and to the losses the businesses incurred before learning how to build effective controls.

William E. Perry

contents

Preface vii

PART I—ARE CONTROLS WORTH THE EFFORT?/1

1. THERE IS MORE THAN ONE WAY TO MAKE MONEY!/3

The Two Best Money-Making Schemes/4

A Lesson in Control Accounting/6

What Are Controls?/8

Aren't Controls for Accountants?/11

How Good Are the Controls in My Business?/12

A Road Map through the Book/15

2. ARE YOU BEING RIPPED OFF?/18

Who Is the Business Crime Culprit?/18

What Is the Probability My Business Will Be Ripped Off?/27

How Can I Tell If I Have Been Ripped Off? (Or, the Twelve Good Ripoff Tests)/31

How Can I Stop Business Crime?/36

3. CONTROL STRATEGIES/38

What Are My Control Choices?/38

How Much Control Is Enough?/41

Management Control Strategies/43

Developing Control Solutions/48

Management Control Plan of Action/54

PART II—WHAT NEEDS CONTROLLING?/59**4. CONTROLLING REVENUE-GENERATING ACTIVITIES/61**

Management's Control Questions/61

What Is the Management Challenge in Revenue-Generating Activities?/62

Why Should I Be Concerned? (The Threat)/64

How Should I Structure My Staff?/66

What Are the Key Controls?/68

What Threats Do the Key Controls Address?/71

If I Can Only Afford Two Controls, What Should They Be?/73

How Do I Know the Controls Work?/73

5. CONTROLLING CREDIT, RECEIVABLES, AND COLLECTIONS/77

What Is the Management Credit, Receivables, and Collections Activity Challenge?/77

Why Should I Be Concerned? (The Threats)/78

How Should I Structure My Staff?/81

What Are the Key Controls?/82

What Threats Do the Key Controls Address?/86

If I Can Only Afford Two Controls, What Should They Be?/87

How Do I Know the Controls Work?/88

6. CONTROLLING THE PURCHASING-AND-PAYABLES ACTIVITY/93

What Is the Management Purchasing-and-Payables Activity Challenge?/93

Why Should I Be Concerned? (The Threats)/95

How Should I Structure My Staff?/97

What Are the Key Controls?/99

What Threats Do the Key Controls Address?/102

If I Can Only Afford Two Controls, What Should They Be?/102

How Do I Know the Controls Work?/104

7. CONTROLLING INVENTORY/108

What Is the Management Inventory Challenge?/108

Why Should I Be Concerned? (The Threats)/110

How Should I Structure My Staff?/112
What Are the Key Controls?/113
What Threats Do the Key Controls Address?/116
If I Can Only Afford Two Controls, What Should They Be?/117
How Do I Know the Controls Work?/117

8. CONTROLLING CASH/121

What Is the Management Cash-Control Challenge?/121
Why Should I Be Concerned? (The Threats)/125
How Should I Structure My Staff?/127
What Are the Key Controls?/128
What Threats Do the Key Controls Address?/131
If I Can Only Afford Two Controls, What Should They Be?/131
How Do I Know the Controls Work?/132

9. CONTROLLING PAYROLL AND PERSONNEL ACTIVITIES/135

What Is the Management Payroll and Personnel Activities Challenge?/135
Why Should I Be Concerned? (The Threats)/138
How Should I Structure My Staff?/141
What Are the Key Controls?/141
What Threats Do the Key Controls Address?/144
If I Can Only Afford Two Controls, What Should They Be?/144
How Do I Know the Controls Work?/146

10. CONTROLLING PROFITABILITY/150

What Is the Management Profitability Challenge?/150
Why Should I Be Concerned? (The Threats)/152
How Should I Organize My Staff?/154
What Are the Key Controls?/156
What Threats Do the Key Controls Address?/161
If I Can Only Afford Two Controls, What Should They Be?/161
How Do I Know the Controls Work?/162

11. CONTROLLING RECORD KEEPING/168

What Is the Management Record-Keeping Challenge?/169
Why Should I Be Concerned? (The Threats)/170

How Should I Structure My Staff?/172
What Are the Key Controls?/176
What Threats Do the Key Controls Address?/179
If I Can Only Afford Two Controls, What Should They Be?/180
How Do I Know the Controls Work?/180

PART III—DO THE CONTROLS WORK?/185

12. EVALUATING THE EFFECTIVENESS, ECONOMY, AND EFFICIENCY OF CONTROLS/187

The Need for Control Review/187
What's It Like to be an Auditor?/189
Control Review Process/190
Monitoring Compliance to Controls/209

13. WHO CONTROLS THE CONTROLS?— THE BIG PICTURE/211

Management's "Real" Control Responsibilities/211
Control Q's and A's/212
Cashing in on Control/218

APPENDIX CONTROL RULES OF THUMB/219

Index/223

I— Are controls worth the effort?

**There are two ways to make money:
one is to increase sales and the other is to reduce
costs. Controls help do both.**

there is more than one way to make money!

To control or not to control—that is the question. Or perhaps the question is: should I control, and if so, what? There may be more misconceptions and misinformation about control than any other single topic in business.

Let's explore a few of the myths about control:

1. *The primary purpose of control is to stop people from stealing.* Of course, controls want to stop people from stealing, but the primary purpose is to stop losses of all kinds. Stealing, while substantial, may not be the largest loss.
2. *Controls cost money.* Not only are controls free; they may be the single greatest generator of profit in the organization. If controls don't provide a positive return on investment, they should not be installed.
3. *Controls slow down progress.* Wrong! Bad controls may slow down progress, but well-designed and effective controls permit tasks to be performed better and more quickly. For example, visualize trying to go from one side of your city to the other during rush hour without traffic lights.

The objective of this chapter is to encourage you to like controls. That's right—like controls. Perhaps you never thought you would like controls, but for a few moments forget your biases and attempt to judge controls on their merits. If at the end of this chapter you still don't like controls, give the book to a business in financial trouble . . . they are probably suffering from a lack of controls and may be ready to take the control cure.

THE TWO BEST MONEY-MAKING SCHEMES

Everybody is looking for a quick way to make \$1 million. Magazines are filled with ads offering a book explaining the success formula for millionaires for the everyday low price of \$9.95. Each author promises to divulge *the* method that not only carried him or her from rags to riches but can do it for you too.

Get ready now for one of the first benefits of this book. I'm going to save you the \$9.95 by telling you right off what the success formula is. In fact, better than that, I'm going to divulge to you the two best ways to make a million dollars, which are:

Number one way to make \$1 million

Increase your current annual sales to a level that will produce \$1 million in profit.

Number two way to make \$1 million

Decrease the cost of your sales to a level that will eventually permit you to make \$1 million on your current rate of sales.

If you don't feel that bit of information will help you become a millionaire, you share the feelings of many who bought a get rich quick book. Using controls is not a get rich quick concept. Controls are a way of life that will help maximize your profits.

The information in the success formula is absolutely correct. The method to increase sales or reduce costs is all that is needed to start you down the yellow brick road. The missing ingredient is how to do it.

Controls are designed to ensure that business transactions are processed in accordance with the intent of management. If management designs good marketing strategies and procedures and if those are followed in accordance with management's intent, sales should increase. If management has designed good policies and procedures for performing work, then costs should be minimized. Let's look at some examples of how control might have helped improve the bottom line.

Some Lack-of-Control Examples

Three real-life examples of how the lack of control decreased profitability follow. Each case will be explained and then the control aspects of that case will be discussed:

Case 1—The “One for You, One for Me” Caper Many small businesses receive cash as payment for items they sell. Employees greet the customer, find out what the customer wants, deliver the desired product, then price and collect the money from the customer. As employees learn this system, they frequently add a new wrinkle. When they collect the money from the customer, some of it goes into their pockets and some into the company’s pocket. The methods are many. Some employees put the money and the sales slip aside to pocket later; others wait until slack hours when they are working alone; and others simply palm the money.

Control Problem Most skimming occurs when there are weak controls over the recording of sales or collection of cash. The “one for you, one for me” caper exists most frequently when the sale does not have to be recorded in a controlled manner at the time of the sale. In this case each dollar lost came directly from the bottom line.

Case 2—The Idle Money Mess This corporation was relatively prosperous. Sales were going well, and money was flowing into the bank. With the need to invoice customers, answer inquiries, and prepare tax forms, there was little time to reconcile bank statements or move monies between accounts. Therefore the bank accounts were reconciled when time was available, and money moved at the same time. On top of that, the company had a super credit rating because bills were paid as received.

Control Problem This company was suffering from a chronic case of money mismanagement. Funds were lost due to keeping large balances in noninterest-bearing accounts and paying vendors before the due date. In some instances money was lost because the company failed to followup quickly on customer checks returned due to nonsufficient funds. What may have seemed like a control burden cost the company several thousand dollars in the course of the year—again, all bottom-line profit.

Case 3—The Poor Adder Problem A medium-sized merchandiser hired numerous sales clerks. The clerks were required to identify the product sold, record it on a sales slip along with a price, calculate the sales tax, and develop a total for charging the customer. Unfortunately, the clerks made a lot of arithmetic mistakes. When overcharged, many

customers complained, and the invoices were corrected. When undercharged, many customers overlooked the error and walked away with a bargain.

Control Problem The business assumed that the school system had done its job in teaching the clerks math skills. However, a good system of control assumes very little. If anything, it assumes that bad things will happen and works either to detect them or prevent them from occurring. The company could have installed a multitude of controls to reduce this threat. Such controls would include using prehiring tests to determine the clerks had mastered arithmetic; providing them with adding machines or even pocket calculators; and giving them tables showing sales tax and other product extensions.

The stories go on and on. However, each has the following central themes:

1. The cause of the loss is common—and usually known.
2. The loss could have been prevented or reduced by a control.
3. The monies saved through control flow directly to the bottom-line profitability of the organization.

A LESSON IN CONTROL ACCOUNTING

Accountants have been counting the beans of business for hundreds of years using the following accounting formula:

Income from sales	\$XXX.XX
Less cost of sales	<u>XX.XX</u>
Gross profit	\$ XX.XX
Less administrative expenses	<u>XX.XX</u>
Net profit	<u>\$ X.XX</u>

This accounting equation, like our two success formulas for making a million dollars, explains what has happened but not how it has happened. The business person looking at the financial statements knows whether or not the company is making money, but may not really know why. Also, if the amount of net profit isn't satisfactory, the manager may not know precisely how to improve it.

The problem with many small accounting systems is that they don't contain the proper chart of accounts. The chart of accounts determines how many buckets the beans fall into. For example, if we don't have an account for damaged inventory, we will never know how much inventory was damaged.

Control accounting is a term I have devised to indicate an accounting system with a control orientation. In other words, it identifies what needs to be controlled and then begins to develop some accounts to control those areas. Some of the financial accounts that can be used for control purposes include:

- Bad debts
- Damaged inventory
- Computation errors
- Mispriced products
- Losses due to fraud and embezzlement
- Inventory sold at less than normal price
- Inventory scrapped

The financial statement that could be prepared if this type of information were collected would tell a story of control problems. The underlying message is that you can't control what you can't see. This message tells one of the underlying problems in the concept of control. It's a strange paradox which is:

An item is not controlled because management believes it's not large. At the same time, the magnitude of the loss is not known because it is not controlled.

The Rule of Thumb in Control

Control is more of an art than a science. There is no one way to control, just as there is no one way to close a sale. On the other hand, there are many good control principles, just as there are many good marketing principles.

The principles I believe are effective in improving a business's profitability have been reduced to thirty-two rules of thumb. These rules may not appear in the textbooks on control theory, but down in the

trenches where the money changes hands, they work. You may want to skim through these rules of thumb (see Appendix A) before you read the book to gain a layperson's look at how controls really work. The first control rule of thumb follows:

CONTROL RULE OF THUMB 1
You can't manage what you can't control.

WHAT ARE CONTROLS?

Once upon a time a small business person enjoyed the fruits of a good business location. To his dismay, he learned that a large department store was opening next to his business. To make matters worse, a few weeks later another large department store announced plans to open on his other side. He pictured the two huge department stores with his own small store nestled in between and thought, "I am doomed." The small business person thought and thought about the type of control that could prevent his profits from eroding when the huge department stores opened. At last the idea came to him. On the day the two stores had their grand opening with their banners flying, he would post a huge sign above his store that stated "MAIN ENTRANCE." The sign worked, it drew customers into his store.

Control should be designed to help reduce losses. The small businessman in the preceding story used a control to point out where his store was located. Too often we are blinded by a narrow definition of control and fail to realize the true meaning of control.

A *control* is anything that will reduce the probability of a threat turning into a loss. Examples of controls include a lock on a door to prevent unauthorized entry, a physical count of inventory to determine if any is missing, one clerk checking on another to make sure an arithmetic computation is performed correctly; and a corporation buying key-man life insurance on a difficult-to-replace executive. Controls are the totality of procedures, methods, tools, and techniques directed at reducing losses.

Controls are broad in scope but have the following three criteria associated with them:

1. *Threat.* A threat is any unfavorable condition of concern to the business. Examples include fire, theft, inventory spoilage, and statutory sanction.
2. *Loss.* There must be a probability of the threat becoming a loss. Equally important is the potential magnitude of the loss. For example, the loss due to spoilage of fruits and vegetables in a supermarket is potentially much greater than the loss of someone stealing the empty bottles returned for deposit.
3. *Control.* There must be some method, procedure, tool, or technique that will reduce either the probability of loss or the magnitude of the loss.

To have a control without a threat is a waste of money. To have a significant threat without a control is foolish. It's not a chicken-and-egg situation. In the control/threat scenario the threat comes before the control. Control begins with a threat, and continues as long as the threat persists.

Threats to businesses can be divided into six general categories. These are the categories of threats that if not controlled can turn into business losses. It is the objective of controls to reduce these threats so that the losses due to those threats are insignificant in size. (See Figure 1-1.)

The six major threats to a business are:

1. *Mismanagement*—failure by the business managers to instigate those policies and procedures necessary for running the business or to provide adequate direction for the business.
2. *Theft and fraud*—assets of the organization will be taken by employees and outside parties. Note that while robbery is a threat within this category, nonviolent crimes will account for most of the losses.
3. *Statutory sanctions*—fines and penalties levied on the organization for failure to comply with a local, state, or federal regulation.
4. *Abuse*—the damage or destruction of assets due to willful or careless acts by employees and nonemployees.