

FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 15

Separation of Duties & Internal Controls Basics

Simple internal controls that protect people, cash, and trust.



TLC Business Solutions · Expert Bookkeeping & Accounting Services

Separation of Duties & Internal Controls Basics



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BOOK 15 OF 16

4

Separation of Duties: Internal Controls Basics

A practical guide to building trust, preventing fraud, and protecting your small business through smart financial controls.

THE FINANCIAL FOUNDATIONS SERIES

TLC BUSINESS SOLUTIONS · EMPOWERING SMALL BUSINESS OWNERS

Separation of Duties & Internal Controls Basics

CHAPTER 14 · FINANCIAL FOUNDATIONS

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FROM THE FINANCIAL FOUNDATIONS SERIES

This chapter is part of TLC Business Solutions’ ongoing series designed to help small business owners build confidence and competence in their financial operations. Each chapter stands alone while building toward a stronger financial foundation — so you can read it on its own or alongside the rest of the series.

WHO THIS CHAPTER IS FOR

Whether you run a one-person consultancy, a growing shop with a handful of employees, or an established small business, the principles in this chapter will help you design controls that fit your size and your budget. No audit department required.

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PART ONE · THE FOUNDATION

Building Trust Into Your Numbers

Every financial transaction in your business carries a story — and a risk. Internal controls, anchored by the principle of Separation of Duties, are how you make sure that story is honest, accurate, and protected.

01 · What Are Internal Controls?

Internal controls are the policies, procedures, and practices a business puts in place to safeguard its assets, ensure the accuracy of its financial records, promote operational efficiency, and encourage adherence to company policies. Think of them as the guardrails on a winding mountain road: they don't drive the car for you, but they keep you from going off the edge when conditions get tricky.

For small businesses, internal controls are not a luxury reserved for large corporations with audit departments. They are an essential layer of protection that helps owners sleep at night, builds credibility with lenders and investors, and creates a culture of accountability from the very first hire. Strong controls reduce the opportunity for theft, catch honest mistakes before they snowball, and produce financial statements you can actually rely on when making decisions.

02 · The Core Concept of Separation of Duties

At the heart of internal controls sits one deceptively simple idea: **no single person should have control over all parts of a financial transaction.** This principle, known as Separation of Duties (SoD), divides responsibility for a transaction across multiple people so that the work of one person naturally checks the work of another.

A complete financial transaction typically moves through several stages — authorizing it, recording it, handling the actual asset (cash, inventory), and later reviewing it. When one individual can perform two or more of those stages alone, the door opens to both intentional fraud and undetected error. Separation of Duties closes that door by requiring independent hands at each step.

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THE GOLDEN RULE

If one person can initiate, approve, record, and reconcile a transaction without anyone else involved, your business has a control gap. Separation of Duties is the practice of making sure that never happens.

Separation of Duties

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PART TWO : THE STAKES

Why It Matters

Separation of Duties is not bureaucratic red tape. It is the single most effective, lowest-cost control a small business can implement — and it protects three things at once: your money, your records, and your people.

PREVENTING FRAUD

Most occupational fraud is committed by trusted, long-tenured employees — precisely the people given broad, unsupervised access. Fraud requires three things: opportunity, pressure, and rationalization. SoD removes the opportunity. When a second pair of eyes reviews every transaction, the would-be fraudster has to recruit a co-conspirator or abandon the attempt. Collaboration dramatically raises both the difficulty and the likelihood of detection.

MINIMIZING ERRORS

Honest mistakes are far more common than theft, and they can be just as costly. A transposed digit in a payment, a duplicated invoice, a deposit posted to the wrong account — each is easy to make and hard to catch when the same person who entered the data also reconciles it. Separating entry from review turns an independent reviewer into a second checkpoint, catching errors before they reach the financial statements or the tax return.

PROTECTING YOUR EMPLOYEES

SoD shields your team as much as it shields the business. When duties are separated, no single employee is ever placed in a position of unmonitored temptation — which protects the innocent from false suspicion when something goes wrong. A clear control structure also means that when a discrepancy does surface, the investigation is orderly and the blame cannot default to "whoever had the keys." Good controls are, at their core, an act of care for the people you employ.

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PART THREE · THE FRAMEWORK

The Four Key Categories of SoD

To put Separation of Duties into practice, it helps to break a transaction into its four functional stages. Ideally, each stage is performed by a different person. At minimum, no single person should own two adjacent stages.

01

Authorization

Approving a transaction before it happens — signing off on a purchase order, authorizing a payment, or greenlighting a new vendor. The authorizer sets the policy; they should not also execute or record the transaction.

02

Custody

Physical or digital control of the asset itself — handling cash, signing checks, receiving inventory, or holding the password to the bank account. Custody is high-risk and must never sit with the recorder or reconciler.

03

Record-Keeping

Entering the transaction into the books — posting the journal entry, invoicing the customer, recording the bill in accounts payable. The recorder documents what happened; they should not be the one who authorized or physically moved the asset.

04

Reconciliation

Independently comparing records to external evidence — matching the bank statement to the ledger, counting inventory against the system, reviewing a supplier statement. The reconciler is the final check, and must be separate from the recorder.

REMEMBER THE PAIRING RULE

The most dangerous combinations to combine in one person are **Custody + Record-Keeping** (someone can take the asset and hide it in the books) and **Authorization + Custody** (someone can approve a payment to themselves and then sign the check). Never let those pairs live in the same hands.

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PART FOUR · IN PRACTICE

Real-World Example

05 · Checks vs. Reconciliation

The classic illustration of Separation of Duties — and the most commonly violated one in small businesses — is the relationship between writing checks and reconciling the bank statement.

THE WRONG WAY

Your office manager **writes and signs the checks, records the payments** in the accounting software, and **reconciles the bank statement** each month. That single person owns custody, record-keeping, and reconciliation. If a check is written to a personal account or for an inflated amount, the same person who could create the discrepancy also has the power to hide or explain it away during reconciliation. There is no independent check.

THE RIGHT WAY

The office manager writes and signs the checks and records them in the software. A **different person** — the owner, a bookkeeper, or an outside accountant — receives the unopened bank statement and performs the reconciliation. Because the reconciler did not write the checks, they have no incentive to conceal anything, and any altered amount, missing check, or unauthorized payee surfaces immediately during the match.

WHY THIS ONE MATTERS MOST

Bank reconciliation is the single most powerful control in a small business, because the bank statement is an *independent* record produced outside your office. The moment you let the check-writer also be the reconciler, you throw away that independence and with it your strongest safeguard.

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PART FIVE · RIGHT-SIZING

SoD for Solo Practitioners & Tiny Teams

What happens when there simply aren't enough people to separate every duty? A solopreneur or a two-person shop cannot hand each stage to a different employee. The answer is not to abandon Separation of Duties, but to substitute **compensating controls** — independent oversight that achieves the same check from outside the business.

- ▶ **External bookkeeper or accountant:** Have an outside professional receive the bank statements directly and perform the monthly reconciliation. You keep custody; they provide the independent review.
- ▶ **Owner review of statements:** Even if you delegate day-to-day bookkeeping, open and review the bank and credit card statements yourself before they reach the bookkeeper. Your eyes are a control.
- ▶ **Bank controls:** Set up dual-signature requirements on checks above a threshold, and enable transaction alerts on the business accounts so you see every movement in real time.
- ▶ **Locked accounting period:** Close and lock each month in your accounting software so prior-period entries cannot be silently edited after reconciliation.
- ▶ **Separate logins for everyone:** Never share a single accounting login. Individual credentials create an audit trail and make every entry attributable to a specific person.
- ▶ **Annual outside review:** Bring in a CPA for a yearly review or compilation. The mere expectation of an external eye deters misconduct year-round.

THE SOLO PRINCIPLE

When you can't separate duties among people, separate them across *time* and *oversight*. The same person may perform two roles, but an independent party reviews the work afterward. Review is a valid substitute for separation — and for a one-person business, an outside accountant is your second pair of eyes.

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CHAPTER 14 · WRAP-UP

Key Takeaways

What to Remember

- ✓ Internal controls are guardrails, not bureaucracy — they protect your assets, your records, and your reputation.
- ✓ Separation of Duties means no single person controls all stages of a financial transaction: authorization, custody, record-keeping, and reconciliation.
- ✓ SoD prevents fraud by removing opportunity, catches honest errors through independent review, and shields employees from temptation and false suspicion.
- ✓ The most dangerous combinations to combine in one person are custody + record-keeping and authorization + custody.
- ✓ The classic example: the person who writes the checks must never be the person who reconciles the bank statement.
- ✓ Solo and tiny teams use compensating controls — external review, owner oversight, bank alerts, locked periods, and annual CPA review — to achieve the same protection.
- ✓ Strong controls build trust with lenders, investors, and your own team — and they produce financial statements you can rely on.

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Helping small business owners build confidence, clarity, and control in their finances — one chapter at a time.



Build Your Financial Foundations with TLC

TLC Business Solutions helps small business owners strengthen bookkeeping, accounting, payroll, tax consulting, financial management, and practical decision-making systems so the numbers are clean, useful, and ready for growth.

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