

THE ROLE OF THE INTERNAL CONTROL SYSTEM IN ENHANCING THE EFFICIENCY OF FINANCIAL RESOURCE MANAGEMENT IN A NON PROFIT ORGANIZATION

DOI: <https://doi.org/10.53486/dri2025.51>

UDC: 657.62:334.012.46

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Abstract: *One of the most important tools contributing to the successful attraction of financial resources is the internal control system. In commercial institutions, this tool is aimed at optimizing financial flows, minimizing risks and increasing transparency, which in turn helps attract investment and improve reputation. For non-profit organizations, internal control performs similar functions, but the emphasis is on compliance with legislation, effective use of funds, and accountability to donors and the public. In this article, we will analyze how internal control affects the processes of attracting financial resources in non-profit organizations, highlight its key aspects and offer recommendations for improving the control system in the context of the specifics of the activities of these organizations.*

Key words: *internal control system, internal audit, donors, assessment, efficiency, financial resource.*

JEL: M41.

1. Introduction

In today's world, attracting financial resources effectively is a crucial aspect for the growth of both commercial and non-profit organizations (hereafter referred to as NPOs). Commercial organizations aim to generate profits and maximize shareholder value, while NPOs focus on implementing social, cultural, or environmental projects aligned with their goals and objectives. NPOs are organizations that do not aim to generate profits, which are then distributed to the founders. In contrast to the commercial sector, NPOs' work is not centred on enriching its founders, and investors, as a rule, do not expect immediate and proportional returns, but rather believe that NPOs will effectively utilize the funds provided and report on their expenditure in a timely manner. Thus, NPOs need to demonstrate the effectiveness and efficiency of using funds raised more clearly than commercial organizations in order to meet the expectations of those who rely on their financial stability. One of the most significant tools for attracting financial resources successfully is the internal control system. In commercial organizations, this system aims to optimize financial flows, minimize risks, and increase transparency, which helps attract investment and enhance reputation. For nonprofit organizations, internal control serves similar purposes, but with a focus on compliance with regulations, efficient use of funds, and transparency and accountability to donors and the public. International Standards on Internal Auditing define internal control as actions taken by management, the board of directors, and other parties to manage risks and increase the chances of achieving goals and objectives. According to the International Standards on Auditing (ISA) 315, a system of internal control is a process developed, implemented, and maintained by those responsible for corporate governance and management to provide reasonable assurance regarding the achievement of organizational goals in the preparation of financial statements, the effectiveness and efficiency of operations, and compliance with laws and regulations.

Therefore, internal control aims to achieve the following objectives:

- efficient and effective operation of operational activities;
- preparation of accurate and reliable financial statements;
- compliance with applicable laws and regulations.

These objectives are essential for the success and sustainability of any organization, as they ensure that the company is operating in a safe and compliant manner and achieving its goals.

The existence of an internal control system helps protect the goals and interests of all stakeholders involved in the organization, including donors who provide resources and recipients who benefit from them. This is confirmed by the recent report of the European Court of Auditors on non-transparent funding of NPOs, particularly by USAID. This report led to the suspension of funding for NPOs in Moldova. According to the report, meeting transparency requirements means knowing not only who, why, and for what purpose funds were provided by the EU, but also how they were spent, the amounts involved, and whether the recipients respected EU values.

This article will analyze how internal controls affect the process of attracting financial resources for non-profit organizations. It will highlight key aspects of internal control and offer recommendations to improve the control system based on the specific needs of these organizations.

2. Basic content.

Despite the fact that the internal control system is one of the essential concepts in international practice, this term remains poorly understood in the Republic of Moldova. Thus, the Law on Accounting and Financial Reporting in Article 18, paragraph 2 (e) defines the responsibility of managers and administrators of accounting entities to organize an internal control system. At the end of 2018, the Official Monitor published the order of the Ministry of Finance on the approval of National Standards of Internal Audit in accordance with the provisions of art.29 of the Law on State Internal Financial Control, thus marking a new milestone of internal audit in the public sector of the Republic of Moldova. According to Birca and Babuci, "internal audit has become a vital tool that reflects not only evaluation mechanisms, but also values, principles and best practices that emphasize the importance of integrity, efficiency and accountability".

As for the non-profit sector, the Law on Non-Profit Organizations, establishing the powers of the supervisory authority in paragraph 1 of Article 20, notes that in order to control the management of a non-profit organization and the activities of the administrator, the supreme governing body may appoint one or more auditors or decide on an annual audit of the organization's activities by an external auditor. At the same time, the supervisory authorities are responsible for compiling an annual report on the financial activities of the organization and submitting it to the governing bodies, notifying them of cases they have identified that contradict the law or the NPO's charter and that have caused or may cause significant damage to it.

The wording "may appoint or make a decision" rather gives a certain choice, but does not oblige an NPO to introduce an internal control system by conducting annual audits and compiling reports to the governing body. Thus, the system of internal control in NPOs, despite its increasing international importance, is more proactive than mandatory.

The Sarbanes–Oxley Act of 2002 (hereinafter referred to as SOX), in particular section 404, is gaining popularity in international practice. This section requires that each financial statement of a commercial organization contain a vulnerability report on the Internal control System (ICW). At the same time, the management of the organization is responsible for creating and maintaining an adequate internal control structure and financial reporting procedures. Such a report should also contain an assessment of the effectiveness of the organization's internal control structure and procedures as of the end of the reporting period.

The main objectives of SOX are:

1. restoring public trust;
2. protecting the interests of investors by increasing the accuracy and reliability of disclosed information;
3. increased corporate responsibility through stricter financial reporting requirements;
4. prevention of corporate fraud;
5. strengthening internal control.

Despite the fact that NPOs are not covered by SOX, many of them in the Western world voluntarily accept the provisions of SOX, and the reasons for this, according to research published in Research handbooks on Accounting by Tinkelman D., Parsons L. are:

1. state nonprofit regulations designed to emulate aspects of SOX;
2. to prevent scandals;
3. because some provisions of SOX, including whistleblower regulations, apply to nonprofits regardless.

The extent of voluntary acceptance of SOX provisions by NPOs remains relatively unknown, but a survey-based study by Vermeer, Raghunandan, and Forgione (2006) sheds light on this issue. The authors found that 36% of NPOs have audit committees, although not all of them are independent. A study by Nezhina and Brudney (2012) also uses survey data to study the use of SOX in the non-profit sector and shows that approximately half of the respondents have implemented some SOX provisions. At the same time, about 25% of respondents noted an improvement in internal control as a result of the adoption of SOX.

Given the global need to attract SOX compliance specialists, according to LinkedIn, as well as the international nature of non-profit relations, it can be assumed that the state of the internal control system and disclosure of information in financial statements is of significant importance to international donors.

According to research, disclosure of information about internal control weaknesses negatively affects NPOs, and donors, as a rule, react negatively to such information. In particular, a study conducted by Petrovits, Shakespeare, and Shih (2011) found a link between the mention of internal control weaknesses in financial statements and a decrease in donations. The results of their research show that donors and government agencies, important sources of capital for NPOs, respond either directly or indirectly to information about internal controls. Another study by Berglund and Sterin (2021) revealed an indirect link between information about weaknesses in internal control and indicators of NPO resource surpluses and charity spending, suggesting that financially successful NPOs have a more reliable internal control system. The findings of their research are relevant to all stakeholders of NPOs, demonstrating that the control environment has a comprehensive impact on the ability of NPOs to effectively carry out their socially useful activities.

Thus, in the context of the lack of funding from international donors, which has been observed recently due to the termination of funding for NPOs by the USAID organization, the establishment of an effective internal control system and the reflection of relevant information in financial statements is becoming especially important in the Republic of Moldova.

When creating an internal control system, an organization's supervisory authority must analyze and identify the risks that lead to misstatement of financial statements.

A suitable basis for building an effective internal control system is the concept proposed and developed by the COSO Committee (The Committee of Sponsoring Organizations of the Treadway Commission) "Integrated Internal Control Framework" designed to help enterprises and other organizations assess and improve their internal controls in order to avoid collapse and heavy losses during financial crises. This concept has been widely recognized and disseminated throughout the world and is currently considered the best basis for the development, implementation and implementation of internal control.

The COSO structure consists of five interrelated components focused on the aforementioned internal control objectives: control environment, risk assessment, control procedures, information and communication, and monitoring.

In addition to the components, the concept is based on 17 principles, representing the fundamental concepts associated with each component. The table below shows the relationship between the components and principles and their application in NPOs, compliance with which will ensure a reliable and effective internal control system.

Table 1. Effective internal control system in NPOs according to the COSO structure

The internal control component	
Principles and their content	Application in NPOs
<p><i>The control environment</i> is the general attitude and culture of the organization in relation to internal control. It includes ethical values, leadership values, organizational structure, and responsibility allocation. An effective control environment helps to create the foundations for other components of internal control.</p>	
<p>Principle 1. The organization demonstrates commitment to the principle of decency and ethical values. It is expected that all structures of the organization will demonstrate commitment to the principle of decency and ethical values through their behavior and directives.</p>	<p>Since the NPO's mission and goals are directly related to the implementation of projects of public importance and dependent on external financing, the honesty and integrity of managers towards sponsors and donors are key success factors. Ethical standards and commitment to high standards of conduct should form the basis for all actions and decisions of the organization in order to ensure trust and support from stakeholders..</p>
<p>Principle 2. The Board of Directors demonstrates independence from management and oversees the development and implementation of internal control. The Management Board is responsible for ensuring that it includes a sufficient number of members who are independent of management and objective in their assessments and decision-making.</p>	<ul style="list-style-type: none"> • The Executive Committee of an NPO should consist of members who are not directly related to the operational activities of the organization. This will help ensure objectivity and independence in the decision-making process. • Defining clear responsibilities of the executive committee, including regular oversight of financial statements, compliance with internal control procedures, and the overall health of the organization. • Regular meetings of the executive committee discussing internal control issues, the current status of projects, financing and compliance with legislative requirements. • Creation of specialized committees, such as oversight committees, audit committees, etc., that monitor various aspects of internal control and report on their activities to the Executive Committee. • The administrative body of an NPO should regularly report to the Executive Committee on key financial performance indicators, budget execution, the state of the organization's net assets, as well as on achieved goals and risks.
<p>Principle 3. Management, under the supervision of the board of directors, determines the structure of the organization, the lines of subordination, as well as the corresponding powers, duties and responsibilities in the process of achieving goals. The Board of Directors approves the company-wide goals and is responsible for overseeing the development and maintenance of lines of command, as well as assigning appropriate powers and responsibilities to achieve the goals.</p>	<ul style="list-style-type: none"> • Development of the NPO's organizational structure and line of command. • Defining roles and responsibilities – approving job descriptions that would specify specific responsibilities, powers, and areas of responsibility. • Holding regular strategic meetings with the executive and administrative committees to discuss strategy, achieve goals and current objectives, clarify responsibilities, and identify the need for changes in structure or processes. • Implementation of systems to ensure transparency and tracking of responsibilities and tasks within the framework of ongoing projects and financial accounting.
<p>Principle 4. The organization demonstrates the desire to attract, develop and retain competent employees in accordance with the set goal. The organization attracts, develops and retains competent employees in accordance with the company's goals.</p>	<ul style="list-style-type: none"> • Develop and use clear recruitment criteria based on the values and mission of NPOs that are willing to contribute to the mission. • Creation and implementation of systematic training and professional development programs for employees to improve their skills and qualifications necessary for the implementation of projects in many areas. • Conducting regular assessments of employee competencies to identify weaknesses and identify which skills are needed to achieve the organization's strategic goals. • Creating a positive and supportive work environment that promotes increased engagement and job satisfaction.

<p>Principle 5. The organization establishes the responsibility of employees for fulfilling their responsibilities in the field of internal control in the process of achieving goals.</p> <p>Holds employees accountable for fulfilling their responsibilities in the field of internal control in the process of achieving goals. This responsibility includes transferring designated responsibilities, implementing performance evaluation systems, and implementing HR processes designed to hold people accountable for their actions.</p>	<ul style="list-style-type: none"> • Setting clear goals for each employee. Each task should have defined criteria for success and evaluation, which will allow you to track the results of the work. • Implementation of a regular reporting system, where employees must present the results of their work and achieved goals to management and colleagues, which promotes responsibility for fulfilling their duties. • Conducting regular assessments of the work of employees in the field of internal control to ensure timely identification of problems, shortcomings or violations, and the opportunity to correct them. • Documentation of processes related to the performance of duties, including records of inspections carried out, problems encountered, suggestions for improvement, etc. This will allow you to monitor the fulfillment of responsibilities at the level of internal control procedures. • Appointment of responsible employees for internal control responsible for various aspects of internal control, which creates clear lines of responsibility and allows for more effective management of control processes.
<p><i>Risk assessment.</i> This component includes the analysis and assessment of risks that may affect the achievement of the organization's goals. The assessment helps identify potential threats and vulnerabilities, as well as determine what measures should be taken to manage them.</p>	
<p>Principle 6. The organization defines clear goals in order to be able to identify and assess the risks that hinder their achievement.</p> <p>Setting goals and regularly identifying and documenting potential risks that may make it difficult to achieve goals.</p>	<ul style="list-style-type: none"> • NPOs should clearly define their strategic goals related to the organization's mission and objectives. Goals should be measurable, achievable, and time-bound to facilitate the risk assessment process. • Operational plans and action programmes must be developed to achieve strategic objectives. Clear planning will help identify key initiatives and actions that need to be taken to achieve the goals. • Conducting regular risk assessments related to achieving the set goals. This may include discussing possible threats and opportunities both within the organization and in the external environment, as well as analysing past experiences and failures. • Identify key performance indicators for goals and risks, which will allow NPOs to continuously monitor progress and assess how effective risk management is.
<p>Principle 7. The organization identifies risks that hinder the achievement of the full range of its objectives and performs risk analysis to determine approaches to their management.</p> <p>Assessment of the probability of occurrence and potential impact of identified risks.</p>	<ul style="list-style-type: none"> • Creation of a risk committee and/or a chief risk manager to coordinate certain activities for other risk management functions. • Establishing responsibility for specific risks and response measures. • Holding regular risk discussion sessions with project managers, volunteers, and donors to identify potential threats that may affect the achievement of goals. • The use of qualitative and quantitative methods for risk analysis. A qualitative analysis may include expert opinions and ratings, while a quantitative analysis may include an assessment of the likelihood of an event and its consequences for NPOs.. • Establishing a regular reporting mechanism to inform the Board of Directors and other stakeholders about the status of risks and effective risk management measure.
<p>Principle 8. When assessing risks that hinder the achievement of goals, the organization takes into account the possibility of fraud.</p> <p>Implements processes for detecting, suppressing and detecting fraud.</p>	<ul style="list-style-type: none"> • Identification of potential fraud risks. Conducting risk assessments for potential fraud threats. Having open sources of information and analyzing the previous experience of NPOs and other organizations can help identify vulnerabilities. • Implementation of an internal control system, which includes mechanisms for tracking financial flows, asset inventory, regular audits, and requesting reconciliation reports with counterparties. This will allow you to identify anomalies and inaccuracies that indicate possible fraud. • Create secure and anonymous channels for employees, volunteers, and external stakeholders to report suspected fraud without fear of consequences. • Organization of independent internal and external audits to assess fraud risks and verify compliance with established control procedures. It will also help to identify and correct weaknesses in the control system.

	<ul style="list-style-type: none"> Assessing the likelihood and impact of fraud. When assessing an organization's risks, it is important to consider possible fraud scenarios and their potential impact on the achievement of the NPO's objectives. This will help determine what measures need to be taken to prevent them. Regularly informing management and the board of directors about the state of fraud risk management, as well as the results of internal and external audits.
Principle 9. The Organization identifies and evaluates changes that may have a significant impact on the internal control system. Since changes can be caused by a wide range of internal and external sources, those responsible must be prepared for new problems that may have a significant impact on the internal control system.	<ul style="list-style-type: none"> Regular monitoring of changes in the internal and external environment of NPOs, such as changes in legislation, the economic situation, social trends and technological innovations. This allows you to identify potential impacts on the internal control system in advance. Conducting assessments of how changes (for example, changes in funding priorities or in the needs of the target audience) may affect the achievement of the organization's goals and, consequently, the required internal control measures. Updating and adapting internal control policies and procedures in response to identified changes. This may include a review of reporting procedures, financial flow management, and audit and control systems. Conducting regular audits and internal audits to evaluate the effectiveness of the updated internal control systems after the changes. This will allow you to identify weaknesses and take corrective measures. Involving stakeholders (volunteers, partners, donors) in the process of evaluating changes and developing strategies for managing internal controls, which can lead to a more comprehensive and effective control system.
<i>Control procedures</i> are policies and procedures designed to minimize risks and ensure that organizational goals are achieved. Control procedures may include automated systems, inspections, separation of responsibilities, and approval mechanisms.	
Principle 10. The Organization selects and develops control procedures that reduce to an acceptable level the risks that hinder the achievement of goals. Maintaining effective internal control and daily implementation of risk management procedures. Operational management identifies, evaluates, controls, and mitigates risks by directing its activities to meet the company's goals and objectives.	Creation of specific internal control procedures: <ul style="list-style-type: none"> control over budget approval and execution; cost control in accordance with the budget plan; procedures for the management of donor funds, targeted use of funds; procedures for reflecting economic events on accounting accounts (availability of accounting policies); procedures for accounting and inventory of assets; rules for handling confidential information; Development of standards and protocols to be followed by staff and volunteers within the framework of internal controls. Implementation of measures to restrict the physical access of unauthorized persons to the assets of the organization, to the document preparation system and accounting records. Providing training for staff and volunteers on the developed control procedures and their significance. This is important to ensure that new requirements are understood and followed. Establish a system for regular monitoring and evaluation of control procedures to ensure that they work effectively and meet changing conditions. Creation of transparent and accessible documents for managing internal controls, which can be easily updated in case of changes in conditions or new risks.
Principle 11. The organization selects and develops common procedures for technology control to achieve its goals. Develops and implements technology-related control measures. This includes developing and disseminating technology-related policies and procedures and ensuring adequate IT controls to help achieve the goals set.	<ul style="list-style-type: none"> Identify the technological needs of an NPO based on its goals and objectives, including data security, license accounting, software management, and access to information. Selection and implementation of technologies that meet the goals of the NPO. This may include project management systems, CRM systems for managing interactions with donors, accounting and reporting software. Establish procedures for controlling access to technological systems, including defining access rights for various employees and ensuring confidentiality and data protection.

	<ul style="list-style-type: none"> • Organization of training programs on the use of technology and compliance with security policies. The training should cover both new systems and general principles of safe technology use. • Creation and implementation of data backup and recovery procedures to ensure the continuity of the organization's work in the event of failures or loss of information.
Principle 12. The organization implements control procedures through policies that define the expected outcomes through which policies are implemented. Periodic review and testing of control procedures to confirm their effectiveness and identify opportunities for improvement.	<ul style="list-style-type: none"> • Create and document policies and procedures that set performance standards and expected results for key NPO processes such as financial accounting, project management, and donor engagement. • A description of the specific, measurable results to be achieved through each policy. This may include KPIs (key performance indicators) that will help assess success in policy implementation. • Establish control methods that allow you to monitor the implementation of policies and procedures at all levels of the organization. This may include regular reports, inspections, and audits. • Establish a process for periodic review and updating of policies to ensure that they remain relevant and consistent with changes in legislation, the internal environment, and NPO targets. • Identify those responsible for the implementation of each policy and control procedures. This helps to create clear lines of responsibility and ensures that everyone understands who is responsible for policy compliance.
<i>Information and communication</i> are processes that enable the effective transmission of important information both within and outside an organization. This includes reporting systems, communication channels, and feedback mechanisms that help ensure that the necessary information is understood and received in a timely manner.	
Principle 13. The organization receives or generates and uses meaningful and high-quality information to maintain the functioning of internal control. All employees should have access to the necessary information to perform their duties and understand the internal control system.	<ul style="list-style-type: none"> • Determine what information is needed for effective management and administration of NPOs. This may include financial reports, donor data, activities and results, as well as other information that is important for making managerial decisions. • Establish a policy for documenting and storing information so that data is available at the right time and in the right place. This may include the creation of centralized data warehouses and the organization of archives.
Principle 14. The organization carries out an internal exchange of information, including information on the objectives of internal control and responsibilities in the field of internal control, which is necessary for its functioning. Encouraging constructive information exchange between different levels of the organization to identify problems and respond promptly to them.	<ul style="list-style-type: none"> • Development of a clear structure and communication channels that ensure regular and effective information exchange between all levels and departments of NPOs. • Clearly articulating and documenting internal control objectives so that employees understand how internal control procedures relate to the overall goals and mission of the organization. • Establish a system of regular reports on the state of internal control, which provide information on the achievement of goals and any identified problems. These reports should be discussed at management meetings and distributed to all departments.
Principle 15. The Organization exchanges information with external parties on issues affecting the functioning of internal control. Having processes in place to provide meaningful information to external parties in a timely manner, including shareholders, partners, owners, regulators, customers, financial analysts, and other external parties.	<ul style="list-style-type: none"> • Feedback from donors. Regular interaction with donors to receive their opinions and suggestions on internal control and project management issues. This can be done through surveys, meetings, or project implementation reports. • Publication of financial and accounting data on the NPO's activities on its website and in reports for third parties. This helps to build trust and strengthen the reputation of NPOs.
<i>Monitoring.</i> This component includes regular assessment and monitoring of the effectiveness of internal control systems. It allows you to identify deficiencies and make necessary adjustments, as well as ensure that control processes continue to operate effectively and up-to-date.	

<p>Principle 16. The Organization selects, evaluates, and conducts continuous and/or periodic evaluations of internal control components to ensure that they are available and operational.</p> <p>Conducting regular audits and inspections to assess the compliance and effectiveness of the internal control system.</p>	<ul style="list-style-type: none"> • Conducting regular internal audits, the purpose of which is to verify compliance with internal control processes and identify areas for improvement. The results of the auditors can help to make adjustments to the procedures. • Evaluating the components of internal control in the context of changing conditions, such as changes in legislation, new information, or changes in the NPO's operating environment. Adaptation of processes in response to such changes. • Preparation of regular reports on the state of internal control and assessments, which will be provided to the Board of Directors or the management of the NPO for analysis and discussion.
<p>Principle 17. The Organization evaluates deficiencies in internal control and promptly informs the parties responsible for implementing corrective actions, including senior executive management and the board of directors.</p> <p>Setting processes for continuous improvement of the internal control system based on monitoring results and changes in the external environment or internal structure of the organization.</p>	<ul style="list-style-type: none"> • Conducting systematic assessments of the internal control system to identify deficiencies through regular internal audits, as well as monitoring key indicators. • The establishment of a reporting mechanism, which implies that all identified deficiencies should be documented and issued in the form of reports, which will be transmitted to responsible persons on time. • Elimination of identified deficiencies in internal control through a system for monitoring the implementation of internal audit recommendations and conclusions.

4. Conclusions.

The internal control system plays a critical role in ensuring the success and financial stability not only of commercial organizations, but also to an even greater extent of non-profit structures. This system applies not only to accounting and reporting, but also to the organization's communication processes, internal and external influences. Effective internal control mechanisms not only help to minimize risks and prevent fraud, but also increase the level of trust among donors, partners and other stakeholders. However, it is important to understand that the creation and maintenance of such a system requires significant financial investments. These investments should be aimed at improving the quality of information disclosed in financial statements on internal control. Otherwise, the lack of changes in control practices, despite increased costs, may lead to a deterioration in operational efficiency, data distortion, and a decrease in management's ability to make informed decisions. Thus, in order to achieve the desired results, it is necessary that every aspect of the internal control system be carefully thought out and implemented, which ultimately will ensure financial stability, sustainable growth and development of NPOs.

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