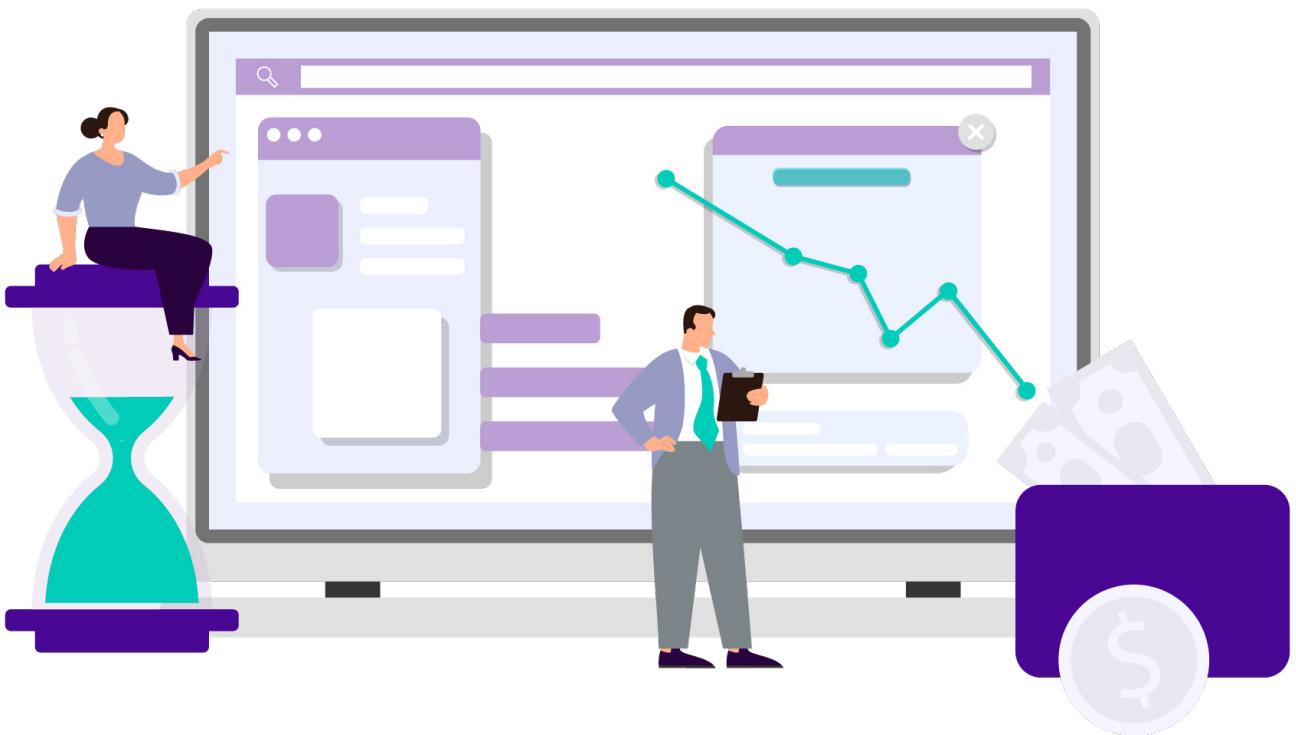


# Importance of Internal Financial Controls for Nonprofit Organizations



Internal control systems are a set of policies, procedures, and practices designed to safeguard an organization's assets, ensure financial record accuracy, and promote compliance with laws and regulations. These controls help to mitigate risks, prevent fraud, and ensure the organization is operating efficiently and effectively.

In the nonprofit sector, internal control systems typically include the following:



- **Financial Controls:** These controls focus on the management of an organization's financial resources. They include processes for budgeting, financial reporting, and the segregation of duties to prevent financial impropriety.
- **Compliance Controls:** These controls ensure that the nonprofit complies with Canadian laws and regulations, as well as any specific regulations related to nonprofits. It may involve monitoring adherence to tax-exempt status requirements and charitable registration.
- **Governance Controls:** Governance controls involve the management and oversight of the nonprofit organization. This includes roles and responsibilities of the board of directors, conflict of interest policies, and ethical guidelines.
- **Operational Controls:** These controls relate to day-to-day activities. They include procedures for program management, fundraising, and volunteer management. Operational controls are meant to ensure the nonprofit achieves its mission efficiently.
- **Risk Management Controls:** Nonprofits, like any other organizations, face a variety of risks. Risk management controls help identify, assess, and mitigate those risks. This can include strategies for dealing with financial volatility, cybersecurity threats, and other challenges.
- **Information Technology Controls:** In a digital world, nonprofits rely on technology from fundraising to data management, and everything in between. IT controls focus on securing data, preventing unauthorized access, and ensuring IT system reliability.

- **Human Resources Controls:** These controls encompass hiring, training, and management of staff and volunteers. They are there to ensure the nonprofit has a skilled and ethical workforce that aligns with its mission.
- **Reporting and Monitoring:** Effective internal control systems include mechanisms for continuous monitoring and reporting of the organization's financial and operational performance. This includes regular financial audits and internal reviews.
- **Documented Policies and Procedures:** A critical aspect of internal controls is the presence of documented policies and procedures that guide the organization's operations. These documents are a reference for staff and volunteers and help maintain consistency in practices.
- **Segregation of Duties:** This control involves dividing tasks and responsibilities among different individuals to reduce the risk of fraud and/or errors. For example, the person responsible for receiving funds should not be the same person responsible for recording those funds in the accounting system.
- **Training and Education:** Nonprofit organizations should provide training and education to staff, volunteers, and board members about the importance of internal controls and their roles in maintaining them.
- **Whistleblower Policies:** Often overlooked, nonprofits “should” establish mechanisms for reporting unethical or illegal activities within the organization, protecting individuals who report such activities from any and all retaliation.

Creating and maintaining strong internal control systems is one of the most important steps that NPOs and charitable organizations can take. They are particularly important for nonprofits (versus their for-profit counterparts) because there is generally a greater atmosphere of trust, revenues from donations are often cash-based, they're tax-exempt entities, and there is a heavy reliance on volunteers who may not have business or financial expertise.

## A Deep Dive into Internal Financial Controls

Internal financial controls are crucial for Canadian nonprofits for several reasons including:

- Financial accountability
- Preventing fraud and mismanagement
- Compliance with regulations
- Donor confidence
- Financial transparency
- Financial decision making
- Budget management
- Risk mitigation
- Accountability to stakeholders
- Sustainability
- Accurate reporting
- Organizational efficiency





## Two Types of Internal Finance Controls

A good internal control system should have two different types of control activities: preventative and detective. Preventative controls aim to deter errors or fraud from happening in the first place whereas Detective controls aim to identify and correct errors or fraud after they have already occurred.

This is easily illustrated with an example of controls to prevent the theft of cash.

- A **preventative control** would be to lock the cash in a safe, change the password regularly, and have only a few select people know the password to the safe. This prevents the theft of cash from occurring.
- A **detective control** would be to perform daily cash counts and reconciliations to check that the cash on hand agrees to the expected amount. This catches any discrepancies in the amount of cash. In the event there is less than expected, theft may have occurred and can be followed up on.

## Importance of Internal Finance Controls in NPOs

Internal finance controls are important for all organizations. They reduce the risk of fraud and ensure that accounting information and financial reporting is accurate. Internal controls also ensure compliance with laws and regulations.

NPOs can also have complex reporting requirements, especially from large contributions that come with restrictions. Without proper internal controls in place, there is a risk that the money is spent on the wrong activity or the reporting is not done correctly or on time. If any of these occur, the NPO runs the risk of losing the contribution.



## Internal Finance Controls in Relation to Governance

The Board of Directors of an NPO have fiduciary duties and responsibilities, and with these responsibilities comes potential liability.

What does fiduciary duty mean? It means that the directors have a duty to safeguard and pursue the interest of the NPO and set aside their personal interest while doing so. Directors who do not follow the basic standard of care in exercising their fiduciary duties can be found liable for damages.

In addition, and as part of their role, directors of an NPO are responsible for the appointment and evaluation of the management of the NPO. Management has direct responsibility for the establishment and maintenance of an effective system of internal controls.

As part of these responsibilities, directors are accountable for ensuring that the NPO has established internal controls required to mitigate risk in the organization. It is important that directors understand and regularly evaluate the risks in the organization and ensure that the proper internal controls have been established and are working properly.

A board that actively discusses internal controls and confirms that they are working properly sends a strong message that internal controls are important to the NPO.

## Improving NPO Internal Finance Controls With Technology

Even the best designed and executed internal controls can occasionally break down. One of the most common reasons that internal controls stop working is because they were not initially designed for real-world use and are too difficult for people to follow. Enter technology. Using technology to make internal controls easier to follow helps ensure they are used successfully.

Here are two examples of how technology can improve internal controls:

### **Cheque signatures**

It's common for organizations to require two signatures on all cheques. This can be difficult when signing officers either work remotely or are on the road. A common internal control breakdown is that people pre-sign the cheques to avoid inaccessibility situations, which defeats the purpose of the internal control and can lead to inappropriate payments.

A cloud-based payment system allows signing officers to electronically authorize payments, eliminating the need for physical signatures. Payments can then be authorized from anywhere in the world.

### **Financial statement and other report reviews**

NPOs often rely on part-time employees for roles like bookkeeping, payroll, and other back office functions. These staff members may not always be in the office, and using and accessing desktop software can be difficult if you aren't sitting at the right computer. This can lead to outdated accounting records and delayed or deferred reviews. Moving the accounting systems to the cloud is a way to improve this internal finance control. Cloud accounting systems are secure and can be accessed easily from any computer with an internet connection. You can login to the system regardless of time and location. This makes it easier to keep the books up to date and to review the reports so that any issues can be caught earlier on before they become bigger problems.

# Conclusion

Setting up a system of internal controls is a time-consuming process. Every NPO is unique and has a different set of risks based on its operations and the available resources.

For example, an NPO with lots of small cash-based donations from a large pool of donors may need to place an emphasis on controls ensuring that cash is not easily stolen. Meanwhile, another NPO with only a few, but largely restricted grants, would be more concerned with setting up controls that ensure the money is spent on the appropriate activities and reporting is done correctly and on time.

Some organizations establish an internal audit department and hire internal auditors to evaluate the effectiveness of their internal controls and address their internal and external risks. However, if your organization doesn't have the resources for an internal auditor, the best place to start is by asking questions about the risks and internal controls. What are the risks of the NPO? What internal controls have been put into place? Are those internal controls working as designed?

If you are the executive director or manage the operations of an NPO, you should regularly conduct risk assessments and evaluate the systems of internal controls that are in place in your organization.

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