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INTERNAL CONTROLS AND REGULATION OF THE NOT-FOR-PROFIT
SECTOR: INCREASING TRANSPARENCY FOR CHURCHES

by
Sarah Catherine White

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of
the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
May 2009

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ABSTRACT

SARAH CATHERINE WHITE: Internal Controls and Regulation of the Not-for-Profit Sector: Increasing Transparency in Churches
(Under the direction of Dale Flesher)

Regulation of for-profit organizations and fraud within them are commonly researched areas; however, many overlook the need for adequate internal controls and regulation of the not-for-profit sector, particularly religious not-for-profit organizations. Fraud has been a problem in this sector for a while, but it is frequently neglected due to the false sense of security that people have when dealing with not-for-profits. The not-for-profit sector is much less regulated than the for-profit sector, and religious not-for-profit organizations are not subject to any of the regulations that other not-for-profit organizations face. In order to gather appropriate data for determining ways through which fraud can be better prevented in the not-for-profit sector, an understanding of types of fraud committed and reasons for committing fraud were found through research. Cases of fraud found through research were reviewed, and the financial departments of two different churches were analyzed through the questioning of the financial director and the overview of audited financial statements. Additionally, the requirements of not-for-profits set by the IRS were researched, and the new Form 990 was studied. It was found that internal controls in churches are often lacking, especially in small churches. It was also found that religious entities are exempt from all governmental regulation, and many argue that these exemptions are constitutional. In conclusion, it was decided that these exemptions are a violation of the First Amendment to the Constitution, and they provide more opportunities for fraud in such organizations through the lack of accountability. All not-for-profit organizations should be regulated equally.

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LIST OF ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
ACFE	Association of Certified Fraud Examiners
CPA	Certified Public Accountant
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
IRC	Internal Revenue Code
IRS	Internal Revenue Service
RFRA	Religious Freedom Restoration Act
RLUIPA	Religious Land Use and Institutionalized Persons Act
SFAS	Statement of Financial Accounting Standard

Introduction

"The biggest issue in a case like this is the violation of trust...It's not about the money so much. It's about the trust."

Pastor Kent Egging of Mount Vernon, Washington

While fraud within the realm of big corporations is fairly common in today's society and widely publicized in many instances, fraudulent activities in the not-for-profit sector often go unnoticed and/or unreported. Identifying the actual fraud and the perpetrators of the fraudulent activities in not-for-profit organizations is a difficult task, not only because of poor internal controls, which could easily be said of any company, but also because of the depth of the 'trust' factor that exists within most, if not all, not-for-profit organizations. There is not a single day that goes by in which fraud is not committed in the United States in one form or another.

It is important for not-for-profit organizations to understand the importance of following the accounting principles set by the American Institute of Certified Public Accountants (AICPA) and other organizations. The importance of having an external audit must also be stressed to this particular sector of companies. It has been argued that such not-for-profit organizations are not 'companies'. This argument is particularly relevant when referring to religious organizations. Individuals who are hired by a not-for-profit organization, whether it be an organization as large as the United Way or a small

church in Oxford, Mississippi, should be held accountable for everything that is within their domain. Because of the element of 'trust' previously mentioned, it is assumed that those employed by these organizations are of the utmost integrity, honesty, and faithfulness. This is an idealistic concept, and it is one that commonly gives not-for-profit organizations a false sense of security. As easily as fraudulent activities in not-for-profits go completely unnoticed, when problems such as these arise, many times they go unreported for fear of losing support.

It has been speculated that an easy way for not-for-profit organizations to prevent or expose fraud is to have an annual external audit. This only seems logical; however, *The Nonprofit Quarterly* states that only twelve percent of fraud in sample organizations was detected by an external audit, while forty-three percent was detected through a tip given by another employee.¹ Although many cases of fraud are not discovered via external audit, it is still extremely important to have an annual audit in place. While most larger not-for-profit organizations now conduct yearly audits, there are many small churches and organizations that have not implemented this process.

When fraud is discovered, a new question arises for the organization to address: How is the perpetrator to be punished if he or she should be punished at all? Not-for-profit organizations rely heavily on their reputation, thus it is of the utmost importance that they remain in the 'good graces' of the general public. These organizations themselves are generally only praised for the good they do in society, and the employees of these organizations are viewed as highly ethical and of the utmost integrity and diligence. In the *Adventist Review*, Pastor Kent Egging of Mount Vernon,

¹ Janet Greenlee, Mary Fischer, Teresa Gordon, and Elizabeth Keating, "How to Steal from a Nonprofit: Who Does It and How to Prevent It," *The Nonprofit Quarterly* <<http://www.nonprofitquarterly.org/Special-Articles/Web-Articles/how-to-steal-from-a-nonprofit-who-does-it-and-how-to-prevent-it.html>>.

Washington, who has placed his primary focus on church embezzlement for his doctor of ministry program, gives an example of a church treasurer who embezzled \$45,000 from a fund established separately from the primary funds. Although a police report was filed and the man agreed to repay the stolen funds, the church was never reimbursed because the man was not required to repay the funds by law since the church did not file charges.² This true story is just one of many church and other not-for-profit frauds that go unreported or unpunished each year. The question of forgiveness in nonprofit organizations needs to be addressed.

Many churches and other not-for-profits fear that they will lose members and supporters if they go public with the incident. For example, many fear that donors will be reluctant to donate if they perceive that money has been squandered through employee embezzlement. Although 'forgiveness' may not be the issue it has been in the past, punishment of perpetrators, or lack thereof, in the nonprofit sector is still a significant problem.

While it is not the place of this paper to persuade an organization to punish those who deceive it, it is the goal to create a clearer understanding of what standards are required of not-for-profit organizations as established by the AICPA, the Financial Accounting Standards Board (FASB), and the Internal Revenue Service (IRS). This study will bring the accounting practices of not-for-profit organizations, particularly those who are religiously founded, into the spotlight for analysis and critique. A *New York Times* article dated October 14, 1877, serves as evidence that this type of fraud has been a concern for a very long time.

² Bob Smietana, "New Interfaith Report Focuses on Pastors Who Steal from Unsuspecting Churches," *Adventist Review* 2005 <<http://www.adventistreview.org/2005-1508/story5.html>>.

The article entitled "Fraud and The Churches", brings attention to the increasingly common fraud in religious organizations, which in the past had been a thing of secular society: "It is certainly remarkable how many of the speculators and defrauders whom the losses of the past few years have brought to light have come from the churches and religious organizations. All sects have contributed to swell the ranks of the dishonest".³

The fact that this topic has been an issue in the past and continues to be an issue today lends merit to the study of the reporting practices of these organizations. Religious not-for-profit organizations are of particular interest in this study due to the "special treatment" they receive from the IRS. As they are exempt from several significant standards, which are required of not-for-profit organizations that are not deemed "religious", it can be speculated that fraud could go more easily undetected due to these exemptions given to them solely because they are "religious". The ultimate goal of this study is to make suggestions regarding the actual controls of a religious not-for-profit organization through the analysis of financial statements and internal control procedures of different organizations and the study of instances of fraud in such organizations. Another goal of this study is to make the argument for equal treatment of all not-for-profit organizations as it pertains to the exemptions from basic standards enjoyed by religious not-for-profit organizations.

³ "Fraud and the Churches," *New York Times* 14 Oct. 1877 <http://query.nytimes.com/mem/archive-free/pdf?_r=1&res=9A02EFDB103FE63BBC4C52DFB667838C669FDE>.

"Until several years ago, 'it was inconceivable for most to think that religion might well be aggressively expanding its power in a way that is harmful to the public good,' said Marci A. Hamilton, author of *God vs. the Gavel: Religion and the Rule of Law*...the power of religious entities 'is at its apex.'"

Diana B. Henriques, *The New York Times*, October 8, 2006

Chapter I

Fraud

A General Overview of Fraud

When examining 'fraud' in its essence, it is difficult to place a single definition on the word. It can encompass a number of deceptive actions and can lead to any number of consequences for both the victim and the perpetrator. However, *Webster* provides a relatively comprehensible definition that is commonly used today:

Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representation. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery.⁴

Because fraud is directly related to the human mind, or "human knavery" as Webster illustrates, it is impossible to narrow his definition to a single type of perpetrator with a single type of victim. Furthermore, it is even more difficult to narrow the rationale behind the crime because the human mind is so complex.

Although it would be impossible to further restrict Webster's general definition of fraud, fraudulent activities can be divided into five different categories (or types) and further explained. These five categories include: 1. Occupational fraud, 2. Management

⁴ *Webster's New World College Dictionary, Fourth Edition.* (California: IDG Books Worldwide, Inc., 2001).

fraud, 3. Investment scams, 4. Vendor fraud, and 5. Customer fraud. This study will focus almost exclusively on occupational fraud. Amongst not-for-profit organizations, occupational fraud is the most prevalent; however, it could be argued that management fraud is possible in this scenario as well. Management fraud is defined as that which is committed by the top management of an organization who misrepresent information on financial documents.⁵

Generally, fraud within not-for-profit organizations is an example of occupational fraud. Joseph T. Wells identifies the three types of occupational fraud as asset misappropriation, corruption, and financial statement fraud. According to *The Nonprofit Quarterly*, a study by the Association of Certified Fraud Examiners showed that misappropriation is by far the most common source of fraud used in not-for-profit organizations. It was also reported that ninety-five percent of these misappropriations directly involved cash.⁶ Cash plays a large role in many not-for-profits, particularly in religious settings. Of the fraud within this percentile, skimming, larceny, and fraudulent disbursements were each used to accomplish the goals of the perpetrator. Skimming is the act of stealing cash before it is recorded. A perfect opportunity for skimming exists every Sunday morning in thousands of churches across the nation.

Although skimming appears to be an easy way to commit fraud, larceny and fraudulent disbursements are far more common. Larceny is the act of stealing cash after it is recorded, such as depositing it into the wrong account or using it for purposes for which it was not intended. Fraudulent disbursement is the most common means of

⁵ W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 432.

⁶ Janet Greenlee, Mary Fischer, Teresa Gordon, and Elizabeth Keating, "How to Steal from a Nonprofit: Who Does It and How to Prevent It," *The Nonprofit Quarterly* <<http://www.nonprofitquarterly.org/Special-Articles/Web-Articles/how-to-steal-from-a-nonprofit-who-does-it-and-how-to-prevent-it.html>>.

committing fraud in the not-for-profit sector. This refers to the act of an organization paying an expense that it never owed. The study by the Association of Certified Fraud Examiners (ACFE) showed that seventy-five percent of these cash misappropriations occurred by fraudulent disbursements.⁷

The AICPA states that the majority of all frauds, approximately 64 percent, fall into the category of occupational fraud. This statistic encompasses all fraud, not just that in the not-for-profit sector. Although this is a startling statistic in itself, the AICPA goes on to say that fraud committed by management is "three-and-a-half times more costly than fraud committed by employees".⁸

These two tables contain data from a 1996 survey of reported cases of fraud.

Table I

Victim	Percent of Cases	Median Loss
Government Agency	24.7	\$48,000
Publicly Traded Company	30.0	\$150,000
Privately Held Company	31.9	\$127,000
Not-for-Profit Organization	13.4	\$40,000

Table II

Number of Employees	Percent of Cases	Median Loss
1-99	39.0	\$127,500
100-999	20.1	\$135,000
1,000-9,999	23.4	\$53,000
10,000+	17.5	\$97,000

⁷ Janet Greenlee, Mary Fischer, Teresa Gordon, and Elizabeth Keating, "How to Steal from a Nonprofit: Who Does It and How to Prevent It," *The Nonprofit Quarterly* <<http://www.nonprofitquarterly.org/Special-Articles/Web-Articles/how-to-steal-from-a-nonprofit-who-does-it-and-how-to-prevent-it.html>>.
⁸ American Institute of Certified Public Accountants <<http://antifraud.aicpa.org>>.

The first table shows that not-for-profit organizations reported the lowest percentage of fraudulent activities, with the lowest median loss as well. Table II provides the most significant information for this study in that it provides evidence that the smallest organizations, consisting of anywhere from one to ninety-nine employees, account for the highest percentage of fraudulent cases reported. The table also shows that the median loss is greatest in smaller organizations.⁹ Both of these tables are important in obtaining a general overview of fraud in different forms; however, the statistics of small organizations are significant because many not-for-profit organizations are small in size.

Next, the perpetrators of fraud will be examined. This review is not limited to the not-for-profit sector. It is important to remember that anyone can commit fraud and that many times the perpetrator is one who has many responsibilities and is widely trusted within the organization. The most common representation for adequately displaying the reasons that one would commit fraud is the fraud triangle, which consists of three elements. Those elements are 1. Pressure, 2. Opportunity, and 3. Rationalization.



The perpetrator perceives internal or external pressure, creates or discovers opportunity to relieve his or her perceived pressure, and then rationalizes the act as acceptable.¹⁰

⁹ American Institute of Certified Public Accountants <<http://antifraud.aicpa.org>>.

¹⁰ W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 28-9.

Fraud perpetrators are stimulated by numerous vices, many of which other people would not understand. The first element of the triangle is Pressure. In his book entitled *Fraud Examination*, W. Steve Albrecht outlines four types of pressures that commonly lead one to commit fraud: financial pressures, vices, work-related pressures, and other pressures. Albrecht has also conducted studies that show that financial and vice-related pressures make up approximately 95 percent of all frauds.¹¹ Financial pressure can cover a broad area, from paying bills and making ends meet to purchasing a \$1 million house on the beach. Vice-related pressure refers to 'extracurricular' activities, particularly addictions such as drugs, alcohol, and gambling. Albrecht quotes a reformed gambler and addicted drug user who was involved in fraud cases: "I degraded myself in every way possible. I embezzled from my own company; I conned my six-year-old out of his allowance".¹² This is the worst type of pressure imaginable, and, sadly, the not-for-profit sector is not immune to this pressure. Work-related pressures are not as common. An example of a work-related pressure would be committing fraud out of fear of losing a job or to make oneself look better to the employer.

The second element of the triangle is Opportunity. A person struggling with the pressures described above will look for opportunities to commit fraud in such a way that he or she will not be caught. Many employees, especially those trusted employees in high positions, will use their specific position to exploit the organization.¹³ It is important for all organizations to do their best to prevent these opportunities from arising. One way to prevent these opportunities is to create the optimum control environment. This environment would be one of "proper" modeling and adequate communication.

¹¹ W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 32.
¹² W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 32.
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Communication is a critical aspect of creating the proper control environment. Another crucial aspect of creating this environment is to show much discretion in the hiring process. Albrecht inserts that research has shown that approximately 30 percent of Americans are dishonest, 30 percent are honest dependent upon a given situation, and only 40 percent are honest all the time.¹⁴ Although interviews are subject to human error, the background of each applicant should be thoroughly examined in an attempt to form the most objective opinion about the person as humanly possible.

In addition to creating a clearly organized control environment, it is important for every organization to establish a consistent accounting system and install effective control procedures. Control procedures include activities such as segregating responsibilities, requiring authorization of certain transactions, requiring independent checks on employees, and requiring documentation of all accounting transactions and audits.

The third element of the triangle is rationalization. The rationalization used by perpetrators of this sort will seem very illogical to one that is not in a similar situation or having similar thoughts. Again, this is an area of fraud that is limitless, just as the human mind is limitless.

It is important to note that the fraud triangle does not apply in all instances. For example, it does not apply to the perpetrator who intentionally applies for and accepts a job with the goal of deception. This person is ignoring the rationalization corner of the triangle, and therefore does not follow the outline provided by the fraud triangle.¹⁵

¹⁴ W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 35.
¹⁵ American Institute of Certified Public Accountants <<http://antifraud.aicpa.org>>.

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¹⁴ W. Steve Albrecht, *Fraud Examination* (Ohio: Southwestern, Thomson Learning, 2003) 35.
¹⁵ American Institute of Certified Public Accountants <<http://antifraud.aicpa.org>>.

Although the fraud triangle does not apply in all cases, it is helpful in understanding the mental sequence experienced by most perpetrators.

Since it has been established that most cases of fraud in not-for-profits occur by means of occupational fraud, particularly asset misappropriation of some variety, it is important for these organizations to adequately and thoroughly compile their financial statements and make them available to anyone who inquires.

Financial Reporting Compliance

Requirements for not-for-profit organizations are set forth through statements issued by the FASB. *Statement of Financial Accounting Standards No. 116* and *No. 117* are the primary guidelines for accounting practices in not-for-profit organizations. *Statement 116, Accounting for Contributions Received and Contributions Made*, was issued in June of 1993 and became effective for fiscal years beginning on or after December 15, 1994, for all not-for-profit organizations except those with total assets less than \$5 million and annual expenses less than \$1 million. For all others it became effective for all fiscal years beginning on or after December 15, 1995. This statement provides that all contributions received and unconditional promises to give be reported as revenues at their fair values in the period in which they were received. The same reporting of expenses applies to contributions given and unconditional promises to give. Conditional promises, received or given, are only to become unconditional upon the completion of the condition on which the promise was made. Once a promise reaches the status of unconditional, it may be reported as a revenue or an expense, accordingly.¹⁶

¹⁶ *Statement No. 116, Accounting for Contributions Received and Contributions Made*. Financial Accounting Standards Board <www.fasb.org>.

Statement No. 117, Financial Statements for Not-for-Profit Organizations, was also issued in June of 1993 with the same dates of effectiveness as stated in *Statement No. 116*. This statement provides the standards for required financial statements and appropriate data to be recorded within those statements as would be significant for external, as well as internal, purposes. The objective of this statement is appropriately placed at the beginning of the document in the "Summary" section:

Its objective is to enhance the relevance, understandability, and comparability of financial statements issued by those organizations. It requires that those financial statements provide certain basic information that focuses on the entity as a whole and meets the common needs of external users of those statements.¹⁷

The objective set forth in the summary of *SFAS (Statement of Financial Accounting Standard) No. 117* is an important one for this study in particular because this is, or should be, the focus when preparing financial statements for not-for-profit organizations. If this objective is met, the external user will feel at ease with the organization; however, it is when this objective is violated, either in the absence of such statements or the presentation of false information within the statements, that contributors may withdraw from the organization causing it to become obsolete.

The financial reporting obligations of not-for-profit organizations consist of three required statements as set forth by FASB. The required statements are a Statement of Financial Position, a Statement of Activities, and a Statement of Cash Flows. Note

¹⁷ *Statement No. 116, Accounting for Contributions Received and Contributions Made*. Financial Accounting Standards Board <www.fasb.org>.

disclosures are also required for "all the standard FASB items that are relevant to nonprofit organizations".¹⁸ The note disclosures exist primarily to distinguish between conditional and unconditional promises in order that the amount of promises may be clearly presented. Another reason for note disclosures involves providing details of the three different classifications of net assets that exist for not-for-profit entities.

The three classifications of assets are permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. Permanently restricted assets are those assets that are required to be used in a certain manner. An example of a permanently restricted asset would be an endowment given by a group or an individual that is to be used for a specific purpose that will not be altered during its term. Temporarily restricted assets are those assets with restrictions for a certain purpose at a specific future date; however, these assets differ from permanently restricted assets in that the asset contribution is not an ongoing activity. For example, an individual may give a certain sum of money for a particular project to be executed in the future. The last category is unrestricted assets, which encompasses all other assets, revenues, and contributions whose use is not restricted. It must also be noted that a "donor-restricted" contribution whose restriction is completed within the same accounting period in which the contribution was received may be reported as unrestricted.¹⁹

Labeling assets properly is very important when reporting the financial information of a not-for-profit organization, particularly organizations that rely heavily on individual donations. If an asset (donation) is labeled inappropriately and thus used for

¹⁸ Paul Copley, *Essentials of Accounting for Governmental and Not-for-Profit Organizations* (New York: McGraw-Hill/Irwin, 2008) 300-1.
¹⁹ Paul Copley, *Essentials of Accounting for Governmental and Not-for-Profit Organizations* (New York: McGraw-Hill/Irwin, 2008) 300.

purposes for which it was not intended, a form of fraud has occurred, regardless of the intentions of the person who mislabeled the asset.

Each organization is to abide by these rules set forth by the FASB; however, it may be difficult to closely monitor such reporting in a national, or even international, organization. Such was the case for The United Way, an international not-for-profit organization with 3,000 local organizations located in 47 different countries and territories.²⁰ The United Way of America is an excellent example of an organization whose leaders recognized a need for improvement of its internal control policies and more uniformity of such controls throughout all United Way organizations and acted in such a way to ensure the public that its practices were being improved through the implementation of more strict, consistent standards for each United Way to follow. These guidelines will be further reviewed as an example in Chapter Two.

²⁰ United Way International <<http://uwint.org/devfinal/members/locations.aspx?mid=2&chk=1>>.

Chapter II

Internal Controls

Cases of Fraud

With the not-for-profit sector being a rapidly growing element of today's economy in the United States, cases of fraud are also becoming more common, from small churches in Mississippi all the way to the United Way of America. Possessing the status of "not-for-profit", or more specifically "religious not-for-profit", has many benefits related to the requirements of such organizations, as will be discussed in a later chapter. However, with those benefits, or "exemptions", comes added responsibility for those in charge of the finances of these organizations. A series of fraudulent incidents in different churches is reviewed in this section.

On January 21, 2009, an article surfaced in St. Paul, Minnesota, regarding the alleged embezzlement of \$37,000 from the Church of St. Bernard, a local Roman Catholic church. The accused was a former finance director of the church, and her name and age of 44 years were given in the article. This church made no attempt to cover up the incident or protect her name. It has been speculated that the alleged criminal had been making out deposit slips that were not identical to the corresponding bookkeeping slips and pocketing the difference before the money was taken to the bank. It was also

recorded that she had told investigators that her family was in debt to the IRS and that she had unpaid medical bills.²¹

The excuses given to authorities provide support for the first element of the Fraud Triangle, which is "Pressure". She felt the pressure to resolve her debt, and she saw an opportunity in her position as financial director to help her resolve that debt. It can be speculated that the internal controls in the finance department of this church were not up to par. If this department had exercised separation of duties, this embezzlement could have possibly been prevented. In such a situation, it would be desirable to have at least two people filling out the deposit and bookkeeping slips and an unrelated person (or persons) actually delivering the deposit slip with the money to the bank. This type of control helps prevent fraud of this nature.

Although the previous situation seemed relatively easy to detect due to the fact that the deposit slips did not match the bookkeeping slips, many cases are more difficult to detect due to the complexity of the crime, and larger losses are also characteristic of more complex crimes. Such a crime was detected in Harrisburg, Pennsylvania, during the summer of 2007 when the former treasurer of the Lower Susquehanna Synod of the Evangelical Lutheran Church of America was let go for "unrelated reasons" and suspicious checks were found after his departure. This alleged fraud, committed by a 61-year-old man, took place for over twenty years, from 1985 until 2007, and it is estimated that \$1.1 million is the magic number in this situation. It has been determined that embezzled church funds were being diverted into a fraudulent bank account with the statements being sent to a fraudulent post office box in Lancaster, Pennsylvania,

²¹ "Church Finance Director Charged With Embezzlement." 21 Jan. 2009 <<http://wcco.com/local/embezzlement.church.finance.2.913900.html>>.

where the treasurer resided at the time. The embezzled funds were those that were intended for overseas missions; however, the alleged criminal was using them for his hobby of restoring collectible cars.²²

In this Lutheran Church, a misappropriation of assets has taken place through mail fraud, and it is unclear how such an incident could go on for over 20 years if adequate control procedures were in place. This situation could possibly have been detected earlier through adequate checks on the treasurer by an individual completely independent of the treasurer and his duties. A discrepancy between the amount given for overseas missions and the amount available in the fund could have potentially been discovered through better internal control procedures.

A smaller incident of fraud was reported in a local news story in Raleigh, North Carolina, in February of 2007. An employee of Ridge Road Baptist Church was accused of stealing more than \$170,000 from the church through the diversion of church funds to aid the purchase of personal items for the employee. While \$170,000 may not seem like a lot of money in today's economy, the loss represented more than half of the church's annual budget. The article suggests that control procedures were not a part of this church's financial reporting before the incident: "They also plan to develop a system of checks and balances in their accounting systems so that such a theft doesn't happen again. An outside auditor will look at church finances on a regular basis, they said".²³

²² Matthew Kemey. "Former Synod Treasurer will plead guilty to mail fraud," *The Patriot-News* 13 June 2008 < http://www.pennlive.com/midstate/index.ssf/2008/06/former_synod_treasurer_to_plea.html>.
²³ "Church Secretary Charged With Embezzlement," 1 Feb. 2007 <<http://www.wral.com/news/local/story/1186530>>.

Ridge Road Baptist Church is a prime example of the problem faced by many small not-for-profit organizations, particularly small religious organizations. Without adequate internal control procedures and an annual audit, the quality of financial reporting is based solely on an individual, or small group of individuals, who may not be qualified in the area of accounting or financial reporting. This situation is growing increasingly less common due to the growing number of churches performing annual audits. While the focus of this study remains on churches, the religious sector of not-for-profit organizations can take some lessons from the internal control procedures of the "non-religious" sector, and The United Way of America embodies an ideal example.

The United Way of America

As discussed previously, the proper labeling of assets and/or contributions is critical to a controlled environment of a not-for-profit organization. This was a major problem faced by many United Ways across the nation. The good intentions of the United Way of America are widely known and respected; however, its accounting practices have been under scrutiny several times throughout its existence. Several instances were reported where two different organizations were reporting some of the same contributions, which inflated their individual numbers as well as the total system numbers. Instances of this nature brought the reporting guidelines of the United Way of America into the spotlight. One problematic area of the guidelines directed the organizations to report money that was handled or raised for competing organizations in shared campaigns as their own contributions, which resulted in the contributions being counted twice. Another questionable guideline allowed for counting the value of a

volunteer's time as a contribution.²⁴ Since a monetary value is not placed on a volunteer's time for purposes of an income tax deduction, it is inappropriate for an organization to place such a value on time contributed by a volunteer.

Inflating contributions presents a large problem in today's society where many donors rely on the ratings of these not-for-profit organizations in determining which organization to support. Inflating contributions makes it appear that the organization's expenses require less contributions relatively, which gives the organization a higher rating. The *New York Times* quoted the president of the United Way of America: "What happened at Enron and WorldCom has raised the bar for both for-profit and not-for-profit businesses," said Brian A. Gallagher, president of the United Way of America. "We have to respond".²⁵

The act of two organizations counting the same contributions, causing the inflated contributions, is referred to as "double counting". Instead of overlooking the problem of double counting, Gallagher decided to address it by forming a task force to review the problem and find a solution. The task force reported that less than 13 percent of United Ways had written guidelines for spending and financial reporting. The issue of uniform reporting compliance for all United Ways also had to be addressed:

²⁴ Stephanie Strom, "Questions Arise On Accounting At United Way," *New York Times* 19 Nov. 2002 <<http://query.nytimes.com/gst/fullpage.html?res=9D0CE0DA1E30F93AA25752C1A9649C8B63&sec=&spon=&pagewanted=1>>.

²⁵ Stephanie Strom, "Questions Arise On Accounting At United Way," *New York Times* 19 Nov. 2002 <<http://query.nytimes.com/gst/fullpage.html?res=9D0CE0DA1E30F93AA25752C1A9649C8B63&sec=&spon=&pagewanted=1>>.

There's so much variance among United Ways in things like accounting, finances and systems, said Arnold Henning, the interim president of the United Way in Chicago. The independence to vary from city to city is our strength when it comes to services because it means we know the needs of our communities. But it's also our weakness because people don't understand that the practices of one United Way are not the practices of all United Ways.²⁶

The problem of uniform financial reporting is not specific to The United Way, as it is also a problem within many religious organizations. If the accounting practices of parts of a church, such as a Catholic parish, are different from the guidelines of the church as a whole, problems will arise if, or when, these practices come into question. It is difficult for an organization to defend itself if its members are not practicing by the same set of guidelines.

The "Accountability" section of the website of The United Way of America includes a list of guidelines to be followed by every United Way organization in the United States. These standards were implemented in 2003 following the promise by Gallagher to solve the financial reporting problems that had surfaced in many United Ways. This action was an attempt to "enhance the level of accountability and transparency in local operations".

Every United Way must:

- Be tax-exempt under Section 501(c)(3) of the Internal Revenue Code as well as corresponding provisions of other applicable state, local or foreign laws or regulations. United Ways must file the IRS Form 990 annually in a timely manner. Large United Ways will submit their entire IRS Form 990 to United Way of America annually.

²⁶ Stephanie Strom, "Questions Arise On Accounting At United Way," *New York Times* 19 Nov. 2002
<<http://query.nytimes.com/gst/fullpage.html?res=9D0CE0DA1E30F93AA25752C1A9649C8B63&sec=&spon=&pagewanted=1>>.

- Comply with all other applicable legal local, state, and federal operating and reporting requirements (e.g., nondiscrimination, Sarbanes-Oxley Act, USA Patriot Act).
- Have an active, responsible, and voluntary governing body, which ensures effective governance over the policies and financial resources of the organization.
- Adhere to a locally developed and adopted statement to ensure volunteers and staff broadly reflect the diversity of the community it serves.
- Represent itself as a United Way in accordance with all United Way of America trademark standards and requirements.
- Support the United Way system by providing financial support to United Way of America according to the membership investment formula.
- Adhere to a locally developed and adopted code of ethics for volunteers and staff which includes provisions for ethical management, publicity, fundraising practices and full and fair disclosure. All large United Ways will submit a copy of their code of ethics to United Way of America.
- Undergo an annual audit conducted by an independent certified public accountant whose examination complies with generally accepted auditing standards and GAAP. United Ways with annual revenue totaling less than \$100,000 may have their financial statements reviewed by an independent accountant. Large United Ways will submit their audited financial statements to United Way of America annually.
- Conduct every three years a volunteer-led self-assessment of its community impact work, financial management, and organizational governance and decision-making.
- Annually submit to United Way of America a report of the total resources generated (annual fundraising campaign plus other resources such as in-kind donations and proceeds from special events). This report must be completed according to a policy that ensures an accurate, unduplicated national accounting for the United Way system.

- Biennially submit to United Way of America a report on United Way income and expenses.
- If managing donor-designated gifts, base any fee charged on actual expenses. If receiving designated gifts from another United Way organization, do not deduct fundraising or processing fees.²⁷

In overcoming such a potentially life threatening obstacle for the organization, The United Way handled itself with poise and assurance, which is the reason that it continues to be one of the largest not-for-profit organizations in the world. While there is still need for improvement in the area of company-wide uniformity for The United Way of America, its story serves as an example of an organization that recognized the existence of a problem, sought a resolution, and ultimately came out a stronger operation with greater organization-wide compliance and transparency. Although its magnitude far surpasses that of many small not-for-profits, particularly churches, the acts of double counting and various other reporting flaws are commonly overlooked and need to be addressed by every organization, regardless of size and revenue.

Review of Internal Controls and Financial Statements

Since not-for-profit organizations are not prohibited from making an excess of revenues over expenses, which is characteristic of many organizations, adequate financial statement presentation and effective internal control procedures are essential for providing transparency in the organization. The financial statement requirements and internal controls of two different religious organizations will be examined. The purpose for the selection of the two entities being reviewed resides in the stark differences in

²⁷ United Way of America <www.liveunited.org>.

governing bodies and internal controls, or lack thereof, found in the different denominations of these entities. While each of the financial statements has undergone an external audit performed by a firm of Certified Public Accountants, or CPA firm as it is more commonly called, it is important to note the differences in the requirements, or lack thereof, set forth by each denomination. It is also important to understand the weaknesses found in each entity's statements and internal controls and whether those weaknesses would be tolerated in a "non-religious" not-for-profit organization.

The first organization represented is a Methodist church that is a part of the Mississippi Conference of the United Methodist Church and is located in Jackson, Mississippi. As a highly organized religious organization, the Mississippi Conference is composed of 1,142 Methodist churches across the state, along with 843 active clergy and a bishop, who serves as the "chief officer". The United Methodist Church is governed by a General Conference that meets once every four years, while state conferences meet annually.²⁸

This analysis will focus on the Mississippi Conference. The website of the Mississippi Conference provides a document entitled "Local Church Audit Guide" for its members, or any individual, to access freely. This document frequently refers to *The Book of Discipline of The United Methodist Church*, which is published every four years immediately following the General Conference, with the most recent edition being that of 2008. This book contains the governing practices of The United Methodist Church,

²⁸ "About Us." Mississippi Conference of The United Methodist Church <<http://www.mississippi-umc.org/page.asp?PKValue=715>>.

including the church Constitution, history of the church, doctrinal standards, and mission statement.²⁹ The guide defines an "audit" as follows:

A local church audit is an independent evaluation of the financial reports and records and the internal controls of the local church by a qualified person or persons for the purpose of reasonably verifying the reliability of financial reporting, determining whether assets are being safeguarded, and whether the law, the Discipline, and policies and procedures are being complied with.³⁰

While the definition of the audit required for members of the Conference appears sound upon first glance, it is clarified later in the audit guide that the "qualified person" performing the audit is not required to be a Certified Public Accountant (CPA). It does go on to say that "generally" the person performing the audit "will have some experience with accounting principles, such as those gained through bookkeeping, office management, or accounting courses".³¹

Several major problems with the statement above need to be considered. First, the use of the word "generally" implies that it is not always the case that the person performing the audit will be someone with any kind of experience in the field of financial reporting. Second, the activities listed as the possible experiences necessary to make one qualified for an audit are very general specifications. The guide also "suggests" that members with annual receipts in excess of \$300,000 to \$400,000 should consider using an outside audit firm; however, this is only a recommendation.³²

²⁹ "The Local Church Audit Guide For United Methodist Congregations," General Council on Finance and Administration <http://www.gcfa.org/PDFs/Local_Church_Audit_Guide.pdf>.
³⁰ "The Local Church Audit Guide For United Methodist Congregations," General Council on Finance and Administration <http://www.gcfa.org/PDFs/Local_Church_Audit_Guide.pdf>.
³¹ "The Local Church Audit Guide For United Methodist Congregations," General Council on Finance and Administration <http://www.gcfa.org/PDFs/Local_Church_Audit_Guide.pdf>.
³² "The Local Church Audit Guide For United Methodist Congregations," General Council on Finance and Administration <http://www.gcfa.org/PDFs/Local_Church_Audit_Guide.pdf>.

It should be recommended that The General Conference of The United Methodist Church require of its members whose receipts are in excess of \$250,000 an annual, external audit performed by a CPA who is independent of the church. It should be understood that small churches may not require the review that larger ones do, which is the reason for the recommendation of a \$250,000 limitation. This requirement would be similar to the requirement of all United Way organizations with annual revenues over \$100,000 to have an annual audit conducted by a CPA. As stated above in its recently adopted standards, all United Way organizations in the United States with revenues less than \$100,000 may use an independent accountant to conduct a review, which would be a less costly process.³³ United Methodist churches would benefit from requirements similar to those of United Way organizations. Since an annual audit of a not-for-profit organization is not required by law, an adequate audit is commonly overlooked in an attempt to save money and time; however, the consequences that could result from a lack of an efficient audit would far outweigh the cost of the audit itself. As the guide eloquently states, an audit should be viewed as a positive affirmation of stewardship: "Conducting an audit is not a symbol of distrust. It is a mark of responsibility. It is good stewardship demonstrated for all to see. It is a message to local church donors that you care about their gifts".³⁴

The next set of statements and internal controls analyzed is that of a large Baptist church located in the Jackson area as well. With three "campuses" around the metropolitan area and attendance well over 5,000 on any given Sunday, it is arguably the largest church in the state. As a part of the Southern Baptist Convention, the church is not

³³ United Way of America <www.liveunited.org>.

³⁴ "The Local Church Audit Guide For United Methodist Congregations." General Council on Finance and Administration <http://www.gcfa.org/PDFs/Local_Church_Audit_Guide.pdf>.

required to abide by any set standards, whether structural or financial. Unlike most other Christian denominations, Baptist churches have no one in an authoritative position to whom they must answer, which gives them the characterization of autonomous. These religious entities are entirely separate of one another, and thus no uniformity exists in their financial statements.

As a part of this portion of analytical research, a few questions concerning internal controls were posed to the Director of Finance of each church. The first question involved five important areas of internal control that CPAs take into account as they audit companies. As described in the textbook *Auditing and Assurance Services*, the major types of control activities are generally placed into the five categories about which each director was asked. These five categories are as follows:

- Adequate separation of duties
- Proper authorization of transactions
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance³⁵

Each director was asked these questions on separate occasions; however, the answers are grouped together in this study for better comparison. Each director also requested that neither his or her identity nor the church's name be mentioned in the study.

When asked about adequate separation of duties, the finance director of the Methodist church responded that his organization employs two people between whom the duties are divided. The employee titles are "Director of Finance and Administration" and

³⁵ Alvin A. Arens, Randal J. Elder, and Mark S. Beasley, *Auditing and Assurance Services* (New Jersey: Prentice Hall, 2008) 298.

"Administrative Assistant to the Director of Finance and Administration", and a volunteer from the finance committee of the church is also frequently used to allow further checking of the employees. The finance director of the Baptist church gave a short response to this question, stating simply that they do "maintain separation of duties". Of the two answers, the one given by the finance director of the Methodist church was more convincing of an effective separation of duties within its finance department. However, neither director went into much detail about how the duties are divided.

When asked about proper authorization of transactions and activities, the Methodist finance director stated that two people must always be present when deposits are made and that accounts payable are authorized by the submitting department and initialed by the finance director. This practice is in place to assure that payables are legitimate. Additionally, the finance director does not have the authority to sign checks, rather a member of the finance committee authorizes signatures. The fact that the finance director is deprived of this duty gives assurance that he does not obtain too much power.

The Baptist finance director also gave a detailed response to this particular question. All checks from this entity require two signatures, regardless of amount, which prevents any one person from having overall authority on check authorization. Before any check is cut, a request for the check must be substantiated and approved by the team leader of the ministry requesting the payment. Deposits are handled by a volunteer team consisting of a minimum of six people, all of whom sign off on a "count sheet" and reconcile to the deposit. With this many people involved in a deposit, it would be difficult for someone to deposit the money for a purpose other than that for which it was approved. Also, the deposit is posted to the General Ledger by a staff member, and the

post must be approved by the finance director. Although it appears the finance director has ultimate authority, at least eight people are involved in this process, giving it the appearance of sound control through a system of checks and balances.

The next category of controls discussed with each finance director was that of adequate documents and records maintained by the entity. The Methodist church has an excellent financial data set, which is called an Automated Church System, and it has a full chart of accounts for each fund. By maintaining an adequate chart of accounts, it is easier to account for funds within individual accounts. The Baptist church has a written policies and procedures manual and a chart of accounts; however, they lack an Automated Church System.

Physical control over assets and records was the next topic of discussion. The Methodist church appeared to be very behind on this type of control. The finance director stated that they lack a detailed inventory record; however, the external auditor for the church verifies all new physical assets acquired during the year. Although verification is a good control, a detailed inventory record is necessary to adequately account for the assets of the church. The Baptist church, on the other hand, keeps a fixed assets inventory with fixed assets being tagged with "Property of..." tags. Additionally, any and all sensitive records are kept in locked safes, and a security camera system is in place. The inventory system of the Baptist church appears far superior to that of the Methodist church.

The last category of control activities discussed was that of independent checks on performance, which refers to internal checks of a person performing a duty by a person totally independent of the duty being performed. In the Methodist church, the finance

director reviews transactions as they are requested by particular ministry departments. Authorized check signers review the transactions that are presented to them for payments. The finance committee reviews financial records on a monthly basis, and the committee is comprised of those with experience in the field of finance, including CPAs, bankers, and financial advisors. An annual audit of records and financial statements is performed by an independent CPA firm. In the Baptist church, monthly monitoring is provided by each ministry via Budget vs. Actual reports. Also, a finance team, consisting of volunteers, reviews the monthly financial statements. An independent audit is performed annually by a CPA firm as well.

In the situation of each entity, it appears that sound control procedures and sufficient financial statement presentation are in place, with few exceptions. Since both entities are large in size, this is expected; however, small entities of each denomination may not have such sound policies. Therefore, it is important to understand that these are the policies of these particular entities rather than the policies of the denomination as a whole. As stated previously, the Methodist denomination has a hierarchy of entities to which each member church must answer. Local churches answer to their State Annual Conference, which, in turn, answers to the General Conference of the United Methodist Church. *The Book of Discipline*, as referred to earlier, requires a governing board for each church to oversee the duties assigned to the finance committee. This governing board, or "church council" as it is frequently called, elects sixteen members for the finance committee who serve on a three-year rotating election term. These churches are also

required to provide the Annual Conference with annual audited financial statements; however, as explained above, guidelines for such an audit are vague.³⁶

Although the scope of this section is limited to the analysis of two large churches located in the same state, the differences exhibited through the research of the practices of each denomination provide for a good contrast. The accounting practices by both entities represent the typical practices of most large churches today; however, the small differences found in the responses given by the finance directors provide evidence that the accounting practices and control procedures of a Baptist church are only as effective as the standards set by that particular church. In contrast, it can be speculated that Methodist churches are less prone to fraud as a result of their control procedures, which are monitored by a governing body. The Southern Baptist Association can learn from the guidelines set by the General Conference of the United Methodist Church, while both organizations should model some of their member requirements after the standards adopted by the United Way of America in 2003.

This chapter consisted of fraudulent situations in religious not-for-profit organizations, along with those of not-for-profit organizations that are not deemed religious in nature. It should be noted here that legal treatment of these two types of not-for-profit organizations differs greatly. The next two chapters present these differences, discuss the constitutionality of this unequal treatment, and analyze how accountability for religious not-for-profit organizations could be improved.

³⁶ The United Methodist Church <www.umc.org>.

Chapter III

Government Regulation

Not-for-Profits and the IRS

The IRS does not require not-for-profit organizations to pay federal income taxes, provided they meet the requirements for tax-exempt status set forth in Section 501 of the Internal Revenue Code (IRC). The only organizations exempt from filing for their tax-exempt status are those that are affiliated with an organization that has already obtained this status and that agrees to act as an "agent" to the organization that did not file for the status or those that are "religious" in nature.³⁷ Although religious organizations are not required to file for tax-exempt status, it should be noted that many do so in order to give their contributors assurance of their purposes. Not-for-profit organizations that qualify under Section 501(c)(3) are the only ones for which donors can claim a deduction for charitable contributions. Organizations qualifying under Section 501(c)(3) are the focus of this study.

There are three elements that an organization must possess for it to obtain tax-exempt status: "A not-for-profit (i.e., nonprofit) organization must be *organized* and *operated* exclusively for one or more *exempt purposes*".³⁸ The organizational element refers to the requirement for the organization to be organized as a corporation, trust, or

³⁷ "Applying for 501(c)(3) Tax-Exempt Status." Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

³⁸ "Applying for 501(c)(3) Tax-Exempt Status." Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

unincorporated association whose organizing documents pertain to the purposes stated in section 501(c)(3) of the IRC and dedicate all assets to these purposes. The operating element exists to ensure that the daily operations of the entity are in line with its tax-exempt purposes. These requirements include, but are not limited to, refraining from participation in a political campaign, restricting lobbying activities to a minute portion of activities, refraining from acting in the private interest of any one person, and abstaining from activities that would violate public policy. The exemption element provides the requirement for the organization to have its "exempt purpose" stated in its organizing documents. The IRC sets forth examples of purposes in section 501(c)(3): "charitable, educational, religious, scientific, literary, fostering national or international sports competition, preventing cruelty to children or animals, and testing for public safety".³⁹ Although not-for-profit organizations could be grouped into a number of categories, the most common three categories are charities, educational organizations, and religious organizations.

Upon obtaining tax-exempt status, organizations immediately assume a number of responsibilities. Arguably the most important of these is the responsibility to adequately record all financial activities in a detailed manner. Although the general public would expect any organization, whether for-profit or not-for-profit, to practice adequate bookkeeping, the next responsibility is one that the average person may not know exists. It is the requirement to file an annual informational return with the IRS. Such a return may be a Form 990, Form 990-EZ, or Form 990-PF along with Schedules A and B, depending on the size and type of tax-exempt organization. Until 2008, small

³⁹ "Applying for 501(c)(3) Tax-Exempt Status." Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

organizations whose gross receipts were \$25,000 or less were not required to file any type of return; however, they are now required to file a Form 990-N, which is the "Electronic Notice (E-Postcard) for Tax-Exempt Organizations not Required To File Form 990 or Form 990-EZ, also known as the e-Postcard".⁴⁰ This type of return is offered only in electronic format.

Although this added responsibility, which was activated in 2008, seemed to cover all tax-exempt organizations, the one category that has been and continues to be exempt from any filing requirements is the "religious organization" category. However, it should be noted that both churches reviewed in Chapter 2 have applied for and received 501(c)(3) status. This is becoming more common in today's society; however, it is not a requirement of any religious not-for-profit organization. In addition to the filing requirements listed above, tax-exempt organizations who have \$1,000 or more gross receipts from an unrelated business or trade must file a Form 990-T, and they are required to pay a quarterly estimated tax if it is expected that their tax will be \$500 or more for the current year.⁴¹

The final category of responsibility pertains to disclosure of information to the general public. Section 501(c)(3) organizations are required by the IRS to make their applications for tax-exempt status (Form 1023) and their three most recent annual returns available to anyone who requests them at no charge, with the exception of copying charges. Prior to March 13, 2000, only those filing a Form 990 or a Form 990-EZ were required to make those documents available; however, the Form 990-PF (for private

⁴⁰ "Applying for 501(c)(3) Tax-Exempt Status." Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

⁴¹ "Applying for 501(c)(3) Tax-Exempt Status." Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

foundations) is now among the required available documents. Also, for tax years beginning on or after August 17, 2006, the Form 990-T must also be made available.⁴²

In addition to the responsibilities imposed by the IRS, federal tax law requires disclosure of two types:

- a donor must obtain a written acknowledgment from a charity for any single contribution of \$250 or more before the donor can claim a charitable contribution on his/her federal income tax return;
- a charitable organization must provide a written disclosure to a donor who makes a payment in excess of \$75 partly as a contribution and partly for goods and services provided by the organization.⁴³

This restriction exists for the practical purpose of providing a donor with evidence of his donation so that he may claim the amount as part of his itemized deductions, if he chooses to do so.

It is important to note that the Form 990 was recently revised and became effective on September 9, 2008, and it became applicable for taxable years beginning on or after January 1, 2008. The redesigned Form 990, which was released by the IRS on December 20, 2007, was an attempt to shorten the form in length while making revisions needed to reflect the increasing diversity and intricacy of the not-for-profit sector, since it had not been significantly revised since 1979.⁴⁴ It will not be clear whether the redesigned Form 990 increases transparency of the not-for-profit sector until it has been active for a few years, thus its effectiveness cannot be analyzed for purposes of this

⁴² "Applying for 501(c)(3) Tax-Exempt Status," Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

⁴³ "Applying for 501(c)(3) Tax-Exempt Status," Internal Revenue Service <<http://www.irs.gov/pub/irs-pdf/p4220.pdf>>.

⁴⁴ Treasury Decision 9423, 09/09/2008, IRC Sec(s). 6033

study. However, a topic that is frequently discussed and debated is the extent to which the IRS should be involved in the governance practices of not-for-profit entities.

Governance and Form 990

At a minimum we should educate on basic standards and practices of good governance and accountability. And we should strongly encourage the community in its efforts to formally elevate standards...Someone needs to lead the sector on this issue. If not the IRS, then whom?

The statement presented above comes from a speech by Steven T. Miller, Commissioner, Tax Exempt and Governmental Entities, on April 27, 2007, at the 24th Annual Conference on Representing and Managing Tax-Exempt Organizations, which was hosted by Georgetown University.⁴⁵ Miller believes that it is the duty of the IRS to present good governance practices to tax-exempt organizations. His rationale is that the IRS would be in a better defensive position when handling large scandals involving not-for-profit organizations if it had adequately presented educational information for such entities on the guidelines that must be followed and the governance practices that are recommended.

The IRS has issued a document available to all tax-exempt entities, as well as the general public, entitled *Good Governance Practices for 501(c)(3)s*. The document itself and some commentary was presented in an article entitled "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" in the July 2007 issue of the *Journal of Taxation*. The document is split into nine sections, each with recommendations by the IRS for practices that could better ensure transparency,

⁴⁵ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

accountability, and compliance with tax laws. The sections are titled as follows: 1. Mission Statement, 2. Code of Ethics and Whistleblower Policies, 3. Due Diligence, 4. Duty of Loyalty, 5. Transparency, 6. Fundraising Policy, 7. Financial Audits, 8. Compensation Practices, and 9. Document Retention Policy.⁴⁶

The first section suggests a "clearly articulated mission statement", which is an excellent suggestion considering the charitable nature of most not-for-profits. Although the IRS recommends such a statement, nowhere on the redesigned Form 990 does it ask for the organization to state its mission statement. If it were a requirement on the Form 990, organizations would be more likely to formulate a uniform statement that would clearly state its mission to the public.

The second section suggests a code of ethics and whistleblower policies. This section places ethical responsibility on the board of directors of the entity: "The board of directors bears ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices".⁴⁷ The term "whistleblower" policy refers to a policy regarding complaints made by the employees of an organization. Ethical standards are especially important in not-for-profit organizations; however, such standards are frequently overlooked because in such an organization they are too-often simply understood rather than presented in writing.

The redesigned Form 990 does ask about a written whistleblower policy, which is a common policy amongst for-profit entities as well; however, nothing about a Code of

⁴⁶ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

⁴⁷ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

Ethics is found in it.⁴⁸ Although ethical responsibility is understood, accountability could be greatly increased by the requirement of a Code of Ethics, since those running not-for-profits are subject to the same "human nature" characteristics as those running for-profit organizations.

The third section addresses due diligence by stating that the directors of a not-for-profit entity should "exercise due diligence consistent with a duty of care".⁴⁹ This section is suggesting that directors act in the best interest of the organization by means of fully understanding the financial and societal positions of the organization.

The fourth section refers to a "duty of loyalty" owed to the organization by its directors. This section suggests that the directors adopt a conflict of interest policy, such as that required of public companies by the Sarbanes-Oxley Act.⁵⁰ A conflict of interest policy is helpful in effectively monitoring the overlapping financial interests that the organization and an individual within the organization may share with another entity that shares a business-type relationship with the organization. For example, auditors in CPA firms are not permitted to perform an audit for a company in which they or their spouses own stock because it is considered a conflict of interest. All public companies are expected to avoid conflicts of interest, and not-for-profit organizations should be expected to do the same.

The fifth section deals with transparency within the organization. This is especially important for not-for-profits because many donors want to know how their

⁴⁸ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

⁴⁹ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

⁵⁰ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

donations are being used for the betterment of society. Certain financial statements are required of not-for-profits for this very reason, and they should be made easily accessible to the general public. However, the redesigned Form 990 does not specifically require that the statements and policies be made public.⁵¹

The sixth section suggests the need for a fundraising policy for the organization. A fundraising policy serves the purpose of ensuring compliance when conducting fundraisers, which is a common practice in not-for-profits: "The board of directors should adopt and monitor policies to ensure that fundraising solicitations meet federal and state law requirements and solicitation materials are accurate, truthful, and candid".⁵²

The seventh section provides suggestions for an annual financial audit by an independent auditor. The troubling aspect of this section, and this entire document, is that it merely consists of suggestions, not requirements. An annual audit by an independent auditor should be a requirement of all not-for-profit organizations. A consideration may be acceptable for those of exceptionally small size.

The eighth section deals with compensation of directors and those who provide services for the organization. According to Thomas Silk, Senior Counsel to San Francisco law firm of Silk, Adler & Colvin and advisor to the American Law Institute's project Principles of the Law of Nonprofit Organizations, the not-for-profit sector is ahead of the for-profit sector in the area of adequate compensation.⁵³ Additionally, the Form 990

⁵¹ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

⁵² Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

⁵³ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*, July 2007.

provides a relatively large section requiring the explanation of compensation paid to directors and insiders.⁵⁴

The last section of the Good Governance Practices document pertains to a document retention policy. This section suggests the need for a "written policy establishing standards for document integrity, retention, and destruction".⁵⁵ This is important to ensure that documents are retained for an appropriate amount of time relative to the importance of the documents to the particular organization.

Although *Good Government Practices for 501(c)(3)s* is a helpful document consisting of an excellent system of guidelines for the management of not-for-profits, it is merely a suggestion guide. Many of the suggestions listed in this document should be requirements, such as a clearly articulated Mission Statement, a Code of Ethics, a well-defined policy on conflicts of interest, an annual financial statement audit by an independent CPA, and a document retention policy for relevant documents. These are practices relevant to the not-for-profit and the for-profit sector, as they add soundness to management policy and legitimacy to the organization in the eyes of the government, as well as the general public.

The Church: A Public Charity

Section 501(c)(3) organizations are divided into two categories: private foundations and public charities. Sections 509(a)(1), (2), (3), and (4) provide the qualifications for an organization that wishes to be considered a public charity. Public charities are the focus of this study, as churches and church associations are considered

⁵⁴ Redesigned Form 990: 2008. *Internal Revenue Service*. Part II.

⁵⁵ Thomas Silk, "Good Governance Practices for 501(c)(3)s: Should the IRS become Further Involved?" *Journal of Taxation*. July 2007.

public charities. Educational organizations, hospitals or medical research associations, organizations benefiting certain state colleges, governmental units, and any publicly supported organizations that normally receive one third of their support from contributions from the general public are considered public charities.⁵⁶

Many benefits that apply to public charities do not apply to private foundations, thus most not-for-profit organizations strive for this status. Some of these advantages are paraphrased below:

- Contributions to a private foundation may only be deducted up to 30 percent of adjusted gross income for each gift and 20 percent for appreciated property gifts. However, the contributions deduction for public charities is up to 50 percent of adjusted gross income for cash gifts and 30 percent for appreciated property gifts.
- Investment income for a public charity is not taxed; however, an excise tax of one or two percent is placed on investment income for a private foundation.
- More limitations are placed on interactions with directors and officers for a private foundation.
- Public charities are permitted to engage in limited lobbying activities, whereas private foundations are not permitted to engage in any lobbying activities.
- Private foundations experience a number of other "operating restrictions" than do public charities.⁵⁷

After learning of the different regulations imposed on the two categories of not-for-profit organizations, one can easily understand why it is beneficial for such an organization to be classified as a public charity, rather than a private foundation.

⁵⁶ Craig R. Stevens and Horton L. Sorkin, *Nonprofit Controller's Manual* (New York: Warren, Gorham, & Lamont, 1998) A1.09.

⁵⁷ Stevens, Craig R. and Horton L. Sorkin. *Nonprofit Controller's Manual*. (New York: Warren, Gorham, & Lamont, 1998) A1.09.

As mentioned above, churches fall under the category of public charities; however, all religious organizations are exempt from the requirements of other not-for-profit organizations imposed by the IRS. Generally, charitable contributions are deductible as itemized deductions on an individual's tax return only if the organization to which the individual contributed had acquired tax-exempt status under Section 501(c)(3) of the IRC. Ironically, this generalization does not apply to all organizations, as religious organizations are not required to file for tax-exempt status. Although a church or other religious organization could benefit from obtaining such status, it is never required of them. Upon obtaining tax-exempt status, a religious entity may become exempt from certain state taxes (i.e. property taxes) if its state law provides such an exemption. Additionally, it will become exempt from Federal excise taxes, and ultimately, this status gives assurance to donors that their contributions are deductible.⁵⁸

Although the use of Generally Accepted Accounting Principles (GAAP) is strongly suggested for adequate accounting procedures within a religious organization, unlike other not-for-profit organizations, it is not a requirement. As mentioned earlier, religious not-for-profits are not required to submit a Form 990 or apply for tax-exempt status through the IRS. Many people, religious and non-religious alike, may ask the question, "Is this fair?" A better question to be posed would be, "Is this constitutional?" Many lawmakers would argue that the special treatment of religious not-for-profit organizations is constitutional based on the First Amendment and the idea of "separation of church and state". After looking at the standards for non-religious not-for-profit organizations imposed by the IRS, this study will now take a look at the constitutionality of the special

⁵⁸ Kathy Crankshaw, "Accounting for Churches," Eastern Michigan University. ACC699, Fall 1998. <<http://people.mich.edu/skattelus/gen004.htm>>.

treatment of religious organizations and how further regulation could increase accountability of such organizations, particularly churches.

Chapter IV

Interpreting the First Amendment

The First Amendment

The freedom to exercise any religion desired without the consequences of scrutiny by the government has long characterized the United States of America. In fact, it dates all the way back to the immigration of those seeking freedom from the religious oppression so commonly found in other parts of the world. Therefore, when the United States became its own country, a provision was provided in the First Amendment to the Constitution that would allow the free exercise of religion for all its citizens. The First Amendment to the Constitution reads:

Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.⁵⁹

This amendment was designed to protect any and all religious groups from any form of unequal treatment under the law and to prevent the government from establishing a "national religion".

As stated in previous chapters, religious not-for-profit organizations are exempt from all regulation by the government. A religious organization, as it pertains to this

⁵⁹ First Amendment to the Constitution. *Constitution of the United States of America*
<<http://www.usconstitution.net/const.html>>.

study, refers to a church; however, all religious organizations of all religions are exempt from regulation. Therefore, it should be noted that the government is not showing favoritism in its lack of regulation of religious entities. From this point forward, religious not-for-profit organizations may be referred to in a general sense as "churches" or "associations of churches".

Over the course of the existence of the United States, much legislation has been passed through Congress protecting religious freedom. It can be speculated that this type of legislation passes due to the fear of the government to get involved with religious issues, particularly when it pertains to Christianity and fighting the "religious right". The United States Supreme Court of the 1960s and 1970s began to set a trend in decision-making of limiting the authority of government to pass legislation that would restrict religious freedom. However, this trend came to an abrupt halt in 1990 with the decision of the Supreme Court in the case *Employment Division v. Smith*, in which the Court decided that the use of peyote, a hallucinogenic drug, by religious groups was not a religious right protected under the Constitution. Although the use of this drug by some religious groups had been around for centuries, it was decided that this restriction, along with other similar restrictions, were constitutional as long as it was applicable to all religions.⁶⁰

In response to this new trend in Supreme Court rulings, many religious organizations and civil liberties groups formed a collective group called the Coalition for the Free Exercise of Religion. This coalition promoted the passage of a federal act that would prevent government from limiting religious freedom. The one exception to this

⁶⁰ "Religious Freedom Restoration Acts: Federal legislation." Ontario Consultants on Religious Tolerance. <<http://www.religious-tolerance.org/rfra1.htm>>.

was that they must have "a compelling societal reason" for limiting religious freedom in any form. Also the act would require the government to use the "least intrusive method to achieve its goal" if they must act to limit religious freedom. This act was called the *Religious Freedom Restoration Act of 1993 (RFRA)* and was passed unanimously by the House of Representatives on October 27, 1993. Additionally, the Senate passed the bill on November 3, 1993, and it was signed into law by President Bill Clinton on November 16, 1993.⁶¹

Throughout its life as a law of the United States, RFRA was used in many cases to "protect religious freedom"; however, the constitutionality of the act came into question when lower level courts in Texas found the act unconstitutional in the case of *City of Boerne v. P.F. Flores, Archbishop of San Antonio*. The case involved a disagreement between the Archbishop of San Antonio, who wished to allow St. Peter Catholic Church of Boerne, Texas, to expand its facilities to accommodate the church's growing membership, and the Boerne City Council, which passed an ordinance a few months later allowing the Historic Landmark Commission of the city to prepare a plan of preservation with historic landmarks and districts. It was not long after the ordinance was passed that the Archbishop applied for a building permit to allow his church to proceed with the planned construction of a new building. However, the city denied the building permit due to the historic preservation ordinance, arguing that the church was a building that must be maintained as a part of the preservation of historic landmarks.⁶²

⁶¹ "Religious Freedom Restoration Acts: Federal legislation," Ontario Consultants on Religious Tolerance, <<http://www.religious-tolerance.org/rfra1.htm>>.

⁶² *City of Boerne v. P.F. Flores, Archbishop of San Antonio*, Supreme Court of the United States, 521 U.S. 507, June 25, 1997 Decided <<http://www.law.umkc.edu/faculty/projects/trials/conlaw/boerne.html>>.

The Archbishop sued under the protection of the RFRA; however, the ruling of the lower courts that RFRA was unconstitutional was upheld by the Supreme Court in June of 1997: "In a 3 to 6 decision, the Supreme Court ruled that the law gave the practice of religion more protection than the court had found to be constitutionally required".⁶³

Two major legislations have been passed through Congress since the demise of RFRA; however, only one was actually signed into law. The first proposed legislation to replace RFRA was the *Religious Liberty Protection Act*; however, it passed the House but was struck down in the Senate. The next proposed legislation of this nature was the *Religious Land Use and Institutionalized Persons Act (RLUIPA)*, which was signed into law on September 22, 2000. RLUIPA granted religious freedom to inmates and restricted governmental interference with the "religious use of land".⁶⁴ Although it was signed into law, the Sixth United States Circuit Court of Appeals declared it unconstitutional in November of 2003 because the judges believed it had "the primary effect of advancing religion", thus it was a direct violation of the First Amendment to the Constitution.⁶⁵

Each of these cases provides evidence that the preferential treatment of religious organizations has been denied in the past. Masked as attempts to preserve religious freedom, these legislative acts are, in actuality, examples of unequal treatment under the law, which is contrary to the principles upon which the United States was founded. Upon the decision of the case of *City of Boerne v. P.F. Flores, Archbishop of San Antonio*,

⁶³ "Religious Freedom Restoration Acts: Federal legislation." Ontario Consultants on Religious Tolerance. <<http://www.religious tolerance.org/rfra1.htm>>.
⁶⁴ "Religious Freedom Restoration Acts: Federal legislation." Ontario Consultants on Religious Tolerance. <<http://www.religious tolerance.org/rfra1.htm>>.
⁶⁵ "Religious Freedom Restoration Acts: Federal legislation." Ontario Consultants on Religious Tolerance. <<http://www.religious tolerance.org/rfra1.htm>>.

Justice Paul Stevens of the Supreme Court made an excellent assertion regarding the lack of constitutionality exhibited in RFRA:

Because the landmark is owned by the Catholic Church, it is claimed that RFRA gives its owner a federal statutory entitlement to an exemption from a generally applicable, neutral civil law. Whether the Church would actually prevail under the statute or not, the statute has provided the Church with a legal weapon that no atheist or agnostic can obtain. This government preference for religion, as opposed to irreligion, is forbidden by the First Amendment.⁶⁶

Justice Stevens' assertion is applicable to this study as it relates to the lack of constitutionality of the exemptions of religious not-for-profit entities from the regulations that burden other not-for-profits every day.

Unequal Treatment of Not-for-Profit Organizations

Although it has been previously discussed that religious not-for-profit organizations are exempt from regulation by the IRS, another startling example of unequal treatment of such organizations surfaced in the state of Alabama in 2006. The scenario under review consists of two daycare centers operating in the same state; however, one is run by an individual in Auburn, Alabama, and one is run by the Harvest Temple Church of God in Montgomery, Alabama. Upon first glance, one would assume that two daycare centers operating in the same state must abide by the same regulations. This is not the case in Alabama, as church daycare programs are exempt from state licensing requirements. Although the state licensing requirements became stricter after

⁶⁶ City of Boerne v. P.F. Flores, Archbishop of San Antonio, Supreme Court of the United States, 521 U.S. 507, June 25, 1997 Decided <<http://www.law.umkc.edu/faculty/projects/ftrials/conlaw/boerne.html>>

nearly a dozen children died in licensed and unlicensed daycare centers over a two-year span, churches were still not added to the list.⁶⁷

State inspectors can investigate any daycare center not operated by a church at any time they wish, announced or unannounced. Additionally, the employees of daycare centers may file suit against their employer if they feel their civil rights are being violated; however, churches are protected from nearly all lawsuits by employees, regardless of the claim in the lawsuit.⁶⁸

As troubling as this may seem to an unbiased onlooker, many scholars across the nation still oppose any and all regulation on religious organizations. Douglas Laycock, a law professor at the University of Michigan, is one such scholar: "Never forget that the exercise of religion is a constitutionally protected activity...Regulation imposes burdens on the free exercise of religion. Exemptions lift those burdens...That is constitutionally a good thing".⁶⁹ Professor Laycock presents a valid point that the exercise of religion is a "constitutionally protected activity"; however, to insist that regulation "imposes burdens on the free exercise of religion" is not a valid argument. Any regulation placed on religious organizations would be no different than regulation on other organizations engaged in similar activities, providing equal treatment under the law.

Professor John Witte Jr., director of the center for the Study of Law and Religion at Emory University law school, voices his objections to regulation of religious organizations through the eyes of an oppressed people: "The special breaks amount to 'a

⁶⁷ Diana B. Henriques, "As Exemptions Grow, Religion Outweighs Regulation," *New York Times* 8 October 2006.

⁶⁸ Diana B. Henriques, "As Exemptions Grow, Religion Outweighs Regulation," *New York Times* 8 October 2006.

⁶⁹ Diana B. Henriques, "As Exemptions Grow, Religion Outweighs Regulation," *New York Times* 8 October 2006.

sort of religious affirmative action program”.⁷⁰ Although affirmative action can be helpful in cases where a group has been oppressed and lacks the ability to better itself in society, religious oppression under the law has not and does not exist in the United States; therefore, this claim is also invalid.

An interesting argument in a Florida case may lead one to believe that at least one lawyer understands the Constitution. Heather Morcroft, an Orlando lawyer, challenged a Florida state law exempting religious publications from the state sales tax on the basis that it was unconstitutional. Her argument stated that the government of Florida was favoring religious ideas over secular ideas by exempting religious publications from the state sales tax. She also argued that “tax officials should not be in the business of deciding what publications are sufficiently religious to be exempt”.⁷¹ This argument can easily be applied to the determination of which organizations are sufficiently religious to be exempt from the regulations imposed on all other not-for-profit organizations.

Anthony R. Picarello Jr., vice president and general counsel of the Becket Fund for Religious Liberty, a legal advocacy group in Washington, defends the exemptions of religious entities from standard regulations: “Providing special treatment is not always constitutionally required, but it is constitutionally permissible”.⁷² The argument in this chapter is that it is never constitutionally permissible to provide special treatment for any not-for-profit organization, religious or not.

⁷⁰ Diana B. Henriques, “As Exemptions Grow, Religion Outweighs Regulation,” *New York Times* 8 October 2006.

⁷¹ Diana B. Henriques, “Religion-Based Tax Breaks: Housing to Paychecks to Books,” *New York Times* 11 October 2006.

⁷² Diana B. Henriques “Religion-Based Tax Breaks: Housing to Paychecks to Books,” *New York Times* 11 October 2006.

Argument for Equal Treatment

Although the argument for the equal treatment of all not-for-profit organizations has clearly defined constitutional implications, churches and church associations could benefit greatly from the regulations imposed by the IRS on other organizations. A requirement for churches and other religious organizations to apply for and acquire 501(c)(3) status would ensure to their contributors that their donations are tax deductible. Additionally, the requirement of all religious organizations to file a Form 990 could have positive results. Although it has been shown that Methodist churches must answer to a governing body, Baptist churches and other religious organizations must answer to no one. Filing a Form 990 would be a positive attempt to hold these types of organizations accountable, since otherwise they are not required to report their finances to anyone.

A financial reporting requirement for all not-for-profit organizations would also be beneficial. Not only does proper financial reporting add to the legitimacy of the organization, it would add transparency as well. As it has been illustrated in this study, effective internal control activities are vital to the survival of any organization. Thus, an annual independent audit performed by a CPA would ensure that controls were evaluated in an unbiased manner and an opinion was given in regards to the accuracy of the organization's financial statement presentation. For an organization that may potentially be too small to afford an independent audit by a CPA, a threshold should be established for organizations meeting a set amount in contributions must conduct an annual independent audit by a CPA. All others falling below the amount must conduct some type of audit, whether internal or external, and must still file a Form 990 with the IRS.

These suggested requirements for churches are not unrealistic, and many churches already adhere to them. However, since it is not a requirement, religious organizations have the opportunity to avoid accountability altogether. The exemptions of religious organizations provide opportunities for fraud. By not requiring any specific presentation of financial information, increased potential for less organized, less accurate financial statements exists in this segment of the not-for-profit sector. Without the filing requirement of an annual Form 990, many religious organizations are autonomous, which provides more opportunities for leaders of these organizations to take advantage of the lack of accountability. Without anyone to whom they must answer, these leaders are more able, and arguably more apt, to commit fraud.

Additionally, the argument that imposing regulations on religious organizations is a violation of the First Amendment is simply invalid. The First Amendment was designed to protect all religious groups from oppression and to prevent the government from establishing a "national religion", in which case no other religion would be permitted. The First Amendment was not designed to give special privileges to religious groups. Instead, it serves the purpose of providing equal protection of any and all religions, just as the Constitution provides equal protection of all citizens under the law.

Conclusion

As discussed throughout this study, the not-for-profit sector is becoming an increasingly larger part of the economy of the United States, and comparatively little research has been conducted and little light shed on the problems that may have arisen in these organizations. As the not-for-profit sector becomes a more prevalent part of the economy, it becomes more important for that segment to be a topic of discussion. The portion of the not-for-profit sector that is most commonly eliminated from the discussion is the religious portion. The focus of this study was to identify the need for transparency in religious organizations, particularly churches, and discuss ways in which transparency could be achieved through more effective internal controls and equality in the requirements of all not-for-profit organizations.

As it stands today, the implementation of effective control procedures in a church is solely in the hands of the organization and its leaders, or in some cases, the organization to which the church belongs. This study has shown that adequate internal controls are necessary for the financial integrity of the church and its leaders to be upheld. Each and every church should follow the five categories of internal controls set forth in the textbook *Auditing and Assurance Services* as a guide for implementing internal control standards that must be met by church staff. Again, these categories include:

- Adequate separation of duties
- Proper authorization of transactions and activities
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance⁷³

These categories are the most clearly defined and easily understood that were found during this study; therefore, it should be relatively easy for churches to implement control procedures that fall into each of these categories.

As discussed previously, the General Conference of the United Methodist Church requires adequate controls, bookkeeping, and submission of an audited financial statement annually. With the exception of the lack of requiring an independent CPA to do the audit, the standards of this organization appear sound. If each and every religious organization and church body had such an organization to which it reported, this study might be entirely irrelevant. In such a case, nearly all measures to prevent fraud would be covered, with the exception of minor internal policies within each individual church. However, as it has been demonstrated in this study, this is not the case. The General Conference is the exception rather than the rule. Thus it is necessary for someone to govern religious organizations, and that organization is the IRS, a branch of the United States federal government.

Chapter Four illustrated that the protection of religious entities from federal regulation has been passed by Congress and signed into law by the President on several occasions but ultimately overruled in a number of cases by the Supreme Court; however,

⁷³ Alvin A. Arens, Randal J. Elder, and Mark S. Beasley, *Auditing and Assurance Services* (New Jersey: Prentice Hall, 2008) 298.

the exemption of these organizations from any and all of the accounting standards imposed on other not-for-profit organizations still stands firm. Rather than being an independent law similar to RFRA, this exemption is simply an understood generalized concept that the government does not question the accountability of religious organizations. Also presented in Chapter Four is the misinterpretation of the First Amendment to the Constitution. The misinterpretation lies in the assumption that because "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof", the government nor any government agency may not impose on churches the same regulations placed upon other not-for-profit organizations that are not characterized as 'religious' in nature. This study can be summarized into a series of proposals.

More Effective Internal Control Procedures

First, it should be the duty of each individual church to implement effective control procedures. These procedures should be modeled after the five categories referred to previously from the book *Auditing and Assurance Services*. Additionally, the standards for the organizations of the United Way of America listed previously should also be referenced when considering the implementation of effective controls.

Annual Independent Audit

Secondly, it should be the duty of each individual church to require of itself an annual independent audit by a CPA firm. These first two proposals are excellent suggestions for churches and church associations; however, they do not carry the weight of law, thus they are unenforceable.

Congressional Legislation

Lastly, it is the duty of the lawmakers of the United States to adequately interpret the Constitution and propose legislation accordingly. If this is unable to be done, the Supreme Court should become involved since the special treatment of religious not-for-profit organizations is a direct violation of the First Amendment. The First Amendment calls for government neutrality towards religion. The case should be made that by exempting churches and other religious entities from accountability regulations imposed on other not-for-profits, they are in actuality hindering these organizations and empowering their leaders. Additionally, the case should be made that by providing exemptions for religious entities, the government is showing favoritism to religion as a whole, which is unconstitutional.

Such a reform would benefit the religious not-for-profit sector and increase transparency in churches because it would provide for accountability for these organizations. Churches would be subject to the same 501(C)(3) tax-exemption rules and filing requirements as other not-for-profit organizations. Rather than being a burden on churches, it is the theme of this study that churches would be better off because their leaders would be less able, and less apt, to perpetrate frauds.

A Form 990 reporting requirement would be a reliable form of control because it would carry the weight of federal law. Equal treatment along with an effort on the part of each organization to better its control procedures would lead to increased transparency, a more confident organization, and ultimately decreased opportunity for fraud.

A reporting requirement combined with an audit requirement would be the ideal solution to fraud perpetration in churches. Audits are expensive, but frauds are far more expensive.

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