ACCOUNTING FOR CHURCHES

Adapted from a report by Kathy Crankshaw, with special thanks

Eastern Michigan University, ACC699, Fall 1998

Introduction

A church is one of many organizations that make up the not-for-profit sector, although a number of financial reporting differences exist due to the constitutional concept of "separation of church and state." The Internal Revenue Service provides guidance and regulation over not-for-profit organizations; however, religious organizations are generally exempt from these requirements. Specifically, churches do not have to apply for tax-exempt status, and consequently do not have to file an income tax return.

As with all organizations, though, managers of churches must properly account for the financial condition, results of operations, and especially cash flows of the church to the governing board, the congregation, and other interested stakeholders. Even in the absence of government regulations, generally accepted accounting principles (GAAP) should be followed in order to provide assurance that the organization's funds are handled appropriately. FASB Statement of Accounting Standards (*SFAS) No. 116* outlines procedures regarding contributions received and made and *SFAS No. 117* outlines financial statements principles for not-for-profit organizations are applicable to churches that prepare financial statements and would like an unqualified audit opinion. If fraud is suspected, the IRS may step in to conduct an inquiry.

Financial Reporting for Churches

The examples of the financial statements presented in other sections are general examples for not-for-profit organizations. Depending on the complexity of the operations within a church organization, the statements compiled by the church may be less complex than other not-for-profit organizations. Because most of the cash inflow transactions that occur in a church are the receipt of contributions, it is important to provide information to those contributors on how those contributions are spent.

Cash Flow Issues

In the short term, a church may be able to operate without an adequate amount of current assets to cover current liabilities by taking advantage of its position in the community. Often, businesses are reluctant to put pressure on churches for fulfillment of debts and will adjust payment schedules and interest payments to assist the church in their debt payments. While this may apply in the short-term, the long-term solvency of a church is very important. A church that is part of a larger unit, such as the Catholic Church, may fall back on the resources of the diocese or national office, but find it difficult to borrow funds as a single unit.

Financial Statement Analysis

The performance reflected in the Statement of Activities shows how effectively the contributions have been used. Since churches are not in the business of generating profit, a significant excess of receipts over expenditures is not viewed as a good measure of performance. This concept should also be reflected in the budget. Ideally, the amount of budgeted receipts should equal the budgeted expenditures, possibly with a little excess to act as a cushion or rainy day fund.

The Statement of Financial Position (balance sheet) is used to determine the net working capital. When restricted assets are deducted from the net working capital, the amount available for current operations is obtained. This statement also provides information on asset acquisition and debt financing.

While it is recommended that all three statements (also Cash Flows Statement) be generated and used for the financial management of the church, this information should be presented in a format that is easily understood. In the opinion of S. William Stock, the presentation of financial information should be targeted toward the specific audience for which it is being presented. In general, there are two audiences for a financial presentation in a church: the financial management committee and the overall church membership. Mr. Stock also suggests that the presentation of financial information be made with a combination of oral and written form. This allows for clarification and explanation of financial information.

Tax-Exempt Status (IRC §501)

In general, charitable contributions that are provided to a nonprofit organization can only be deducted by a taxpayer if the organization has filed for tax-exempt status. IRC §501(c)(3) states "Exemption application not filed. Donors may not deduct any charitable contribution to an organization that is <u>required</u> to apply for recognition of exemption but has not done so." This stipulation does not apply to the church organization because a church organization is not *required* to file for tax-exempt status. Therefore, a taxpayer may claim the deduction, even if the church organization has not filed for tax-exempt status.

Sometimes a church is advised to file for tax-exempt status to assure taxpayers that their contributions are deductible. This application is made on IRS Form 1023 *Application for Recognition of Exemption under* IRC §501(c)(3). Benefits of exempt status include public recognition of tax-exempt status, exemption from certain state taxes, assurance to donors of deductibility of contributions, exemption from Federal excise taxes, and nonprofit mailing privileges. It is not clear that this is good advice.

Internal Audit Procedures

In addition to complying with GAAP, the church should have an adequate system of internal controls in place to assure 1) that assets are safeguarded, 2) that financial statements are reliable and 3) that management policies are followed effectively and efficiently. It is often the nature of church members to hold a certain level of trust for fellow members, including those members placed into a position of financial management. Even so, it is necessary to employ internal audit procedures in the church organization. Audit procedures help to assure the people that make contributions to the church that the funds are handled responsibly. Audit procedures also protect those people in contact with the funds against possible accusations of inappropriate handling. These internal procedures do not need to be complicated, but should be followed and enforced.

Items that can be evaluated in an internal audit are not only related to financial performance. Nonfinancial operations, such as attendance rates can also be evaluated, along with policies established by the church government and laws.

A church accounting system should have a minimum of three positions including 1) a controller, 2) a financial secretary and 3) a finance-budget committee. The qualifications of these positions are important.

A knowledgeable person with proven accounting ability should be chosen to hold the position of controller. If the controller's normal accounting profession involves normal business reporting and planning, this person should be able to remove themselves from the regular reporting and planning techniques and be able to focus on the interests of the church organization.

The financial secretary is often in charge of maintaining accounting records and may also prepare checks for signature. It is good policy to require the signature on the check to be a different person than the person preparing the check. Often, two signatures are required for checks exceeding a pre-determined amount according to church policy.

The persons selected for the finance-budget committee should also be knowledgeable of accounting and financial management. It is common for churches to select committee members based on their popularity or position in the church, and not because of their ability to contribute to the financial matters. Therefore, the church should be careful in its selection of people who will be involved in the financial administration of the organization.

Often, one of the functions of the finance-budget committee is to establish an audit committee. This audit committee may be charged to reconcile, or review the reconciliation, of the church bank account and they may also be charged to examine contribution records to confirm that they agree with actual contributions.

The audit committee should be encouraged to conduct a periodic internal audit of the church. Loudell Ellis records a number of objectives of a church audit:

1. To determine that adequate internal control procedures exist and that such procedures are being followed.

2. To determine that all donations to the church were deposited and recorded correctly.

3. To determine that securities were safeguarded and that related revenue was collected and recorded.

4. To determine that disbursements were properly authorized (i.e. that the budget was followed or that changes were approved) and that authorized members approved payment of invoices.

5. To determine that payments to vendors at year-end were not delayed because of overspending the budget.

6. To determine that records were maintained on plant and equipment items and that adequate insurance was obtained.

7. To determine compliance with federal and state regulations, including properly and timely paid employment taxes and income taxes, if applicable.

8. To recommend improved procedures and practices.

The audit committee should assess whether the financial goals of the church were met regarding whether expenses were met, whether debt was managed properly and whether funds were used as the contributor intended.

External Audits

Many churches prepare their financial statements internally rather than have them prepared and reviewed by a Certified Public Accountant (CPA). For larger churches, this approach may introduce problems in dealing with organizations outside of the church. For instance, if a church with insufficient collateral were to apply to a banking institution for a loan, that banking institution may require audited financial statements, among a number of other reports. Audited statements may also be desirable as a verification of internal audit procedures or as an additional assurance to the members and stakeholders that financial statements are accurate. For these reasons, a church may voluntarily undergo external audits conducted by a CPA.

While it is true that the church organization is exempt from taxes and need not file Form 990 with the IRS under IRC§501(a), the IRS may, under certain circumstances, require an audit. Religious organizations exempt from taxes are expected to report and pay taxes on unrelated business income exceeding $1000 using Form 990-T, Exempt Organization Business Income Tax Return. IRC§7611 outlines restrictions on church tax inquiries and examinations.

The IRS has very specific guidelines and restrictions regarding its ability to examine church records and activities. The first step for the IRS is to conduct an inquiry of the church. IRC §7611 dictates that the IRS may submit for a church tax inquiry if there is reasonable belief that 1) the organization may not be exempt, by reason of its status as a church or 2) it is carrying on an unrelated trade or business or otherwise engaged in activities subject to taxation. A notice of inquiry must be sent to the church in advance and is required to contain an explanation of the concerns that gave rise to an inquiry and the general subject matter of an inquiry. Also included in the notice are any applicable administrative and constitutional provisions regarding the inquiry, including the right to a conference with the IRS before any examination of church records.

Once these inquiry requirements have been met, an examination can then be arranged. This examination of church records may only be to the extent necessary to determine the liability for, and the amount of, any tax imposed. This examination may also only be to the extent necessary to determine whether an organization claiming to be a church, is a church for any period.

At least fifteen days prior to the examination, a notice is provided to the church and to the regional IRS counsel. This provides reasonable time for the church to participate in a conference, but only if the church requests a conference before the examination. This notice of examination must contain 1) a copy of the church tax inquiry notice, 2) a description of the church records and activities that are to be examined, 3) an offer to have a conference to discuss concerns relating to the examination and an attempt to resolve these concerns, and 4) a copy of all documents collected and prepared by the IRS for use in the examination (this disclosure is required by the Freedom of Information Act (5 U.S.C.552).

Once the examination of church records has started, the IRS examiner may examine any church records or religious activities which were not specified in the examination notice, as long as there is reasonable belief that 1) the organization may not be exempt, by reason of its status as a church or 2) it is carrying on an unrelated trade or business or otherwise engaged in activities subject to taxation.

An example of the application of IRC §7611 can be observed in a dispute between the IRS and a church organization. In 1989, the IRS went to court regarding a dispute with the Church of Scientology Flag Service Org, Inc. and its secretary and directors. The church claimed that a number of violations occurred regarding the involvement of the IRS and its examination of the church. The church claimed that the inquiry notice did not adequately explain the subject matter or the concerns of the inquiry. The church also claimed that there was not sufficient evidence to question the exempt status of the church. The court found that the IRS did in fact comply with IRC §7611 by stating in the inquiry notice that the tax-exempt status was questionable due to the church's "substantially commercial purpose". The inquiry letter also stated that the church's agreements regarding trademarks, patents, copyrights and trade names would lead to operations of the church that are not consistent with the tax exempt status it claimed.

The church also contended that the reasonableness of the claim that the church's tax-exempt status was not valid. The court stated that IRS was required to comply with the notice requirement, which it did, and that the church has no ground to challenge the belief of the IRS regarding the reasonableness of the claim.

The church claimed that the IRS' participation in the conference held before the examination was not for the purpose of settling their concerns, but was merely "going through the motions" to comply with the code. The court stated that whether or not those claims are true, the IRS code does not require that the conference hold any good faith or sincerity. The code only states that a conference must be held, and no further laws regarding the content of the conference are in place.

The only claims of the church that were referred to the United States Magistrate was a claim regarding whether or not the items requested by the IRS are necessary for the determination of the church's tax-exempt status, and a claim regarding the allowance of discovery by the church to provide whether the IRS was acting in bad faith.

Conclusions

Religious organizations are an interesting segment of the not-for-profit sector. The concept of "separation for church and state" interpreted from the United States Constitution means that certain exceptions must be made for religious organizations regarding financial reporting. Even so, religious organizations should comply with GAAP in order to assure that assets are safeguarded, that financial statements are reliable, and to make sure that management policies are followed.

The use of internal controls in a church is important. While a high level of trust exists between the church membership and those in position of financial management, audit controls are needed to assure the membership that funds are handled responsibly. Audit procedures also protect those in position of financial management against possible accusations of improper handling. It is also recommended that large churches have a periodic external audit conducted by a CPA.

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