Internal Financial Controls in the U.S. Catholic Church

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One of the by-products of the recent U.S. Catholic Church clergy sexual abuse scandal was a new focus on the Church's financial transparency and accountability. As the scandal unfolded, parishioners learned that in some dioceses, payments related to the scandal had been taking place for years. Some of the payments went to victims in the form of settlements or to pay for counseling; some went to pay for the "rehabilitation" of priests accused of pedophile; and some funds were paid out in lawyers fees. The vast majority of Catholics was unaware of these payments, and therefore surprised by the magnitude of the scandal. A number of parishioners pointed out that, if the Church had been more open in its finances, the expenses associated with clergy sexual abuse, and hence the nature and magnitude of the problem, would have been uncovered much sooner than it was. This might have caused church leaders to take action sooner and prevent some of the abusive behavior, especially that by repeat offenders.

As parishioners became more aware of the lack of financial transparency and accountability, they clamored for some institutional controls and mechanisms to address this issue. After further investigation, it was learned that Catholic dioceses (and to a lesser extent, Catholic parishes) were subject to a variety of internal financial control mechanisms embodied in canon law. Once this became well-known, the focus shifted to the degree of effectiveness of these mechanisms.

This paper analyzes the effectiveness of the internal financial control mechanisms employed by U.S. Catholic dioceses on one measure of their effectiveness -- the amount of embezzlement that has occurred in the diocese in recent years. The study is based on data collected from a recent survey of diocesan chief financial officers.

In the next section of this paper, a general discussion of the nature of internal financial controls is presented. That is followed by a consideration of the internal financial control mechanisms available to Catholic dioceses. Multiple regression analysis is used to examine the effect of these controls on the amount of recent embezzlements experienced by dioceses. The paper concludes with some recommendations.

Corporate Financial Controls

The Catholic Church is not the only institution that has come under attack for its inadequate financial controls. Recent scandals, such as the Enron and Tyco scandals, contributed to the passage of the Sarbanes-Oxley Act in 2002. This has resulted in U.S. corporations undergoing intensive review, analysis, and testing of their internal control structures.

The primary focus of the Sarbanes-Oxley bill is on fraudulent financial reporting. In a number of high-profile cases, management aggressively recognized revenue or manipulated (deferred) expenses to purposely make the company look better than it really was. This financial reporting chicanery had the impact of inflating the stock price which greatly benefited top management, holders of large blocks of the companies' stock and stock options.

Fraudulent financial reporting is much less of a concern for the dioceses and other not-for-profit entities. Safeguarding an entity's assets is a bigger concern for not-for-profit entities. Revelations of embezzlements in not-for-profit entities are routinely reported in the media. Occasionally, those embezzlements occur at the highest levels of the organization. For example, the Orthodox Church of America recently fired its chancellor and began an audit. The chancellor is at the center of allegations brought by the former church treasurer of missing money, diverted cash, and un-audited accounts totaling millions of dollars (Washington Post, March 18, 2006). A pastor in the Bridgeport, Connecticut Catholic diocese was investigated on charges that he misspent $1.4 million of parish donations (Boston Globe, July 28, 2006). Four purchasing agents for the archdiocese of New York allegedly extorted over two million dollars in a kickback scheme over eight years from various food vendors to maintain lavish lifestyles. The church lost over one million dollars by having to pay higher prices for the food being purchased for schools and parishes (States News Service, January 5, 2006).

There have been a number of studies that have documented the importance of and the general inadequacy of internal financial controls in churches (Chester, et al, 1999; Duncan, et al, 1999; Edwards, 1990; Flesher and Duncan, 1999; Harper and Harper, 1988; Jordan, et al 1991; McEldowney, et al, 1993; Smith and Miller, 1989; and Stock, 1995). Others have focused on the relationship between the spiritual aspects of a church and its accounting practices (Abdul-Rahman and Goddard, 1998; Booth, 1993; and Loughlin, 1998).

The objectives of the internal control structure of an entity are:

1. Provide reliable financial statements and accounting records
2. Safeguard the entity's assets
3. Promote operational efficiency and effectiveness
4. Promote adherence to management's policies and procedures

Regardless of whether the entity is a Fortune 500 company or a diocese of the Catholic Church, the objectives of the internal control structure remain the same. A diocese would slightly reword the fourth objective as "promote adherence to the mission of the Church."

Oftentimes, embezzlements occur when trusted employees have access to both assets **and** financial records. Not-for-profits often have small accounting departments which presents two problems. They have difficulty separating duties and employees often have little supervision by a qualified financial manager. A fundamental tenet of internal accounting controls is to keep the financial recordkeeping duties separate from those individuals that have access to assets, especially cash.

Researchers have identified a number of other internal control issues that are relevant to non-profit organizations, especially churches. Duncan, et al, (1999) noted several characteristics that are unique to non-profit organizations that interfere with effective internal financial controls. These include:

1. Due to the absence of stock ownership, managers might not regard themselves to be as accountable to donors as they are to owners.
2. It is difficult for managers of non-profits to evaluate the effectiveness of their organization since they lack a single measure of performance, such as profits.
3. Non-profits are frequently managed by professionals who, while competent in the provision of the services offered by the non-profit, possess little or no training in accounting or business management.
4. Likewise, members of a non-profit's board are frequently chosen because of abilities that have little to do business management (Duncan, et al, 1999, p. 142).

It is easy to replace "non-profit" with "church", or "congregation", or "parish" in the above statements. Duncan, et al, suggest an additional danger that churches face. Since churches rely on sacred belief systems, internal controls might be viewed as a secular concern and either inherently evil or at a minimum unnecessary in churches. In fact, it might be considered insulting to church workers and volunteers to even imply that internal financial controls are important (p. 145). On the other hand, Irvine (2005) argues that internal accounting controls are "a manifestation of holistic stewardship…consistent with a church's sacred agenda" and they assist it in achieving its spiritual goals (p. 212).

An effective internal control structure consists of three levels

1. Control environment (overarching, pervasive)
2. Accounting system
3. Control procedures (detailed, transaction-level)

This study focuses on controls at the highest level, the control environment. The control environment typically includes the following aspects of an entity:

1. The organizational structure of the firm (in the Catholic Church, this involves questions such as is the diocese organized as a corporation sole?)
2. Oversight by the board (in the Catholic Church, this is the diocesan finance council, or DFC)
3. Management's philosophy and operating style
4. Procedures for delegating responsibility and authority
5. Management's methods for evaluating performance
6. External influences (e.g., regulatory oversight)

Diocesan Financial Controls

From a doctrinal perspective the Catholic Church is highly centralized under the authority of the pope and his bishops. However, from an administrative perspective the church is quite decentralized with each diocese and each parish within the diocese having a fair amount of autonomy. Dioceses have virtually no external or regulatory oversight of their financial statements. Unlike corporations which provide quarterly financial statements to the SEC and hold quarterly conference calls with outside analysts, the church is subject to almost no recurring outside financial scrutiny. Many dioceses voluntarily post their audited annual financial statements on their website at the conclusion of the year-end audit. Additionally, many dioceses provide parishioners with an annual financial and administrative newsletter which provides a highly summarized view of the cash flows for the year and the results of social and spiritual programs offered by the diocese. But many other dioceses do neither. Since they are not required by law to be transparent and accountable in their finances, they choose to keep their finances private.

The primary document governing the Catholic Church is the revised Code of Canon Law, which became effective in 1983. Canon law contains a number of provisions directed at good management and financial practices. For example canon 1284 requires Church administrators to carry out their responsibilities with the prudence of a "good householder". As a hierarchical church, the buck stops with the bishop, who can delegate authority but not responsibility. Hence, it is imperative the bishop take responsibility for ensuring that an effective system of internal controls is in place.

The primary diocesan institution to monitor diocesan finances is the diocesan finance council (DFC). According to canon 492, each diocese is required to establish a DFC, to be presided over by the bishop or his delegate. Other canons delineate the DFC's responsibilities. These include:

- Final preparation of the annual diocesan budget (c. 493)
- Examine the diocesan annual income and expense report (or annual audited financial statements (c. 494)
- Advise the bishop on the appointment of (and if necessary, removal of) the diocesan finance officer (c. 494)
- Assist the bishop in reviewing annual reports submitted by clerical and lay administrators (c. 1287.1)
- Advise the bishop on both real and financial investments (c. 1305)
- Approve the sale of property at or above the amount established by the United States Conference of Catholic Bishops ($1 million for dioceses with more than 500,000 Catholics, $500,000 for smaller dioceses) (c. 1295).

In addition to the activities specified by canon law, bishops might also consult with their DFC's on other important financial matters, such as the appointment of an external auditor, employee compensation and benefits, property management, fundraising, and banking arrangements.

There must be at least three members on the DFC, and each is appointed to a five year term (c. 493).

In addition to canon law, the United States Conference of Catholic Bishops (USCCB) has established recommended guidelines for diocesan financial management. Unlike canon law, with which in theory bishops are required to comply, the USCCB guidelines are just that -- guidelines. Individual bishops can abide by them in whole or part, or reject them entirely.

In 1995, the USCCB's Committee on Budget and Finance published *Diocesan Internal Controls*, which was meant to serve as a framework for dioceses. In addition to providing guidance on specific issues faced by dioceses, the Committee recommended that the USCCB develop a structure for bishops to provide support for one another while still respecting the right of each bishop to manage his own diocese.

Based on this recommendations, the USSCB in 2001 approved a resolution requiring each bishop to submit to his metropolitan archbishop the names and professional titles of each member of the DFC, the dates of their meetings during the last fiscal year, and a statement signed by the DFC members that they have reviewed and discussed the financial statements of the diocese.

In 2002 the USCCB approved *Diocesan Financial Issues*, a 213 page handbook that was meant to supplement the *Guide to Preparing Nonprofit Financial Statements* (Cline, Paschall, Eason, 2006). The handbook covers a variety of issues, including those affected by both Church and civil law, but also includes the role of DFC's and the effective use of internal controls.

Church law grants the diocesan bishop ultimate responsibility for managing his diocese. Each bishop chooses the extent to which he abides by USCCB guidelines.

Research Findings

In order to learn more about diocesan internal controls, a questionnaire was sent to the CFO's of all 174 U.S. Catholic dioceses. We received 78 responses for a 45% response rate. The questions focused on the following topics:

1. Oversight provided by the diocesan finance council (DFC)
2. Risk factors
3. Financial reporting
4. Controls and audit

The sample was fairly distributed among different diocesan sizes: 14 percent had chancery (central office) budgets of over $20 million annually; another 14 percent had annual budgets of between $10 and $20 million; 34 percent had budgets under $5 million, and the rest had annual budgets between $5 and $10 million. Two-thirds were organized as a corporation sole.

Most of our questions related to the **overall control environment** of the diocese. We asked the CFO's to provide information about the oversight provided by the Diocesan Finance Council for example. We asked about internal and external audit activity, the timeliness of financial reporting and reviews, and high-level policies (e.g., fraud policy, conflict-of-interest policy) and high-level financial reporting procedures. Rather than inquire about detailed control procedures, we asked about the trend in Management Letter Comments from external auditors. Management letter comments typically cite weaknesses in control procedures as well as control environment weaknesses providing us with an overall view of control strength.

Findings: Descriptive Statistics

Diocesan Finance Councils

Every diocese in the sample reported having a DFC. We asked about the types of financial professionals serving on the finance council. Eighty-eight percent of the finance councils have at least one CPA; 15 percent have two or more CPA's on their councils. Sixty-nine percent have bankers and 44 percent have brokers. Other business professionals serving on the finance council include insurance executives, financial planners, business professors, corporate executives, lawyers, real estate developers, and entrepreneurs. It is uncertain whether some of these professionals are financially literate. Some dioceses (12 percent) had priests serving on the DFC.

The finance councils are quite active. CFO's rated 75 percent of their councils either a 4 or 5 on a five-point scale (5 being highly active). Only 7 percent of the CFO's rated their councils low (1 or 2 on a 5-point scale). To support this claim, we collected data on the frequency of DFC meetings. Ninety-six percent of the councils meet either monthly or quarterly and 69 percent review the financial statements (budget vs. actual comparisons) at least quarterly. This is an important control procedure. The aforementioned USCCB Report *Diocesan Internal Controls: A Framework* recommends that the DFC review the budget vs. actual statements at least quarterly.

The DFC selects the external auditors in 57 percent of the dioceses. The bishop selects the auditors at 28 percent of the dioceses, while the CFO selects the auditors in only 12 percent of the dioceses. Since the auditors are primarily auditing work performed by the CFO and his/her staff, it is a good internal control to have the auditors selected by and report to the DFC or the bishop. Most of the external auditors have a very long tenure with their respective dioceses, so that selecting the auditor is really reappointing them or not. The average tenure for the current external audit firm is 10.4 years and the average tenure for the current CFO is 12.5 years.

The DFC has a formal conflict-of-interest policy in only 55 percent of the dioceses. This is a straightforward and important policy to implement. The document *Diocesan Internal Controls: A Framework* recommends that dioceses should have a formal, written policy in this area. The objectivity of the DFC is an important component of the internal control environment.

Risk Factors

CFO's ranked the following risk factors in this order (1= highest risk):

1. Lack of expertise at the parish level
2. Parish finances and controls
3. Litigation
4. Adequacy of insurance coverage
5. Property management

Litigation risk was most frequently cited as the number one risk (25 of 67 respondents), although parish finances and controls and lack of expertise at the parish level had the highest overall risk scores. Insurance coverage was also rated fairly high. Property management issues placed a relatively distant fifth. The CFO’s were also asked to include other important risk factors (open-ended question). Investment performance (listed twice), schools, demographics and declining church attendance were risk factors mentioned by CFO’s. Parish financial condition could be a byproduct of this final risk factor, declining church attendance and demographics.

Of the responding dioceses, 46 percent had experienced more than one annual deficit over the past five years. The average was 1.65 deficits over the past five years. One-third of the dioceses had experienced no deficits during that period. We separately analyzed the major city (large budget) dioceses. There is a high degree of variation in the financial status of the major city dioceses with an average of 2.8 deficits, which is considerably higher than the overall sample.

The dioceses make loans to parishes and high schools for construction and for operating reasons. It is of concern when the borrower falls behind in their payments (e.g., the loan is in arrears). Twenty-six percent of the dioceses had no parish loans in arrears and 56 percent of the dioceses had no high school loans in arrears. Sixteen dioceses reported to us that they had loans totaling less than $100,000 in arrears from their parishes. Nine of the eleven major city dioceses had over $1 million in arrears from parishes (the other two had between $501,000- and $1,000,000 in arrears).

CFO’s provided us with the cumulative total of (detected) embezzlements over the past five years. Of those responding, 85 percent reported that embezzlements had occurred in their dioceses within the past five years. Of these, 29 percent had experienced less than $50,000 worth of embezzlements while 11 percent reported total embezzlements over that period of greater than half a million dollars. In 93 percent of the embezzlement cases, police reports were filed and in 91 percent of the cases, insurance claims were filed. The dioceses appear to pursue embezzlements in a professional manner, which in all likelihood is a deterrent against future occurrences.

It is interesting to note the parties responsible for detecting the theft. Most often, it was the parish priest, followed by the parish bookkeeper, an internal auditor, and the parish finance council. Not surprisingly, external auditors do not typically uncover embezzlements. The external auditors’ focus is on the fairness of the financial statements of the diocese, not at the more detailed parish (or high school) level. Parishes and high schools have many cash transactions and high schools have a variety of special-purpose funds which do not receive regular scrutiny. Internal audits are typically triggered upon change of key personnel in the parish—either a change in pastor or bookkeeper. There does not appear to be a typical internal audit cycle of parishes and high schools.

<u>Chief Financial Officers</u>

On paper, the CFO’s appear well-qualified for the position with many years of experience. Most have a financial background. The average amount of experience in the CFO position was over 12 years for our respondents. The range was from one year to over 30 years. Only 18 percent had three years or less of experience at the position.

Sixty-three percent of the CFO's had an accounting/finance background and another 27 percent had a business background other than finance or accounting.

Findings: Empirical Testing

Table 1 shows the results of a multiple regression analysis that tests the effect of various diocesan internal control mechanisms on the amount of fraud/embezzlements that a diocese has experienced in the last five years.

Internal control theory suggests that strong internal control structures should result in less embezzlement, fewer internal control problem areas, and fewer financial reporting errors. Material financial reporting errors presumably would be detected by the external auditors and corrected prior to filing the annual report. However, auditors would write a Management Letter Comment highlighting the deficiency in financial controls that permitted the error to occur and they would offer their recommendation for mitigating or eliminating the control weakness. Management letter comments would also be written for embezzlements. In addition, management letter comments are written even if a "violation" did not occur when the auditors believe the controls are such that a violation could occur if the controls are not strengthened.

The independent variables fell into five categories: the size of the diocesan budget (a control variable); oversight by the DFC; the role of the CFO; internal reporting control procedures; and internal and external audit activity. Consistent with the literature on other criminal activity, there are two possible interpretations of the statistically significant variables (see, for example, Krambia- Kapardis, 2002), revolving around the issues of criminal behavior detection vs. criminal behavior prevention.

A positive significant variable indicates that it is associated with detecting more fraud. This is a good thing to the extent that it means that fraud detection policies are working. It is a negative if it results from poor prevention policies. A negative significant variable indicates that it is associated with detecting less fraud. This is a good thing if it means that fraud prevention policies are working. To the extent that it implies that fraud detection policies are not working, it is not a positive finding. In the analysis of the empirical findings, we generally give dioceses the benefit of the doubt in interpreting whether a significant coefficient represents effective detection or effective prevention. Naturally, one could surmise an opposite interpretation.

Somewhat surprising, the size of the chancery budget (and therefore presumably the size of the diocese), has no effect on the amount of fraud/embezzlement committed.

Among the independent variables analyzing the impact of the DFC, an institution mandated by canon law, two variables were significant. If the Diocesan Finance Council (or one of its committees) is involved in reviewing the diocesan budget, there is less fraud detected (better prevention). The more frequently the DFC meets, the greater the amount of fraud detected (better detection). Having DFC conflict of interest guidelines plays no significant role in the amount of fraud that a diocese detects.

Three CFO variables were significant and negative: the tenure (years of the experience on the job) of the CFO, whether the CFO had an accounting background, and if the CFO selects the auditors. Interpreting the first two findings as representing better fraud prevention makes sense in that an experienced CFO can implement the controls needed and that a CPA background provides the relevant expertise to implement and monitor the appropriate controls. Interpreting the third finding as representing enhanced prevention can also make sense. The CFO is probably the best judge of the auditors' ability to perform the audit and internal control analysis. However, from an independence standpoint, Sarbanes-Oxley prefers that the Audit Committee of the Board of Directors (an independent body) select the auditors. The auditors, in effect, are auditing the CFO and his/her staff. Thus, a negative coefficient for this variable could alternatively be interpreted as demonstrating lax detection. In some dioceses, the bishop selects the auditors and in some others the DFC selects the auditors. In cases where the bishop or DFC feels capable of making that decision, it seems appropriate that they do so.

Three internal control variables were significant. Those dioceses with formal, written fraud policies experienced less embezzlement, presumably the result of better prevention. A formal fraud policy shows employees that you are serious about fraud and will prosecute individuals who are caught. A second variable that was significant had a positive impact on fraud detection: the frequency with which parishes submit their financial data. More frequent data collection can increase the opportunity for fraud detection, either at the submitting (parish) level or at the receiving (diocesan) level. Most of the dioceses (82 percent) operated diocesan-sponsored high schools. It is interesting to note that the frequency with which high schools submitted their reports had no effect on fraud/embezzlement detection.

A third internal control variable that was significant is difficult to interpret. Dioceses that present comparative financial data in their monthly budget versus actual reports experienced more embezzlement. This control is really a financial reporting control. It is not a control that would typically be used to detect embezzlements. It is a control that would more likely be used to detect errors in financial reporting.

Finally, in the audit category, the frequency of internal audits of parishes was significant and positive, and, based on the value of the standardized coefficient, the most important factor in explaining the level of diocesan fraud. This seems logical in that more frequent internal audits result in more detected embezzlements. On the other hand, one could argue that more internal audits would be a deterrent to employees and less fraud and embezzlements should occur. We asked CFOs how often internal audits are conducted. Only three percent of the dioceses conducted an annual internal audit of their parishes. Nearly 14 percent responded that internal audits do not routinely occur, but are triggered by a change in key personnel—either the pastor or the parish bookkeeper. Twenty-one percent of the dioceses indicated that they seldom or never audit their parishes. As was the case with the submission of financial data, the frequency of internal audits of high schools was not significantly related to the detection of fraud or embezzlements.

Conclusion and Recommendations

Based on a survey of 78 Catholic diocesan CFO's, we were able to identify those internal accounting controls associated with curbing financial fraud/embezzlement. Some were important because they were effective in detecting fraud and embezzlement; others because they served as a deterrent to fraud and embezzlement.

Based on these findings, we recommend the following environment control policies:

- Implementation in every Catholic diocese of the policies prescribed in the USCCB handbook *Diocesan Financial Issues*

- The establishment of fraud policies in every diocese

- Annual internal audits of parishes supplemented by external audits conducted at least every three years

- Public disclosure of the names and professions of every member of the Diocesan Finance Council, along with their conflict of interest guidelines

- At a minimum, quarterly meetings of the DFC (or one of its subcommittees) to monitor diocesan office, parish, and school financial reports

- Selection of the diocesan auditor by someone (bishop or DFC) other than the diocesan CFO

- At least annual (and preferably more frequent) submission of financial data by all parishes and high schools

- Establishment of a uniform budgeting process and standardized software for all diocesan entities

- Establishment of communication channels for church workers to report suspected irregularities or fraudulent activities while protecting their anonymity.

Appropriate policies and procedures at the other two levels of an internal control system (accounting system, control procedures) should be implemented. However, this discussion is beyond the scope of this paper.

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Table 1
Fraud/Embezzlement Regressions
Standardized Coefficients

Dependent Variable Value of Frauds/Embezzlements
Detected in last Five Years

Variable	Standardized Coefficient
Control	
Size of Diocesan Chancery Budget	-.01
DFC	
Involved in Reviewing Diocesan Budget	-.28*
Conflict of Interest Guidelines	.21
Frequency of Meetings	.31*
CFO	
CFO Receives Mgt Letter	.20
Years as CFO	-.24*
CFO Selects Auditor	-.44**
CFO Has Accounting Background	-.37**
Internal Reporting Controls	
Budget Reports Show Comparable Data	.34*
Frequency Parishes Submit Financial Information	.28*
Frequency High Schools Submit Financial Information	.18
Diocesan Fraud Policy	-.47**
Greatest Risk -- Property Mgt Issues	-.09
Audit Policies	
How Long With Current Auditor	.15
Frequency Audits of Parishes	.50**
Frequency Audits of High Schools	.10
ADJ R-Squared	.567
F-Statistic	4.36**

*	.05
**	.01