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**DIOCESAN
ATTORNEYS'
PAPERS**

**AICPA ACCOUNTING
PRACTICES
AFFECTING CHURCH
ORGANIZATIONS**

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Recently, a subcommittee of the American Institute of Certified Public Accountants, the AICPA, issued for public comment a discussion draft entitled "A Tentative Set of Accounting Principles and Reporting Practices for Nonprofit Organizations Not Covered by Existing Audit Guides." That is not a very catchy title but it is an important document nonetheless.

The purpose of the draft is to solicit comments and suggestions from interested persons before the subcommittee finalizes its conclusions. This tentative statement will have a significant impact on any organization it covers. For this reason, it is important that the affected groups offer their comments before the June 30, 1977, deadline.

Since 1972, the AICPA has issued similar type pronouncements, called audit guides, in the not-for-profit field. Specifically, they cover hospitals, colleges and universities, voluntary health and welfare organizations and state and local government. This tentative statement is intended to cover everything else in the not-for-profit field, which is a large number of organizations, as you can imagine. The draft goes on to cover the following: trade associations, social and country clubs, cemetery societies, professional associations, private foundations, libraries, civic organizations, labor unions, condominium management associations, residential real estate management associations, child care organizations, museums, performing arts organizations, political parties, public broadcasting stations, research and scientific organizations, zoological and botanical societies, other cultural institutions, private elementary and secondary schools, and last but not least, religious organizations, including churches. As you

can see, the Church is thrown in with a very diverse group. These are all the organizations in the not-for-profit field not covered that the subcommittee could think of, but the rule is that if it is not covered by an existing audit guide, it is covered by this document.

The Subcommittee for Nonprofit Organizations of the AICPA was formed in 1975. It is made up of 11 members and 11 alternate members, and all the Big Eight accounting firms are represented. The firms of S. D. Lidesdorf, Alexander Grant and Main Lafrentz make up the 11. The committee was partly an outgrowth of the work done by the Accounting Advisory Committee of the Commission on Private Philanthropy and Public Needs, better known as the Filer Commission. In its report to the Filer Commission, the Advisory Committee stated the following and I quote: "In the Committee's opinion, private philanthropy cannot achieve its full potential without completely open, understandable financial reporting based upon uniform principles. The Committee is concerned that if private philanthropy does not do a more effective job of financial reporting, regulatory bodies will increasingly assume responsibility to regulate philanthropic organizations. Inadequate reporting, including the absence of uniform accounting principles, will encourage governmental intervention and may lead to decisions regarding philanthropic goals being made more by government and less by the contributor."

As I am sure you are aware, this concern about government regulation is not imaginary, as evidenced by the Wilson bill, which as mentioned, refers to generally accepted accounting principles in the reporting requirements to the Post Office Department. The subcommittee, then, has worked for more than a year on this document, which was issued in February, 1977. As I mentioned before, comments on the draft will be received until June 30, 1977. After that the subcommittee will review the comments and meet with interested parties to discuss their views. Now, it is hoped that this stage will be completed by January 1, 1978. At that time an exposure draft of the subcommittee's final conclusions in the form of a Statement of Position will be issued with further opportunity for interested parties to comment. I would expect this exposure period to be fairly short, two or three months at the most. At the end of the exposure period, the Statement of Position would be forwarded to the Financial Accounting Standards Board, the FASB, which is the ultimate accounting rulemaking body in the United States. The Board, by the way, is not a government entity; it is funded by the private sector.

At this point, the Statement of Position, assuming concurrence or even non-action by the FASB, and that is very possible because they have a lot of problems in the commercial area as you all know, then will become rules of the road for the CPA, and will be considered generally accepted accounting principles, which we call GAAP.

The actual implementation of these rules will probably not come before 1979. What all this means is that the CPA must take exception in his accountant's report to practices that vary from the Statement of Position.

In other words, where an organization does not comply with these principles, the CPA would be required to issue a qualified, or perhaps an adverse opinion on the financial statements of that organization. In and by itself, a qualified or adverse opinion may not cause a problem for the reporting organization. So what? Well, as you know, certain legislation now before Congress, the Wilson bill, and certain laws now in place in some states for nonprofit organizations require reporting of such organizations to be in accordance with generally accepted accounting principles. Therefore, assuming further government regulation in the nonprofit field is coming, organizations will be forced for all practical purposes to adopt these principles. So it is pretty important that we consider them in depth. Again, I want to stress the importance of commenting on the document in its early stages before it gets locked in concrete because I believe that it is something that we will all have to live with for a long time. As you may be aware, and I think it was referred to before, the Church is in the process of preparing a response to the draft through a committee headed by Father Bennett of the Diocese of Brooklyn. Regional meetings have been held throughout the country to obtain the views of the dioceses and the religious orders. And I understand that a meeting will be held shortly, or has been held, to summarize the comments of the regional meetings and to develop the Church's position.

In addition to this response by the Catholic Church, it is hoped that a joint response with Protestant and Jewish groups can be developed. Now, this is the kind of input that the subcommittee is looking for and I am sure that the Church's position will be seriously considered when it is received.

Now, I will try to summarize some of the major principles in the draft which will significantly affect the Church. For the last several years the Church for the most part has been following accounting principles set forth in a publication called "Diocesan Accounting and Financial Reporting." This document was first issued in 1971 under the auspices of the National Council of Catholic Bishops (NCCB). In some cases, the principles in the draft are the same as those found in the NCCB Manual. In other cases, they are radically different.

Probably the most significant difference is the depreciation issue. The draft requires that depreciation be recorded and reflected as an expense in the financial statements. The theory is that it is important to show the *full cost* of providing services and that full cost *must include depreciation*, or the pro-rata cost of buildings and equipment as an expense. The NCCB Manual, on the other hand, follows the theory that capital outlay, or the cost of acquiring plant assets and *debt service* should be shown as an *expenditure in lieu of depreciation*. The theory here is that it is inappropriate to try to match revenues and expenses as would a commercial enterprise. In other words, the generation of net income is not the Church's objective, but rather the important story to get across to the readers of the financial statements is the *generation and use of resources*. Obviously, the two methods will portray a totally different result in a statement of finan-

cial activity. The bottom line, so to speak, will vary significantly under the draft from that now reported under the NCCB Manual guidelines.

Another significant problem which came up time and time again at the regional meetings and which I am sure you gentlemen may get very involved in is the section of the draft which deals with related organizations or the *reporting entity*. The draft states and I quote: "The financial statements of two or more nonprofit organizations should be combined when (a) the governing board of the reporting organization appoints or approves appointments to the governing board of the other organization, or (b) the majority of the other organization's governing board consists of individuals who are also members of the reporting organization's governing board or who are its officers, or (c) (and this one is going to be a tough one to apply) one organization solicits contributions in the name and with the approval of the reporting organization and when substantially all the resources of that organization will be used for the benefit of the reporting organization." It goes on to say that "if a controlling organization meets the criteria of any of the three preceding paragraphs but does not provide combined financial statements, the financial statements of the controlling organization would not be in conformity with generally accepted accounting principles."

What does this mean to the Church? As I understand it, this principle says that a diocese must include in its financial statement all entities controlled by the Ordinary to be in accordance with GAAP. If a diocese chose to exclude parishes, for example, the public accountant would be obliged to state that the financial statements did not conform with GAAP. The subcommittee did not specifically consider this topic in the light of the Church's organization, and certainly was not aware of the canon law which affects some of these relationships. Where the Church begins and ends has always been difficult to define, and we can see this with the present problems the IRS faces in defining section 990 filing requirements. Hopefully, the subcommittee will lend a sympathetic ear to a well-reasoned position by the Church in this matter.

Some of the other areas of concern which were voiced at the regional meetings were these. The draft requires that all *unrestricted funds be combined* in the financial statement, and that *investment income*, including gains and losses on investments, *be reported as revenue* in the statement of activity or income statement. Under the NCCB Manual, a separate fund, called a quasi-endowment fund, which represents those unrestricted assets designated for long-term investment, is recommended. Investment gains and losses on these designated funds under the NCCB are added or subtracted directly from the fund and not shown as revenue.

The draft requires the accrual basis of accounting in the financial statement, if they are represented as being in accordance with GAAP. The principle does not preclude a church from keeping its records on the cash basis during the year and converting to the accrual basis on the year end, however.

The draft also requires the recording of pledged contributions while the NCCB Manual recommends that pledges not be recorded. The criteria for recording contributed services and materials is spelled out. For example, the value of services contributed by a member of a religious order would be recorded as revenue and expense when that person's function *would otherwise be carried out by salaried lay personnel*. On the other hand, the services which only religious may perform are not to be recorded, for example, the services of the bishop.

Expenses would be required to be reported by function, that means pastoral function, welfare, health care, etc., with fundraising expenses specifically identified. Object reporting by itself, that is, salaries, rent, electricity, would not be permitted. This requirement will require more sophisticated cost accounting procedures as certain overhead expenses, such as heat, light, power, depreciation, etc., will have to be allocated to the various functions.

In addition to requiring the *depreciation* of fixed assets, churches will be *required to record fixed assets at cost* or fair market value at date of gift. If cost information is not available, a cost-based appraisal may be used to establish cost. Now, this is obviously some expense. That is just a cost-based appraisal, not a current value appraisal or an insurance value.

Also, under the draft, investments may be carried on the balance sheet at either cost or market value.

Again, the period for public comment on the draft ends on June 30, 1977. We expect to have many comments, obviously, from all the various organizations involved. I urge each of you who have an interest in the financial reporting to review the document in detail and let us have your comments, either individually or through Father Bennett's committee, or both. Most of us in the accounting profession believe that it is essential that accounting principles continue to be developed by the private sector. So let us continue our discussion and resolve our problems together before the government finds it necessary to do it for us.

Thank you.

QUESTIONS TO JOHN McLAUGHLIN

MR. REED:

We have a little time here for questions and answers, and Mr. McLaughlin has agreed to answer as many questions as you wish.

DARROUZET:

Does what you are saying totally eliminate the idea of a general gift of ecclesiastical property? In other words, if I want to make a gift of \$10,000 to the church, not in trust, just so that it becomes what the canons call "ecclesiastical property," does what you are saying eliminate that com-

pletely, or did I misunderstand what you said about having to keep the fund in relationship to the function?

McLAUGHLIN:

Well, certainly it does not change anything like that.

QUESTION:

How would that be treated from an accounting standpoint?

McLAUGHLIN:

A restricted gift?

QUESTION:

Yes.

McLAUGHLIN:

It would be treated as a liability until it was used for its restricted purpose.

QUESTION:

You are saying it would not have to be tied in with any function?

McLAUGHLIN:

When talking about functions, I was talking about expenses only. Some dioceses report salaries and wages and fringe benefits, etc., as expenses. This document would say "you can't just show that, you have to show what you do: health care, pastoral work and fundraising," and you have to allocate those expenses to those functions. So the theory, and again it does not necessarily apply to a church, is to *relate fundraising expenses to funds raised*.

QUESTION:

What about state law regarding the question of this organization, whether it is a related organization or not. Suppose some organization it sets up under state law, a no member nonprofit corporation, which by state law is not necessarily the alter ego of this other organization. Does state law play a part in determining whether it is a related organization or not?

McLAUGHLIN:

Quite definitely. In most cases, dioceses, as far as I know, tend to meet the criteria of a controlled organization.

JOHN FLYNN:

I would like to know whether we can get a copy of this statement, if we will not violate any copyright laws? I would like to have a copy of the statement. Also, assuming that some of our people would want to make a comment, should they make it to Father Bennett? I assume he is coordinating activities for the Church, and if so, how would we communicate with him?

McLAUGHLIN:

Well, as far as the draft is concerned, I know the Church, probably Father Bennett, received many copies. If they are not available through that avenue, let me give you the name and address of the person to write to. It is Gabriel Carifi, Manager, Accounting Standards, AICPA, 1211 Avenue of the Americas, New York, New York 10036.

REED:

In response to that question, we are going to endeavor to get copies of the recommended procedures and send them out to all of the diocesan attorneys, state directors, etc. Now, the diocesan fiscal agents are meeting two days after the conclusion of our meeting. They will come up with the final recommendation. I hope as soon as possible to secure their recommendations and send them out to you, so you will have the picture from the standpoint of the AICPA and our specific recommendations. If any other significant recommendations come to our knowledge, of other church groups and the like, we will also send those to you for your comments. I think that it is essential that you meet with your diocesan fiscal agents as early as possible to get their insight into the manner in which the procedure will affect our institutions. Are there any other questions?

FATHER TINNELLY, DIRECTOR OF THE DAUGHTERS OF CHARITY:

Is there anything being done similar to the relationship of parishes to the diocese in the area of religious communities? Now, most of them, or a great many of them, are exempt from the Bishop and therefore would be responsible to the Holy See under canon law.

McLAUGHLIN:

I understand, through most of my experience with relationships within the Church, that since the religious order is normally not controlled by the Ordinary, it would not have to be included. It would stop in most cases at the parish level. But the question here is control. Where it is substantively controlled by one organization, the financial statements should be combined.

JOHN CONNELLY:

I understand that the restricted funds in order to be considered restricted must be restricted by the donor. In other words, the organization itself cannot take funds, set up a program, and on its own motion set aside funds for that purpose and call them restricted funds. Is that correct?

McLAUGHLIN:

That is correct.

QUESTION:

What is the rationalization then?

McLAUGHLIN:

It is a definition of accounting terms. Restricted means restricted by outside sources. Anything that is designated internally can be undesignated, so we use the term "designated" for unrestricted assets set aside, and "restricted" for those legally restricted sources of funds which are restricted by outside sources.

QUESTION:

Is the definition that you used of a combination of facilities for use in a combined financial statement also the same criteria that is being used by the individual to combine hospital auxiliaries, public charities and supporting organizations so that they, too, would have to be combined into the financial statement of the hospital? The ABC criteria that you set down for the combination for the standard, is that also the same standard that is being proposed for the combination of a hospital auxiliary, public charity or supporting organization that a hospital might have, so that those entities would also have to be combined into the financial statement of a hospital?

McLAUGHLIN:

Well, this is in the Hospital Audit Guide, which of course the hospitals have to follow. They have some criteria for when you combine and when you don't combine financial statements. It is rather vague. This was an attempt to go a little further and spell out exactly when you have to combine a related organization. The Hospital Committee of the AICPA is working on that particular problem, and its conclusions will probably be very close to what I referred to in this draft.

FATHER MAIDA:

Has the subcommittee gone into any great detail with respect to defining the type of control which would be needed to bring together this one

report? What I mean by this is that in any diocese there are any number of nonprofit corporations that exist. In some, the Ordinary may appoint the board and have all kinds of control. On the other hand, there might be nonprofit corporations over which he has minimal control to determine when it is going to terminate. And so in between you have just all kinds of control that the Ordinary can use with respect to different corporations. To what extent, then, are there criteria to determine the kind of control which will then require consolidated reports?

McLAUGHLIN:

The committee spent a lot of time discussing this. (By the way, a lot of things in this tentative draft are by no means 100% unanimous as far as the committee is concerned. There has been a lot of compromise. Some issues are 11 to 0, some issues are 6 to 5, etc. So this document is still subject to change.) This is one of the areas that is going to cause a lot more discussion, obviously. To practically apply this is going to be very difficult. But the idea was to try to make the language as clear as possible so you knew when you had a controlled organization and when you did not have a controlled organization. Now, there is always some area that is going to be gray and then you get into a judgment. That is what CPA's are supposed to exercise. It is pretty clearly spelled out when you have control and when you don't, I think.

LEON HERBERT:

Mr. McLaughlin, as I understood your answer a while ago, you said that donations made into an unrestricted fund could not be restricted by the donee, but had to be restricted by the donor. In our diocese we have seminary scholarship funds that were so announced and contributions are made annually in the name of some deceased priests and some deceased laymen. The donor makes no specific statement except he sends it to the XYZ Fund, scholarship fund. Now, he does not know whether it is restricted or unrestricted, but in his mind he is giving to a particular fund. How do you handle that in your bulletin there?

McLAUGHLIN:

Well, with my clients we have the same kind of contributions, and every legal opinion that I have ever received indicates that if you go out and solicit funds and say you are going to use them for a particular purpose, say the XYZ Fund, which will be used for endowments or scholarships only, and you receive money for that fund, it is restricted.

QUESTION:

In other words, the recipient has to notify the donor that it is being received in a restricted fashion?

McLAUGHLIN:

Well, it depends on the circumstances under which it is received. If a particular fund drive, say the Century Drive, has a narrative which says that this money will only be used for scholarships, I think we can assume that everything received in the Drive is restricted without any written intention by the donor.

BILL JASPER:

I am not a lawyer; I am an accountant from the Diocese of Columbia. I did attend a meeting in Chicago of the AICPA at which you were present and there were 81, I wanted the lawyers to know this, there were 81 suggested changes to be discussed by the AICPA. We picked 11 and talked about those 11 changes. It was to be a two-day meeting, but it was cut back to a one-day meeting. Included in our group of religious organizations were the brotherhoods and the sisterhoods and all of the various separate organizations within our own Catholic Church that demand different attention. Also included in the religious organizations were all the Baptists and Methodists and anybody who believed in Jesus Christ, I suppose, and perhaps even the Jewish organizations, I am not aware. However, religious organizations was one title out of about 18. We cannot even discuss religious organizations as one unit and come up with a uniform accounting system. I asked one specific question, which was, "Who started this all?" It was started by the AICPA. Secondly, I asked, "Does this include accrual accounting and depreciation and all the other 81 items at the diocesan level, the church level, the athletic organization level, the school board level, every level of every part of the diocese that is in control of the Bishop?" And the answer was, "Yes." Now, that, gentlemen, will cost millions upon millions of dollars across the country and it will not work because it is uniform for all kinds of Catholic organizations and every one of them is a different entity in its own.

JOHN DiVITO:

I am fascinated by the question of restricted and unrestricted funds. For example, we have an annual Bishops Charity Drive. Money is solicited and requested. There are probably 15 or 20 different projects and recipients of that. Now, are you saying that monies collected as a result of such an appeal is restricted, is it unrestricted, are there separate funds and each one of them is restricted, are you saying that all of that is going to be reported as *income* when, as and if this super-duper financial statement is ever prepared by Lord only knows who for what purpose?

McLAUGHLIN:

The treatment of restricted funds in this draft is really no different than that found in the NCCB Manual and all generally accepted account-

ing principles for other nonprofit organizations. There is a little different twist as to when you recognize it as revenue. The *determination of whether something is restricted or not is really a legal determination and when you get into those very gray areas it gets difficult*. If we are not satisfied as to how to treat a particular contribution we ask for a legal opinion.

BERNIE FRIGON:

Are you saying that we could have our Ordinary file a disclaimer that he has no interest in any organization except for the following, and will that be acceptable?

McLAUGHLIN:

No, I did not mean to say that at all. There would be no disclaimer from the Ordinary as to related organizations. No, what we're saying is, if we can get away from the Church for a second, it is that there are organizations which will set up a captive corporation to receive contributions. The main reason they do this is to keep the government away from those contributions.

Well, if you report on the controlling entity and do not include those contributions, I think it's misleading. So we are saying, okay, we have to do something about this situation and we have to report on both. They should be combined in one statement.

REED:

The chair is going to take the prerogative of asking a couple of questions. John, I would like to know what the situation would be where members of religious orders working as teachers, nurses and the like, in accordance with their vow of poverty turn their income over directly to the order. Now, how would the order treat that on its books?

McLAUGHLIN:

Well, if you are reporting on the order, the sister's salary would become revenue to the order, not to the sister. If it came to the order and it had the right to do with it as it wished, it would be revenue to the order.

QUESTION:

The other question I have is in the context of the corporation sole. Has there been any discussion in the context of the corporation sole, a typical corporation sole which characterizes so many of our dioceses?

McLAUGHLIN:

No. As I mentioned in my remarks before, when the related organization problem was discussed, there was not a lot of time spent or even

consideration given to the problems the Church might have with this. Again, the people on the committee were of rather diverse backgrounds and not everyone had experience with the Church and how it is organized. Assuming there is a problem, now is the time to define it, explain it, and maybe change it.

REED:

Thank you, John. I just want to make an announcement. If you have any questions, observations or the like that you wish to make, send them to our office. We will be sure to see that they get to the proper source, to the diocesan fiscal group that is going to make a recommendation. I think that would be the appropriate one. We can pass some of them on to John also.