

FINANCIAL INTERNAL CONTROLS

IN HEARTLAND CHURCHES:

A SURVEY REPORT

NOTE FROM THE AUTHORS

For over twenty-five years, Keller & Owens, LLC (KO) has served the professional needs of faith-based, not-for-profit organizations, especially churches. We have seen a number of churches with sound, reliable controls over financial transactions and resources. Sadly, we have seen many with weak and incomplete financial internal controls that undermine the reliability of data used by management, lenders and regulatory agencies. As important, weak or incomplete controls raise the risk of incidents of financial (also known as occupational) fraud. Unfortunately, significant financial frauds often also result in the disruption of normal church operations, distrust of church leadership and even church splits. However, the most damaging effect occurs as the general public's view of the Christian church declines even further. Of course, any inaccurate financial reporting or any theft of precious church resources is unacceptable.

In the spring of 2012, we took steps in assisting churches to access their financial internal controls and to strengthen or replace those controls when warranted. In January Rich Bili, CPA, CFE and John Parrish, CPA, CFE, both owners of Keller Owens, LLC and Glenn Miller, CFE, President of Miller Management Systems developed a multi-part 8 question on-line survey. In February, 2012, we invited over 12,500 churches in Kansas and Missouri to participate in the on-line survey over a six week period.

This report provides the results of that survey. We hope the findings in the report will help churches assess and strengthen their financial internal controls.

A handwritten signature in black ink that reads "Greg Owens". The signature is written in a cursive style with a large, stylized initial "G".

Gregory D. Owens, CPA
Managing Owner, Keller & Owens, LLC.

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EXECUTIVE SUMMARY

Summary of Findings

- Even though churches responding to the survey were nearly evenly split between Kansas and Missouri, slightly more Missouri churches reported on their financial internal controls.
- Substantially more churches from small, rural communities (under 25,000 in population) responded to the survey.
- Slightly more than three-quarters of the churches responding reported average Sunday worship attendance of less than 250 congregants.
- Sixty percent of churches responding to the survey reported annual average budgeted revenue of \$250,000 or less.
- Slightly more than 90% of churches reported having at least 2 people assisting in the accounting/finance areas underscoring the importance of the internal control principle of adequate segregation of duties.
- The survey found that the majority of the reporting churches evidenced the importance of a significant level of independence and accountability at the governing board level. Two-thirds also reported having a “financial expert” on the board.
- The survey also found that there were many entity level controls that were absent such as a written code of conduct and conflict of interest policy.
- While over 90% of the respondents in the KO survey stated that their accounting and finance staff/volunteers provide timely and accurate internal financial data, only 57% reported that they could prepare formal financial statements.
- A problematic finding revealed that 62% of churches stated that their accounting and finance staff/volunteers could not identify the absence of a needed internal control let alone design and implement that needed control.
- The survey found that while internal controls over cash offerings were generally strong, general internal controls over cash, cash disbursements and payroll represent areas of substantial risk and opportunity for improvement.
- Internal controls over purchasing as well as basic controls over information systems were found to be areas where constant review of internal controls is warranted.
- The survey found that poor or non-existent oversight or inadequate internal controls provided fraudsters with the most frequent opportunities to commit fraud.
- Sixty-five percent of the churches that reported having no financial fraud gave strong oversight, good segregation of duties and sound internal controls as the reasons for no fraud.

INTRODUCTION

A Biblical Example

The Apostle Paul reported in 2 Corinthians 8:18-19 an incident where the New Testament Church applied sound financial internal control:

“And we are sending along with him [Titus] the brother [unnamed] who is praised by all the churches for his service. What is more, he was chosen by the churches to accompany us as we carry the offering, which we will administer to the glory of the Lord Himself and to show our goodwill”.

Here the Church is sending a person of high integrity with a respected pastor to protect the pastor from temptation and criticism and the resources from loss.

Survey Demographics

As indicated earlier, over 12,500 churches in Kansas and Missouri were invited to participate in an anonymous, on-line survey. The survey requested information regarding internal controls implemented by the churches. The survey also asked questions about instances of financial fraud that occurred in these churches. This document focuses on internal controls implemented by the churches and reports only incidents of financial fraud (or lack thereof) where internal controls were mentioned. The survey responses related to fraud are described in detail in the *Financial Fraud in Heartland Churches: A 2012 Survey Report* that is available for free download at www.kellerowens.com/resources/links_and_downloads/.

Survey respondents were nearly evenly split by state with 4% more Missouri churches participating. Substantially more churches from small, rural communities (under 25,000 in population) responded to the survey.

The survey also reported respondents by average Sunday worship attendance. Slightly more than 76% of the churches participating in the survey reported average Sunday worship attendance of less than 250 congregants.

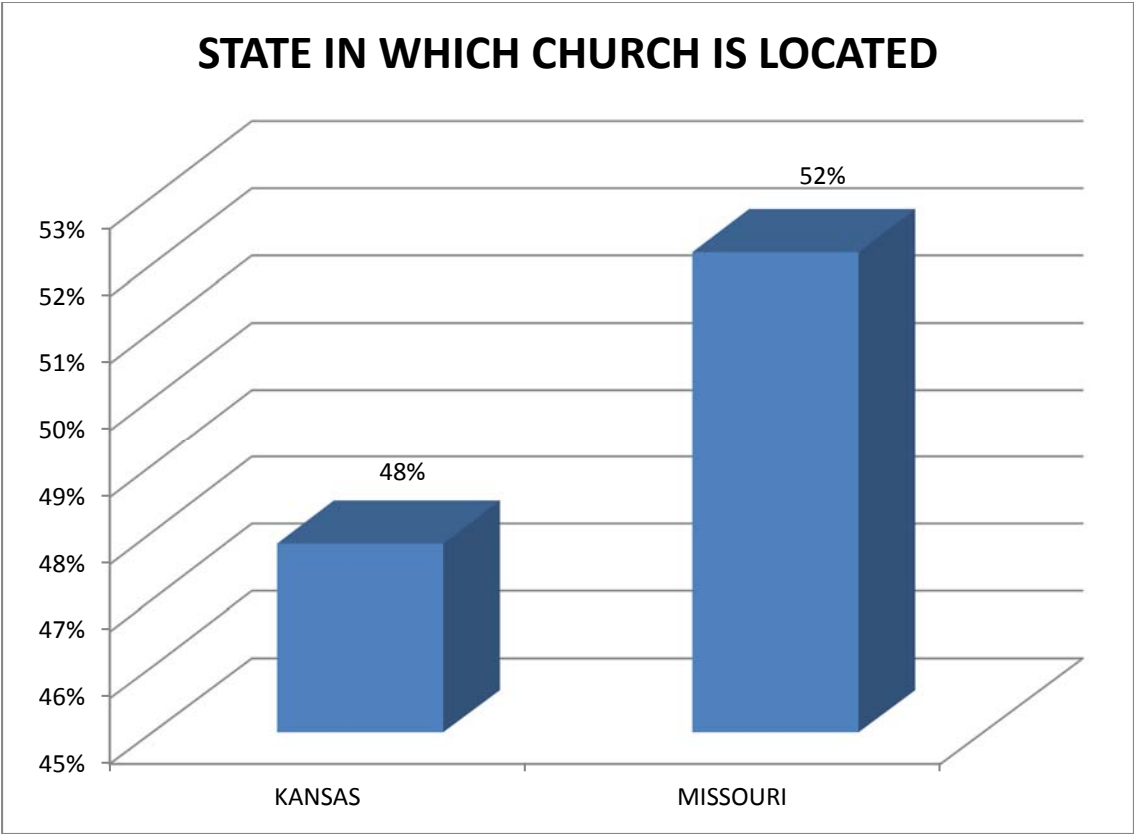
Sixty-eight per cent of the reporting churches had average annual budgeted income of \$250,000 or less. The largest segment of participating churches (59%), reported total budgeted annual income ranging from \$50,000 to \$250,000. Churches with budgets of \$251,000 to \$500,000 and \$1,000,001 to \$5,000,000 made up 18% and 14% of respondents, respectively.

The survey participants also reported their denominational affiliation, if any. Baptist churches were the largest segment at 25% followed by United Methodist churches at 8%, Lutheran churches at 6%, Presbyterian churches at 3%, and Catholic parishes at 2%. The remaining 56% of the respondents either were non-denominational churches, members of smaller denominations or declined to report this factor.

Finally, the survey asked participants to indicate the number of employees or volunteers who played an active role in the church’s accounting and finance activities. The results were somewhat surprising considering that the data above indicates a predominance of respondents (50% or more) were from small churches. The survey found that 80% of participating churches reported that 3 or more persons played an active role in the accounting and finance activities of the church. Twenty-seven percent used 6 or more while 9% used only one person in these critical roles.

Characteristics of Churches Reporting on Internal Controls

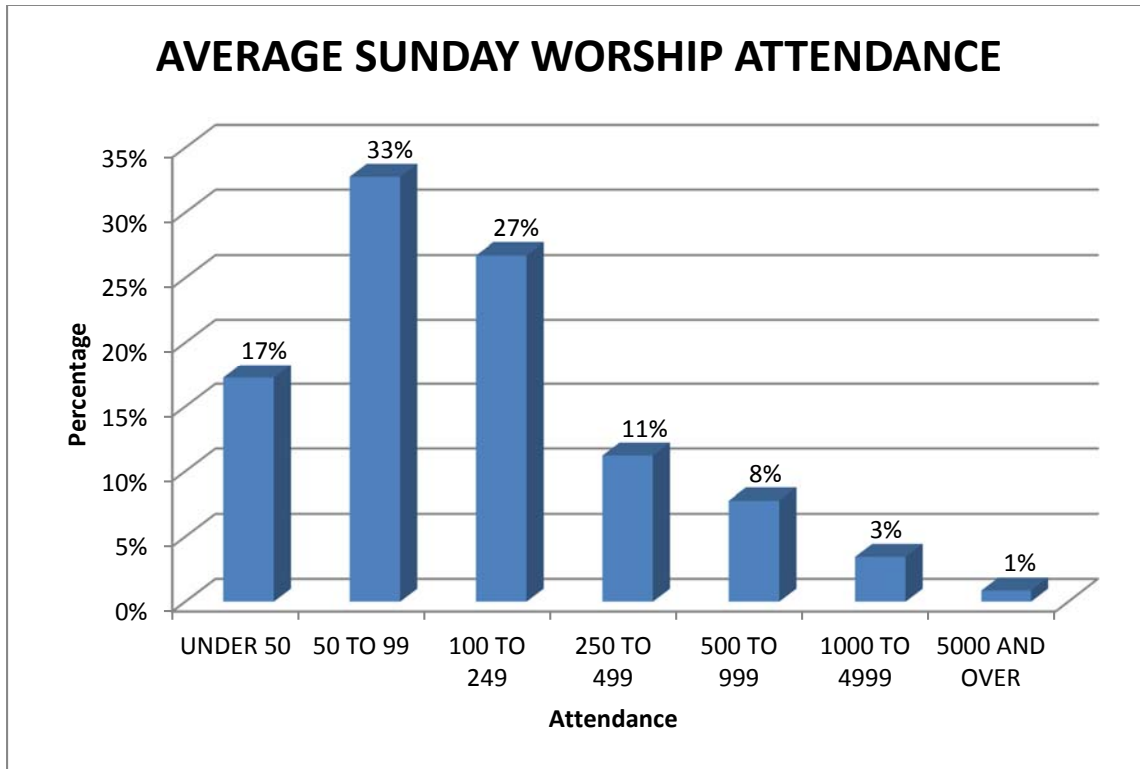
Survey respondents were nearly evenly split by state with slightly more Missouri churches participating and reporting on financial internal controls.

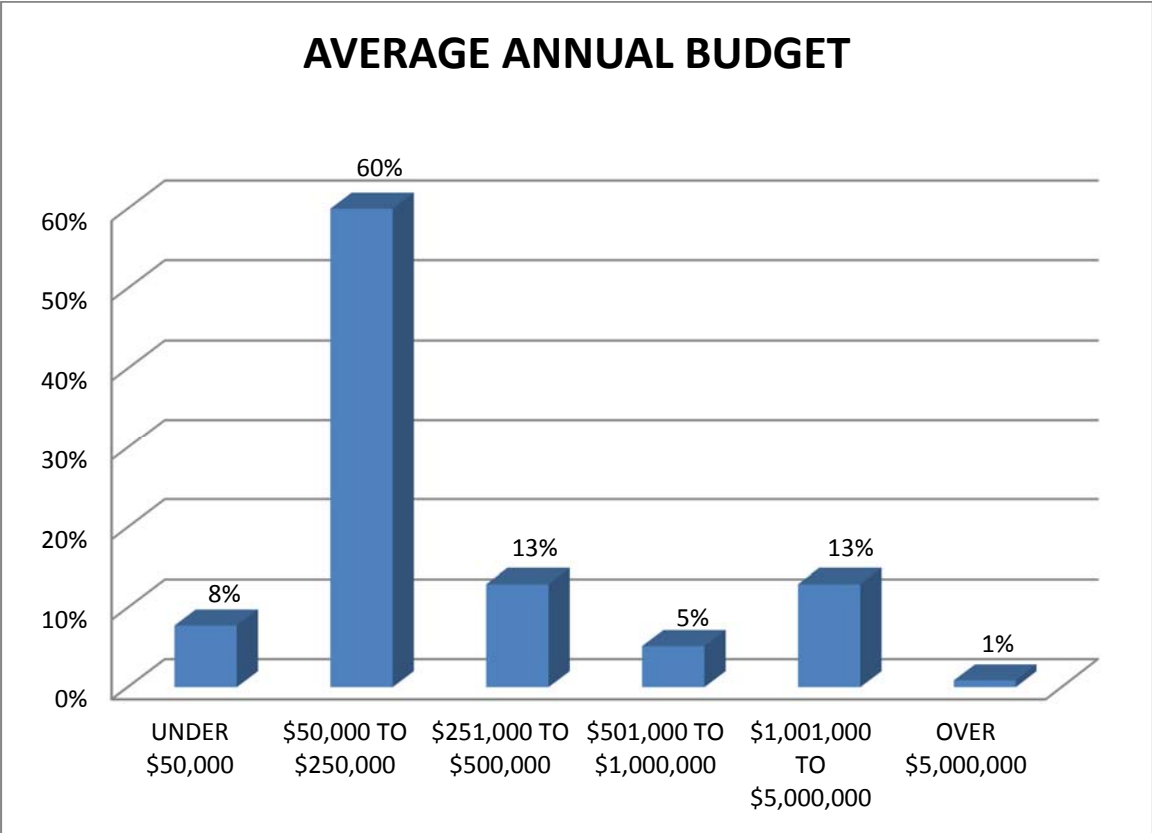


The survey used two criteria, average Sunday worship attendance and average annual budgeted revenue, to categorize churches reporting implemented financial internal controls.

As shown by the following graph, 50% of the churches participating in the survey reported average Sunday worship attendance of less than 100 congregants. Seventy-seven percent of the total number of churches participating in the survey reported less than 250 in attendance in the average worship service.

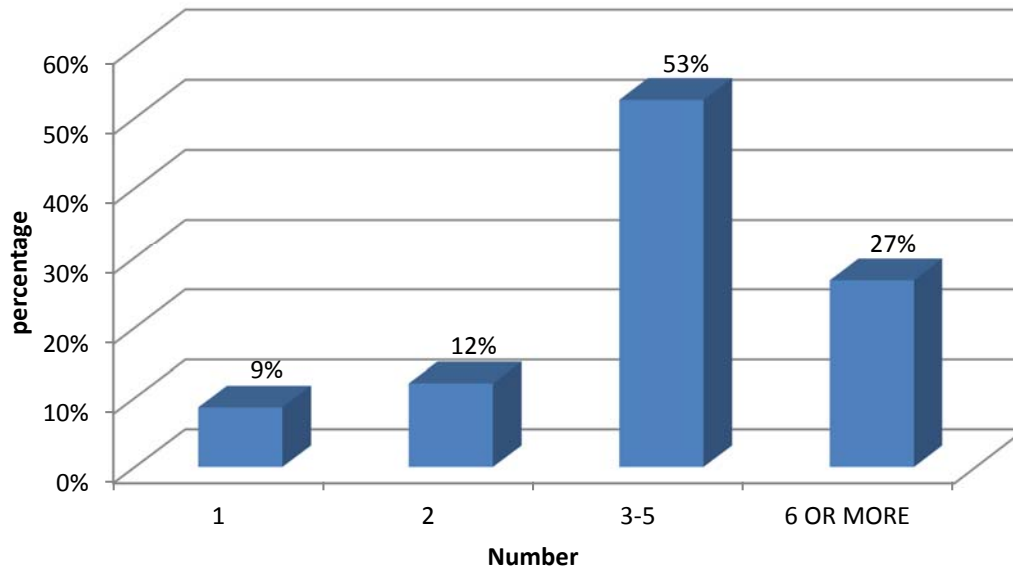
The second graph below shows that 60% of the participating churches reported annual average budgeted revenue of \$250,000 or less. Increasing the revenue amount to just \$500,000 per year increased the percentage to 81% of the respondents.





Overall our survey found that 80% of participating churches reported that 3 or more persons played an active role in the accounting and finance activities of the church while 9% used only one person in these critical roles. However, as the graph below shows, 92% of churches reported having only at least 2 people assisting in these areas underscoring the importance of the internal control principle of adequate segregation of duties.

EMPLOYEES/VOLUNTEERS IN ACCOUNTING & FINANCE FUNCTION



Framework for Sound Internal Controls

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released a study on the development of comprehensive frameworks and guidance on internal controls and fraud deterrence. The study was updated in 2013.

The COSO study describes 5 primary components of internal control and 17 internal control principles associated with the components that can be used to achieve effective internal control by applying all the principles. The components and principles are described in detail in *Financial Internal Controls in Not-for-Profit Organizations for Effective Management and Fraud Deterrence* that is available for free download at www.kellerowens.com/resources/links_and_downloads/.

Financial Internal Controls Defined

COSO defines internal control as a process, affected by an entity's governing body, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

Setting the Tone at the Top

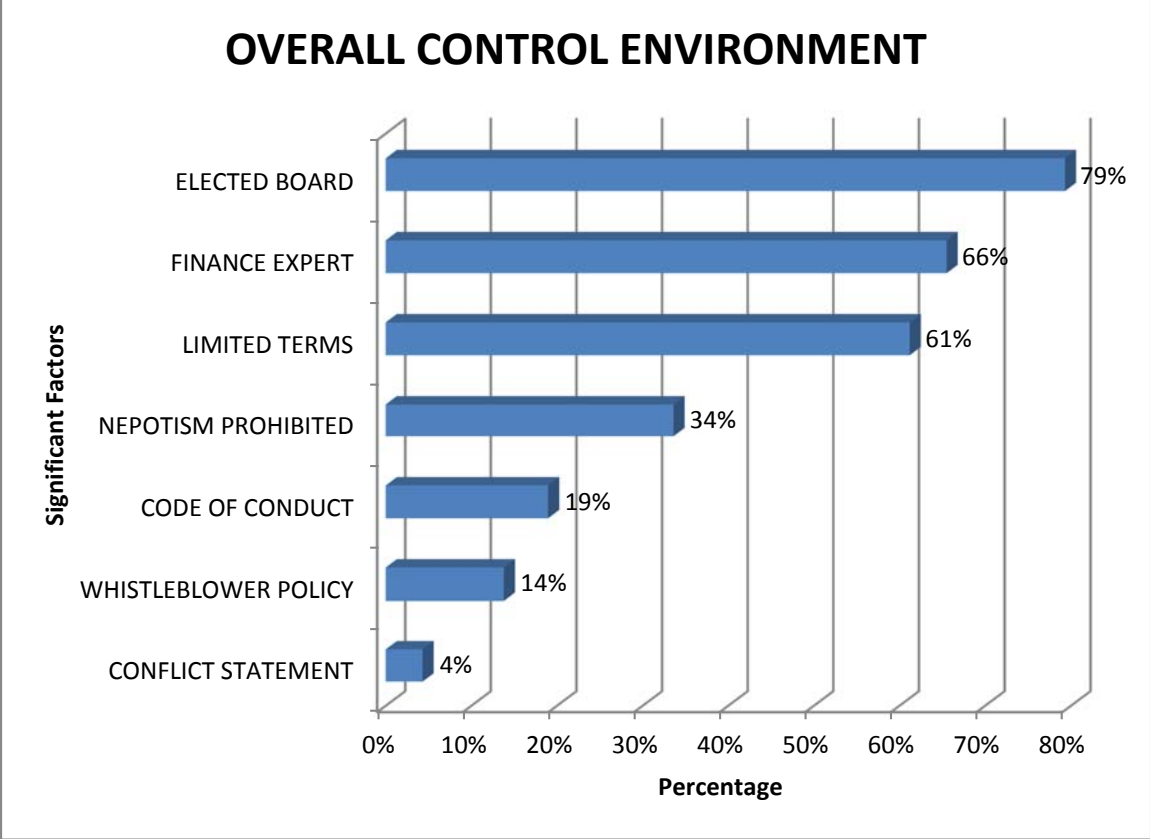
Management, including directors and officers, need to “set the tone at the top” for ethical behavior in an organization. These parties must show employees, volunteers and third parties through their words and actions that dishonest or unethical behavior will not be tolerated, even if the result of the behavior benefits the organization. Organizations use formal policies such as code of conduct and conflict of interest policies and internal controls such as entity level controls to communicate and monitor the ethical behavior of the organization.

Entity Level Controls

Entity level controls are integrated components: the control environment, risk assessment, information and communication (excluding the financial reporting system) and monitoring that have a pervasive effect in the entity's system of internal control, and influencing the design and effectiveness of other controls.

The following two graphs illustrate entity level controls. The majority of the reporting organizations evidenced the importance of a significant level of independence and accountability at the governing board level. Seventy-nine percent stated that the governing board was elected (presumably by the membership) and most boards required periodic turnover due to terms limits (61%). While 34% of the churches indicated that relatives could be simultaneous members of the governing board, it is not clear that those situations resulted in board control – generally an undesirable circumstance. Another positive entity level control was the involvement of a “financial expert” on the board as reported by 66% of the respondents. Though the definition of a financial expert was left to the respondent, the qualifications shown in the graph, **Qualifications of Accounting & Finance Personnel/Volunteers** would have been helpful.

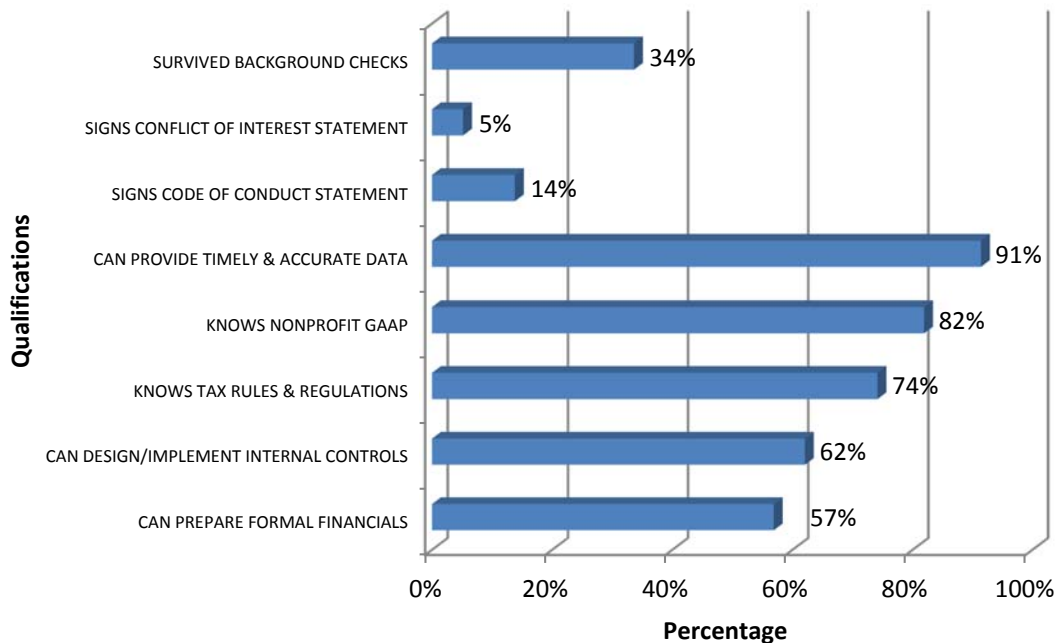
The survey also identified important entity level controls that were absent in many churches. For example, best practices indicate that the church should have a written code of conduct approved by the board and communicated to all employees and volunteers. Only 19% of the churches had such a policy. Conflict of interest is the wrongful use of influence to procure a benefit for a person of influence or another person contrary to the duty or rights of others. A conflict of interest scheme where the church purchases goods or services from a company owned by a board member or key employee at greater than market prices is an example of corruption. Only 4% of the respondent reported having a written conflict of interest policy that would be reviewed and signed by all board members, employees and key volunteers annually.



Another important area of key entity level internal controls relates to the qualifications of the persons, employees or volunteers, who handle and report the church’s accounting and financial resources. The board and church management must rely on timely, accurate data to fulfill their stewardship duties. Over 90% of the respondents stated that their accounting and finance personnel/volunteers provide timely and accurate [internal] financial data. Interestingly, they also stated that they believed only 82% were knowledgeable of the specialized accounting principles required for nonprofits and that only 57% could prepare formal financial statements - often required by third parties such as lenders. Almost 75% felt that the accounting and finance personnel/volunteers have a working knowledge of the relevant tax rules and regulations required to keep the church in compliance with regulatory authorities. Apparently, the other 25% rely on outside experts or are at risk. Another problematic response was that only 62% of the accounting and finance employees/volunteers can identify the absence of a needed internal control and then design and implement it.

The accounting and finance function not only requires persons with the commensurate education and experience but persons of proven integrity. The survey reported that churches were only requiring [criminal and financial] background checks in 34% of the cases. In addition, while 14% of those in the accounting and finance function signed a code of code statement (more than the board), only 5% were required to sign a conflict of interest statement.

QUALIFICATIONS OF ACCOUNTING & FINANCE PERSONNEL/VOLUNTEERS



Segregation of duties is the policy and practice of dividing incompatible duties among different people and systems so that no one person can authorize transactions, record those transactions in the financial records and exercise custody of the related assets. While segregation of duties is an entity level concept, it is more evident in activity level controls.

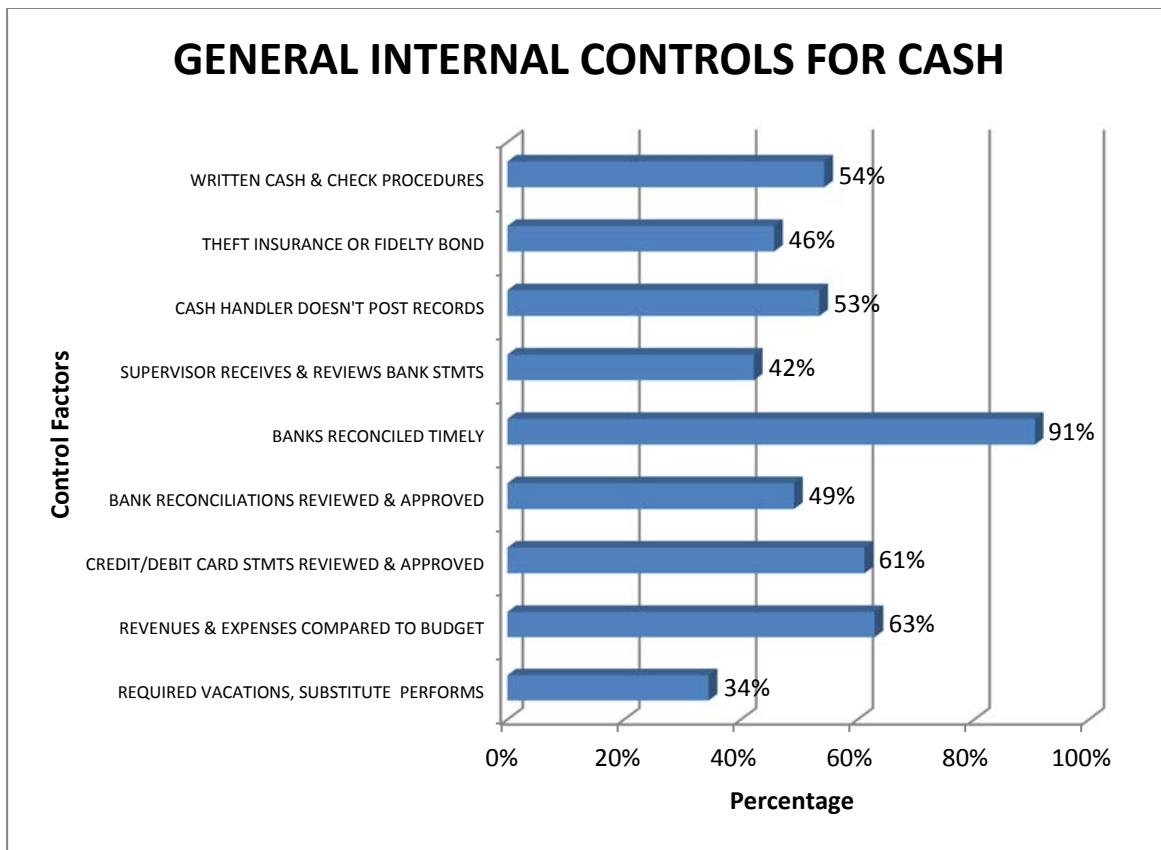
Activity Level Controls

Activity level controls are controls that are directly related to initiating, authorizing, recording, processing, correcting, and transferring to the general ledger and reporting the entity's transactions.

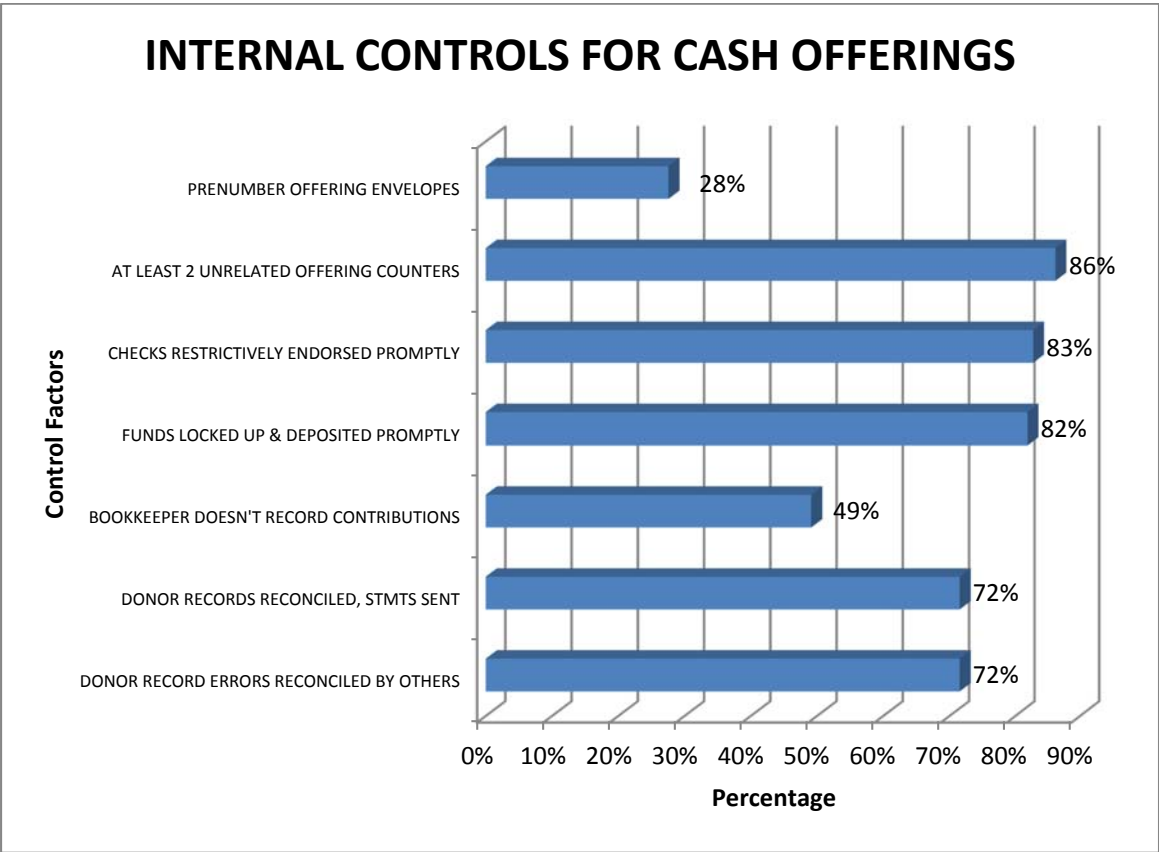
Many churches conduct and report their financial activities on the basis of cash received and cash disbursed. Some of the larger churches use the accrual basis of accounting which also reflects revenues earned but not yet received (i.e., accounts and pledges receivable) and expenses incurred but not yet paid (i.e., accounts payable and accruals). When asked about general internal controls for cash over 90% of the respondents indicated that bank statements were reconciled to the accounting records on a timely basis (not defined). However, only 49% of the churches reported that the bank reconciliations were reviewed and approved by an appropriate supervisor thereby reducing the risk of error or fraud. In addition, 58% of the respondents failed to have a supervisor receive the unopened bank statement and review it for irregularities before providing it to the party who will reconcile it – another step designed to prevent and detect fraud.

The survey found that 63% of the churches used a budget to monitor reported revenues and expenses for reasonableness. It also found that only 61% of the churches reviewed and approved credit/debit card statements. If a church has an accountable reimbursement plan, it must implement certain requirements which if not met may cause the full amount of the reimbursement to be allocated to an employee's Form W-2. Failure to report the amount as income could subject the employee to intermediate sanctions.

The survey also revealed two somewhat expected, but undesirable control deficiencies: 1) the general absence of the detective/preventative fraud policy of having key finance and accounting staff take vacations during which others perform their duties and 2) the use of theft insurance and fidelity bonds to assist recovery of lost resources due to asset (usually cash) misappropriation.



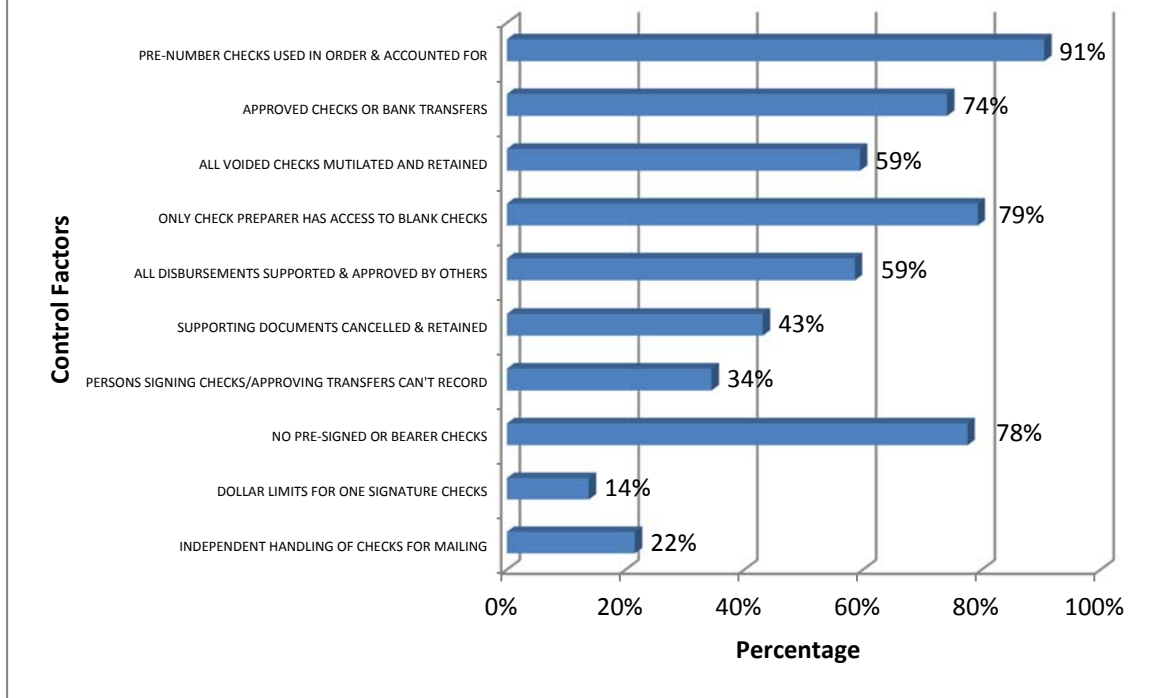
The survey found that most churches have instituted reasonable internal controls for handling cash receipts, primarily cash offerings. For example, over 80% of the responding churches have at least two unrelated persons counting the offering with checks restrictively endorsed, locked up and then deposited in the bank promptly. However, the respondents also indicated more often than not that their bookkeeper records the donations in both the general ledger and the supporting donor records – usually considered a control deficiency. This deficiency was partially offset by compensating controls such as sending statements to donors and another party reconciling any discrepancies found between the donor statements and the donor records.



A recent survey by the Association of Certified Fraud Examiners in its *Report to the Nations on Occupational Fraud and Abuse* determined that over two-thirds of asset misappropriations involve cash disbursements. The Keller & Owens, LLC survey found that internal controls over disbursements reflected numerous deficiencies. For example, 86% of churches set no dollar limit on checks requiring only one signature. Furthermore, two-thirds of the respondents permitted the same person who signed the checks to record the transactions in the records with 57% of the churches not cancelling and retaining supporting documents. On the positive side, approximately 75% of the churches required independent approval of checks and bank transfers, nearly 80% prohibited the practice of pre-signing checks and limiting access to blank check stock. The survey found that the most frequently implemented control was the practice of accounting for checks which seems to correlate with the general internal control for cash related to the practice of reconciling the bank statements.

In summary, internal controls for cash disbursements represent an area of significant risk and opportunity for improvement.

INTERNAL CONTROLS FOR DISBURSEMENTS

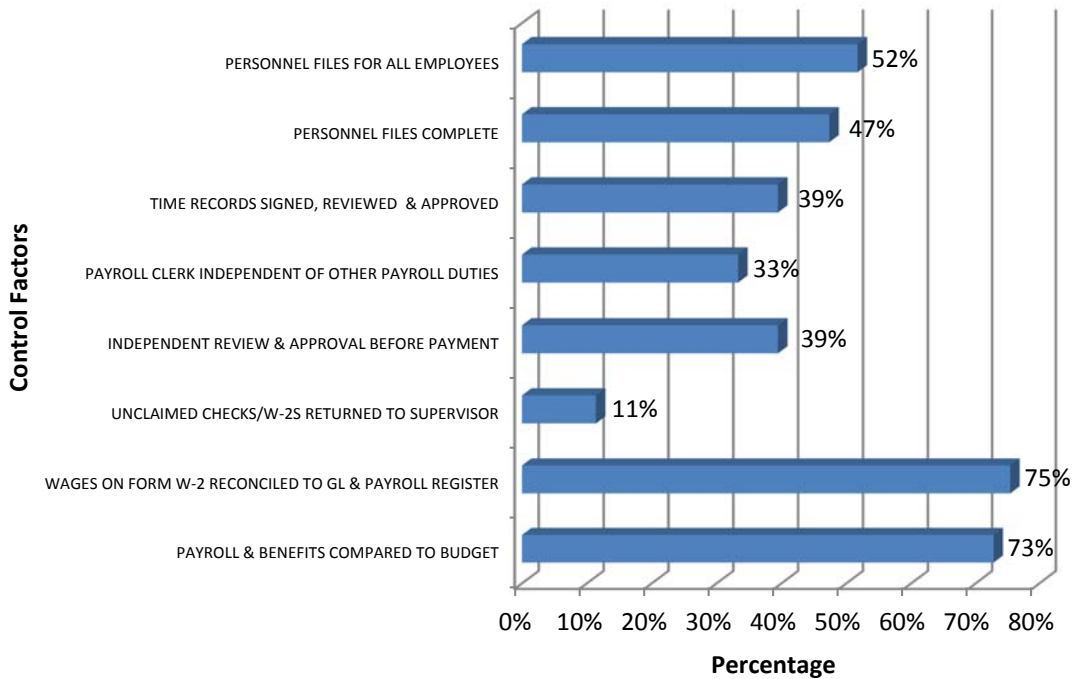


Payroll typically represents from 50% to 66% of all cash expenditures. In addition, this is an area that requires compliance with government regulations and reporting. Failure to meet those requirements could have significant consequences for both the church and its employees as well as presenting another opportunity for fraud.

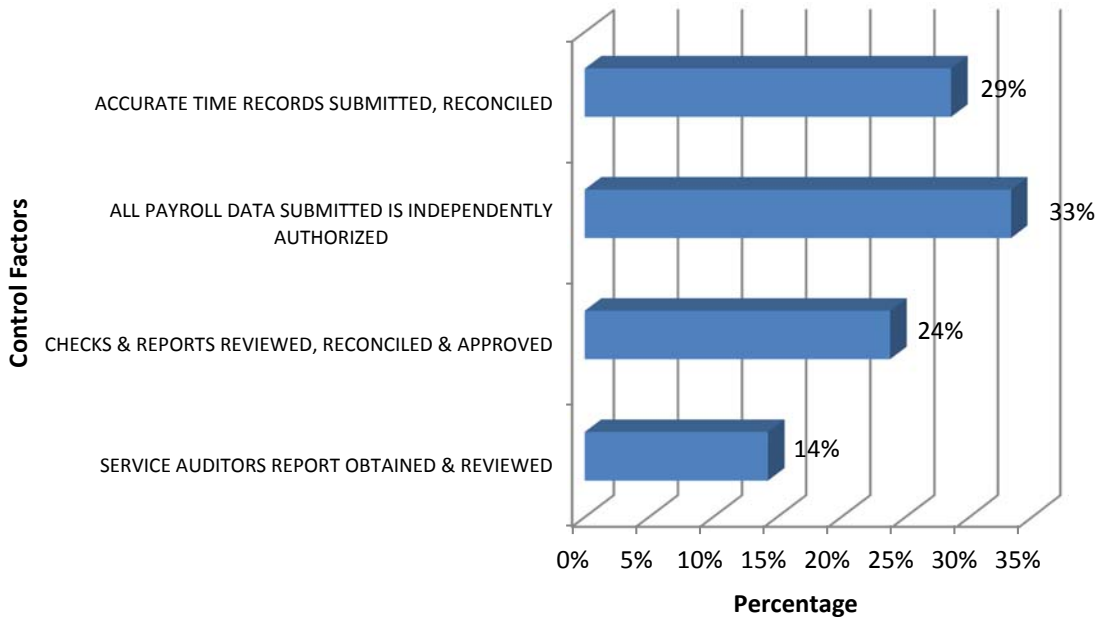
As the following graphs show, internal controls for payroll – whether processed by the church staff or outsourced to a service provider – fall far short of what best practices demand. The results seem to demonstrate a serious lack of oversight. The survey found that personnel records were often incomplete if not lacking all together. Though not stated, this must include lack of support for a pastor's qualifications for a housing allowance. Time records and payroll reports were independently reviewed and approved less than 40% of the time. The person preparing the internal payroll was involved with other payroll duties, such as distributing payroll checks, 67% of the time, a clear lack of appropriate segregation of duties.

When an organization outsources its payroll and payroll tax preparation and reporting to a third party service entity it is relying, at least in part, on the internal controls of that entity. This reliance may be acceptable if the church determines that those internal controls are not materially deficient. In addition, the church retains the responsibility for certain corresponding controls that it must implement as a bridge between it and the service provider. The survey found that the independent audit report many payroll service companies provide on the reliability of its internal controls was not obtained and reviewed by the respondents in 86% of the cases that used such service provider. In addition, the necessary corresponding controls required of the church were not implemented 67% of the time.

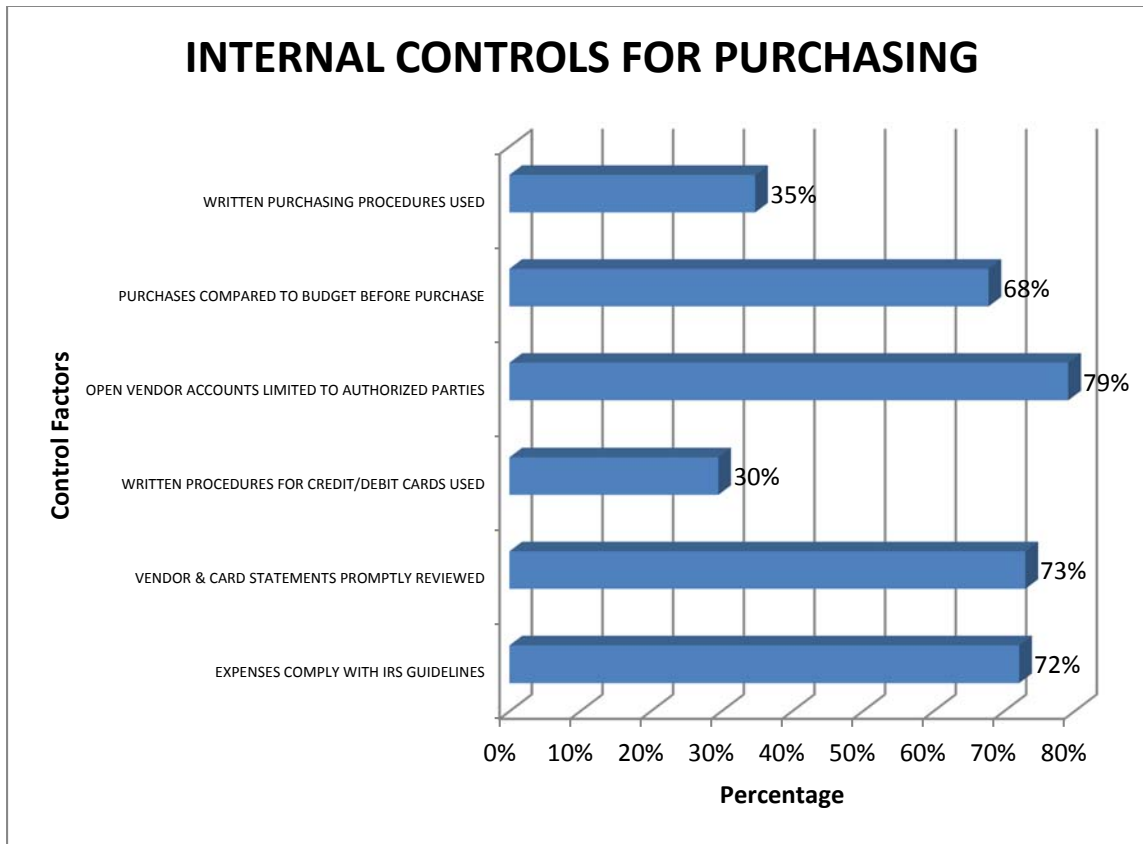
INTERNAL CONTROLS FOR INSIDE PAYROLL



INTERNAL CONTROLS FOR OUTSOURCED PAYROLL

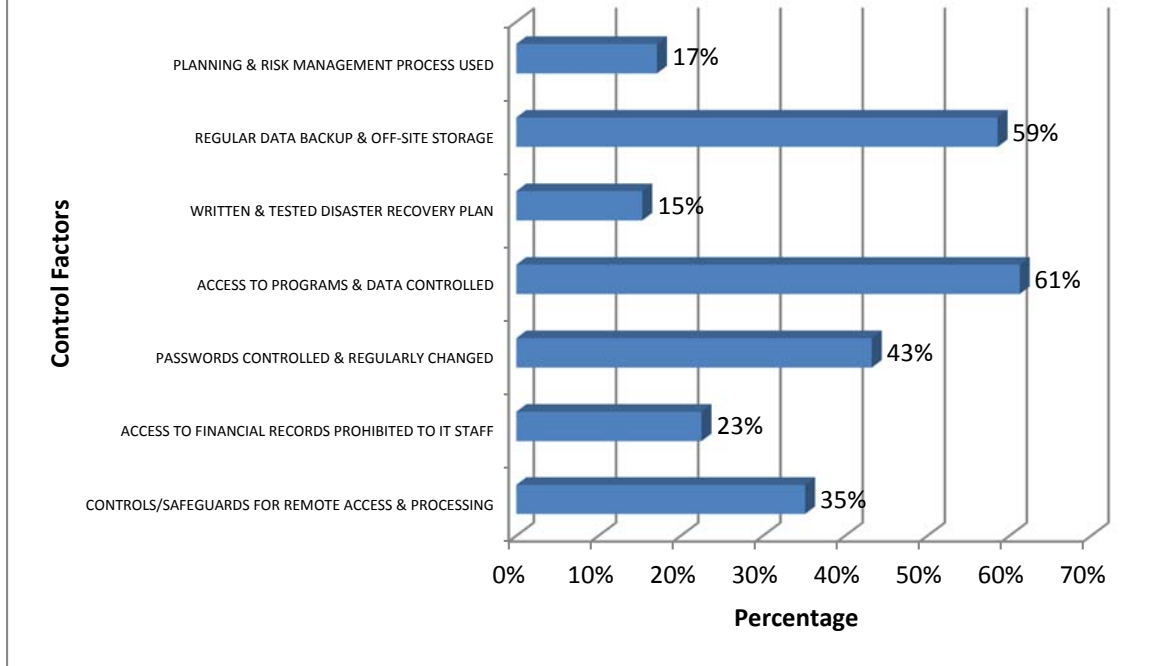


Even though most respondents indicated that their church did not use written purchasing procedures that would guide the what, when, who, why and how much of dealing with vendors, the controls in this area appear, at least a first glance, to be consistently stronger than many of the other areas of controls surveyed. However, these results must be considered in combination with the results in the area of controls for disbursements. And since the threat of fraud from conflicts of interest, vendor kickbacks, false vendors, payment of personal expenses and other schemes continues to be high, this is another area where constant review of internal controls is warranted.



A study of internal controls over information systems is beyond the scope this survey. We sought only to determine if churches had implemented basic, common sense controls in this important, complex and ever-changing area. As the graph below indicates, only the practices of regularly backing-up data and storing it off-site (59% of respondents) and limiting access to data controlled (61% of respondents) received moderate attention. Procedures such as controlling and regularly changing passwords were only done by 43% of the respondents. Remote access to accounting records for processing is a growing practice. Providing controls and safeguards in this area was reported by only 35% of the respondents. Risk management and planning, including preparing and testing a disaster recovery plan, was virtually non-existent.

GENERAL INTERNAL CONTROLS FOR INFORMATION TECHNOLOGY



The Importance of Internal Controls in Fraud Prevention and Detection

As indicated earlier, over 12,500 churches in Kansas and Missouri were invited to participate in an anonymous, on-line survey. The survey requested information regarding internal controls implemented by the churches and also asked questions about instances of financial fraud that occurred in these churches.

While not limited to religious nonprofits, the recent survey by the Association of Certified Fraud Examiners in its *Report to the Nations on Occupational Fraud and Abuse* found that some of the following internal control weaknesses had contributed to the fraud they had investigated: 1) lack of internal controls, 2) lack of management review, 3) override of existing internal controls, 4) poor tone at the top and 5) lack of competent personnel in oversight roles.

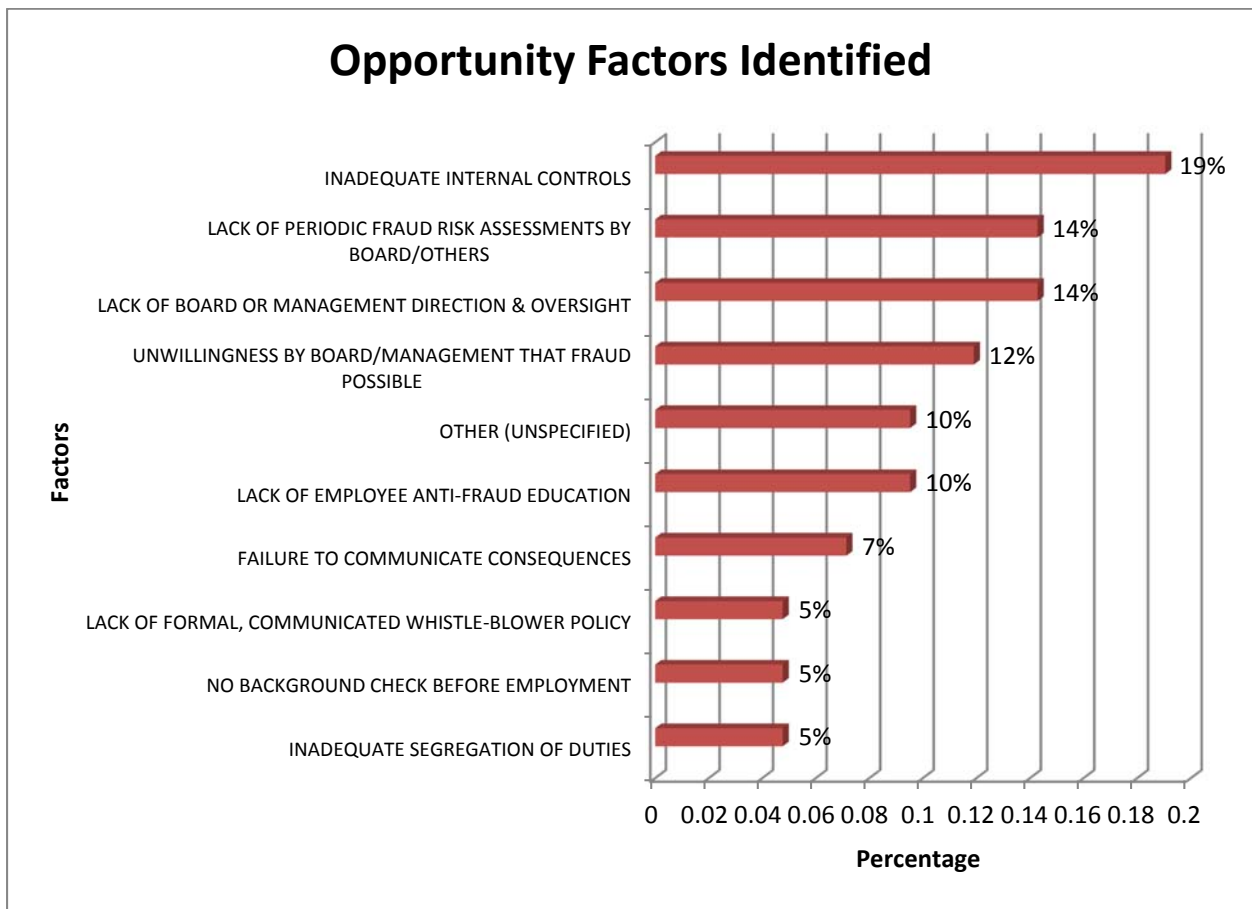
An article authored by Oklahoma State University Professors Robert M. Cornell and Carol B. Johnson reported that "Houses of worship are particularly vulnerable to fraud, but most feel they are impervious."⁴ The authors suggested that because "trust among employees and volunteers fuel church engines... they feel bulletproof."⁴ Consequently, such churches don't establish policies and procedures including proper internal accounting controls or consistently follow them. Cornell and Johnson believe that the level of controls reported in their studies "were so poor that they probably harbored many undetected frauds."⁴

⁴ *Fraud in Houses of Worship: What Believers Do Not Want to Believe*, January/February 2012, Fraud Magazine

Donald R. Cressey, PhD, renowned behaviorist scholar and researcher, indicated that there are three elements inherent in the minds of most fraudsters when they commit fraud: pressure, rationalization and perceived opportunity. Both the findings in the ACFE survey and the conclusion of Professors Cornell and Johnson strongly suggest weak or non-existent internal control provides opportunities to fraudsters.

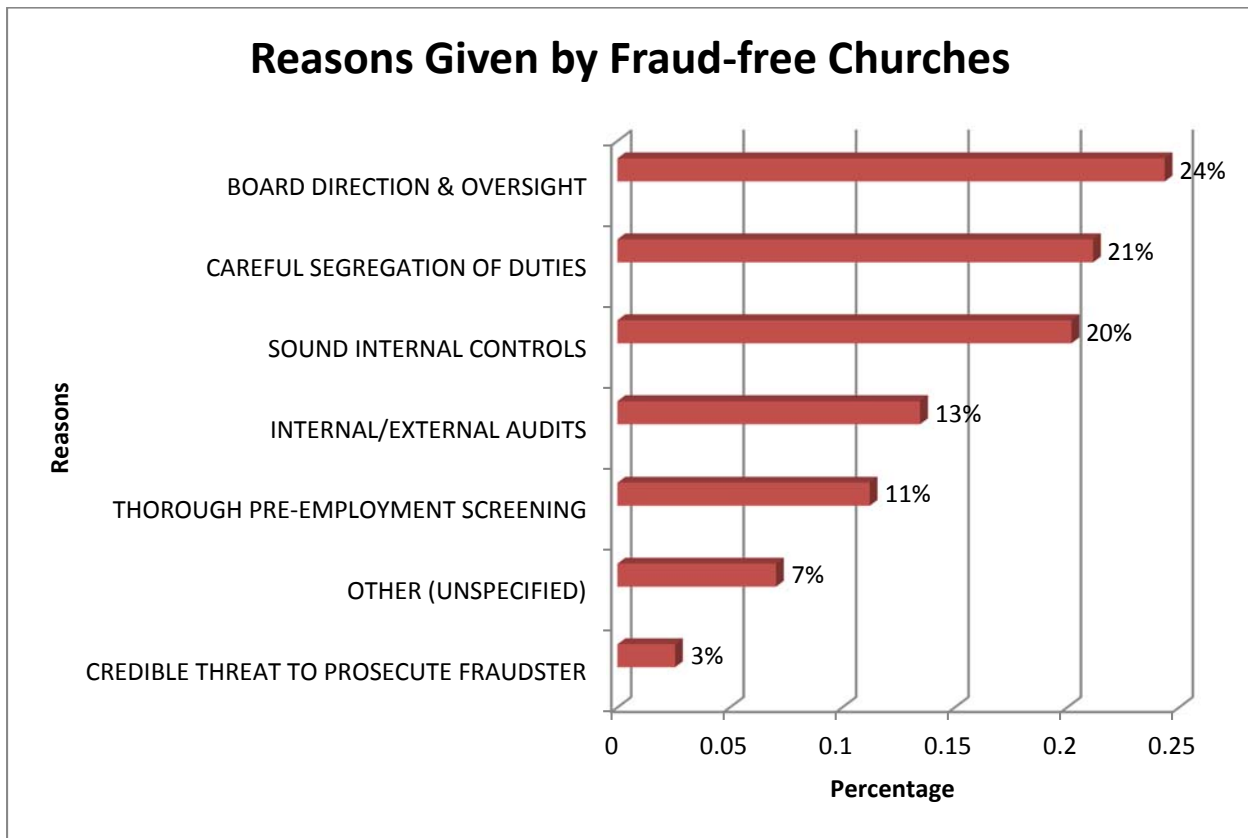
Perceived Opportunity

Circumstances exist – for example, the absence of controls, ineffective controls, or the ability of management to override controls – that provide opportunities for fraud to be perpetrated. This is the crucial ingredient without which the fraud can't occur even if the pressure and rationalization factors are present. The KO survey found that poor or non-existent oversight or inadequate internal controls provided the fraudster with the most frequent opportunities to commit fraud.



Lessons Learned from Churches Reporting No Fraud

Most respondents to the fraud incident portion of the KO survey indicated that they had not experienced financial fraud in the recent past. When asked to what they attributed their good fortune, they replied as noted in the chart below.



The responses of these churches support KO's strong belief that the "tone at the top", when evidenced by a formal and communicated code of conduct and regular fraud risk assessments by the governing body and church management, is the critical foundation to fraud prevention. A close second in importance must be sound internal controls, including reasonable segregation of duties among employees (and volunteers). We also believe that an important part of any church's insurance portfolio should be theft and dishonesty coverage amounting to no less than three months cash receipts. Finally, even though most respondents above did not so indicate, many fraud prevention experts believe that a credible threat to detect and prosecute the fraudster is a key factor in successful fraud prevention.

Conclusion

While some of the survey findings were positive, the results disclosed significant opportunities for churches to improve their financial internal controls and fulfill their responsibilities to their congregants and the Christian church as a whole. Our hope is that readers of this report will use it to carefully assess their needs and work with governing boards, financial staff/volunteers and, where relevant, outside advisors to strengthen their financial internal controls.

KELLER & OWENS, LLC

Who We Are

Keller & Owens, LLC was founded in 1980 with the needs of clients in mind. The founders believed individuals, commercial and not-for-profit organizations wanted and deserved the opportunity to obtain high quality, timely, broadly-based services from trained and experienced professionals at a reasonable cost. They were convinced that these attributes combined with close, personal services of management level personnel would mean success for clients and the firm. As a result, Keller & Owens, LLC has become one of the larger independent local firms in the greater Kansas City metro area specializing in serving churches.

Keller & Owens, LLC is a full service public accounting firm providing accounting, auditing, consulting and tax services to our clients. The firm specializes in services to not-for-profit organizations and has one of the largest not-for-profit client bases in the city. The firm consists of seven management level personnel, including three owners, and twenty-three full and part-time professional and clerical personnel. Most of our professionals are CPAs and average about 10 years of experience in public accounting and business.

For more information about Keller & Owens, LLC visit our website at www.kellerowens.com.

Serving the Needs of Churches

Our firm offers a wide variety of services to churches and church-related organizations. We tailor our accounting, assurance, consulting, payroll and tax services to your specific needs.

Accounting

Meaningful, well-organized financial records help you manage your operations more efficiently. Our firm provides a full range of cost-effective accounting services including the following:

- ✓ General ledger and financial statement preparation
- ✓ Bookkeeping
- ✓ QuickBooks® and other software consulting
- ✓ Accounting policies and procedures manuals

Assurance

Many times you need an expert's report on matters of significance to your operations or for your stewardship to others. We offer a variety of services designed to provide the desired level of assurance on such matters. The following is a partial list of the assurance services we offer:

Assurance (continued)

The following is a partial list of the assurance services we offer:

- ✓ Audits of financial statements
- ✓ Reviews of financial statements
- ✓ Internal control system examinations
- ✓ Other nontraditional examination situations

Consulting

In addition to acting as a ready resource to the Board and management, we provide a variety of consulting services including the following:

- ✓ Cash flow and budgeting analysis
- ✓ Compensation and benefit planning
- ✓ Financial forecasts and projections
- ✓ Fraud and forensic accounting services
- ✓ Training financial and accounting personnel
- ✓ Training effective board and finance committee members

Tax

By specializing in non-profit organizations, we are in a position to identify key issues and needs for tax exempt organizations and clergy. We offer the following services, among others:

- ✓ Tax exemption application and Form 1023 preparation
- ✓ Clergy tax planning and return preparation
- ✓ Unrelated business income consulting
- ✓ Charitable giving consultation

Payroll

Our Payroll Partners Plus division offers a full range of payroll services customized to the unique needs of churches and their employees. The following are some available options:

- ✓ Preparation of payroll checks (including laser signature), reports and federal forms
- ✓ Direct deposit of employee checks
- ✓ Electronic payment of payroll taxes
- ✓ Consulting on payroll matters, including for clergy

For more information about the services we offer or the experienced professionals serving churches and church-related organizations ask us or visit our website at www.kellerowens.com.

Internal Control Review and Design Services

Years of experience working with accounting systems has enabled us to provide the following internal control services:

- Document the design and implementation of your financial internal controls and recommend opportunities for improvement.
- Create financial policies and procedures manuals for use by your accounting and financial staff and volunteers.
- Train your accounting and financial staff and volunteers to implement sound financial internal controls.

Financial Fraud Deterrence Services

Our team of professionals, led by Certified Fraud Examiners, is available to provide the following services:

- Train your governing body on the risks of financial fraud in churches and how to combat it.
- Train your employees on how to identify financial fraud and steps to take if it's detected.
- Review your internal policies covering such areas as conflict of interest, code of conduct, whistleblower and others with recommendations for improvements.
- Work with you to document your anti-fraud internal accounting controls and make recommendations for improvements.
- Work with you to develop tailored fraud risk assessment tools for use by the governing body and by management.
- Assist you in developing an internal audit program to help detect fraud and provide other important financial oversight for the church.

Other Fraud Prevention and Detection Resources from KO*

Preventing and Detecting Fraud in Not-For-Profit Organizations, 2012 Revised Edition

2012 Fraud Risk Assessment Materials for Church Governing Bodies

Video of an Interview with a Whistleblower in a Major Church Financial Fraud – for Church Governing Bodies

* These resources are available for viewing or download free of charge at www.kellerowens.com/not-for-profit organizations/religious organizations.