

NPO, Internal Controls, and Supervision Mechanisms in a Developing Country

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Abstract The premise of this paper is that effective supervision and proper internal control system (ICS) can promote accountability and transparency, and this will attract more donors. However, in a developing country like Malaysia, it is common that proper accounting standards are not available, the laws are not enforced, and charities often struggle for survival. Debates on regulating nonprofit organizations (NPOs) have been sensitive to many and are often left unresolved, and some quarters believe that NPOs should be left to handle their own affairs. This paper provides evidence from a survey of 60 charities on the status of their ICS. It briefly describes the current state of regulations in Malaysia and makes a case for better monitoring of the sector, as this might be the reason NPOs are lacking in their ICS. We propose what type of regulation and assistance can be provided by the authorities to this sector, not only in Malaysia but also in other developing countries facing similar challenges.

Résumé L'hypothèse de départ de cet article est qu'une supervision efficace et un système de contrôle interne (SCI) adéquat peuvent favoriser la responsabilité et la transparence, attirant ainsi plus de donateurs. Cependant, dans un pays en développement tel que la Malaisie, on trouve rarement des standards de comptabilité adéquats, les lois sont rarement appliquées, et les organismes charitables luttent souvent pour leur survie. Les débats sur la régulation des Organisations à But Non-Lucratif (OBNL) sont une question sensible pour beaucoup et restent souvent sans réponse, et certains pensent qu'il faut laisser les OBNL gérer leurs propres affaires.

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Sur la base d'une recherche empirique, cet article rend compte du statut des SCI de 60 organisations charitables. Après une brève description de l'état présent des réglementations en Malaisie, nous avançons qu'il conviendrait de mettre en place une meilleure surveillance du secteur, étant donné qu'il s'agit peut-être là de la raison pour laquelle les SCI des OBNL sont défaillants. Nous suggérons quel type de réglementation et d'aide les autorités pourraient fournir à ce secteur, non seulement en Malaisie, mais aussi dans d'autres pays en développement confrontés à des difficultés similaires.

Zusammenfassung Dieser Beitrag geht davon aus, dass eine effektive Überwachung und ein angemessenes internes Kontrollsystem Verantwortlichkeit und Transparenz fördern können, was wiederum mehr Spender anzieht. In Entwicklungsländern wie Malaysia ist es jedoch allgemein üblich, dass es keine angemessenen Rechnungslegungsstandards gibt, Gesetze nicht vollstreckt werden und gemeinnützige Organisationen oftmals ums Überleben kämpfen. Diskussionen über die Regulierung von Nonprofit-Organisationen sind für viele ein heikles Thema und bleiben oftmals fruchtlos. In einigen Kreisen ist man der Meinung, dass man Nonprofit-Organisationen die Regelung ihrer Angelegenheiten selbst überlassen sollte. Der vorliegende Beitrag liefert Nachweise aus einer Umfrage von 60 gemeinnützigen Organisationen zur gegenwärtigen Situation ihrer internen Kontrollsysteme. Die Abhandlung geht kurz auf den gegenwärtigen Stand der Regulierungen in Malaysia ein und liefert Argumente für eine bessere Überwachung des Sektors, da dies der Grund dafür sein mag, dass es in den Nonprofit-Organisationen an internen Kontrollsystemen mangelt. Wir unterbreiten Vorschläge dahingehend, welche Art von Regulierung und Unterstützung die Behörden diesem Sektor bereitstellen können; nicht nur in Malaysia, sondern auch in anderen Entwicklungsländern, die ähnlichen Problemen ausgesetzt sind.

Resumen La premisa del presente documento es que una supervisión efectiva y un sistema de control interno apropiado (ICS, del inglés internal control system) puede fomentar la responsabilidad y la transparencia, y esto atraerá a más donantes. Sin embargo, en un país en vías de desarrollo como Malasia, es normal que no se disponga de normas contables apropiadas, que las leyes no se apliquen y que las organizaciones benéficas luchan a menudo para sobrevivir. Los debates sobre la regulación de las Organizaciones sin ánimo de lucro (NPO, del inglés NonProfit Organization) son sensibles para muchos y a menudo se dejan sin resolver, y en algunos ámbitos se cree que debe dejarse que las NPO manejen sus propios asuntos. El presente documento proporciona pruebas de una encuesta de 60 organizaciones benéficas sobre el estado de su ICS. Describe brevemente el estado actual de las reglamentaciones en Malasia y defiende una mejor monitorización del sector, ya que esto podría ser el motivo de que las NPO tengan carencias en sus ICS. Proponemos qué tipo de reglamentación y asistencia puede ser proporcionado por las autoridades a este sector, no sólo en Malasia, sino también en otros países en vías de desarrollo que se enfrentan a desafíos similares.

Keywords Charities · Developing country · Internal control system

Introduction

The issue of accountability has become synonymous with the third sector—the domain of the charities. The third sector is very large and has been growing so rapidly that its financial sustainability has become a major concern (Lyons and Hocking 1998). This sector is a substantial employer and a provider of services that fills the gaps in government services (Abraham 2003, p. 5). In more developed countries where the NPO sector is well structured and properly regulated, the accountability of NPOs is often indicated by transparency and the timely submission of annual reports. However, in a developing country like Malaysia, it is common that proper accounting standards are not available, the laws are not enforced, and charities often struggle for survival.

Debates on regulating NPOs have been sensitive to many and are often left unresolved, and some quarters believe that NPOs should be left to handle their own affairs. It is a common knowledge that occurrence of fraud in charities has not been widely publicized in the developing countries. In any case, it is not as intensively covered in the media in more developed countries. In fact, the occurrence of fraud might not be reported in the first place. As a result, donors are not aware of the occurrence of fraud and they are expected to keep on contributing to their chosen charities. Given the rapid development of easily accessed media in the developing world, the demand for transparency and accountability is unavoidable for these charities. According to Bottiglieri et al. (2011), transparency that results in more satisfied donors correlates with increased donations and more effective NPOs.

Empirical evidence indicates that high standards of transparency and disclosure can increase confidence among decision-makers such as donors who must decide where to place their money. Few studies have found positive relationships between the extent of disclosure levels and the amount of future donations received (Buchheit and Parsons 2006; Trussel and Parsons 2008; Christensen and Mohr 2003; Gordon and Khumawala 1999). In Malaysia, a recent study by Atan et al. (2012) concluded that the financial information provided by a charity can influence a potential donor's decision to donate. They found that the amount of donations was significantly and positively related to the extent of disclosure and proposed that the management of NPO must improve their financial disclosure information in order to attract more support from donors. This means that the donor's decision to donate depends on the level of transparency of the charity organizations. Unfortunately, the overall extent of disclosure made by the charity organizations in Malaysia is very low. Atan et al. (2012) found that the mean disclosure score was 141.16 and the maximum total disclosure score (228) are less than half of the total scores (p. 121). Since their study was conducted in much developed state (Selangor) and city (Kuala Lumpur), we believe that the results might be worst if it was to be conducted in a less-developed, rural state such as Kelantan.

Charities have to work hard to prove that they are fiscally stable, responsible, and deserve support as institutions of value to the community (Doncaster and Hughes 1996). Since the first reports in the 1980s, the associated trends have remained the same: a failure to monitor nonprofit organizations (NPOs) and a failure to explain their problems and protect vulnerable citizens (Rodrigue 1998). To make matters

worse, the inefficiency of governmental supervision and regulation has resulted in these entities performing their stated purposes inadequately and inefficiently and has allowed financial indiscretions to tarnish their reputations (Bottiglieri et al. 2011, p. 51). Sacco and Nagy (2004) assert that charities and membership or advocacy nonprofit entities cannot carry out their public-service missions faithfully without an accounting system that provides sufficient information to the board, the public, donors, and the state (p. 381). According to them, poor performance in accounting and management control will lead to a possible collapse of faith and trust in this sector. Unfortunately, the accounting systems in NPOs are underdeveloped, mainly because the implementation of internal and external controls in these entities is different from those in the private sector (Anthony 1978). Nevertheless, the objectives of the internal control system (ICS) remain the same regardless of the nature of the entity, and remaining financially sustainable should be the main focus for charities.

Internal controls are the policies and procedures designed to insure operating efficiency, production of reliable data, and compliance with laws and regulations. Lacking an ICS can prevent charities from producing timely financial statements, which means that the public cannot see their financial status. The result of this may be that potential donors will lack confidence in the charity, thus perpetuating the vicious cycle of struggle for survival. In the case of the United States, Bottiglieri et al. (2011) propose that since most NPOs fail to efficiently regulate themselves, the government and the Financial Accounting Standard Board (FASB) must establish compulsory procedures and policies for nonprofits (p. 59). In Malaysia, or other developing countries for that matter, where the regulations are less efficient and charities are not transparent, governmental intervention for the benefit of the vulnerable citizens whom the charities have vowed to protect and the missions they uphold can only be realized if the government itself could improve the situation, not worsen it. In other words, to help NPOs government oversight should be limited and efficient, while the government itself should be also transparent and accountable. History has revealed that if this sector is not taken care of, charities are more vulnerable to other white-collar crimes such as fraud and misappropriation of funds, and they will be making the headlines in the major media, as is the case in more developed countries.

We believe that if charities were to implement proper ICS, the improved financial and performance information could contribute to showing the efforts and accomplishments of the charity and might help to obtain social and financial support (Torres and Pina 2003). Even though the management might not be involved in any form of financial scandal, the lack of a strong ICS might put them into the spotlight for accusations of fraud and financial improprieties. According to Duncan et al. (1999), inadequate internal controls can hinder the effectiveness of church officers and employees and place them in a position where they may be tempted to engage in questionable activities or accounting practices. Thus, this research is based on the premise that establishing effective internal controls will improve the quality of economic activity and management efficiency (Liu 2005). In the absence of the proper accounting practices, the research argues that a charity that has not established at least a basic ICS is a threat to their continued existence.

Therefore, it is the responsibility of the management to put in place an ICS that allows such evidence to be collected by the auditors. The less attention the NPO gives to internal control, the more risky the NPO is, as the auditors cannot rely on the evidence and draw their conclusions about the truth and fairness of their financial statements.

This is compounded by the fact that, in addition to their inherent limitations as described above, charities are not sufficiently regulated in Malaysia. There is nothing much that we can do about the inherent nature of charities, but we believe that effective supervision and monitoring mechanisms can, to a certain extent, coerce them to at least improve their ICS, directly or indirectly, in order to fulfill the requirements of the regulators to submit their audited annual reports in a timely manner. Properly drawn-up annual reports cannot be delivered unless a charity has a good ICS in place.

Literature Review

Charities are classified as NPOs, which include lobbying groups such as for women's rights or the environment, service organizations for disaster relief or humanitarian aid, and specialized organizations focused on international affairs. The NPO is also an alternative delivery mode for public services, a rich source of diverse ideas, and an avenue through which minority demands for public goods can be channeled (Douglas 1987; Weisbrod 1988). Some of the common characteristics of an NPO are as follows: it is essentially voluntary, independent, and not for profit; it is set up for a specific objective; and funding may come from members, subscriptions, public donations, grants, or investments. NPOs do not have shareholders and their managers might not consider themselves accountable to the supporters or members of the organization (Duncan et al. 1999).

Previous studies related to the accounting and financial reporting systems of charities have been predominantly western focused, especially in the United Kingdom (UK) and the United States (US) (see Ashford and Clarke 2006; Bode 2004; Cullis et al. 2004; Torres and Pina 2003; Connolly and Hyndman 2001; Sansing 2000). Miller (1997) reports a record number of UK charities involved in fraudulent activities in 1993. In the US, major financial scandals have come to light; for example, embezzlement by the president of the United Way of America (Murawski 1995); investment fraud of the Foundation for the New Era Philanthropy (Stecklow 1997); theft by leaders of the Episcopal and Baptist churches (Greene 1995) and an excessively generous compensation package for the president of Adelphi University (Thornburg 1997). Bottiglieri et al. (2011) report two recent incidents involving the American Red Cross and the United Way, which have come under criticism for a number of reasons, including excessive CEO pay, mishandled or lost funds, and inefficient disaster relief. Fraud cases are mainly due to embezzlement and misappropriation of funds (see examples from Barton et al. 1996; Smith 1997; Lambert et al. 1998). According to Gilbelman and Gelman (2004) and Bottiglieri et al. (2011), the wrongdoings have tarnished the public image of these organizations, and their perpetuation over time further erodes public

trust. Gilbelman and Gelman (2004) claim “crack downs” on charity abuses are ineffective. The major reason for this is said to be deficiencies in accounting standards and systems (Miller 1997).

It is normal to expect worse in the developing countries due to their inherent limitations in terms of resources and regulations. Copal Partners Research (2006) estimates that nearly half of the 4 million charities in India are unregistered and 53 % of them operate in rural areas with limited financial resources. In Malaysia, Sulaiman et al. (2008) examined ICSs in religious institutions and found that the management committees take their duty to safeguard the public monies entrusted to them quite seriously. Studies in non-religious organizations were not conducted exhaustively and reported publicly. Donors in Malaysia are not concerned about the reporting issues in themselves, but they do have concerns about the accountability of charities and availability of a supervision mechanism (Nasir et al. 2009). As stated by Abraham (2003), issues of financial sustainability and accountability arise as a result of external demands and internal needs. Since the various types of fraud have become increasingly ingenious, the system that needs to be put in place must be as good and watertight as possible (Palmer and Randall 2002) as the quest to stop fraud in the nonprofit sector has always been termed “difficult” (Carr 2000).

As part of the management control system, the ICS provides measures which prevent and detect errors and frauds by implementing various checks and balances (Abraham 2003, p. 3). Having an ICS helps an organization to insure the reliability of its financial reporting system, to safeguard its assets, to make sure that financial statements will be prepared in a timely manner and, most importantly, to prevent fraud and error from happening. A sound ICS is even more fundamental in charities which suffer from insufficient resources such as staff and funding, in making sure that any money is spent appropriately to pursue their missions.

Regulatory Settings in Malaysia

Malaysia’s NPO sector includes societies, associations, clubs, organisations, companies limited by guarantee, and foundations. The constitutional form may be either a registered society under the supervision of the registrar of societies (ROS) or a registered company limited by guarantee (CLBG), under the supervision of the Companies Commission of Malaysia (CCM). As at 1 October 2010, there are 2,702 CLBGs registered by the CCM. The majority of these NPOs are Foundations, with 1,127 of these registered.

The ROS is within the jurisdiction of the Ministry of Home Affairs. It is the principal government department responsible for supervising and controlling the activities of NPOs. The ROS places NPOs under broad categories, which also indirectly depicts the functions that they carry out in consonance with their characteristic features. The 13 categories as classified under ROS are: (1) religious, (2) welfare, (3) social and recreation, (4) women, (5) culture, (6) mutual benefit societies, (7) trade associations, (8) youth, (9) disable (10) education, (11) political, (12) employment associations, and (13) general. Organizations categorized under “general” include consumer associations, environmental associations, old boys/girls’ associations, residential associations, and ex-police and ex-servicemen’s

associations. Of the 41,196 societies (not including branches) registered with the ROS at 31 December 2006, nearly 7,000 are involved in welfare activities, and over 5,000 are involved in religious activities, including Islamic NPOs (Fig. 1).

The Inland Revenue Department (IRD) of Malaysia is the body responsible for granting status for tax-exempt purposes. Charitable organizations may formally apply for tax exemptions under Section 44(6) of the Income Tax Act 1967 from the IRD. However, the IRD guidelines for application of Section 44(6) approval have only a general requirement for audited financial statements for the immediately preceding 2 years, without a detailed breakdown of the components of the financial statements. The IRD establishes two conditions for these organizations to qualify for tax-exempt status: (1) it must be established in Malaysia for charitable purposes only and (2) the organization must spend at least 50 % (or such percentage as may be determined by the Director General) of its income, including donations received in the previous year for the activities that were approved to achieve its objectives for the basis period for a year of assessment [para 3.4 Section 44(6)]. The failure of societies and charitable corporations with tax-exempt status in submitting annual reports is not a new issue, and this has prompted us to conduct interviews with people directly and indirectly managing NPOs to have their insight on the problems that still persist in Malaysia. These are discussed in “[ICS Analysis](#)” section.

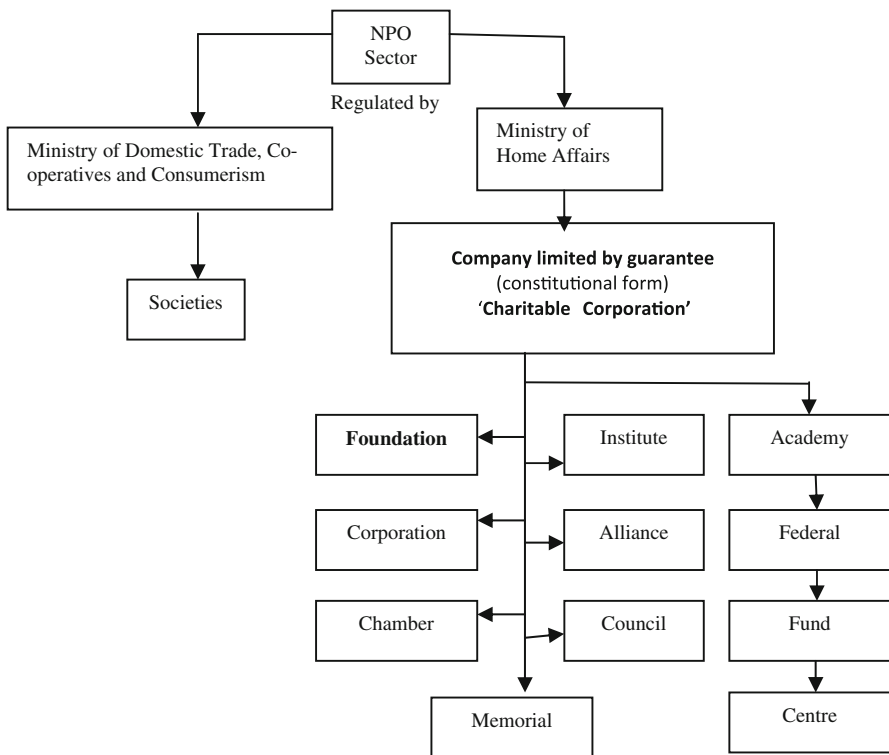


Fig. 1 Regulatory system of NPO sector in Malaysia

Malaysian NPOs are not isolated from common problems to charities in developing countries such as inexperienced staff, lack of volunteers, inadequate governance, lack of funding, lack of regulation, and improper accounting and reporting practices (Othman et al. 2012). These problems could be minimized if the enforcement and monitoring mechanisms are more effective. Pursuant to Section 14 of the Societies Act (SA), all registered societies are required to submit annual returns to the ROS which include: a financial statement including a balance sheet, minutes of general meetings, and audited accounts. Sections 63, 64, and 66 of the SA provide the ROS with effective powers to: enter and search the premises of a society, and to inspect all books and records; search a person for evidence; seize relevant materials; and summons any person whom the ROS believes will be able to give any information as to the existence of operations of any unlawful society, a suspected unlawful society, or the operations of any registered society. In the case of CCM, it requires CLBG under Section 167 of the Companies Act 1965 (CA) to maintain records which will sufficiently explain the company's transactions and financial position for a period of 7 years. CLBG are obliged under the CA to maintain such records, but there are no such obligations in the case of NPOs registered with the ROS. APG (2007) comments that limited measures are in place to insure that societies are not raising or expending funds in a manner inconsistent with their stated purposes. In fact, ROS does not appear to have a clear policy for the identification and closer monitoring of those societies and appears to be relying largely upon information from the public, media, and the police to target investigation of misuse of NPOs (APG 2007, paragraph 913).

CCM and ROS have conducted few measures to promote transparency, accountability, and integrity of NPOs such as CCM's Corporate Directors Training Programs and Annual Dialogue Sessions between directors and the CCM. ROS conducts introductory courses on the management and financial management to newly registered societies, and produces pamphlets and brochures relating to good society management. Despite all these efforts, the issues of transparency and accountability of NPOs still persist. This situation must be improved, especially in times of tough economic crisis, when people are more concerned about staying afloat and cannot afford discretionary expenditures such as charitable donations (Bottiglieri et al. 2011), even though they are tax deductible. According to Bottiglieri et al. (2011, p. 55), lack of regulations has an effect on the external funding of NPOs and prevents strong internal control of finances. As sound financial data comes from a good ICS, without one, the NPO might have difficulties in knowing basic information such as how much money it has to hand and how to manage that money to survive. In order to investigate these issues further, we conducted a survey of 60 charities to ask about the status of their ICSs and the factors that they think contribute to a good system. The results of this survey are discussed in the next section.

ICS Analysis

A list of Kelantan NPOs registered with ROS and CCM was obtained separately from the offices. The NPOs were then contacted and briefed about the survey. Only

66 NPOs were willing to be interviewed and participate in the survey. The data collection method required personally administering questionnaires to the 66 NPO representatives at random between 20 August and 10 September 2011 in the state of Kelantan in Malaysia. However, only 60 questionnaires were usable (six questionnaires were incomplete), accounting for 90.9 %. This is an on-going study where the survey will be extended to the other 12 states in Malaysia. Kelantan was chosen first because it is one of the more underdeveloped states in Malaysia, where hard-core poor people reside and the standard of living is quite low compared to other states in Malaysia. As a result, many NPOs have been established there to pursue various missions for the people in the state, such as providing services in the areas of Health and Reproductive, Environment, Community Development, and Women's Development, as described in Table 1.

Questionnaires were administered personally as this is considered a better method for respondents to clarify any questions and queries that they might have. Interviews could also be conducted at the premises on various issues concerning their answers to the questionnaires. The questionnaire was adapted from Duncan et al. (1999) and consisted of two main parts. Part 1 focused on general information such as the type of charity, number of employees, gender of respondent, and the existence of a board in the charity. Part 2 comprised a series of questions on the basic ICSs related to receiving income and disbursing funds. The respondents were required to indicate either "YES" or "NO" in the boxes provided. There was also a smaller Part 3 that sought to collect information on the number of residences served by their charities and the total amount of grants received from the National Council of Social Welfare and Development of Malaysia (NCSWDM, a government agency).

Even though the questionnaire had been pre-tested with six NPOs on 5 April 2011, we acknowledge that aspects of the control systems are not equally important to all NPOs. The 60 respondents came from a diverse group of NPOs. The largest number (27 %) came from the Community Welfare and Development sector and the smallest number (3 %) came from the Water and Environment and Health and Reproductive related organizations.

Table 1 Respondent distribution

Type of NPO	No.	%
Water and environment	2	3
Health and reproductive	2	3
Disabled people	4	7
Youth	6	10
Religious	6	10
Women's development	6	10
Poor people and orphanage	8	13
Sports and recreation	10	17
Community welfare and development	16	27
Total	60	

The respondents were equally divided between male and female (29), although two people did not disclose this information.

Only 52 respondents disclosed the number of employees in their organization (see Table 2). There were two organizations that did not have employees and were run by volunteers. Most of the NPOs were staffed by two to five employees, indicating that they were generally small organizations. Only six respondents claimed that they were from large organizations with more than 50 employees.

As seen in Table 3, only 44 out of 60 respondents disclosed their positions. The majority (54.5 %) were top and middle-level management, including executive officer, accounting officer, administration officer, and financial officer. The other 45.5 % held clerical jobs in their charities.

As shown in Table 4, only 52 NPOs representatives disclosed the number of employees and the presence of the board of directors in their organizations. Thirty NPOs did not have a board of directors. For the NPO that do have a board of directors, it is interesting to note that the NPO size does not necessarily determine the board's presence, as initially predicted.

Following Duncan et al. (1999), there were 40 basic ICSs recommended for charities, covering general controls, cash receipt controls, cash disbursement controls and reconciliation controls (refer to Appendix). The respondents were asked to tick “yes” if the internal control was being practiced in their organization, and they would get 40 marks in total if they practiced them all (Question 3 has one sub-question).

At a glance, Table 5 shows promising results on the ICS scores. The minimum score is 2 and only one charity was scored as having a bad ICS. Nevertheless, we argue that the 40 recommended internal control practices were the minimum

Table 2 No. of employees

	No.	%
None	2	4
2–5	16	31
6–9	14	27
10–20	10	19
21–50	4	8
>50	6	12
Total	52	

Table 3 Respondent position

	No. of respondents	Percent
Executive Officer	3	6.8
Accounting Officer	5	11.3
Admin Officer	9	20.5
Financial Officer	7	15.9
Clerical	20	45.5
	44	

Table 4 NPOs with a board

NPO employees	NPO with a board		Total
	No	Yes	
None	1	1	2
2–5	11	5	16
6–10	7	7	14
10–20	6	4	10
21–50	3	1	4
Total	30	22	52

necessary and the charities should have more than 40 practices as recommended. The 40 practices as recommended cover only the basic general control, cash receipts and cash disbursements controls, and reconciliation practices. These do not cover other controls in other areas such as revenues and receivables collection, payroll, inventory, purchase, and payables, which are most likely absent in the small charities surveyed. Large and established charities might have better internal controls covering more areas as compared to small charities, which run on a cash basis, as these are very costly to be implemented. The 40 practices recommended are very basic (refer to [Appendix](#)), and therefore they are expected to be implemented even in small charities. As can be seen from [Table 5](#), only three out of

Table 5 ICS score

Total scores	Total score/ recommended (41) (%)	No. of charities	Percent	Cumulative percent
2	5	1	1.7	1.7
19	46	2	3.3	5
24	58	4	6.7	11.7
25	61	4	6.7	18.4
26	63	2	3.3	21.7
27	66	10	16.7	38.4
28	68	7	11.7	50.1
29	70	7	11.7	61.8
30	73	2	3.3	65.1
31	76	3	5.0	70.1
32	78	5	8.2	78.3
33	80	3	5.0	83.3
34	83	2	3.3	86.6
36	88	1	1.7	88.3
37	90	1	1.7	90.0
38	93	2	3.3	93.3
39	95	3	5.0	98.3
40	98	1	1.7	100.0
Total		60	100.0	

Table 6 ICS score and category

ICS category	No. of charities that scored at least 90 %	Percent
General controls	4	6.7
Cash receipt controls	10	16.7
Cash disbursement controls	31	55.0
Reconciliation controls	2	3.3

60 charities (5 %) had less than 20 of the 40 recommended practices. Seven charities (12 %) had in place more than 37 or 90 % of the recommended practices. Table 6 summarizes the number of charities that scored at least 90 % according to ICS category.

As can be seen from Table 6, most of the charities had better control in cash disbursements, with 55 % of them scoring at least 90 % of the recommended practices, followed by cash receipt controls (16.7 %). Unfortunately, less than 10 % of the charities scored at least 90 % in the categories of general controls (6.7 %) and reconciliation controls (3.3 %).

We then examined the internal controls used by the charities to highlight the practices that are significantly different in Table 7. An analysis of the internal control practiced by the charities was analyzed. Any practice that is not commonly practiced by the charities is considered as “significantly different” and indicated by the p value. If the internal control practice is statistically significant at 5 % level means, that particular internal control practice has 95 % chance of being practiced in the sampled charities (or a 5 % chance of it not being practiced). Thus, Table 7 shows the internal control practices which are commonly (not commonly) practiced by the charities. Table 7 shows that for general controls, only three practices (43 %) were significantly different from the total of seven recommended practices (refer to the Appendix). For instance, due to limitations in terms of employees and financing, some of the facilities were not locked up when not in use. This included facilities for the keeping of cash and valuables. Also, a worrying situation was evident in the auditing responsibility. An audit should be performed by an independent party who conducts an examination of the accounts and financial statements of the charity. However, the interviews with the charities revealed that this was not necessarily what happened. It is quite worrying to know that in most of the smaller charities, it was the accounting employee or internal auditor who would perform the auditing. This is clearly a violation of the objective of the audit, which is to provide an independent opinion on the truth and fairness of the financial statements prepared by the charity. The charity representatives told us that the audit was actually meant for internal use as they could not afford to hire an auditor. In a previous study by Nasir et al. (2009) on the financial reporting practices of Malaysian charities, audit fees charged to charities ranged from as little as US \$100 to more than US \$2,000. Since there were no follow-ups being carried out by the regulator for not submitting audited financial statements, the NPOs did not consider this was critical, as it was more important for them to find ways to survive than pursue transparency. This phenomenon might be unacceptable in other countries, but it is one of the

Table 7 ANOVA test for difference in the means of items related to internal control system practices according to NPO type

Internal control	<i>F</i> test	<i>p</i> value
General (3/7)		
Are facilities locked when not in use?	2.135	0.049**
A CPA who is staff of the organization performs the annual audit	1.842	0.091*
Does your organization have its up-to-date accounting procedures in writing?	1.928	0.076*
Cash receipts (2/12)		
Is the handling of donations always controlled by at least two people?	2.002	0.067*
Are incoming mail and in-office contributions handled by people who are not responsible for the accounting records?	2.280	0.038**
Cash disbursements (1/13)		
Are requisition slips prepared for anticipated disbursements that do not have standing authorization?	1.820	0.096*
Reconciliation practices (3/8)		
Are valuables (marketable securities, notes, valuable documents, jewels, etc.) afforded protection in a bank safe deposit box?	2.827	0.012**
Is an updated inventory of securities, valuables, equipment, and other major non-cash assets maintained?	1.997	0.067**
Are budgeted expenditures periodically compared to actual expenditures to insure that funds are being spent as authorized?	2.026	0.064**

** Significant at 5 % level

“uncomfortable truths”—at least, in Malaysia. As expected, having up-to-date accounting procedures in writing was also significantly different across the sample.

The charities were quite similar in terms of their cash receipt and disbursement practices. Out of 12 practices for cash receipts and 13 practices of cash disbursements, only two practices (16 %) of cash receipts and one practice (7 %) of cash disbursement were significantly different across NPOs. All these three practices—the handling of donations, incoming mails, and requisition slips—were related to proper segregation of duties, and charities that did not have sufficient employees would clearly violate these practices. In terms of reconciliation practices, three out of eight practices were significantly different. These practices were about whether valuables such as important documents were protected in a bank safe deposit box, whether the charities maintained an updated inventory of the valuables and major non-cash assets, and whether budgeted expenditures were periodically compared to actual expenditures.

Table 8 shows the minimum (lowest value), maximum (highest value) and the average number of residence/members, self-generated monthly income, and the amount of government support received by the sampled charities. Table 8 shows that the charities had housed residences or members of between five and 10,000 people. The average number of residents/members was 694. Our analysis also revealed that six charities (10 %) did not have any monthly income. A third (33.7 %) had income between US \$0.32 and US \$641 monthly. About one-fifth

(21.7 %) had self-generated income between US \$3,205 and US \$9,616, and 9.9 % had an income of more than US \$32,052. In terms of support (funding) from the government through the NCSWDM, only 43 respondents answered this question. Out of these, 36 charities (83.7 %) did not get any funding from the NCSWDM. Only two charities obtained US \$3,205, another two charities got US \$4,808. Only one charity managed to obtain US \$89,746 and only two charities managed to secure US \$115,387.

In order to get funding from the NCSWDM, charities must register first with NCSWDM. One of the requirements is the ability to furnish audited financial statements, which made some charities shy away from requesting the available funding. Some representatives called this a vicious cycle because the main reason for them not being able to furnish complete and audited financial statements was that they did not have sufficient finance, and in order to get the “finance” or support from the NCSWDM they must furnish audited financial statements.

Table 9 analyzes whether organizational factors such as the number of employees, existence of a board of directors, the number of housed residences or members, average income, and government support had a significant influence on the NPOs’ internal control practices, indicated by Pearson χ^2 . Unfortunately, none of the variables studied has a significant influence on internal control practices, which brings us back to the monitoring issues. The NPO representatives were asked why NPOs in general did not have good ICS practices in their organizations. All respondents said it was because this was not made mandatory and there were no best practices or guidelines to be followed. They did admit that having a good ICS would help them prevent fraud or inappropriate use of funding and assist them in preparing their financial statements since all documents would be made available.

It is clear that the NPOs were not uniform in terms of their internal control practices, and in some organizations most of the recommended control systems had never been practiced. This is compounded by the fact that the current regulations do not require submissions of sound financial data. Lack of regulations might have prevented strong internal control of finances as the charities were not required to furnish timely annual reports and the regulator had been inefficient in performing follow-ups when they failed to do so.

Proposed Regulation and Assistance Framework

Large or small, charities with tax-exempt status should reinvest every cent of their income back into operations to fulfill their missions since they are not burdened with

Table 8 Descriptive statistics for housed residence/members, self-generated monthly income, and government supports

	Minimum	Maximum	Average (mean)
Housed residence/members	5	10,000	694
Monthly income (US\$)	0	80,130	22,910
Government support (US\$)	0	115,387	24,419

Table 9 Factors influencing ICS scores indicated by Pearson χ^2

	Organizational Level				
	No. of employees	Board existence	No. of housed residence/ members	Average monthly income	Government support
Youth	0.199	0.199	0.241	0.242	NA
Disabled people	0.261	NA	0.199	0.213	0.157
Sports and recreation	0.163	0.238	0.227	0.291	0.116
Poor and orphanage	0.276	0.343	0.297	0.297	0.713
Water and environment group	NA	NA	NA	NA	–
Religious group	0.261	0.199	0.242	0.242	NA
Health and reproductive system	NA	NA	0.157	0.157	–
Community welfare development	0.285	0.534	0.361	0.233	0.154
Women's welfare	NA	0.135	0.285	0.285	NA

tax liability. This requires close monitoring from the government to make sure that the income is properly channeled and used. According to Bottiglieri et al. (2011), such regulations are important to influence how NPOs maintain and record their finances.

According to Bottiglieri et al. (2011), the majority of scandals could have been avoided if proper effective regulation had been in place to monitor the activities of the organizations. In the UK, the Strategy Unit's review of charities and the wider voluntary sector in England and Wales made 68 recommendations for oversight reform in 2002 (Pratten 2004). The proposed reforms involved an updating of charity law; changes to the regulatory framework governing the sector; and a greater emphasis on improving the accountability, transparency, and performance of charities and voluntary organizations. Previous studies have shown that compensation contracts, political regulation, closeness to debt covenants, and changes in accounting regulation influence the manipulation of accounting disclosures (see, for example, McNichols and Wilson 1988; Jones 1991; D'Souza 1998).

We propose regulation and assistance for NPOs in Malaysia. As emphasized by Bottiglieri et al. (2011), preventive regulations would not only help avoid the criticism and scrutiny, but would also save charities the time, money, and effort in trying to recover from the negative attention (p. 52). The proposed regulation and assistance discussed below are specific to Malaysia but might also be useful to other developing countries facing similar challenges in regulating charities.

Regulation

The regulation proposed should be imposed on NPOs and coercively enforced by government. The Societies Act 1966 makes it a legal obligation on the part of societies (including charities) to maintain proper records and accounting books to verify whether their transactions are properly recorded and accounted for and that

they are consistent with the society's objectives. However, this provision must be followed by appropriate enforcement and the ROS should be granted the power to legalize this provision. The power should come with an appropriate number of enforcement officers, dedicated units, and cooperation with other enforcement agencies such as the police and the Malaysian Anti-Corruption Agency. On top of that, the annual reports must be made accessible to the public since public examination could be more thorough and simultaneously more independent than governmental.

Continuous monitoring is vital for efficient regulation. The ROS and the CCM could adopt the e-filing method practiced currently by the IRD to save time and cost. The ROS and the CCM should provide an on-line system where charities can submit their annual reports. The on-line system should be able to trigger the relevant authority if a charity has not submitted their accounts so that immediate field-site visits can be conducted. These visits could be helpful in finding out the reasons for the failure of submission. The visiting officers must be ready to train charities' employees on site should they require such training for on-line submission. A separate team should handle the submitted annual reports for further examination of the financial statements even though they have been audited by auditors. The examination should focus on the mission, the fund-raising activities, and the expenditure in detail, as well as other information that the ROS and the CCM think is critical. Priority should be given to analyzing the annual reports of vulnerable charities having "red flag" indicators, such as expenditure that is more than the income generated for the year, or when the administration cost is significantly higher than usual.

Governance should also be promoted at the macro level. Baker and Collins (2005) claim that the safeguarding of the beneficiaries' interests depends heavily on the governance and control structures of the organization. The charities' top management must be provided with training on awareness of governance and then be included in a task force for formulating a code of governance for charities. This code of governance must be agreed unanimously before it can be imposed on all charities. Thus, the voice of the charities must be taken on board. The code must provide a clear and detailed checklist so that all charities can self-regulate their own compliance. This self-check governance should be submitted by charities to their regulators (ROS for societies; CCM for CLBG).

Gilbelman and Gelman (2004) support the idea that every non-governmental organization should concentrate on several areas of concern: clarifying board responsibilities, strengthening internal organization controls, and investing in board development. The reason is that the charities with "better" governance regimes are more likely to develop more extensive internal systems to target, measure, and report performance, particularly performance related to effectiveness and efficiency (Connolly and Hyndman 2004; Jobome 2006). The regulators should provide more platforms where there could be open discussions with charity leaders, government representatives, and the public on what should be required in terms of governance. If the charities perceive this would bring in more funding, and the government is willing to facilitate charities in fulfilling the public's demand for transparency, charities might be agreeable to the idea of their own sustainability.

Moreover, a website could be useful, not only for the charities to submit their annual reports on-line but also for the public to report suspicious activities and misuse of money among charities in Malaysia. The enforcement team should follow up any complaint by the public if provided with sufficient evidence. The website could also be a platform for the authorities to disclose publicly the governance status of all charities in terms of compliance.

Assistance

The proposal on assistance covers aids to NPOs in meeting certain standards regarding transparency and accountability and ICS procedures. Small charities might have difficulties in preparing financial statements. Instead of punishing them for non-compliance, the regulators could provide some incentives to help and facilitate them according to their needs. For instance, the Charity Commission of Singapore provides certain discounts to charities to assist in procuring basic equipment such as a computer, laptop, and printer if they need it to prepare annual reports. If the charities already have the basic equipment but they do not have any staff knowledgeable in accounting to prepare the annual reports, the Commission helps to provide a subsidized training grant for certain courses and training. For very small charities that do not have any knowledgeable staff to go for training or handle the equipment, the Commission provides a vendor of shared accounting services, to which charities can submit any necessary documents, and annual reports are then prepared on their behalf at a subsidized monthly fee. The service provider also helps the charity submit its annual report directly to the Commission after the reports have been audited. The Commission also subsidizes consultancy fees if charities in Singapore wanted to engage an approved consultant to help them design their ICS or establish a code of governance in their organization.

The introduction of relevant accounting standards in the sector might be crucial in Malaysia. In the United States, the Financial Accounting Standards Board (FASB) set accounting and financial reporting regulations for private NPOs that came into effect in late 1995. Their main purpose was to increase consistency and comparability among the entities so that private donors, investors, and government could have a clearer picture of the source of funding and use of money. However, in Malaysia, there are no specific accounting standards tailored to the needs of charities. Recording events becomes more complicated given the diversity of income sources, as donations can come in various forms, from cash donations to goods and payments in kind, which makes it more difficult to determine the net income, since valuation of the assets is a very complex issue. Charities do not have a voice in the accounting standard process and therefore need a strong lobbyist to insure that their interests are taken into consideration (Palmer 1996). Further, the diversity of establishment, nature, and objectives has made standardization an onerous task. There are no specific benchmarks to measure performance, and often they are not even obliged to produce financial statements. Charity leaders might complain that it would be expensive for them to comply with the accounting standards as it requires investment in staff training and development. In addition, the final accounts will need to be audited and audit fees might be too high. Torres and

Pina (2003) report that US and UK charities present the balance sheets in list format, whereas the account format is used by Canadian and Spanish charities. Minimal standards and the vague nature of those standards give nonprofits much more flexibility when it comes to financial reporting (Bottiglieri et al. 2011, p. 54), and this often creates more confusion for the employees of the charities.

Charities should be provided with a handbook on financial issues and the guidelines should cover all financial reporting issues, such as the standardized format or template, composition of financial reporting items, totals to be reported, and a requirement to make the submitted financial statements publicly available. Specific details should also be provided, such as guidelines on recognition of contributions received and contributions made, guidelines on recording of contributions as revenue or gains, and how to categorize contributions as revenues or gains, and definition and classification of costs (allowable and unallowable). If the board members, management, or volunteers need to travel or spend on behalf of charities, there must be standard rates for meals, travel, and lodging, with specific limits and conditions. Such rates should not be higher than the government rates. The board may approve higher rates, but this must be disclosed in the annual report. In terms of budgets, charities with budgets of more than a certain amount (such as RM250,000 annually) should be required to inform the IRD, have independent auditors, and change the auditor every 5 years to maintain independence. There must be guidelines for budgeting to make sure that uniform budgeting procedures and reporting formats are followed. Charities should be encouraged to have standardized accounting software approved by the regulator, or at least software that can provide a detailed accounting program to keep track of their finances, and perform automatic reconciliation of disbursement accounts and generation of financial statements.

The implementation of a management control system may be a necessity and should be promoted and encouraged by the regulators. A management control system is an integral aspect of a good accounting and financial reporting system, and it is an indispensable condition for the viability of a charity (Sacco and Nagy 2004, p. 382). A management control system insures the safekeeping of assets, maintains productivity, and produces reliable and relevant financial records and other reports. Accountability expectations extend management control into areas of planning and budgeting, raising funds, allocating resources, record keeping, monitoring and evaluating, and reporting and auditing (Elkin 1985). According to Leslie (1987), a control system is considered as one of the most important components of the management function. A proper control system needs to be in place in order to attain efficiency and effectiveness in business operations (Mohsin 2006). It must be designed, maintained, and continually re-evaluated if it is to be relied on the study of Duncan et al. (1999). The basic concepts of management control are the same for both profit and NPOs (Anthony and Young 1994, p. 3), but the actual implementation in charities might be difficult since the third sector is a complex and heterogeneous sector, where organizations are defined by exclusion, and include different entities such as charity, religious, research and scientific, artistic, educational, cultural or professional associations, political parties, libraries, museums, trade unions, social and country clubs, and private foundations (Torres and Pina 2003, p. 267).

The regulators should provide a list of approved auditors who are willing to audit charities for a minimal fee without compromising quality. Charities must appoint an auditor from the approved list, and the appointed auditor must not be part of the same team who prepares the financial statements as this can jeopardize the independence of the auditor. If the budget permits, the auditor should be engaged for a mandatory annual audit and interim audits every 6 months.

Every charity should have its own finance committee appointed from volunteers, industry experts, or local accounting academics. This committee should meet quarterly to review financial statements and budgets and select an auditor. The finance committee could also establish anti-fraud policies, conflict-of-interest policies, and guidelines. It should serve as an intermediary between the management and the auditor, and provide a safe channel of communication for volunteers and employees to report any suspicious fraudulent activities and irregularities.

Summary and Conclusion

Our premise is that major scandals in charities could be avoided if proper effective regulation is put in place to monitor their activities, especially when the lack of an ICS is evident. In some countries like Malaysia, regulation plays an important role. However, this can only be realized if the government itself could improve the situation, not worsen it. The regulatory framework aims to govern the charities better with greater emphasis on accountability and transparency. Also, better controlled finances would boost their reputation and make Malaysian charities more noticeable and trusted by the public at local and international levels. We admit that the main limitation of the study is that the vast majority of NPOs surveyed in this study were service provider NPOs as compared to human rights NPOs, which are expected to have better ICS and could suffer from strict government regulation as it will interfere with their mission to make the government accountable. Nonetheless, if charities generally lack a basic ICS this might have an impact on their financing, directly or indirectly. Thus, the government and relevant authorities must effectively enforce procedures and policies to improve both their credibility and the credibility of the charities.

We acknowledge that amendments to relevant acts and improvements in cooperation among government agencies can take decades, but we propose that it might be timely for the government to start with the formation of a Charity Commission at a national level to specifically oversee the sector through the proposed regulation and assistance. This would include continuous monitoring, establishment of a code of governance, development of an interactive website, facilitation of operational issues, and producing guidelines on the preparation of financial statements and reporting, budgeting, and auditing. Representatives from the charities must be involved in this process, and their voices must be “heard” to insure better acceptance and compliance. We are nonetheless mindful of the fact that these initiatives are not easy as the challenges of overcoming the fear of change, changing the mindset, dealing with high operating costs, understanding work

processes, training, and sustaining quality commitment (Sinha 1997) can be overwhelming.

The proposal for more regulation raises more questions such as what extent or degree of regulations is needed. The leaders of charities might argue about cost-benefit issues and think of regulation as harsh and punitive rather than helping them to survive. To counter this resistance, the authorities should encourage the charities to implement internal controls that are most relevant and affordable, depending on the size of the charities. Since the CCM and ROS had conducted training to the NPOs' managers such as training on good financial management practices, they must be aware of the importance of internal controls and the benefits to their organizations. Though we support for tighter regulation and supervision to insure that NPOs will keep proper accounting records and produce timely financial statements, we also believe that the authorities should facilitate NPOs in improving their internal controls, transparency, and accountability as practiced by the Charity Commission of Singapore on funding and support (CCOS 2012).

Donors would then have a better picture of the donations, and this would encourage more trust and confidence and, hopefully, would bring in-flows to their cash, not only from local but also from international donors from the developing countries. It is a simple fact that charities could not survive without donations, and therefore they need to step up the initiatives to improve their finance and reputation. We believe reasonable and simple regulations to fit charities of every size and mission could be a good starting point. It is also important that charities are given the platform and sufficient time to give feedback on any proposed regulations. The government should be ready to facilitate this process throughout. Ultimately, this would prevent wrongdoings in charities, especially considering their missions, which are to help others. We are hopeful that better and "friendly" regulation would not be harsh and punitive but would, in fact, help the charities to help more people in the future, especially when they receive more finance in their pockets.

This paper has some limitations. First, the vast majority of NPOs surveyed in this study were service provider NPOs as compared to human rights NPOs, and therefore the conclusion cannot be generalized to all NPOs. Analysis on potential risks, side-effects, and threats to NPOs' independence as a result of regulation are beyond the scope of this paper. Therefore, we suggest longitudinal research to examine the impact of regulations on risk of corruption and picking the winners and losers on the basis of loyalty and interruption of normal activities.

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Appendix

See Table 10.

Table 10 Internal controls checklist (Duncan et al. 1999)

Internal controls

General

- Y N 1 Are facilities locked when not in use?
- Y N 2 Is an audit committee operational?
- Y N 3 Are the accounting records and the underlying internal controls audited annually? If yes, who performs the audit?
- _____ An independent CPA
- _____ A CPA who is a staff of the organization
- _____ Person(s) within the organization
- _____ An auditor from the government
- _____ Other: _____
- Y N 4 Do the financial secretary's (or treasurer's) activities involve only keeping the records of cash collections and preparing the support for disbursements?
- Y N 5 Is the head of organization prohibited from counting money, signing cheques, and keeping financial records?
- Y N 6 Are all employees who have access to cash bonded/insured?
- Y N 7 Does your organization have its up-to-date accounting procedures in writing?

Cash receipts

- Y N 8 Are staff encouraged to use donation envelopes?
- Y N 9 Is the handling of donation always controlled by at least two people?
- Y N 10 Is the handling of cash receipts at times other than in office (outside office events) always controlled by at least two people?
- Y N 11 Do the money counters verify the contents of the donation envelopes are identical to the amounts written on the envelopes by the staff?
- Y N 12 Is all cash received deposited in the bank?
- Y N 13 Is cash safeguarded in a safe, lockbox, or similar protective container when in office?
- Y N 14 Are copies of the collection report prepared by the counters given to both, the financial secretary (or treasurer) for entry into the accounting records, and an audit committee for subsequent audit purposes?
- Y N 15 Does an audit committee regularly compare the list of cheques received with the bank deposit slip?
- Y N 16 Are incoming mail and in-office contributions handled by people who are not responsible for the accounting records?
- Y N 17 Are contributions records maintained for donors?
- Y N 18 Do donors receive periodic notices of their donations/contributions? If yes, how often are notices sent? _____
- Y N 19 Are the donors instructed to report any irregularities or errors in their notices of contributions to an audit committee (or someone other than the individual who keeps these records?)

Cash disbursements

- Y N 20 Are requisition slips prepared for anticipated disbursements that do not have standing authorization?
- Y N 21 Are pre-numbered purchase orders used for all disbursements that do not have standing authorization for payment?
- Y N 22 Are invoices for goods and services approved by a qualified person before payment is made?

Table 10 continued

Internal controls

Y	N	23	Are invoices checked for accuracy before being paid?
Y	N	24	Does the finance committee examine supporting documentation for purchases and the subsequent cancellation of the documents?
Y	N	25	Is a cheque authorization slip prepared to support the disbursement of funds?
Y	N	26	Are all payments, except for minor items, made by serially numbered cheques?
Y	N	27	Do all cheque signers inspect all supporting documents before signing?
Y	N	28	Are at least two signatures required for all cheques?
Y	N	29	Are supporting documents marked “paid” when cheques are issued?
Y	N	30	Are all voided cheques marked and retained?
Y	N	31	Is a petty cash fund used for minor disbursements of cash?
Y	N	32	Are vouchers prepared for all disbursements from the petty cash fund?

Reconciliation practices

Y	N	33	Are reconciliations of all bank accounts prepared monthly by a person who is not involved in writing cheques?
Y	N	34	Are accounting balances in the books ever reconciled with the amounts presented in the financial reports?
Y	N	35	Are valuables (marketable securities, notes, valuable documents, jewels, etc.) afforded protection in a bank safe deposit box?
Y	N	36	Are two signatures required for access to the safe deposit box?
Y	N	37	Is an updated inventory of securities, valuables, equipment, and other major non-cash assets maintained?
Y	N	38	Are scheduled reviews made to determine if insurance coverage is adequate?
Y	N	39	Are budgeted expenditures periodically compared to actual expenditures to insure that funds are being spent as authorized?
Y	N	40	Are all deliveries received compared with the bill of lading on receipt?

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