VOICE OF THE FAITHFUL
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What to Look for When Reviewing Diocesan Financial Statements

We get it. Financial statements are big scary documents with lots of numbers, lots of footnotes, and too many words only accountants can understand. But there's a way through the thickets, and these guidelines will help you examine a diocese's financial transparency and assess its financial health. We promise.

The Checklist

Good financial statements have these characteristics:

- ❑ Audited by an <u>independent</u> public accounting firm
- ❑ Includes all three of these statements:
  - ❑ Statement of Financial Position
  - ❑ Statement of Activities
  - ❑ Statement of Cash Flow
- ❑ Has extensive <u>Notes</u> (i.e., footnotes that may, or sometimes may not, be referenced on either the Statement of Financial Position or the Statement of Activities; they are rarely on a Cash Flow statement)
- ❑ Allows you to assess the transparency of the financial affairs of the diocese

Transparency (*good disclosure*) as described above leads to better accountability, which could also lead to better financial health for the diocese. The remaining guidelines detail the above characteristics and include tips on reviewing each type of statement and assessing the data.

Is Report Audited by an Independent Firm?

Audits by an independent certified public accounting firm are essential. Without them, the diocese has the flexibility to present only that which it wants to show. A non-audited report may include numbers an auditing firm would not accept, or it may present less than the full financial picture.

But remember: An audit is not a guarantee of good financial health. It's only a start.

How can I tell if the statements are audited?

You should find a "**Report of Independent Certified Public Accountant**" in the first several pages of the diocesan financial statements.

If you do, review the report with this in mind:

1. Did the Independent Certified Public Accounting Firm give the diocese a "clean" opinion—one labeled *unqualified* (meaning the firm has found nothing that would cause it to limit its own endorsement)? Or did the firm give a *qualified* opinion (the sign of a significant financial problem)?

2. An *unqualified* or "clean" report may not be stated directly, but it's a clean report if no problem is highlighted in the "Opinion" section of the auditor's report and if it uses language such as "presents the financial position of the diocese fairly in all material aspects" and "in accordance with generally accepted accounting principles."

Is an "unqualified" opinion a sure sign that no problems exist?

No, but it's a good start. Unfortunately, even an audited financial statement can contain "material" (i.e., really significant) misstatements. Further, audits seldom find <u>intentional but well-hidden</u> fraudulent activity.

Why not? Because in <u>all normal audits</u> the auditing firm:

- Checks only a small sample of transactions and can't find assets and liabilities that are well-hidden.

- Is not required by either congressional legislation or accounting industry standards to audit the "internal controls" of non-profit organizations or even those of privately held for-profit corporations.

  Note: "Internal controls" simply means the accounting procedures used to prepare the financial statements.

On the other hand, do not be alarmed if, despite a “clean” report, the independent auditor’s report says the preparation of the financial statements is the responsibility of management rather than the auditor, and/or that the audit only provides “reasonable assurance” the statements are free of a “material” misstatement. That language is standard for any audit report, because the auditor is not running the day-to-day accounting operations.

Are Three “Statements” Included in the Report?

If an independent certified public accounting firm has audited the financial statements and if the audited statements contain that auditor’s “Opinion” report, the next checkpoint is the financial statements themselves.

First check to be sure the financial report has *all three financial statements*—Financial Position, Activities, and Cash Flow—along with *full footnotes* (i.e., “Notes”). *Note 1 (or, sometimes, Note A) is very important* because it tells you exactly what entity was audited. It explains the entity covered by the financial statements, and it’s typically called “Nature of the Organization.” (See the guideline on Notes, page 11, for details.)

So if the diocese financial report has three statement and notes, it’s good?

Many dioceses have numerous entities. If a diocese’s financial report has these elements, it has full disclosure and, therefore, excellent transparency—but only for the entity described in “Note 1” or “A.” Conversely, if the financial report does not contain all of these elements, the diocese has deficient transparency.

Any disclosure improves transparency, and is always better than **no disclosure**. But the more disclosure, the better.

What to do after applying the Checklist?

If your diocese has no reporting at all, your first task is to request such accounting. It’s your money the diocese spends, and a transparent report about finances is the first step.

But the second step and any that follow are your responsibility: *Learn how to review the information in the financial statements and the footnotes provided*, as detailed in the next pages.

Reviewing the Statement of Financial Position

Review this statement primarily to see the diocese's assets (plus side), liabilities (the negatives), and net assets (do we have more assets than liabilities?).

The Statement of Financial Position sometimes is called a "balance sheet" because *assets* equal the sum of *liabilities* and *net assets*:

- Liabilities, both short-term and long-term, are the "bills" the diocese owes. Think not only of outstanding bills for heat and electricity for the buildings and staff in those buildings, but also for supplies, pensions, mortgage loans, and so on.

- Assets are cash, the cash that's expected to come in (*accounts receivable*), money market funds, and the like, plus property and equipment that could be converted to cash (by selling it).

- Net assets are what you get by subtracting liabilities from the assets, and it's the term commonly used for a non-profit like a diocese. (In the for-profit world, this value is called Stockholders Equity or "net worth.")

Review this Financial Position Statement to see whether the diocese can meet both its **current obligations** (outstanding debts payable within a year, including the current portion of its long-term debts) **and its longer-term obligations** (debts that don't have to be paid within one year, like mortgage loans and other loans payable).

(1) Evaluate the Assets

One asset is not the same as another. Short-term assets, like cash and what easily can be converted to cash within the next year, represent the *current assets*. Another category—the *fixed assets*—not only are harder to convert to cash if needed, they also present a challenge in terms of proper evaluation.

Here are factors to consider as you review the assets reported:

❑ Does the diocese have a significant level of **Cash** and **Cash Equivalents** in comparison with its short-term (i.e., due within one year) liabilities? To answer, look for the cash numbers at the top of the Assets section. Compare them with the liabilities listed in categories with such labels as "Accounts Payable" and "Accrued Expenses."

The higher the level of cash and cash equivalents, the more flexibility a diocese has to meet its short-term "liabilities" (bills).

- ❑ What's the value of the diocese's **Current Assets**? This includes the Cash and Cash Equivalents and any other assets that will become cash within one year (like money owed to the diocese—*accounts receivable* and *interest receivable*—for example) or "Prepaid Expenses" that avoid the need to pay cash in the next fiscal year (like an annual payment on an insurance policy that covers a particular expense that is really part of "next year"—the fiscal year that follows the year presented in the Statement of Financial Position).

- ❑ Look at the **Fixed Assets**, which typically are listed at the bottom of the Assets section in the Financial Position Statement (look for the labels *Land*, *Buildings*, and *Equipment*).

  Fixed Assets are tricky—they're like plums in an apples bin. All the other assets are expressed in terms of their current cash value dollars. Not the fixed assets. **Their value is based on what it cost to acquire them**.

  What effect does that have? In most dioceses, most parish land and buildings were acquired decades ago, at a very low cost compared with what it might cost to buy the same property today. Not only that, but the value of the buildings then is depreciated over a fixed number of years (usually 30). So the "value" for buildings is reduced each year from that low purchase cost down to zero.

  The result? Values shown for Land and Buildings on the Statement often are **vastly understated in terms of their current "selling value"** even though the diocese is using proper accounting procedures.

(2) Check the Liabilities

Here's where you see what bills the diocese owes. They are listed in categories labeled **Accounts Payable**, **Accrued Expenses**, and **Notes Payable**. (Accounts Payable and Accrued Expenses to be paid out within 12 months are called *Current Liabilities*.)

- Accounts Payable is exactly what you think it is: bills for supplies, rent, salaries, gas, heat, electricity, etc., which must be paid in cash during the next 12 months.

- Accrued Expenses are amounts owed but not yet paid out—like vacation days that have been earned but not yet taken by staff, payroll tax deductions collected from staff but not yet remitted to the government, and that portion of interest on loans accrued on the date of the Financial Statements but not due for payment until the next fiscal year.

- Notes Payable means long-term debt more than one year in the future. Examples are loans for remodeling or building schools, or loans made simply because the diocese was short of cash to cover some bills it needed to pay.

(3) Assess Current and Long-Term Financial Health

Here's where **Net Assets** factor into the financial evaluation. In its simplest form, net assets are what you get when subtracting all the liabilities from all the assets. But with factors like long-term debt, current assets versus fixed assets, depreciation, restricted and non-restricted funds (to be described later), financial evaluations seldom are that simple.

Begin by assessing the ***current financial health*** of the diocese:

1. Is the total of Current Assets double the total of Current Liabilities?

2. Is there a significant amount of debt (Notes Payable) coming due within the next few years?

If the answers are Yes for #1 and No for #2, the classic "rule of thumb" (which means it's not always true) is that the organization is financially healthy.

Now look at the ***long-term position***. The evaluations here are more complex because they involve fixed assets, which as noted before typically are undervalued.

1. Is the total of Net Assets double the total of its long-term Liabilities (those due more than 12 months in the future)? If the answer here is Yes, you may assume the diocese has sufficient assets to meet its long-term liabilities … depending on the answer to the next question.

2. Are the bulk of the Net Assets tied up in land and buildings that may be difficult to convert to cash in time to meet long-term liabilities coming due within the next few years? If this answer is No, you are looking at a healthy financial situation. If this answer is Yes, the diocese may be headed into a difficult financial period … depending on the answer to Question 3.

3. Is the diocese's credit good enough to refinance long-term debt if necessary? Again, if the answer is No, trouble lies ahead. If the answer is Yes, then the Assets tied up in land, buildings, etc., *may not be a problem* because the long-term debt can be refinanced if necessary.

If the total of Net Assets is **not** double the long-term debt, it may be a sign that the diocese is financially overextended or leaning in that direction.

And if the total of long-term liabilities is double the total of Net Assets, the diocese is very likely at risk of serious financial difficulties.

What does it mean if the diocese has negative Net Assets?

Pretty much what you think it means:

- Its financial health is extremely poor.
- It probably received a "Qualified" opinion from the independent auditor.
- It might even be in or headed towards bankruptcy.

(4) Review the Restricted Assets

Restricted assets are funds and property that can be used only for the purposes specified by the donors.

Most of the dollars we donate to our parish or diocese are **unrestricted**: They may be used for any activity or operation appropriate to the diocese. (At the parish level, think "Sunday collection" money.) Restricted funds cannot.

The more restricted funds the diocese has, the less flexibility for meeting general expenses. So you should examine the relationship between Unrestricted, **Temporarily Restricted**, and **Permanently Restricted** Net Assets.

- Temporarily Restricted assets are those with restrictions that can be fulfilled during a specified period of time or by completing specified activities. If you donate money and specify that it should be used to purchase new furnaces for the chancery, for example, the bishop can't use the money to run a soup kitchen or buy new chairs. And if you donate it for the soup kitchen, it can't go to the furnaces.

- Permanently Restricted assets are the funds restricted by the donor for a purpose or a time that does not expire. The diocese must maintain 100% of this asset (e.g., cash or investment) indefinitely. However, income from a permanently restricted asset becomes a temporarily restricted asset that can be used, as long as it is used only for the restricted purpose specified by the donor.

Obviously, the diocese has much greater flexibility if the overwhelming majority of its Net Assets are Unrestricted. When too many net assets are Permanently Restricted, there is almost no flexibility.

(5) Check the Footnotes!

This is a final stage in reviewing the Statement of Financial Position, but you probably will be noticing the items all along. Any time you see a letter (A, B, C …) or number (1, 2, 3 …) next to a line item in the statement, it means there's a "note" in this document.

These Notes provide background information on the financial statement. It's also where you are most likely to learn about separate corporate entities (foundations or funds) that a diocese may NOT be reporting on fully in this statement. Dioceses increasingly are using such foundations, as we'll describe in later pages.

Reviewing the Statement of Activities

The Statement of Activities shows the income and expenses of the diocese in this order:

- The sources of income (various kinds of donations, interest income, investment income, and so on), line by line
- The various expenses incurred by the diocese, line by line
- Whether income exceeds expenses (operating at a "profit") or expenses exceed income (operating at a loss)

(1) Check the Change in Net Assets

You begin this part of your review at the bottom of the statement, not the top. Look for the term **Change in Net Assets**. If it's positive, the diocese operated with a *surplus* (as a non-profit, the diocese won't label this "profit," but it's the equivalent of one).

If the Change in Net Assets is negative, the diocese ran at a loss or a *deficit*. This number will be shown within parentheses rather than with a minus sign: a –$55,600, for example, would be displayed as ($55,600).

A negative number is not necessarily a sign of poor financial health. Non-profits are not expected to show a surplus each year, and many try to operate at break-even: that is, neither a surplus nor a deficit.

But operating with a **large negative Change in Net Assets** and/or repeated annual losses will drain the assets of the diocese. That's **not healthy.**

Repeated losses may reflect budgeting problems and/or an inability to raise sufficient income (e.g., donations) to balance a budget.

(2) Review the Line Items

Now go back to the top of the Statement of Activities and review each of the line items under both *Income* and *Expenses* to see where the diocese is getting its money and where it is spending that money.

Also check for any letters or numbers next to the line items. These identify any Notes that provide background information on the specified line items. As stated previously, these footnotes carry particular importance in a financial report, and we will assess them later.

Reviewing the Statement of Cash Flow

This Statement is usually the most difficult for those not familiar with financial statements to read and understand. It presents all of the positive and negative factors that affect *Cash* and *Cash Equivalents* for the given year, starting with the *Change in Net Assets* (reviewed under the Statement of Activities) and continuing with all of the other asset, liability, income, and expense items for the year that affect the Cash and Cash Equivalents.

The Cash Flow Statement separates the various change factors into four categories:

- Change in Net Assets
- Changes related to operating activities (from the Statement of Financial Position and the Statement of Activities)
- Changes related to Investing Activities
- Changes in Financing Activities

These four "Change" categories added together produce a *Net Increase (or Decrease) in Cash and Cash Equivalents* for the given year.

Accountants use this Net Increase/Decrease, calculated from the four change factors, at the bottom of the Cash Flow Statement to <u>reconcile "Cash and Cash Equivalents" in the current year</u> to the <u>prior year</u>.

Other than the comparison to the previous year, what do I look for?

<u>If the diocese operated at a loss</u> (that is, has a negative Change in Net Assets), check the Statement of Activities for the item ***Depreciation*** *of Buildings and Equipment*. This is a *non-cash expense* that did not require the use of cash in the given year—the cash was used in the year the building was constructed or the equipment acquired. If the **depreciation** number is larger than the loss, it means the diocese actually operated with a <u>cash surplus</u> for the year and its loss is not as threatening in the short term as it might seem.

<u>Scan the line items on the Cash Flow Statement</u> to see if there is one of interest to you and you'd like to understand more about it (e.g., find out background information). If there is, look for that background in the "Note" section of the Financial Statements (we describe the Notes in the next section of these guidelines).

Unfortunately, if you do want to know more, the line items on the Statement of Cash Flow usually do not contain alphabetic or numeric references to a specific Note. You must search all the Notes for the item of interest unless there was a helpful specific reference on the Statement of Financial Position or the Statement of Activities related to the same item.

Reading the Notes

Notes, or footnotes, usually are placed immediately after the Statement of Cash Flow in a financial report. Many of them are referenced on two Financial Statements: the Statement of Financial Position and the Statement of Activities.

Diocesan personnel prepare the footnotes, but the independent auditing firm carefully reviews them. The firm also will insist that a footnote properly disclose important background information to a line item found on the Statement of Financial Position and/or on the Statement of Activities. (These Note references are not typically found on a Statement of Cash Flow.)

Many of the footnotes present important information that provides critical background related to a dollar number on one of the financial statements. Without detailed explanation in the footnote, that dollar number is simply a number commingled with other numbers and it cannot be fully understood.

If there are no footnotes to the financial statements, the statements are either not audited by an independent firm or, if audited, the diocese decided not to disclose the footnotes. It means **the diocese is deficient in transparency**. (Yes, the footnotes are that important!)

Parishes differ: Parish financial statements don't need footnotes because they are almost never audited; parishes are only one small part of a larger organization (i.e., the diocese) and it's the diocese therefore that is the audited entity.

All Footnotes Are Not Equal

Note A or **Note 1** is extremely important. Also pay attention to notes that describe *contingent liabilities* or *related party transactions* or background on line items you especially wanted to review. Other notes will cover both financial and non-financial information that may interest you. And in many of these reports, you will find the best ones at or near the end of the Notes section.

Here's a little checklist for your Notes review:

- ❑ Note A (or 1), typically called *Nature of the Organization*, is always an explanation of the entity covered by the financial statements. **This is the most important note to review.**

  Why? Because dioceses often have **multiple related organizations** (such as high schools that are not part of a parish, clergy retirement funds, Catholic charities, cemeteries that are not part of a parish, seminaries, Catholic media, hospitals, and so on) **that are not included in the Financial Statements** of the main "Organization" (in this case, the diocese).

Does the diocese disclose any other diocesan-related but separately incorporated entities in Note A (Note 1) or any other Notes? If it does, check the diocesan web site to see if they have financial statements that were independently audited for that separate corporate entity or entities. If they do have such statements, that is good transparency. If they do not, the diocese has inadequate financial transparency.

During the past few years, we also have seen an increasing number of dioceses reporting the existence of *separate but related non-profit corporate entities* (e.g., foundations). Some of these entities may be mentioned in Note A (Note 1) or another Note. Or they may not be mentioned at all. Examples are foundations that finance school loans or support, foundations that run a hospital, foundations that handle a building fund, and so on.

Sometimes the auditor will comment that they **have not reviewed** the accounts for these entities—in such reports, it may be the reason cited by the auditor for adding a "qualification" to its audit results.

- ❑ Skip Note B (Note 2), which usually has a name like *Summary of Significant Accounting Policies*, unless you have a great interest in such policies. It's long—usually by far the longest one in the Notes section. It requires a detailed understanding of generally accepted accounting principles. It's frustrating to read unless you're an accountant.

- ❑ Look for the footnotes on those line items you marked in your review that were of special interest to you.

- ❑ Check for information about such things as *Contingent Liabilities* (these can include details on ongoing legal proceedings, future clergy abuse settlement liabilities, etc.); or *background* on other assets or liabilities (whether pensions and retirement benefits are adequately funded, for example, or details about loans payable by the diocese); or *Related Party Transactions* (i.e., those in which assets may have been transferred to or from a related entity such as a cemetery organization, a seminary) which may involve a conflict of interest; or *Subsequent Events*, which is usually the last footnote if and when there has been a major event affecting the financial statements between the end of the fiscal year being audited and the date on which the auditor expresses an opinion.