How to Speak the Language of Investments and Finance

The language used in investment and finance discussions can be overwhelming and intimidating. This is especially true of pastors who often come to their jobs without having received any formal financial education. This workshop seeks to begin bridging that knowledge gap.

The objective of this workshop is to provide a foundational vocabulary sufficient to allow a person to speak the language of investments, finance, and non-profit accounting. We will explore the terms commonly used in these areas as well as looking at an example of "proper" church financial statements.

This brief workshop will not make you an expert in finance, investments or accounting; but hopefully it will equip you with sufficient knowledge to actively participate in or lead discussions regarding church finances.

The Four Major Workshop Topics

- A Basic Vocabulary of Finance and Accounting
- Understanding Financial Investments
- Types of Investment Funds
- Understanding Church Financial Statements

<u>A Basic Vocabulary of Finance and Accounting</u>

The area of FINANCE can be broadly described as being founded upon money, time, available alternatives, and liquidity. While these four areas are each distinct, they are also deeply intertwined with each other. Also, like any language, the general description of a word can take-on different meanings under different circumstances.

Key terms in Finance and Accounting:

- **Accounting years**—The timeframe for all accounting procedures is a 12 month time frame. If that time frame coincides with the calendar year (January through December) it is called a <u>calendar year.</u> Any other one-year time frame is called a <u>fiscal year</u> (for example, an accounting year which begins on July 1st and ends on June 30th of the next year).
- **Cash Basis Accounting—**Income is recorded when it is received and expenses when they are paid. Think of it like an old-time cash register.
- **Accrual Basis Accounting—**Income is recorded when it is earned and expenses when they are incurred. You will know you have an accrual basis system when you see these words on the financial statements: accounts receivable or accounts payable.
- **Capital**—The funds that are used or available for use by an organization. Note that while there is financial capital, there is also knowledge capital (both people and intellectual property), and organizational capital (the capacity of the organization to use its resources to achieve results).
- **Idle or excess cash**—Funds which the organization has under its control but which are not expected to be used in the next six months to one year, or longer.
- **Liquidity**—Refers to the capacity of an organization to have sufficient cash to meet its operating costs and make principal and interest payments on its debts.
- **Current assets and liabilities**—The term "current" indicates a that the asset or liability will be used up or become due within the accounting year of the organization. Thus, current assets are those that will be available during the accounting year (think payments received on church pledges). Likewise, current liabilities are those payments due in that same accounting year (think mortgage payments due during the year).
- **Long-term assets and liabilities**—These are assets or liabilities that will be used or due at time periods greater than one year.
- **Equity**—This is a mathematical calculation in which total organizational liabilities (debts) are subtracted from total organizational assets (money+property). In some ways this represent the financial "cushion" which the organization has when faced by financial hardships (think savings accounts, investments, and equity in church property).
    - A slight confusion occurs with this term when it is used in the plural (**equities**). In that sense it generally means an investment in a stock or

security of a company (that is the investment is in the ownership of the company).

- **Deferred incomes or expenses**—The are amounts of money that we may have in our hands now, but which need to be held for a future event. For example, a payment received this year for next year's church pledge would not be recorded on the church's books as current year income. Instead the income would be deferred until the next.
- **Accrued incomes or expenses**—The opposite of deferred financial items. These are incomes or expenses which are accruing (or building-up) now with a due date in the future.
- **Deferred Liabilities**—A liability which we know about now but which is not due until the next accounting year.
- **Stocks or securities**—The stock of a company (the certificates which indicate company ownership) are also called securities. Both indicate an investment in company ownership the value of which can change due to many factors.
- **Bonds**—Companies will offer to sell bonds for a variety of reasons (refinancing current debt, investing in new facilities or products, etc.). Bonds are a company's IOU promising to pay the bond holder a fixed interest rate each year on the amount of money invested by the bond holder to purchase the bonds. At the maturity date (the date at which the bond "loan" ends) the company will repay to the bondholder their original investment. Purchasing bonds requires some expertise as the market value of the bonds (what you can receive if you sell the bonds before their maturity date) fluctuates with the changes in interest rates.
- **Underwater**—A financial slang term which indicates that the value of some asset is less than the amount of money owed on it.
- **Internal rate of return**—a mathematical calculation which determines the effective interest rate of an investment based upon its initial costs, inflows or outflows of cash during the investment holding period, and the expected value of the investment at the end of the holding period. Most smart calculators provide a function to make this calculation.

<u>Understanding Financial Investments</u>

The area of investments can be characterized as a series of decisions which are made along a continuum between two very different end-points. So, for example, when we talk about investments we talk about:

Fixed income	vs	Securities or stocks
Short Term	vs	Long Term
Safety	vs	Growth
Liquid	vs	Illiquid

These financial discussions can quickly become complex. But even their complexity, the fundamental questions that need to be asked are straight forward:

- <u>How much money do we have to invest?</u>
    - How much "excess cash" do we have now that is not needed for current church operations?
- <u>What is our investment timeframe (or investment horizon)?</u>
    - When do we estimate this cash will be needed? Next month, next year, in 5 years?
- <u>Are we more concerned about loss of principle or loss of purchasing power?</u>
    - Financial assets are subject to two primary risks. The risk of loss of principle and the risk of loss of purchasing power. For example, if a stock is purchased for $25.00 per share its price on any given day will be either higher or lower than the original cost of $25.00 per share. On the other hand, if the inflation rate is 4% and the interest rate is 1%, there is a loss of 3% of purchasing power.
- <u>What is our need for liquidity?</u>
    - If we need to draw down our investment funds, how quickly can they be converted in cash without a loss of principle value.
- <u>What is the projected rate of return on the proposed investment?</u>
    - How much money can we earn on the funds we invest?

These questions involve some additional investment vocabulary terms:

- **Fixed income**—A stated interest rate paid on invested funds where the return of the principle amount is guaranteed.
- **Investment time frame**-How long the investment funds can or will remain in the proposed investment. Short term investments are usually 30 days up to 2 years. Long term investments usually start at 3 years. The time between 2 years and 3 years is the difficult decision area.
- **Loss of principle**—The risk that the original amount of funds (principle) can decline. This is also sometimes termed the "safety" concern.

- **Loss of purchasing power**—The risk that funds that are not projected to be needed for some time (think long term) will lose their capacity to purchase the same amount of goods and services in the future that the can purchase today.
- **Liquidity**—How quickly an investment can be turned into cash without a reduction in principle value. Typically, a liquid asset is one that can be converted into cash within 30-days.
- **Rate of return**—The estimated increase in value of a principle amount over a given time period. For example, a 4% rate of return on $1,000 will equal $40 over a one-year time period. In the world of financial investments, an 8% to 10%, compounded rate of return is considered to be quite good.
- **Projected or estimated**—The best guess of future conditions given what is known about the present and what is not known about the future. Sometimes these projections are called **proformas**.

<u>Here are some quick answers to the question about what a church should do with its excess cash funds.</u>

If cash funds will be needed in the next two years and the risk of loss of principle is of concern, then this is where the church should consider "parking" the funds:

- **Checking accounts**—These are necessary for the day-to-day operations of the business. Checking accounts usually do not pay interest on account balances.
- **Savings accounts**—These are the "old fashioned" way of earning interest on excess cash funds. They are usually offered by the same financial institution that hold an organization's checking accounts. The interest rates are usually very low.
- **Certificates of deposit**—These are interest earning funds offered by a wide range of financial institutions (banks, credit unions, investment companies, etc.) which invest client funds for set periods of time and pay a fixed interest rate. Time periods can vary from 30 days to five years with the most popular being 3-month, 6-month, and 1-year time periods.
    - An **automatic rollover** indicates that the client has directed the CD issuer to re-invest (i.e., rollover) these funds in a similar financial instrument when the current CD matures (note that the interest rate for the rollover investment will almost certainly be different than the maturing investment).

- **Money market funds**—These are funds run by investment companies (think Fidelity, Schwab, JP Morgan, etc.) which invest money in short-term corporate and government debt instruments. Interest rates on money market funds and certificates of deposit are generally competitive with each other.

If the church's cash funds will not be needed for 3 years or longer, then consideration should be given to placing these funds with a professional money management firm.

- Two excellent PCUSA-related fund managers are Texas Presbyterian Foundation and the Presbyterian Foundation; and/or
- National banks or financial firms such as, without being exclusive, Fidelity, Schwab, JP Morgan, Wells Fargo, Bank of America, etc.

Why should you choose to invest funds in the stock market given that there is a potential for loss of principle? Because historically, over say a given 10-year period, the stock market has yielded an average rate of return between 9% and 10%. This means that a fund of money can double in value in 7 or 8 years. By comparison, money in a 3% CD will take about 25 years to double in value. The power of compound interest is very real!

Oh, what is **compound interest**? That is when interest earned in a given time period is added to the principle balance which then earns interest in the next time period. Thus, the interest earnings are compound or added to the value of the principle balance.

Of course there are other investment alternatives including real estate, oil and gas properties, and private investment partnerships; but these are outside of today's discussion topic and timeframe.

Types Investment Funds

Once you cross the line of adding investments to the church's balance sheet the financial statements take on an entirely new dimension of complexity. Most church treasurers are not aware that there are very specific rules for how investment funds are classified on the balance sheet as well as how the income from these funds are recorded on the income statement.

We will discuss this in more detail in the last section of the workshop.

At this point we will limit our discussion to the two types of investments:

A. Funds held by the church for use by the church

These are funds the church holds in its own name in some type of investment account (e.g., certificates of deposit, money market funds, investment funds). Investment funds held by the church are usually managed by professional investment managers (e.g., Presbyterian Foundation or Texas Presbyterian Foundation).

The rules for classifying these investment funds are set forth by the American Institute of CPAs (see next section). These rules require that investments be segregated according to these classifications:

- **Unrestricted**—These are investment funds and the income which comes from them which have no restrictions on their use.
- **Organization (e.g., the Session) Designated**—These are investment funds which were originally unrestricted funds but now have been "designated" for some specific use by the organization's governing body. The governing body can also restrict, expand or eliminate any specific use previously associated with a specific fund.
- **Donor Restricted**—These are investment funds in which the donor has set forth specific restrictions as to how the funds are to be used, the time frames in which these funds can be used, and/or whether or not the original principle amount of the donated funds (call the **corpus**) can be "invaded" or drawn-down below the original amount.

Here is an especially important concept to know: the investment fund's **spend rate**.

The spend rate is the percentage obtained by dividing the annual income from a fund into the amount of the value of the fund. For example, a $5,000 annual distribution from a fund with a value of $100,000 would be a 5% spend rate.

Spend rates at or below 5% are considered to be “safe” rates in that over time the investment funds will grow at an average rate greater than 5%...thus allowing the funds to grow in value.

Spend rates in the 7% or more range will generally deplete the investment funds over time.

A spend rate of 6% is an aggressive rate which will deliver the most annual funds to an organization while maintaining the value of the fund’s principle.

B. <u>Funds held by others for use by the church</u>

The other type of investment funds are those funds (usually an endowment fund) held in trust by a financial institution for the benefit of the named beneficiary; in this case a church or church organization. The income generated by these invested funds are then distributed to the church in a manner dictated by the original trust document.

The income from these funds will generally be classified as either unrestricted or donor-restricted.

The way to think about these funds is that they are like an annuity in that the church will receive a fixed amount (adjusted for investment performance) on a periodic basis (like a social security check).

These funds can be an important part of a church’s annual budget.

Reading and Understanding Church Financial Statements

What most church financial people know about financial statements is…not very much. This is most often the result of the lack of available financial training.

More to the point, what they do know about financial statements usually comes from exposure to business world financial statements. However,

Church and business financial statements are not the same!

The primary difference in financial statement presentations between the two is that churches (and other non-profit organizations) often utilize investment funds in their operations. For-profit organizations do not use or recognize such funds which for non-profits may be a primary source of operational support.

This is a small difference with a very BIG impact on how church financial statements are SUPPOSED to be presented.

The arbiter of professional standards in the accounting world is the American Institute of Certified Public Accountants. This organization identifies three separate areas of accounting practices and sets forth the accounting rules for each:

- Business accounting
- Non-profit accounting
- Governmental accounting

In the specialized area of non-profit accounting, the commonly named balance sheet and income statement have different names:

- Balance sheet = Statement of Financial Position
    - Breaks assets down into unrestricted and restricted classifications
    - Has an equity section which shows fund balances rather than capital + retained earnings
- Income Statement = Statement of Activities
    - Separates out operational activities by how they are funded, either by unrestricted funds or by restricted funds.

The following pages set forth examples of financial statements which conform to the AICPA standards.