

## **Teaching Note**

### **Refuge: A Place of Safety or Danger**

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#### **Critical Incident Overview**

Ed Post, a new member of the Messiah Board of Deacons, needs to make a recommendation on a proposal for a ministry outreach. There is a significant amount of funds associated with the project and a lease commitment of ten years. Possibly complicating the situation is that the church has seen a decline in revenue in the last year and is currently operating at a loss. There is some uncertainty regarding future finances and fiscal stewardship must be considered.

Refuge: A Place of Safety or Danger is a critical incident that can be used in an accounting, not-for-profit, or small business class probably at the undergraduate level that covers the topics of financial analysis, strategic analysis and decision making. The information presented is relatively straightforward and a decision needs to be made. There are a sufficient number of extenuating circumstances to make for a good discussion of critical factors in this type of decision analysis.

#### **Research Methods**

This critical incident was a field-researched study with multiple visits to Messiah Church and interviews with Ed Post. Follow-up communication supported various drafts of the critical incident and accumulation of relevant financial and non-financial data.

The names in the critical incident have been disguised and permission has been received by the protagonist and host organization to publish this critical incident.

#### **Learning Outcomes**

In completing this assignment, students should be able to:

1. Analyze the current financial condition of Messiah Church.
2. Appraise the overall situation for Messiah Church and recommend a decision for the Refuge proposal

## Discussion Questions

1. Complete a financial analysis of Messiah Church and discuss the organization's financial strengths and weaknesses. (LO 1)
2. Identify quantitative and non-quantitative issues related to the Refuge proposal which may impact the financial situation for Messiah Church. (LO 2)
3. What recommendation should Ed Post make regarding the Refuge? (LO 2)

## Answers to Discussion Questions

### 1. Complete a financial analysis of Messiah Church and discuss the organization's financial strengths and weaknesses. (LO 1)

The last four years of balance sheets and the last three years of income statements for Messiah Church were presented. The organization had a cash balance of \$395,531 and no current liabilities beyond minor credit card balances. The balance sheet shows a strong net worth position. However, the cash balance did have an 18 percent decline this last year  $((466,765 - \$395,531)/\$395,531)$ .

Maturing church bonds provided a one-time stimulate of over \$100,000 in cash, but the cash balance is only around \$50,000 higher, implying that half of the funds received from the bonds have already been spent.

Table TN 1 presents the revenue and expense items for the last three years and specifically highlights and comments on potentially critical issues.

Table TN 1  
Messiah Church Revenues and Expenses with Critical Highlights  
For the Period December 31, 20x6 to December 31, 20x8

	20x6	20x7	20x8	Interpretation of Numbers & Financial Impact
<b>Revenues</b>				
Tithes & Offering	1,428,879	1,453,630	1,382,025	Noticeable decline in 20x8. Could be decline in membership or rate of giving. Significant concern as this is a voluntary organization with limited sources of income. <b>Negative factor</b>
<b>Expenses:</b>				
Administrative	75,296	42,479	36,483	Considerable decline over the last two years. Could be in response to increases in other expense accounts, decreases in administrative services, deferring necessary expenses or on the positive side some better management of expenses. <b>Could be positive or negative factor</b>
Benevolence	75,518	83,707	110,376	Significant increase over the two year period. Appears to be increasing requirement to provide for others in need which supports the mission of the church, but can benevolence support be sustained. <b>Could be a positive or negative factor.</b>
Depreciation	102,099	111,110	119,645	Reflects increase in depreciable assets. <b>Minimal impact.</b>

Insurance	9,870	10,009	13,085	Increasing and could increase more with Refuge project. Costs will continue to increase and must be funded. <b>Negative factor</b>
Maintenance	54,471	58,002	59,423	Remains relatively constant could increase with Refuge project <b>Appears to have minimal impact</b>
Ministries	328,051	292,508	224,708	Substantial decline in expense. While at first this may appear to be a positive situation with increased efficiencies, there could easily be negative implications as Ministry Expenses would most closely align with the mission of the church. Is the church sacrificing necessary programs to fund other areas. <b>Could be a positive or negative factor.</b>
Payroll	659,463	739,759	785,596	Large portion of expenses and increasing. Represented 48%, 52% and 54% of total expenses respectively. The cost is fixed in nature with salaried positions and can be difficult to reduce as it would mean the possible termination of positions should the church run into financial difficulties. <b>Negative factor.</b>
Rents/ Leases	17,834	16,377	17,961	Stable but will increase significantly with the Refuge. Refuge lease is a 10 year commitment at \$6,000 per month increasing to about \$8,000 per month. <b>Negative factor</b>
Travel		4,157	18,881	Why the increase during a year with decreasing revenue. Appears to be an unnecessary expense especially in light of the decline in ministries expense and increase in payroll expense. <b>Negative factor</b>
Utilities	53,003	60,096	71,837	Steady increase, will increase even more with Refuge project. Like insurance this is a necessary expense which will always be increasing. <b>Negative factor</b>
Total Expenses	1,375,605	1,418,204	1,457,995	Expenses continue to increase while revenues are decreasing <b>Negative factor</b>
Surplus	53,274	35,426	(75,970)	Declining trend, significant loss in 20x8. Reflection of worsening financial situation. <b>Negative factor</b>

Another way to evaluate the financial viability of an organization is through the use of vertical and horizontal analysis. Vertical analysis, Table TN2, uses either total assets for the balance sheet, or sales revenue for the income statement as the denominator. The other line items in the balance sheet and income statement are used in the numerator to determine what proportion they are of the total. Horizontal analysis, Table TN3, is computed to determine the growth rates or change in the different revenue and expense accounts. The formula  $(P1 - P0)/P0$  can be used to determine the change with P0 the value at the beginning of the period and P1 the value at the end of the period with the period generally representing one year.

Table TN 2 gives the details of the revenue and expense items as a percent of total revenue, which can be used in a vertical analysis. Also, comparisons can be made over a three-year period.

Table TN 2  
Messiah Church Revenues and Expenses with Percent Relationships  
For the Period December 31, 20x5 to December 31, 20x8

	20x6	Percent Revenue	20x7	Percent Revenue	20x8	Percent Revenue
<b>Revenues</b>						
Tithes & Offering	1,428,879	1.000	1,453,630	1.000	1,382,025	1.000
<b>Expenses:</b>						
Administrative	75,296	0.053	42,479	0.029	36,483	0.026
Benevolence	75,518	0.053	83,707	0.058	110,376	0.080
Depreciation	102,099	0.071	111,110	0.076	119,645	0.087
Insurance	9,870	0.007	10,009	0.007	13,085	0.009
Maintenance	54,471	0.038	58,002	0.040	59,423	0.043
Ministries	328,051	0.230	292,508	0.201	224,708	0.163
Payroll	659,463	0.462	739,759	0.509	785,596	0.568
Rents/ Leases	17,834	0.012	16,377	0.011	17,961	0.013
Travel		0.000	4,157	0.003	18,881	0.014
Utilities	<u>53,003</u>	0.037	<u>60,096</u>	0.041	<u>71,837</u>	0.052
Total Expenses	<u>1,375,605</u>	<u>0.963</u>	<u>1,418,204</u>	<u>0.976</u>	<u>1,457,995</u>	<u>1.055</u>
Surplus	53,274	0.037	35,426	0.024	-75,907	-0.055

By far, the largest expense for Messiah Church is payroll and that has increased from 46.2 percent of revenue in 20x6 to 56.8 percent of revenue in 20x8. Some determination will need to be made regarding the fixed nature of this cost. If there is a continued decline in revenue, will some employees have to be terminated?

The church has five pastors and is that the optimal number for a church with this level of revenue?

The second largest expense category is ministries which would most likely reflect the primary operation of the church. The expense category as a percent of revenue has actually declined from 23.0 percent of revenue in 20x6 to 16.3 percent of revenue in 20x8. Is the church cutting back in its primary operational mission in the face of declining revenues?

The benevolence category has increased from 5.3 percent of revenue in 20x6 to 8.0 percent of revenue in 20x8. It appears that the ministry is actively involved in some type of a helping ministry which could include projects like the Refuge. This expense category could increase even more.

Pastor Newborn indicated that operating expenses for the Refuge would remain approximately the same. However, the space at the new facility was at least five times larger. One should assume that there would be increases in utility and insurance costs at a minimum.

Administrative costs have declined as a percent of revenue from 5.3 percent in 20x6 to 2.6 percent in 20x8. Is this decline associated with the decline in ministry expenses? It is also possible that some administrative costs are being delayed.

Overall, in the face of declining revenues, the large probably somewhat fixed payroll cost is putting pressure to decrease spending in other areas beginning with operationally related costs like ministry and administrative. Cutbacks in these areas could have a negative impact on attendance and services provided for the membership. Any short-term savings in ministry and administrative expenses may be undermined by long-term consequences from reduced programs.

Table TN 3 reviews the annual growth rates for each classification of revenues and expenses for 20x7 and 20x8.

Table TN 3  
\*Messiah Church Revenues and Expenses with Annual Growth Rates  
For the Period December 31, 20x5 to December 31, 20x8

	20x6	Growth 20x7	20x7	Growth 20x8	20x8
<b>Revenues</b>					
Tithes & Offering	1,428,879	0.017	1,453,630	-0.049	1,382,025
Expenses:					
Administrative	75,296	-0.436	42,479	-0.141	36,483
Benevolence	75,518	0.108	83,707	0.319	110,376
Depreciation	102,099	0.088	111,110	0.077	119,645
Insurance	9,870	0.014	10,009	0.307	13,085
Maintenance	54,471	0.065	58,002	0.024	59,423
Ministries	328,051	-0.108	292,508	-0.232	224,708
Payroll	659,463	0.122	739,759	0.062	785,596
Rents/ Leases	17,834	-0.082	16,377	0.097	17,961
Travel			4,157	3.542	18,881
Utilities	<u>53,003</u>	0.134	<u>60,096</u>	0.195	<u>71,837</u>
Total Expenses	<u>1,375,605</u>	0.031	<u>1,418,204</u>	0.028	<u>1,457,995</u>
Surplus	53,274	-0.335	35,426	-3.143	-75,907

After just a 1.7 percent growth in revenue in 20x7 the revenue had a decline of 4.9 percent in 20x8. Revenue shortages in the future could have a significant impact on the financial viability of the church especially when expansion projects like the Refuge are being considered.

The church is cutting back in expenses in the areas of administrative and ministries which are generally the most easy to cut. However, if there are a lot of fixed costs, such as payroll, future cuts may be more difficult to achieve.

Payroll costs increased 12.2 percent in 20x7 and another 6.2 percent in 20x8 and this is during a period of declining revenues. These trends can probably not continue.

While travel costs are a relatively insignificant cost, the fact that there was a considerable increase in 20x8 when funding was at a deficit should raise some question of concern.

The growth in benevolence funding has been 10.8 percent in 20x7 and increasing by 31.9 percent in 20x8. There are obviously some needs the church is meeting, but can this level of support be sustained?

The 20x8 budget was at a deficit and the actual results had even a larger deficit. While there is still a positive cash balance and strong net worth position, continued deficits could be a problem.

## **2. Identify quantitative and non-quantitative issues related to the Refuge proposal which may impact the financial situation for Messiah Church. (LO 2)**

### Issues in support of the Refuge Proposal

- Reaching these young adults is a major ministry of the church.
- Pastor Newborn would say: “The value of one saved soul was priceless.”
- Messiah Church is actively addressing a social-economic need
- There is an opportunity to generate supplemental revenue of \$2,000 per month from music concerts
- The church is receiving prime space at a very favorable lease rate starting at \$6,000 per month
- There can be more music venues
- The facility has plenty of space for a variety of activities and will support growth of the ministry
- The Refuge can be a positive addition to the urban renewal movement in the city
- The first six months are rent free
- There is a sufficient cash balance to provide for the \$100,000 up front renovation costs
- Messiah Church has no debt

### Issues against the Refuge Proposal

- Is the program a success or does it only provide a front for these youth to carry on illegal or improper activities
- The lease space was a former grocery store, is that too large for groups of 10 to 20 people
- There is a 10 year lease commitment
- \$100,000 is needed up front for renovation
- The church is seeing a decline in revenue and an increase in expense
- The church operated at a loss for the last year
- The targeted population of lost young adults and teens will not be a revenue generating group in terms of tithes and offering
- Are members of the church body willing to give to support concerts and other similar events for this group.
- Is there a demand for music concerts of this nature in the area
- There is no history on the reliability of income through the music concerts
- There is no guarantee that the new location will attract the desired youth
- There could be a question about the safety and security of the location
- In addition to the grocery store, there are three other vacancies in the shopping center

- The space is much larger and there will be higher costs associated with the operation of this facility
- No information is available on the additional operational costs of the new facility
- Awareness of operating costs does not appear to be a priority for Pastor Newborn
- Will the up-front costs of \$100,000 be enough to renovate the facility

### **3. What recommendation should Ed Post make regarding the Refuge? (LO 2)**

The decision could vary depending on the interpretation of the answers from Questions 1 and 2. There is sufficient justification for a vote to approve the Refuge proposal as well as a vote to reject the Refuge proposal.

What can make this a more difficult decision is trying to compare actual costs against benefits to society. There is substantial financial evidence and information from the answers to Question 1 that seems to indicate and justify not supporting the Refuge proposal. However, the information from the answers to Question 2, which has strong evidence both for and against the proposal, which could support the Refuge proposal. It is difficult to put a price on the benefit to society and specific individuals from an outreach ministry of this nature.

A strong answer will show logical justification on a yes or no vote for the proposal.

### **General Discussion**

This critical incident can be presented open-ended without any specific questions or directed with several recommended questions focusing on both quantitative and non-quantitative issues. Classroom formats can be instructor-led or student-led discussions of the critical issues and decision in the critical incident. This critical incident could be great for a debate format pitting societal benefits against fiscal responsibilities. The critical incident may also be used as an exam exercise.

### **Epilogue**

Messiah Church approved the proposal to lease the property for the Refuge. It took over a year to get the property renovated and the cost was \$136,000. Extra funds were raised through special promotions and contributions. The concert income is about 30% of what was anticipated, and the venue is being discontinued. Also operational costs have been higher than budgeted as insurance, utilities, and maintenance costs increased, while overall revenues continue to decline. The number of teenagers and young adults attending the Refuge activities has increased but only slightly. On the positive side, there have been good life changing experiences for some individuals.