

THE EPISCOPAL CHURCH IN THE
DIOCESE OF CALIFORNIA

DECEMBER 31, 2006

INDEPENDENT AUDITORS' REPORT

AND

FINANCIAL STATEMENTS

**The Episcopal Church in the
Diocese of California**

**Independent Auditors' Report
and Financial Statements**

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Independent Auditors' Report

THE BOARD OF DIRECTORS
THE EPISCOPAL CHURCH IN THE
DIOCESE OF CALIFORNIA
San Francisco, California

We have audited the accompanying statement of financial position of **THE EPISCOPAL CHURCH IN THE DIOCESE OF CALIFORNIA (the Diocese)** as of December 31, 2006, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the Diocese's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Episcopal Church in the Diocese of California as of December 31, 2006, and the changes in its net assets and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also have audited the adjustments described in Note 15 that were applied to restate the 2005 financial statements to correct an error. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 2005 financial statements of the Diocese other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 2005 financial statements taken as a whole.

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August 29, 2007

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The Episcopal Church in the Diocese of California

Statement of Financial Position

December 31, 2006

	Operating	Custodial and Unexpended Income	Endowment and Trust	Deferred Gifts	Total All Funds
Asset:					
Cash and cash equivalents	\$ 424,060		\$ 243,465		\$ 667,525
Receivables, net	1,314,897	\$ 44,413	351,597		1,710,907
Investments in securities			18,473,186		18,473,186
Other investment			100,000		100,000
Notes receivable held for investment, net		58,000	198,167		256,167
Pledge receivable			306,640		306,640
Equity interests in real property		151,500	4,009,451		4,160,951
Property and equipment, net	754,092				754,092
Investments - charitable remainder unitrusts				\$ 16,120,604	16,120,604
Due to/from other funds	317,754	906,473	(1,224,227)		0
Total assets	\$ 2,810,803	\$ 1,160,386	\$ 22,458,279	\$ 16,120,604	\$ 42,550,072
Liabilities and Net Assets					
Liabilities:					
Accounts payable and accrued expenses	\$ 688,660	\$ 4,000	\$ 12,095		\$ 704,755
Accounts payable, related parties	215,205	235,000	5,028,750	\$ 245,230	5,724,185
Deferred revenue	135,107				135,107
Funds held in trusts for beneficiaries				13,124,324	13,124,324
Total liabilities	1,038,972	239,000	5,040,845	13,369,554	19,688,371
Net Assets:					
Unrestricted	1,649,156		1,314,569		2,963,725
Unrestricted-board designated	122,675				122,675
Total unrestricted	1,771,831		1,314,569		3,086,400
Temporarily restricted		921,386	12,243,934	306,736	13,472,056
Permanently restricted			3,858,931	2,444,314	6,303,245
Total net assets	1,771,831	921,386	17,417,434	2,751,050	22,861,701
Total liabilities and net assets	\$ 2,810,803	\$ 1,160,386	\$ 22,458,279	\$ 16,120,604	\$ 42,550,072

The Episcopal Church in the Diocese of California

Statement of Activities

Year Ended December 31, 2006

	Operating	Custodial and Unexpended Income	Endowment and Trust	Deferred Gifts	Total All Funds
Support and Revenue:					
Parish and mission assessments	\$ 3,525,939				\$ 3,525,939
Gifts, grants and other	455,382				455,382
Investment income, net	37,807		\$ 237,203		275,010
Interfund transfer	59,099		(59,099)		-
Total support and revenue	4,078,227		178,104		4,256,331
Expenses:					
Episcopate	417,742				417,742
Diocesan finance	376,913				376,913
Diocesan administration	828,022				828,022
Clerical	206,636				206,636
Support services-Diocese	173,393				173,393
Support services-outside Diocese	809,358				809,358
Planned giving office	183,262				183,262
Mission development	369,896				369,896
Ordained ministry development	88,262				88,262
Congregation and lay ministries development	388,574				388,574
Social ministries	74,254				74,254
Community Ministries	405,709				405,709
Jubilate Deo	265,298				265,298
Payments to beneficiaries and other custodial fund disbursements	929,992				929,992
Total expenses	5,517,311				5,517,311
Changes in Unrestricted Net Assets	(1,439,084)		178,104		(1,260,980)
Changes in Temporarily Restricted Net Assets:					
Gifts, grants and other		\$ 216,064	5,000	\$ 64,811	285,875
Investment income, net		176,486	1,523,020		1,699,506
Interfund transfer		144,665	(144,665)		-
Change in temporarily restricted net assets		537,215	1,383,355	64,811	1,985,381
Change in Permanently Restricted Net Assets:					
Gifts, grants, and other			245,000	247,089	492,089
Interfund transfer			256,660	(256,660)	-
Change in permanently restricted net assets			501,660	(9,571)	492,089
Net Assets Released from Restrictions	918,360	(447,590)	(470,770)		-
Change in Net Assets	(520,724)	89,625	1,592,349	55,240	1,216,490
Net Assets, beginning of year	2,292,555	831,761	15,825,085	3,451,375	22,400,776
Prior period adjustment				(755,565)	(755,565)
Net Assets, beginning of year, as restated	2,292,555	831,761	15,825,085	2,695,810	21,645,211
Net Assets, end of year	\$ 1,771,831	\$ 921,386	\$ 17,417,434	\$ 2,751,050	\$ 22,861,701

**The Episcopal Church in the
Diocese of California**

Statement of Cash Flows

Year Ended December 31, 2006

Cash Flows from Operating Activities:

Change in net assets	\$ 1,216,490
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Depreciation	59,956
Net realized and unrealized gain on investments	(1,501,473)
Change in charitable remainder unitrusts	(87,005)
Change in allowance for doubtful accounts	(3,115)
Changes in operating assets and liabilities	
Increase in receivables	(255,305)
Increase in accounts payable and accrued expenses	221,218
Increase in accounts payable, related party	744,746
Decrease in deferred revenue	(66,000)

Net cash provided by operating activities	329,512
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Cash Flows from Investing Activities:

Purchases of investments	(4,095,010)
Proceeds from sale of investments	5,548,783
Principal payments received on notes receivable held for investments	212,813
Purchases of property and equipment	(126,233)
Issuance of new notes receivable held for investment	(58,000)
Purchase of investment in equity interest in real property	(3,286,688)

Net cash used by investing activities	(1,804,335)
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Net Decrease in Cash and Cash Equivalents	(1,474,823)
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Cash and Cash Equivalents, beginning of year	2,142,348
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Cash and Cash Equivalents, end of year	\$ 667,525
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The Episcopal Church in the Diocese of California

Notes to Financial Statements

Note 1 - Summary of Significant Accounting Policies:

a. Organization

The Episcopal Church in the Diocese of California (the Diocese) is a nonprofit entity that administratively supports Episcopal parishes and other ancillary institutions throughout the San Francisco Bay Area in the State of California.

b. Basis of Accounting

The accompanying financial statements have been prepared on the accrual basis of accounting and, accordingly, reflect all significant receivables, payables, and other liabilities, including deferred revenue. The principles of “fund accounting” are utilized in order to provide a more detailed accountability for the funds entrusted to the Organization.

c. Basis of Presentation

Financial statement presentation follows the recommendations of the Financial Accounting Standards Board in its Statement of Financial Accounting Standards (SFAS) No. 117, Financial Statements of Not-for-Profit Organizations. Under SFAS No. 117, the Organization is required to report information regarding its financial position and activities according to three classes of net assets:

Unrestricted Net Assets. The portion of net assets that is neither temporarily restricted nor permanently restricted by donor-imposed stipulations.

Temporarily Restricted Net Assets. The portion of net assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization.

Permanently Restricted Net Assets. The portion of net assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization.

d. Cash and Cash Equivalents

For purposes of the Statement of Cash Flows, cash and cash equivalents include time deposits and all highly liquid debt instruments with original maturities of three months or less.

The Episcopal Church in the Diocese of California

Notes to Financial Statements

e. Receivables

Receivables consist of amounts due to the Diocese from parishes that are within the Diocese of California and represent assessments, reimbursable expenses, and other receivables. The Diocese records bad debts using the allowance method. Subsequent to year-end, the Department of Missions, a department within the Diocese, has granted payroll relief of \$19,000 to various parishes. Thus, an allowance has been created as of December 31, 2006 for this amount.

f. Investments

Investments are carried at fair value, with realized and unrealized gains and losses reflected in the statement of activities. The fair value of investments is based on quoted market price and such investments are subject to market fluctuations.

g. Notes Receivable Held for Investment

Notes receivable held for investment consists of notes to several churches and an individual. The notes bear interest at rates ranging from 0% - 8% and are due through 2016. The notes are secured by property or unsecured and are recorded net of an allowance related to interest accruals.

h. Equity Interest in Real Property

Equity interest in real property consists of amounts funded by the Diocese for the purchase of property by related parties. The Diocese has an equity interest in the property for the amount of the purchase price funded by the Diocese. This interest is recorded at cost.

i. Property and Equipment

Purchased property and equipment is recorded at cost. Donated property is valued at fair value at time of donation. Depreciation is provided on a straight-line basis over the estimated useful lives (five to thirty years) of the related assets. Maintenance and repairs are charged to expense as incurred. Significant betterments and renewals are capitalized.

j. Deferred Revenue

Deferred revenue consists of assessments, payroll, and benefits received from parishes in advance of the period to which they relate.

k. Recognition of Support and Revenue

Current year parish and mission assessments have been prepared on the accrual basis of accounting.

The Episcopal Church in the Diocese of California

Notes to Financial Statements

Gifts and grants are recognized when the donor makes an unconditional promise to give to the Diocese. Donor-restricted gifts and grants are reported as increases in temporarily or permanently restricted net assets depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets.

Investment income is recognized as revenue when earned. Investment income earned on permanently restricted net assets is recorded as an increase or decrease in temporarily restricted net assets unless specifically restricted as permanent by the donor.

l. Income Taxes

The Diocese is a tax exempt organization under the provision of the Internal Revenue Code, Section 501(c)(3), and the related state provisions. Accordingly, no provision for income taxes has been reflected in these financial statements.

m. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 - Description of Funds:

a. Operating Fund

This fund is used to account for all expenditures related to unrestricted support and revenue. It also accounts for all assets and liabilities of the Diocese which have not been restricted. However, the Board of Directors of the Diocese has set aside certain donor unrestricted funds for certain designated uses. These funds are included in the operating fund as board designated.

b. Custodial and Unexpended Income Fund

This fund is used to account for gifts and grants designated for specific projects or programs by donors.

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

c. Endowment and Trust Fund

This fund is used to account for assets contributed by donors which are subject to various restrictions. The Diocese is responsible to assure that distributions be made in accordance with the provisions of each trust.

d. Deferred Gifts Fund

This fund is used to account for funds held in trust and administered by the Diocese, the income of which is payable to individual beneficiaries. Income earned but not paid to beneficiaries is treated as a liability, which is included with "Funds Held in Trust for Beneficiaries". Upon the expiration of the income beneficiaries' interest, the principal will be distributed in accordance with the conditions prescribed by the Charitable Remainder Unitrust agreements. Any principal that will ultimately be distributed to third party beneficiaries has been recorded as a liability, "Funds Held in Trust for Beneficiaries." The remainder is distributable to the Diocese and is stated at the estimated present value, which is calculated based on the actuarial life expectancy of the donor or designees. The discount rate used, ranging between 5% and 6.5%, approximates the 30 year U.S. Treasury Bond rate in the year of origination.

Note 3 - Receivables:

Receivables consist of the following at December 31, 2006:

Receivables	\$ 256,012
Assessments	19,000
Reimbursable expenses from related entities net of allowance	1,039,947
Endowment receivables	351,597
Other receivables	63,351
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	\$ 1,710,907

Note 4 - Pledge Receivable:

The pledge receivable is from one donor in the amount of \$306,640 and was paid in full subsequent to year-end.

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

Note 5 - Investments:

The fair value of investments at December 31, 2006 is as follows:

	Fair Value
Government obligations	\$ 3,050,972
Corporate equity	15,522,214
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	\$ 18,573,186

Investment income for the year ended December 31, 2006 consists of the following:

Interest and dividends, net of management fees of \$41,368	\$ 680,520
Realized gains and losses	1,159,102
Unrealized gains and losses	134,894
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	\$ 1,974,516

Investment income is included in:

Unrestricted net assets	\$ 275,010
Temporarily restricted net assets	1,699,506
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	\$ 1,974,516

Note 6 - Charitable Remainder Unitrusts:

The Diocese is the trustee for various charitable remainder unitrusts, which have been invested. These investments represent gifts received subject to certain restrictions on the distribution of income and the assets of the unitrust. The unitrust agreements specify the beneficiaries of the income and the assets.

The charitable remainder unitrust agreements provide for annuity payments to donors of 5% to 10%. The Diocese records this investment at fair market value. The estimated liability is based upon the annuity payments and donor life expectancy using a discount rate of 5% to 6.5% and is classified as funds held in trust for beneficiary.

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

The investments in charitable remainder unitrusts consist of the following at December 31, 2006:

	Fair Value
Funds, including notes receivable of \$131,250	\$ 16,120,604
Less funds held in trust for beneficiaries	(13,124,324)
Less accounts payable to related party	(245,230)
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	\$ 2,751,050

Note 7 - Notes Receivable Held for Investment

Notes receivable held for investment consist of the following at December 31, 2006:

Note receivable from Episcopal Church of the Redeemer and Redeemer Pre-School; bearing interest at 6%; principal and interest due through January 2014; secured by Episcopal Bishop of California property.	\$ 179,581
Note receivable from St. Augustine Episcopal Church; bearing interest at 6%; principal and interest due through July 2007; secured by a Deed of Trust.	18,683
Note receivable from individual; bearing interest at 8%; principal and interest due when certain secured property is sold.	51,408
Note receivable from St. James Episcopal Church, Oakland; bearing interest at 0% and due in 2016.	58,000
<u>Less valuation allowance relating to interest accruals</u>	<u>(51,505)</u>
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	\$ 256,167

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

Note 8 - Equity Interests in Real Property:

Equity interests in real property, which are recorded at cost, consist of the following at December 31, 2006:

45% equity interest in real property owned by the Executive Officer of the Diocese	\$ 249,661
31% equity interest in real property owned by the Culmers	160,000
22% equity interest in real property owned by the Mission Clergy	100,000
23% equity interest in real property owned by the Mission Clergy	51,500
50% equity interest in real property owned by the former Bishop	927,500
100% equity interest in real property for current Bishop	2,672,290
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	\$ 4,160,951

Note 9 - Property and Equipment:

At December 31, 2006, property and equipment consisted of the following:

Diocesan House	\$ 998,194
S. F. Campus Center partial interest	30,000
Computers/server	14,969
Other furniture and equipment	46,209
Toyota Prius	27,108
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	1,116,480
Less accumulated depreciation	(362,388)
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	\$ 754,092

Depreciation expense for the year ended December 31, 2006 was \$59,956.

Note 10 - Line of Credit:

The Diocese has an unsecured line of credit agreement with a bank under which it may borrow up to \$500,000. The line of credit bears interest at the prime rate and expires on October 12, 2008. No outstanding borrowing existed at December 31, 2006.

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

Note 11 - Net Assets:

Temporarily restricted net assets are restricted for specific purposes as of December 31, 2006.

Net assets were released from donor restrictions by incurring expenses satisfying the purpose of the restriction for the year ended December 31, 2006.

Permanently restricted net assets are invested in perpetuity, with the income available to support the programs of the Diocese as of December 31, 2006.

Note 12 - Related Parties:

The Diocese and The Episcopal Bishop of California (The Bishop), a Corporation Sole, are related parties in that the Bishop administers and oversees the operations of the Diocese.

The Diocese is the guarantor of notes payable of one parish in the approximate amount of \$26,152.

Included in accounts payable, related party are the following funds due to the Bishop (a Corporation Sole) at December 31, 2006:

Funds investment in the Diocese pooled endowment	\$ 4,942,520
Short-term loan	215,205
Charitable remainder trusts for the benefit of the Bishop	245,230
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	\$ 5,402,955

Also included in accounts payable, related party is funds held for others. Several years ago, the Church of Incarnation, a church within the Diocese, gave funds to the Diocese to invest and hold for them. At December 31, 2006, the balance due to the Church of Incarnation was \$86,230.

**The Episcopal Church in the
Diocese of California**

Notes to Financial Statements

The Diocese has made several promises to give to related parties. The amounts owed to each of these related parties at December 31, 2006 are as follows:

Church Divinity School of the Pacific \$100,000 due over five years	\$ 40,000
Grace Cathedral \$25,000 due over five years	15,000
Bay School \$200,000 due over 10 years	180,000
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	\$ 235,000

These amounts are payable as follows:

Less than one year	\$ 45,000
One to five years	110,000
More than five years	80,000
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	\$ 235,000

Note 13 - Retirement Plans:

The Diocese funds defined contribution pension plans covering lay employees. The Diocese contributes between 5% and 9% of employee compensation depending upon the employee contribution. The 2006 contribution by the Diocese to the defined contribution pension plans approximated \$67,000.

The Diocese also provides pension benefits for the clergy through a national plan. The plan is a defined benefit pension plan funded by specific assessments charged to the Diocese based on a specified percentage of compensation. In 2006, the Diocese contributed approximately \$96,000 (18% of compensation) to the clergy defined benefit pension plan.

Note 14 - Concentrations of Credit Risk:

The Diocese has identified its financial instruments which are potentially subject to credit risk. These financial instruments consist principally of cash and cash equivalents, investments in securities, and notes receivable held for investment.

The Diocese invests its cash deposits with three financial institutions. Of these deposits, \$567,525 was not federally insured at December 31, 2006.

The Episcopal Church in the Diocese of California

Notes to Financial Statements

Investments in securities are diversified into various equity instruments and other investment securities in order to limit the concentration of market risk.

The notes receivable held for investments, as described in Note 5, consist of notes secured by property and unsecured notes.

The Diocese bills and collects assessment revenue from the various parishes. Assessment revenues comprised 52% of total revenue the Diocese received in 2006.

Note 15 – Prior Period Adjustments:

During the year ended December 31, 2006, it was discovered that a charitable remainder trust (the trust) had been improperly recorded. The trust had been recorded with the Diocese as the remainder beneficiary, when the remainder actually belongs to a third party. An adjustment to properly reflect the trust has been recorded. That adjustment decreased permanently restricted net assets in the deferred gifts fund by \$755,565 and increased funds held in trust for beneficiaries by the same amount as of December 31, 2005. Of that amount, \$24,446 was included in net income for 2005 and the remainder was net income of prior periods.

Also during the year ended December 31, 2006, it was discovered that certain funds within the endowment fund were improperly recorded with respect to net asset classification. An adjustment to properly reflect net assets as of December 31, 2005 has been recorded. That adjustment increased permanently restricted net assets by \$600,582 and decreased unrestricted and temporarily restricted net assets by \$269,533 and \$331,049, respectively. The adjustment had no impact on net income.