UNITED STATES BANKRUPCTY COURT

SOUTHERN DISTRICT OF CALIFORNIA

In re:

THE ROMAN CATHOLIC BISHOP Of SAN DIEGO, a California Corporation sole,	)	Case No. 07-00939-LA 11
	)	Chapter 11
Debtor	)	FIRST REPORT OF EXPERT R. TODD NEILSON, CPA PURSUANT TO APPOINTMENT DATED APRIL 30, 2007

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I.

APPOINTMENT

On April 11, 2007, the Honorable Louise DeCarl Adler conducted a hearing on an Order to Show Cause Re Contempt or Other Sanctions (the “OSC”). The Court ordered, *inter alia*, that an Expert accounting professional shall be appointed pursuant to Federal Rule of Evidence 706 (a). The Court decided, after consideration of suggestions from the Roman Catholic Bishop of San Diego (“RCBSD” or “Debtor”), the Official Committee of Unsecured Creditors, the Organization of Parish for the Roman Catholic Diocese of San Diego (“OPSD”), and the United States Trustee, to appoint an Expert “to examine the financial structure of the RCBSD, its cash flow, including uses and sources of income, and such other issues pertinent to the Cash Management Motion of RCBSD, all to be more fully defined by the Court in a separate order in this case.”

On April 30, 2007, R. Todd Neilson was appointed as Expert witness (“Expert”) pursuant to Federal Rule of Evidence 706 (a). In accordance with the Order, the Expert was to “perform the following investigation and analysis and make appropriate findings regarding the Cash Management System of the Debtor, including:

(1) The identity of each Account, including the account number, name and address of all Account depositories’ branches, the name and address of Account holder as reflected in the Account depositories’ records, the tax identification number associated with the Account if different from the Debtor’s tax identification number, the owner of such tax identification number and the date the Account was opened.

(2) All documents pursuant to which the Account was established.

(3) The identity of each Account that, after the commencement of the Debtors chapter 11 case, was closed or changed in any way, including but not limited to changes in tax identification numbers, Account signatories or any agreement affecting the Account. To the extent of any such changes or closures, the identity of the person requesting the closure or changes and the authority of such person to make or seek such closure or change.

(4) Any alleged restriction(s) or limitations with respect to the funds in the Accounts.

(5) An analysis of the Account holder's compliance with any alleged restrictions or limitations with respect to the funds deposited in or withdrawn from the Accounts. The Expert's analysis may be derived from his performance of such random tests and/or samplings as he deems appropriate and necessary.

(6) An analysis of whether the Cash Management System described in the Debtor's FIRST DAY MOTION #1 (d.e. #9) operates in a manner consistent with the Debtor's representations in said Motion. The Expert's analysis and opinion may be derived from his performance of such random tests and/or samplings as he deems appropriate and necessary.

(7) The restrictions, if any, on use of funds raised in the Annual Catholic Appeal.

(8) The Debtor's state and federal tax returns, if any, for the last five (5) years."

The Order also directed the Expert to "include a list of all individuals interviewed by the Expert, all documents reviewed by the Expert, all documents requested by the Expert but not produced and the identity of the person failing" to produce the documents and the reasons provided for such failure. [1]

The Order further directed all persons "identified in the OSC shall cooperate fully with the Expert."

The Order allowed the Expert, in accordance with Local Rules of Bankruptcy Procedure and guidelines of the Office of the United States Trustee, to "employ professionals (including Professional firms in which the Expert is a principal, shareholder, member or partner) to assist in the performance of the Expert's duties." Pursuant to that Order, on May 25, 2007, the Court ordered the appointment of LECG to act as financial advisors to the Expert in furtherance of his duties. The Expert wishes to express his sincere appreciation for the invaluable support of the Directors and employees of LECG. Without their extremely valuable assistance this report would never have been compiled within the tight time parameters as imposed by the Court. Within this report, the collective efforts of both the Expert and the financial professionals at LECG are singularly referred to as the Expert.

Cooperation and Accessibility

The Order appointing the Expert expressly directed all persons "identified in the OSC" to "cooperate fully with the Expert." The Expert wishes to thank Bishop Brom and all other

Diocesan personnel as well as all Parish Priests and the lay personnel associated with their respective Parishes for their invaluable assistance and cooperation in the preparation of this report. All of the above individuals, including the professionals employed by the Diocese, have been wholly supportive throughout this entire process. During the many similar matters in which the Expert has been engaged, he cannot recall an assignment where he has had more complete and positive cooperation.

As more fully outlined in the report, the Expert has met with Bishop Brom and other supporting personnel at the Diocese. Within a few days after his appointment, the Expert also met with a representative group of Parish Priests to receive their input into the process of reviewing the financial operations of their respective Parishes. During the course of preparing this report, the Expert met with various personnel from the Diocesan offices as well as a substantial number of Parish Priests and their accounting staffs. In conjunction with these meetings and interviews, the Expert reviewed thousands of documents in preparation for this report and both the Diocesan staff, as well as almost all of the Parish staff, responded quickly and professionally to the voluminous requests for records and supporting information. A listing of the individuals the Expert interviewed is attached as Exhibit 90. A schedule of the records reviewed by the Examiner in the preparation of the report is attached as Exhibit 91.

Audit Process

The Expert did not audit, review or compile the financial information contained within this report in accordance with generally accepted auditing standards nor does the Expert express

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[1] See Pages 15 – 20 for a detailed response to each of the points raised in the Court's Order. Also, see Section II Executive Summary – Results of Parish/School Visits & Analysis – Bank Accounts.

any opinion or any form of assurance on the accuracy or completeness of the data provided by the Diocese[2], schools, or parishes which have been made available to the Expert.

This report is intended solely for the purposes as outlined in the Order appointing the Expert and should not be used for any purpose other than those described herein.

II.

Executive Summary

The following Executive Summary provides a condensed abridgment of the material contained within the entire Expert Report. It is intended to provide the Court with a cogent recap of the major issues and opinions rendered by the Expert. The Court is invited to review the more detailed portions of the Expert Report following the Executive Summary.

Organizational Structure

On February 27, 2007, The Roman Catholic Bishop of San Diego "RCBSD" ("Debtor") commenced a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code ("Petition Date"). The RCBSD is a civil entity which, as a sole corporation organized under the laws of California, conducts the business of the Roman Catholic Diocese of San Diego ("Diocese"). The Diocese was incorporated March 29, 1937[3] (Exhibit 1) and is now the canonical entity which operates in the San Diego and Imperial counties of Southern California under the canonical authority of Bishop Robert H. Brom. The purpose of the Diocese is declared in the Articles of Incorporation and amendments thereto, which were filed January 4, 1967 (Exhibit 2), February 24, 1976 (Exhibit 3) and December 19, 2005 (Exhibit 4).

[2] For purposes of this report the Expert refers to both the "Diocese", the "Roman Catholic Bishop of San Diego", ("RCBSD"), and the Debtor interchangeably. The use of any of these terms is not to be construed as a legal statement by the Expert. The Expert is primarily referring to the entities in an accounting context and is not opining as to the legal definition of any term.

The Diocese has ministered to the spiritual needs of the Roman Catholics in the Southern California area since the founding of the Mission San Diego de Alcala on July 16, 1779. Since that date, the Diocese has evolved to encompass 98[4] Parishes and 16[5] missions which address the spiritual and ecclesiastical needs of the approximately 980,000 Roman Catholics presently residing in the San Diego/Imperial County areas.

The Diocese also offers educational opportunities through 43 elementary schools and three high schools in San Diego and Imperial counties. The high schools are Marian Catholic High School[6] ("Marian") in Chula Vista, (Mater Dei Catholic High School in Chula Vista will replace Marian in the upcoming school year) ("Mater Dei"), Vincent Memorial High School ("Vincent") in El Centro, and Cathedral Catholic High School ("CCHS") in San Diego[7].

The Diocese employs 246[8] people in a variety of areas, including but not limited to, finance, accounting, schools, civil affairs, human relations, personnel and other areas[9]. The Diocese also owns and operates Holy Cross Catholic Cemetery and Mausoleum ("Holy Cross").

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[3] Previous to the incorporation in 1937, the San Diego Diocese was part of the Los Angeles Diocese.
[4] The 2007 Catholic Directory (See Appendix C) contains conflicting information regarding the number of parishes and missions in the San Diego Diocese. According to the introductory material, there are 98 parishes and 16 missions. However, the parish and mission section of the Directory reflects 99 parishes and one mission. The reason for this discrepancy is rooted in the designation given to the Immaculate Heart of Mary, Niland. The Immaculate Heart of Mary is not an independent parish but, in actuality, a small mission associated with the St. Patrick, Calipatria Parish. Hence, with this change there are 98 parishes.
[5] The reference to 16 missions being located in the Diocesan area is somewhat confusing to the Expert. A review of the 2007 Catholic Directory reflects 13 missions as being associated with various Parishes in the Parish Directory. With the addition of the Immaculate Heart of Mary, Niland, referenced above and the St. Maximilian Kolbe Mission, which is listed separately, the total number of missions is actually 15 – not 16. However, for purposes of this report, the Expert will accept the number of missions as 16.
[6] RCBSD is in the process of constructing a new high school, Mater Dei, which will replace Marian. The proposed enrollment in Mater Dei will approximate 2,000, substantially larger than the present enrollment of 700 in Marian High.
[7] RCBSD owns two of the high schools – St. Vincent and Marian. The other high school, Catholic Cathedral, is owned by Catholic Secondary Education – Diocese of San Diego Incorporated ("CSE") of which RCBSD is the sole member.
[8] Per Debtor's Disclosure Statement dated March 27, 2007.
[9] The Administrative Office includes a number of support functions such as accounting, legal, information technology, architectural oversight, and human resources. Bishop Brom's office is located at the Pastoral Center and, in addition to the religious programs offered at or through the Pastoral Center, the primary function of the Pastoral Center is to assist Bishop Brom in his responsibilities as Ordinary of the Diocese.

In addition to the services as outlined above, RCBSD provides a variety of administrative, management and custodial services for the parishes, schools and other Catholic entities within the territory of the Diocese. These services include, but are not limited to, payroll services, investment advisory and management services, construction management services and insurance services. Those services are primarily provided by personnel located at the Diocesan general offices located on Paducah Drive in San Diego. The Diocesan revenues come primarily from donations by Catholic laity faithful from the following sources:

1. Parishes are assessed the Diocesan Tax (sometimes called the Parish Assessment or Chancery Tax), which is defined as 13% of their annual income[10]. The revenue from the Diocesan tax totaled $6,783,611 in fiscal 2006, $6,452,541 in fiscal 2005 and $6,253,966 in fiscal 2004.
2. The Annual Catholic Appeal which generates $2.5 million a year.[11]
3. The Diocese retains earnings in excess of interest paid on deposits in the Diocesan Bank or PSDL Trust[12]. These excess earnings, accumulated over a number of years, constitute net assets of the Diocesan Bank and totaled $12,539,713 as of November 30, 2006.[13]
4. Investment income from marketable securities.
5. The Diocese earns revenue from fees for administrative, insurance and religious programs, rental income, direct bequests, donations and interest or investment income.

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[10] Annual Income is also referred to as "Ordinary Receipts" upon the annual reports as filed by the individual parishes with the Diocese.

[11] The cash from the Annual Catholic Appeal is temporarily retained at the Diocesan level but ultimately flows through to the chosen charities.

[12]The PSDL Trust is an acronym for Parish, School Diocese Loan Trust Account which supplanted the previously designated Diocesan Bank account. The Expert believes this account and name was primarily a post-petition designation. Throughout this report the Expert will use the term Diocesan Bank to describe the account pre-petition and will use the term PSDL Trust to describe elements of this account on a post-petition basis.
The Diocese pays 3.5% interest on funds located in the PSDL Trust and periodically loans funds to parishes and schools from the PSDL, charging 4.5% for those loans, thereby earning the 1% differential. There is also a variable differential associated with investing remaining funds in the PSDL Trust. The Expert believes the PSDL Trust operates in a manner very similar to a bank, of course without the regulatory requirements, and hence, previous to the petition date, it was referred to as the Diocesan Bank.

“Accounts” at the Diocese

In prior hearings before the Court the Debtor has referenced in excess of 700 separate bank accounts being maintained at the parish level. In addition, the Court previously referenced a possible further accumulation of 500 “accounts” purportedly being maintained at the Diocese level, prompting the Court to describe the accounting system at the Diocese as “Byzantine”. The Expert understands the Court’s frustration. The source of this frustration is probably based upon two factors. First, the term “account” can have a number of different but distinct meanings depending upon the circumstances in which the term is used. The Expert believes the Court naturally assumed the term “account” meant a bank account or savings account located at a financial institution which is not necessarily the same meaning perhaps ascribed to “account” by the Debtor. Secondly, for reasons described further within this report, there truly are a massive number of bank accounts collectively maintained at the Parish level. The Expert believes the number of bank accounts at the Parish level will ultimately exceed 900 upon completion of his analysis. The thought of analyzing 900 bank accounts is a daunting but manageable process. However, the potential existence of 500 separate undefined “accounts” maintained at the Diocese combined with 900 accounts at the parish level, clearly moves us into the realm of Byzantine.

In actuality, the number of bank accounts at the Diocese level does not even begin to approximate 500 separate bank accounts. When using the term account as being an account maintained at a financial institution, the Debtor had 35 bank or brokerage accounts at the date of

[13] The date of the most recent financial statement prepared post-petition by the Debtor. (Exhibit 52)

petition and added three additional accounts post-petition, bringing the present number of accounts to 38[14].

The 500 "accounts" discussed by the Court probably relate to the individual claims the parishes and schools assert upon funds located in the PSDL Trust, which involves only one banking account. As will be further explained in the report, the PSDL trust accepts funds from parishes and schools as deposits thereby creating a "depositor account"[15] with the PSDL Trust. Many parishes and schools have multiple depositor accounts in the PSDL Trust (as of the Petition Date the number was 201 different accounts and as of July 7, 2007 the number had increased to 218). With the monies deposited by the parishes and schools, the PSDL Trust provides loans to parishes and schools from available funds thereby creating a "loan account."[16] As of the Petition Date, loans to parishes or schools was 33 and as of July 7, 2007 had increased to 36. Therefore, as of July 7, 2007, the total of depositor and loan "accounts" was not 500 accounts, as originally referenced, but 254 (218 plus 36), "depositor or loan accounts" maintained in one single bank account – the PSDL Trust.

There was also discussion before the Court as to the number of checking accounts maintained at the parish level. That number was estimated to be approximately 700. Each parish or school maintains from one to twenty two individual checking accounts at banks with which the parish or school receives donations, fees, tuitions, etc, and pays operating or construction expenses or transfers excess funds to the PSDL Trust. The Expert's investigation concerning the

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[14] In actuality, the Administrative Office has personal control over only 12 bank accounts and 8 brokerage or marketable securities accounts. The remaining accounts were controlled directly by Divisions within the Diocese, such as high schools and the Holy Cross Cemetery.

[15] Assuming the PSDL Trust is a stand alone entity, the depositor accounts are liabilities or beneficiary interest of the PSDL Trust.

[16] Assuming the PSDL Trust is a stand alone entity, the loans to parishes and schools are assets of the PSDL Trust.

total number of parish accounts is still continuing but his current estimate of outstanding checking accounts at both the school and parish level is between 900 and 1000 accounts[17].

Cash Management System

The Pastoral Center, sometimes called the Administrative Office, maintains a cash management system ("CMS"), which is used to administer monies[18] for its operations; monies in the PSDL Trust; and monies in servicing activities. It is intended to provided "an efficient and secure means of managing and disbursing cash for RCBSD's operations"[19] incorporating all of the 38 banking accounts previously referenced. It contained a number of components, all of which are described in greater detail throughout the Expert Report. In its simplest terms, the CMS system provided the structure whereby the Administrative Office received and disbursed all cash flowing into the Administrative Office.

On a pre-petition basis the Administrative Office directed nearly[20] all cash flowing into the Administrative Center, directly or indirectly, into the Pastoral Center Main Checking Account at Union Bank of California, also called the Diocesan Bank. In essence, all water flowed into this communal pond.

The Pastoral Center Main Checking Account was the repository of all funds from the Diocesan revenue stream including the Diocesan or Chancery tax, the Annual Catholic Appeal, interest and investment income and administrative fees. In addition to the Diocesan funds referenced above, the parishes and schools also deposited money in the Pastoral Center Main

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[17] See Pages 15 – 19 for further clarification of ongoing investigation into Parish accounts.
[18] The Expert utilizes the terms monies and funds somewhat interchangeably. Any reference to the phrase funds primarily relates to cash and should not be confused with the accounting theories underlying fund accounting.
[19] Per the Debtor's First Day Motion No. 1: Debtor's Motion for Order: (A) Authorizing Continued Use of Debtor's Cash Management System

Checking Account. There were two primary purposes which would cause the parishes or schools to forward funds to the Pastoral Center Main Checking Account. The first purpose was to place parish or school monies in the Diocesan Bank, later to be called the PSDL Trust. ("Funds on Deposit") The parish or schools also received interest on these Funds on Deposit, somewhat similar to a bank, hence the name – Diocesan Bank. The second purpose was to reimburse the Diocese for servicing activities including payroll, employee benefits and insurance which were the responsibility of the individual parishes or schools but were administered by the Diocese ("Servicing Activities").

Post-petition the general cash flows of the CMS have remained approximately the same with comparable receipts and disbursements by activities[21]. However, the Debtor opened two[22] new bank accounts at the Administrative Office in the post-petition period. The first account is the PSDL Trust Checking Account. This account is designed to accommodate the receipts and disbursements related solely to the PSDL Trust, which avoids commingling PSDL Trust monies with non-PSDL Trust monies, as was the practice during the pre-petition period. The second new account is referred to as the Pastoral Services – Main Checking Account, which is now utilized the house the funds solely belonging to the Diocese. The prior Pastoral Center Main Checking Account which, on a pre-petition basis, was the central repository of all funds flowing into the Administrative Office was renamed the Pastoral Services – Main Checking II Account and is designed to house the monies related to the Service Activities, which avoids commingling the Service Activities monies with non-service activities monies.

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[20] Relatively minor deposits were made directly into the lay or Priest Health checking accounts from Service Recipients rather than going through the Main Diocesan Bank account and then being deposited into this account.

Debtor's Declarations With Regard to the First Day Motions

It is the opinion of the Expert that the representations made by Mr. Mirando (See Exhibit 5), Mr. Linscott, (See Exhibit 6) and Mrs. Jassoy (See Exhibit 7) within their declarations as attached to the FIRST DAY MOTION NO. 1 DEBTOR'S MOTION FOR ORDER: (A) AUTHORIZING CONTINUED USE OF DEBTOR'S CASH MANAGEMENT SYSTEM, are by and large correct, with the following clarifications:

Linscott Declaration:

Paragraph #12 - "RCBSD has traditionally subsidized parishes. Contrary to the allegations in the Unsecured Committee's Objection, this is not part of the Debtor's cash management system. Parish subsidies are active conscious gifts made pursuant to RCBSD's mission as a faith-based non-profit organization."

> The Expert disagrees with the portion of Linscott's declaration wherein he asserts that the subsidies were not part of the Debtor's cash management system. The Expert believes all subsidizations, "gifts" or any transfers involving the PSDL Trust or Diocesan Bank were, by definition, a portion of the Debtor's Cash Management System.

Paragraph #15 - The PSDL Trust is not a component of the Debtor's operational cash management.

> The Expert disagrees with the statement contained in the Linscott declaration, Paragraph #15, concerning the PSDL Trust not being a component of the Debtor's

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[21] There was a period after the Petition Date when transfers from the PSDL Trust were frozen and then later released.

[22] The Debtor also opened a separate checking account for the new high school – Mater Dei.

operational cash management. The Expert believes the PSDL Trust to be an integral element of the Debtor's Cash Management System.

Mirando Declaration:

Paragraph #10 – "The Service Recipients carry on their own activities and functions and maintain and control their own bank accounts into which deposits are made and expenses paid. No one at RCBSD has access to or control over any of the Service Recipients' accounts, any knowledge of location or depository for such accounts or the activity in those accounts."

It is the opinion of the Expert that this portion of the declaration is not fully inclusive of the operational and audit capabilities present within the Diocese. It is true that no one at the Diocese is a signatory or actively controls disbursements or receipts into the parish or school local checking accounts and accordingly, at any given time, the Diocese may be unaware of parish and school local checking account information. However, annual reports provided by the parish to the Diocese contain bank account information. Also, although the audits of the parishes by the Diocese are only conducted every five (5) years, the audit reports provide a limited amount of banking information. In addition, in accordance with the Handbook – Diocese of San Diego – 2007 ("Handbook"), see Appendix A, the Diocese can obtain information as to the location and activity within any of the parish and school local checking accounts should they choose to do so.

Jassoy Declaration:

The Expert has no comments or clarifications concerning Mrs. Jassoy's declaration.

Specific Responses to the Order of the Court

The Expert was directed to perform an "investigation and analysis and make appropriate findings regarding the Cash Management System of the Debtor." In an attempt to provide particularity as to the investigation and analysis performed by the Expert and in response to the specific assignments listed within the Order, the Expert presents below a recap of the individual tasks delineated within the order and provides references to relevant sections of the report or Exhibits and Appendices which relate to that task. The Expert also submits general responses he feels will further clarify the investigation he has conducted.

- "The identity of each Account, including the account number, name and address of all Account depositories' branches, the name and address of Account holder as reflected in the Account depositories' record, the tax identification number associated with the Account if different from the Debtor's tax identification number, the owner of such tax identification number and the date the Account was opened;

    a. The Expert was able to provide a significant portion of this information to the Court as included in the referenced Exhibits and Appendices referenced below. However, due to the lack of response from many of the financial institutions who were served with subpoenas requesting account information, the Expert has not fully concluded this portion of the report. The Expert intends to file a supplemental report to the Court when he has received all of the responses. The Expert may seek further direction of the Court should his attempts to obtain the subpoenaed material be unsuccessful.

b. See Exhibits – 24, 25, 26, 27, 28, 31, 35, 97& 98

c. The information is also included in Appendices B.1 – B.74 which includes the audit results and documentation for the 48 parishes and 26 schools audited by the Expert. Additional information, provided to the Expert, is included in the 250 binders of supporting documentation received during the course of the audit.

- All documents pursuant to which the Account was established;

a. All documents to the extent available and provided to the Expert relating to the establishment of the accounts concerning the 48 parishes and 26 schools audited by the Expert are included in the 250 binders of supporting documentation received by the Expert during the course of the audits.

b. As detailed above, the information which the Expert has sought within the aforementioned subpoenas includes specifics concerning the establishment of the account. Unfortunately, the Expert has not fully concluded his account analysis and will file a supplemental report upon receipt of all of the subpoenaed material.

- The identity of each Account that, after the commencement of the Debtors chapter 11 case, was closed or changed in anyway, including but not limited to changes in tax identification numbers, Account signatories or any agreement affecting the Account. To the extent of any such changes or closures, the identity of the person requesting the closure or changes and the authority of such person to make or seek such closure or change;

a. The Expert has previously referenced the opening of three new bank accounts by the Administrative Office.

b. See Exhibits 25, 26, & 98

c. As previously stated, the Expert has not fully concluded his account analysis and will not be able to do so until he receives all of the subpoenaed material.

d. The information is also included in Appendices B.1 – B.74, which includes the audit results and documentation for the 48 parishes and 26 schools audited by the Expert. Additional information, provided to the Expert, is included in the 250 binders of supporting documentation received during the course of the audit.

- Any alleged restriction(s) or limitation with respect to the funds in the Accounts;

a. See Exhibits 21, 55, 77, 84, 93, 94, & 95

b. See Report Pages

c. The information is also included in Appendices B.1 – B.74, which includes the audit results and documentation for the 48 parishes and 26 schools audited by the Expert. Additional information, provided to the Expert, is included in the 250 binders of supporting documentation received during the course of the audit.

- An analysis of the Account holder’s compliance with any alleged restrictions or limitations with respect to the funds deposited in or withdrawn from the

Accounts. The Expert's analysis may be derived from his performance of such random tests and/or samplings as he deems appropriate and necessary;

a. See Exhibits 21, 77, 84, 93, 94, & 95.

b. The information is also included in Appendices B.1 – B.74, which includes the audit results and documentation for the 48 parishes and 26 schools audited by the Expert. Additional information, provided to the Expert, is included in the 250 binders of supporting documentation received during the course of the audit.

- An analysis of whether the Cash Management System described in the Debtor's FIRST DAY MOTION #1 (D.E. #9) operates in a manner consistent with the Debtor's representations in said Motion. The Expert's analysis and opinion may be derived from his performance of such random tests and/or samplings as he deems appropriate and necessary;

a. See Section Entitled <u>Debtor's Declarations With Regard to the First Day Motions</u>

b. The cash management system is discussed liberally throughout the Expert report.

- The restrictions, if any, on use of funds raised in the Annual Catholic Appeal;

a. The issue of restrictions is discussed in detail within Section III entitled The Roman Catholic Bishop of San Diego/San Diego Diocese

b. See Section VI – Annual Catholic Appeal and Designated Special Collections

c. See Exhibits 9, 10, 11, 12, 77 & 84

- The Debtor's state and federal tax returns, if any, for the last five (5) years
    a. The Expert has been advised by the Debtor that no tax returns are required and none have been filed within the past five-year period.
- The Order also directed the Expert to "include a list of all individuals interviewed by the Expert, all documents reviewed by the Expert, all documents requested by the Expert but not produced and the identity of the person failing" to produce the documents and the reasons provided for such failure.
    a. See Exhibits 90 & 91
    b. The Expert has been unable to fully complete the account analysis section of the report for the reasons described above. The Expert is disappointed with the response of certain financial institutions and will work diligently to obtain an adequate response from each financial institution. If the Expert is unsuccessful, he will provide, within a supplemental report, the identity of each person or entity failing to produce the documents as requested by subpoena.

<u>PSDL Trust and the Diocesan Financial Statements</u>

The financial statements of the Debtor, on a pre-petition basis, were referred to as the Diocesan Office Funds of the Roman Catholic Diocese of San Diego, ("The Diocesan Office Funds Financial Statements") and were audited by Ernst & Young LLP for the years 2002 through 2006. In the course of their audit, Ernst & Young LLP obtained representations concerning the financial information from the management ("management representation letter") of the Diocese (Exhibit 8). Management representation letters are obtained by an auditor in the normal course of their audit engagement for the purpose of obtaining written representations from the client attesting that the information in the financial statement is correct. The Debtor's management representation letters were signed by Bishop Robert H. Brom, Hal Gardner, Director of Finance (since deceased) and Karen Jassoy, Controller.

In a number of filings with the Court, the Debtor has consistently asserted that the funds maintained in the PSDL Trust (or Diocesan Bank) are received and maintained solely in behalf of the individual parish or school and do not constitute the property of the Debtor's estate. However, the Debtor's management representation letters for the year ended June 30, 2204 through 2006.:

> "Ownership and Pledging of Assets"
>
> "The Diocesan Office *has satisfactory title to all assets* (italics added) appearing in the statement of financial position. No security agreements have been executed under the provisions of the Uniform Commercial Code, and there are not liens or encumbrances on assets, nor has any asset been pledged". (Exhibit 8, page 2)

The Diocesan Office Funds Financial Statements contains all of the funds held by the Diocese, including the Diocesan Bank, makes no disclosure of a trust relationship and gives no indication that any asset in the Diocesan Bank belongs to anyone other than the Diocese. Any assertion by the Diocese that they are holding the Diocesan Bank funds in behalf of the individual parishes and schools in a trust capacity is in direct conflict with the representations made by the Debtor's officers in the management representation letters[23]. It should be further noted that the Debtor's Bankruptcy petition did not list the assets of the PSDL Trust and accordingly, were filed in direct contradiction to the assertions with the management representation letters attested to by the Debtor.

The Diocesan Office Funds Financial Statements, as audited by Ernst & Young, were provided to a number of financial or other institutions in connections with financing or other arrangements. In light of the potential third parties reliance thereon, it would also be a critical misrepresentation to report that assets belonging to others are included in the Diocesan Office Funds Financial Statements as the Debtor's assets. Some of the entities which received the Diocesan Financial Statements are as follows:

1. Union Bank of California,
2. Bank of America,
3. Allied Irish Bank,
4. California Department of Insurance for Gift Annuities,
5. California Department of Insurance – Self Insurance Plans for Workers' Comp,
6. Insurance carriers CMG and CMU, and
7. The Department of Motor Vehicles.

<u>Reliance on the Diocesan Office Financial Statements to Meet Debt Guarantee</u>

Footnote 10 of the Diocesan Office Funds Financial Statement for the years ended June 30, 2002 through 2006 (Exhibits 9 through 12) describe a guarantee between the Debtor and a bank that provides a letter of credit securing $28.4 million of variable rate demand revenue bonds issued for the benefit of CSE to finance, in part, the construction of the Cathedral Catholic High School. Certain loan covenants of the guarantor are discussed in Footnote 10 to the

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[23] The Expert has included a copy of a footnote (Exhibit 65, starting with the last sentence on page 36) from the annual report of The First American Corporation's public annual report that is filed with the Securities and Exchange Commission as an example of how such trust relationships are disclosed in financial statements under generally accepted accounting principles. The First American Corporation holds billions of dollars of assets in

financial statements. Both the management of the Debtor, as well as the auditor, declare the Debtor in compliance with the covenants of the aforementioned guaranty.

Noting that the debt was funded in May of 2003, two of the guarantee covenants described in Footnote 10 could not be met in subsequent years without including all of the assets of the Diocesan Bank, which were supposedly held in trust by the Diocese in behalf of the parishes and schools and other claimants.

The first covenant is the requirement to maintain a minimum of $10 million in unrestricted cash and readily marketable securities[24] which was only possible in the years ended June 30, 2004[25] and 2006 with the inclusion of all of the marketable securities in the Diocesan Bank. The calculations in Exhibit 13 demonstrate this fact. There is not a sufficient level of unrestricted cash in the Administrative Office General Fund in fiscal year 2006 to comply with this covenant without including the funds supposedly being held in trust in the Diocesan Bank. Even adding to the Administrative Office Restricted Fund the amounts in the Bishop's Burse Fund does not satisfy the financial covenant. Only by adding the marketable securities in the Diocesan Bank can the covenant be met.

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behalf of others in escrow accounts or as a trustee. As the footnote states, "…trust deposits are not considered assets of the Company and, therefore, are not included in the accompanying consolidated balance sheets."

[24] The Guarantee Agreement (Exhibit 60, page 2) defines unrestricted cash and readily marketable securities as, "…all cash, cash equivalents, and Readily Marketable Securities held by the Guarantor and treated under GAAP in a manner consistently applied, as historically applied by the Guarantor as unrestricted and available for use for the payment of principal or premium, if any, and interest on Debt or <u>for the payment of operating expenses</u> (underline added) of the Guarantor."

[25] When the Diocesan Office Financial Statements were first issued for the year ended June 30, 2004, the Property fund was shown as a separate fund. In 2005 the Property fund was merged with the Diocesan Bank and a change was made which moved the Accounts Receivable, CSE from the Administrative Office General fund to the Diocesan Bank. Hence, the changed 2005 presentation of the 2004 financial information would qualify on this loan covenant where the 2004 presentation would not.

The second covenant mentioned in Footnote 10 is the requirement to maintain a ratio of assets of unrestricted cash and temporarily restricted cash and marketable securities[26] to debt of not less than .75:1. That ratio, as detailed in Exhibit 14, cannot be met without including the assets of the Diocesan Bank which are supposedly being held in trust in behalf of the Parishes and Schools. The Administrative Office unrestricted cash and temporary cash and marketable securities are shown in Exhibit 14. The ratio to the then outstanding debt balance is calculated and demonstrates the failure of this loan covenant based solely upon these Administrative Office General Fund assets in each of the three years. Even with the addition of the Bishop's Burse Fund there still exists a failure to meet the loan covenant in three of the years. With the addition of the Interfund account balances, assuming them to be cash (which they probably are not for purposes of the covenant definition), there is a failure to meet the loan covenant in three of the years. Only after adding the Diocesan Bank assets does the Debtor meet the required loan covenant.

The definitions in the loan covenants refer to cash, cash equivalents, and Readily Marketable Securities held by the Guarantor, the RCBSD, that are available for the payment of "operating expenses of the Guarantor." Including the Diocesan Bank cash, cash equivalents and Readily Marketable Securities in the loan covenant implies that the assets of the Diocesan Bank are available to pay the operating expenses of the Debtor.

Ernst & Young LLP advised the Expert they are not in possession of a workpaper which provides their computations of compliance with the loan covenants. However, when the Expert

[26] The Guarantee Agreement (Exhibit 60, page 2) defines unrestricted cash and temporarily restricted cash and marketable securities as, "…all cash, cash equivalents, and Readily Marketable Securities held by the Guarantor and treated under GAAP in a manner consistently applied, as historically applied by the Guarantor as unrestricted or temporarily restricted by the Governing Body of the Guarantor…available for use for the payment of principal or premium, if any, and interest on Debt or <u>for the payment of operating expenses</u> (underline added) of the Guarantor."

spoke with Kristin Janix, manager at Ernst & Young LLP, who was assigned to the audit of The Diocese Funds Financial Statements, she agreed that in order to comply with the loan covenants, it would be necessary to include all of the assets of the Diocesan bank.

Accounting Treatment for Land Held in Trust for Parishes

It is the policy of the Diocese to provide a parish, upon establishment, a sufficient amount of developable land from the Diocese on which to build their parish (Exhibits 15 and 70). With a few exceptions, parishes which are in the start up phase, The Diocesan Financial Office Funds Financial Statements for the years ended June 30, 2002 through 2006 (Exhibits 9 – 12, Pages 2 & 3) do not include the cost or other basis for land held for the benefit of parishes.

The financial statements of the parishes the Expert analyzed do not include the cost or other basis for land used by the parish in their financial statements. At the parish level, when construction costs are incurred they are expensed and therefore no capital asset is created, including land gifted to the parish from the Diocese. Hence, the land held in the name of The Roman Catholic Bishop of San Diego, which the debtor asserts it holds for the benefit of the parishes (Exhibit 16, pages 1 to 19) is not carried on the books of the Diocese or the parishes

Diocese Construction Management

The Diocese provides construction supervision and management to the parishes for all projects over $100,000. Joel King, AIA, serves as Director of Construction Services (“CS”) within the Pastoral Center. Parishes that wish to build facilities submit their proposals to the Building and Renovation Committee (the “BRC”). A copy of the bylaws of the committee and other policies concerning parish project construction are contained in Exhibit 17.

Mr. King provided the Expert with three samples of Construction Contracts (Exhibits 72, 73, & 74). It should be noted that all three of the sample contracts provided by Mr. King have the Roman Catholic Bishop of San Diego, a corporation sole (or variation thereof), as the owner of the project even though the projects were for construction of parish facilities. The Expert has seen certain contract documents (Exhibit 75) where the individual parish is named as the owner. Mr. King indicates that some parishes wish to be named as the owner, while others have no preference or specifically do not want to be listed as owner on the contract.

Diocese Divisions

The Diocese has several different operating units or divisions. The major characteristic of each Diocesan division is their autonomy of accounting operations from the Pastoral Center. These divisions presently maintain their own accounting systems separate from the Administrative Office but it should be noted that the Debtor's Monthly Operating Report for March 31, 2007 was the first time, other than the Debtor's bankruptcy schedules, that the Debtor prepared a consolidated financial statement containing what it considers to be its divisions i.e. Holy Cross Cemetery, Vincent Memorial, Marian and Mater Dei High Schools, the Newman Centers and the Apostleship of the Sea. Prior to that time, the divisions all had separate accounting statements which were not consolidated into the Debtor

Audit Results of Parish and School Accounting

The Order required the Expert to provide the Court with information concerning the existence, as well as the operational and informational data regarding bank accounts, as well as any restrictions which may be imposed with respect to those funds. In order to do so, the Expert was required to conduct an audit[27] (or accounting analysis) of various Diocese and parish accounting records. The audit was also required to determine whether the CMS operates in a manner consistent with declarations as provided by responsible officials in the Diocese.

Due to appropriate and understandable time constraints, the Expert was not able to visit all 98 parishes and 43 elementary schools. However, the Expert reviewed all available data related to all 98 parishes from the list below and based upon that data selected 48 parishes to audit.

Exhibit 18 is a schedule of all the parishes in the San Diego Diocese with a notation of the 48 parishes the Expert chose to audit. Exhibit 19 is a full schedule of the 43 schools in the San Diego Diocese and the 26 schools which were reviewed by the Expert.

<u>Accounting for the Parishes & Schools</u>

Approximately $165 million flows through the annual collective coffers of the Diocese, parishes and schools of the RCBSD[28]. One would naturally assume that such a large financial enterprise would establish a standard system of accounting and reporting, which would allow for meaningful financial measurement standards to be imposed throughout the entire organization. If such a system were in place, any entity, such as the Diocese, should be able to access financial information concerning each of the parishes or schools within the Diocese in order to monitor their financial performance or adherence to established procedures. However, the Diocese has no such system and, absent a personal visit, cannot independently access the full level of parish

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[27] The Expert utilizes the terms "audits, visits and reviews" throughout this report to describe the accounting analysis which he conducted. However, the term "audit" as well as "review", as defined herein, is not to be construed as complying with the standards of an audit or review as defined by the AICPA.

[28] Excluding the funds flowing from the high schools and other separate divisions associated with the Diocese.

or school accounting information. As a result, they are often woefully unaware of the specific financial operations of the individual parishes.

In practice, each parish and school is responsible for their individual method of accounting and bookkeeping leading to a lack of standardized accounting. This absence of a prevailing accounting system leads to an incredible array of accounting programs and methods to record their financial transactions. As a result, the accounting programs within the parishes range from a handwritten system of ledgers[29] to advanced parish accounting software packages.

Regardless of the method used, the Expert found that the parishes and schools were reasonably well organized and sufficient detail was generally available to allow the Expert to analyze the receipts and disbursements of each parish or school. This availability is probably due, in part, to the fact that each parish and school is required to send an annual report to the Diocese. This requirement is detailed in the Diocesan Handbook, which is included as Appendix A. The accounting system of the Parish must be adequately standardized to provide accounting data in sufficient detail to allow the parish or school to prepare the annual reports to the Diocese.[30]

The Expert has reviewed all of the annual reports for the fiscal years ended 2003 through and including 2006 as provided by the Diocese and the 48 parishes and 26 schools which were audited by the Expert[31]. The financial data in the annual reports to the Diocese is primarily a receipt and disbursement based analysis. It also contains information concerning restricted (or extraordinary) donations, as well as a supposed list of the bank accounts maintained by the

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[29] It should be noted that the handwritten system was meticulously maintained.
[30] Some of the parishes use specialized software for parish accounting which allows the report to be printed from their software system.
[31] To the extent provided, copies of each of the annual reports for the 48 parishes and 26 schools are included in the binders maintained by the Expert containing the supporting accounting information obtained during the audit.

parish. As in most parish related accounting issues, there is a wide disparity between the accuracy and inaccuracy of the information.

In conjunction with the duties of the pastor, the guidelines, as outlined in the General Handbook, regarding parish cash state, "Accounts with financial institutions may be established *only with the permission of the pastor*. All accounts *must be* in the name of the parish. The pastor *must be* a signer on all such parish bank accounts. Anytime a change of signature(s) on an account is required, *the pastor must* sign the new signature card(s)….Separate accounts for parish organizations (altar society, etc.) are permissible. However, such accounts must contain reference to the name of the parish to which they pertain (e.g. St. Vincent Altar Society) and the pastor must be an authorized signatory on such accounts. Subsequent changes in authorized signatures must likewise be made only with the pastor's approval and signature on the new signature card(s)." (Emphasis added)

The Expert found that the pastors in the individual parishes audited by the Expert almost always complied with the aforementioned procedures especially relating to the principal bank accounts within the parish. However, a number of the smaller special purpose accounts at the parish level did not comply with these guidelines.

As outlined above, the pastor has ultimate responsibility for the administration of the parish. He may delegate certain responsibilities but according to the Handbook he retains supervisory control. The first general responsibility outlined in the handbook is "All parish receipts and disbursements shall be entered in the parish financial records according to the parish chart of accounts." During the audits conducted by the Expert, it was determined that a good faith effort was made to accurately record all receipts and disbursements in accordance with the aforementioned policy. When deviations from the parish chart of accounts occurred, it was generally due to the inexperience of the person making the entry, as many lay personnel, who lack conventional accounting skills, are designated that task. However, those entries which were discovered to have been recorded incorrectly did not have a material effect upon the financial reports.

Collection of Donations and Designation of Restricted Funds

Within the 48 parish audits conducted by the Expert, he found the collection of ordinary and restricted/designated donations for parishes to be administered in a comparable manner. The collections are gathered and separated by type, i.e., ordinary or extraordinary. Ordinary receipts are those designated for the general operation of the parish. Extraordinary donations are those which fall outside the general operational nature and may include building funds, special purpose donations such as hurricane or other disaster relief, Diocesan special collections, and ACA rebates[32]. The manner of designation or segregation is normally determined by the color, notation or other distinguishing factor on the donation envelope. Based on that designation, or occasionally through verbal directions to the pastor, the donation is categorized as either ordinary receipts or designated as restricted receipts for specific causes[33]. In some cases the general collection process may be modified to create a designation. For example, the pastor might have a second collection on the first Sunday of a month and designate those collections for the building fund or some other cause.

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[32] Diocesan special collections include such pass through collections which go directly on to the Diocese, such as Peter's Pence and the Annual Lenten Appeal. The Annual Catholic Appeal (ACA) rebates represent the return of funds advanced to the Diocese as contributory amounts which are estimated by the Diocese in the first part of the year and a parish may ultimately have advanced more than required under the final assessment.

[33] It should be noted that the Diocesan tax of 13% is not charged against those collections designated as extraordinary. Thus, in certain instances, it is beneficial for a parish to designate certain collections as extraordinary as it reduces the Diocesan tax due from the parish.

Occasionally, the parish will receive a larger than normal donation that may or may not necessarily be designated for a specific purpose. Often the donor will direct the pastor to use the funds in areas where he feels the parish may have the greatest need. In those instances, it is not uncommon for the pastor to designate these donations as an extraordinary contribution and allocate it to a specific purpose, such as a new construction campaign. This procedure, which is used regularly in the parishes, is not in accordance with the handbook as when handling unspecified purpose receipts, such as those mentioned above, the handbook states, “funds that are not restricted by the donor and are internally designated by the parish are to be classified as ordinary receipts.”

Most, but not all, large contributions the Expert reviewed included a letter designating the purpose and intended use of such contribution. The Expert has retained copies of all such letters in the binders of supporting documentation for each individual audit.

Following receipt and counting by three or more parishioners, the funds can then be deposited into one or more accounts established at the parish. Most parishes have separate accounts for general donations, building funds, or other designated gift accounts. The number of bank accounts maintained by the parishes range from one general account to as many as twenty-two separate accounts at the Our Lady at Mount Carmel, San Ysidro.

The above practice generally comports with the procedures outlined in the Handbook under the section “Administration – Parish” (see Appendix A). This section contains detailed cash counting and accounting procedures. The pastor and parish personnel generally try to follow these guidelines based on the specific circumstances at each parish. The handling of cash is one of the primary areas addressed whenever the parishes are audited by the Diocese and accordingly, parishes endeavor to comply with all of these requirements.

In summary, with the exception of those contributions whose purpose have been supported by a specific letter detailing the intentions of the donating party, the Expert has relied upon the procedural descriptions, as provided by the pastor and the lay personnel assigned to each parish, as to which contributions have been designated for general operations or extraordinary or specifically designated contributions. The Expert believes most parishes made a good faith attempt to comply with the procedures as outlined in the Handbook. However, as stated before, there is a significant variation between both the accounting capabilities of parish personnel and the diligence to which the individual pastor observes the Handbook guidelines concerning the designation of restricted funds. The Expert was not present during the collection procedures and the envelopes containing past contributions have been discarded. Therefore, there is not sufficient independent accounting documentation available to allow the Expert to provide a conclusory opinion as to the adequacy of the procedures employed. Consequently, the Expert is unable to opine as to whether the preponderance of those funds were accurately designated as restricted. If the procedure is followed, which in most cases it appears to have been, the procedures as outlined are probably sufficient to allow a pastor to designate funds as restricted as to purpose. Nevertheless, the Expert witnessed a number of occasions during the course of the audits wherein those procedures were not adhered to or, in some cases, completely disregarded.

In regard to disbursements at the parish level, the Expert believes with a few exceptions, the pastors and parishes make a good faith attempt to comport with the guidelines enumerated in the Handbook.

A significant amount of the funds actually spent for normal operating expenses are paid directly to the Diocese. Generally, most clergy salary and benefits, religious and lay salaries and benefits, diocesan tax, clergy pension tax and insurance for property and auto are directly transferred to the Diocese from the parish accounts by automatic transfer twice a month[34]. Prior to the bankruptcy these funds were paid to the Diocese with checks written from the parish accounts. According to Diocesan policy, as detailed in the Handbook, all personnel are to be paid from the Diocesan payroll system. Based on Exhibit 20, which demonstrates the operating expense analysis for the 48 parishes visited by the Expert, these operational expense transfers to the Diocese account for approximately 71.15% of the total general operating expenses.

Parishes and the Diocesan Bank/PSDL Trust

There is a clear obligation on the part of the parishes to deposit excess funds into the Diocesan Bank/PSDL Trust and a goodly number of the parishes are attempting to comply with the guidelines as best as they can understand those procedures. However, there is an understandable, but clearly apparent, ambivalence on the part of the parishes to comply with that requirement. A number of the parishes have collected substantial donations from their parishioners over the past few years to replace or renovate their parishes. Those designated monies collectively represented in excess of $35,000,000 for the fiscal year ended June 30, 2006. When faced with the looming specter of bankruptcy and the possibility that those donations may be swept into the vortex of the Diocesan litigation, many of the parishes have become defensibly protective of those monies. As will be further detailed within the report, a number of parishes choose to employ various means to protect the funds they believe to be the exclusive property of the parish. Those means range from a complete disregard of the requirement to deposit excess

[34] It should be noted that those withdrawals cannot occur without the express approval of the respective parishes as the Diocese is not a signatory on any of the parish accounts and accordingly cannot unilaterally make such withdrawals.

parish funds into the Diocesan Bank/PSDL Trust to occasional inappropriate and discreditable methods.

The Parish Administration section of the Handbook provides the following clear direction as to the procedure for transfer of surplus funds from the parish to the Diocese. "Surplus funds *must* (italics added) be on deposit with the diocese in accordance with diocesan policy. Surplus funds are amounts above what is needed for normal operations for a two month period, which is estimated to be $50,000." The Expert has found a veritable plethora of interpretations at the parish and school level of the surplus funds requirement which range from good faith adherence to absolute disregard. The designation of surplus funds as being those funds in excess of $50,000 <u>and</u> an additional two months operating expenses was the most common interpretation of the surplus funds procedure the Expert received from the parishes during the course of his review. Thus, if a parish were to adopt that interpretation and had monthly operating expenses of $60,000, surplus funds would be those funds greater than $170,000, or two times $60,000 plus $50,000. A goodly number of the parishes the Expert reviewed tried to comply, at least to some degree, with their interpretation of this policy. There were also a significant number of parishes, such as Our Lady of Mt. Carmel, San Ysidro Parish, who demonstrated a willful disregard of this procedure. The audits of the parishes and schools confirmed the wide variation afforded this procedure. For example, strict adherence to this policy would indicate that each of the 74 parishes and schools audited by Expert visited should have each had approximately $50,000. In practice, only nine (9) of the seventy-four (74) parishes and schools the Expert visited had less than $100,000 on hand at the petition date and three (3) had more than $1.1 million. Another eighteen (18) had between $400,000 and $1,100,000, and seventeen more had between $250,000 and $400,000. If this policy were implemented to limit each of the 74 parishes and schools the

Expert reviewed to a total of $50,000, the amount remaining at the parish level would be approximately $3.70 million ($50,000 X 74). Nevertheless, the total cash on hand at the petition date, as reported on Schedule K, for the same 74 parishes and schools is $25.46 million, which results in excess or surplus funds of approximately $21.76 million being held in the multiple accounts of the 74 parishes and schools audited. Even if the base amount was raised to $100,000, the surplus monies at the parishes and schools would still be in excess of $18 million.

<u>Post Petition PSDL Activity</u>

The Expert was provided a schedule of activity relating to the PSDL for all parishes and parochial schools from the petition date through early July 2007. This information is summarized in Exhibit 21. The following summarizes the activity in the PSDL Trust for this period:

Deposits & Credits to Funds on Deposit	$ 4,521,870
Payments on Debt	1,415,237
Total Receipts	$ 5,937,107
Withdrawals & Debits from Funds on Deposit	$ 3,475,733
Draws on the PSDL Debt	3,425,018
Total Withdrawals	$ 6,900,751

From the 74 parishes and schools the Expert selected for audit he reviewed the fifteen parishes or schools with the highest levels of available cash on hand at the petition date based on Schedule K. The fifteen all had more than $500,000 in their parish or school accounts according to Schedule K. As a combined group these 15 parishes and schools had $11,965,094 on hand at the petition date according to Schedule K. Six of the fifteen had principal activity in the PSDL

Trust from February 28, 2007 through early July 2007. As a group, these fifteen parishes and schools had no withdrawals of Funds on Deposit or draws on debt from the PSDL Trust during this time frame. During this same period, as a combined group, the six parishes and schools either deposited into the PSDL Trust or made debt payments to the PSDL Trust totaling $902,126.

It appears the parishes and schools continued to ignore the Diocesan policy regarding the deposit of excess funds into the PSDL Trust. This disregard for the policy is even more troubling given a memorandum sent to the pastors, administrators and principals on May 24, 2007 by Monsignor Steven Callahan. This memorandum has been included as Exhibit 22. The document declares, "At a hearing in the bankruptcy court on May 10, 2007, both the Diocese of San Diego and the Organization of Parishes agreed to comply with the diocesan policy that surplus funds be deposited in the Parish and School Deposit and Loan (PSDL) Trust (formerly known as the diocesan bank)…*Therefore, you are directed to deposit surplus funds no later than May 31, 2007"* (emphasis added). The memo closes with the statement, "Your cooperation is essential so that the diocese and parishes are in compliance with the commitment to the Court." It is apparent, according to the most recent information available to the Expert, most parishes continued to ignore the diocesan policy, the direction of this memo and their commitment to the court.

Loans to Parishes

There is a separate diocesan policy dated November 1, 2006 that addresses loans from the Diocese to individual parishes which are primarily used for construction of new projects, but may also include purchases of assets, maintenance projects and even the purchase of Rectories.

The Expert found one instance where a parish borrowed funds from other parishes. The parish that borrowed the funds was St. Brigid Parish. The Expert visited St. Brigid on May 31, 2007. At the time of the bankruptcy petition, St. Brigid had a new rectory construction project underway which was scheduled for completion in July 2007.

According to parish personnel, due to the bankruptcy, they were unable to access the funds in these three accounts in the PSDL Trust. The construction was ongoing for the new rectory and the parish did not have sufficient funds on hand to pay for construction costs. St. Brigid had only one parish bank account with a balance of $69,179 as listed on the Schedule K.

Because of the financial constraints referenced above, St. Brigid borrowed funds from three parishes in March 2007. The parish borrowed $50,000 each from St. Therese of Carmel, St. Gregory and Guardian Angel. The parish also borrowed $20,000 from a retired priest associated with the parish during March 2007. As of the date of the Expert's visit to the facility, the loans had not been repaid. Subsequent to the Expert's audit, the parish was able to access its monies in the PSDL Trust. The parish subsequently withdrew $38,722.70 from the "Funds on Deposit" account in the PSDL Trust and $47,000 from the "New Rectory" account in the PSDL Trust.

The Expert spoke with parish personnel on July 11, 2007, and was informed the three loans from the parishes remain unpaid. The $20,000 loan from the retired priest has been repaid.

The requirements and implementation procedures imposed by the Diocese are generally designed to protect the financial well-being of the individual parishes and to assure some form of repayment to the Diocese.

In order for a loan to be given the parish must have obtained the following:

1) The approval of the parish finance council,

2) All the required approvals of the Building and Renovation Committee and the Bishop have been obtained,
3) One-third of the approved cost of the project must be on deposit with the Diocese; evidence that the loan will not jeopardize the pastoral and financial responsibilities of the parish and
4) An agreed upon plan for repayment.

As of the date of petition, there are 30 separate loans from the PSDL Trust to the parishes and schools totaling $21,929,960[35]. Of the 30 outstanding loans at the petition date, eight were interest free loans. Generally, the parishes have been very diligent in paying off outstanding loans.

School Accounting

The pastor of the sponsoring parish has the primary responsibility for the financial administration of the school. As stated in the Handbook, "The pastor shall have the responsibility for the financial administration of the school in consultation with the Parish Finance Council. This responsibility may be delegated to the school principal." According to the Handbook, the pastor of the sponsoring parish is also a member of the executive board of the school. In addition, the pastor must be a signatory on all school bank accounts and has approval responsibility for fundraising and activities that involve publicity. The parish also assumes responsibility for the building and maintenance of the school and equipment following construction.

The same accounting and internal control procedures which apply to the parishes, as outlined above, also apply to the schools. Schools have reporting requirements similar to the

[35] These 30 loans include two relatively small loans to Cathedral Catholic High School and Vincent Memorial High School.

parish which include an annual report in a standard format issued by the diocese or in a form substantially equivalent to the parish form.

The major source of revenues for the school is tuition and student fees. The tuition rate is usually set by the principal with input and approval of the pastor and Parish Finance Council with due consideration for the local economic conditions. A summary of the tuition charged by the schools the Expert audited is included as Exhibit 23. The Expert did not specifically request this information from the schools, but most provided it as an act of courtesy. Accordingly, Exhibit 23 contains information for only 19 of the 26 schools the Expert audited. The schools receive a limited amount of restricted gifts and those gifts generally relate to tuition assistance or equipment needs of the school. For the fiscal year 2006, 38[36] of the schools analyzed had total restricted gifts of just under $900,000. By way of comparison, the total tuition and fees for the 38 schools was $44.61 million.

The parish may have the responsibility to supplement tuition and fees with parish funds if required by the approved budget. Many of the parishes the Expert visited provide at least some subsidy to the school. As reported by 38 of the 43 schools in fiscal year 2006, the parishes provided total subsidies of $1.22 million. However, many of the schools have established reputations and accordingly generate sufficient tuition and fees to cover all expenses and often generate excess operating funds. In fact, the aforementioned 38 schools generated excess operating revenues of approx. $2.86 million. During fiscal year 2006, those schools increased their Funds on Deposit by a net amount of approximately $760,000.

Schools are entitled and required to participate in the PSDL Trust in the same manner as the parishes. The Diocesan policy is clear that surplus funds of the schools must also be on deposit in the PSDL Trust. It is common for the schools to deposit tuition funds in the PSDL Trust because substantial amounts are collected at the beginning of the school year and at mid-year. These funds are then sent to the PSDL Trust and drawn as required by the school to meet ordinary operating expenses. The schools generally designate these Funds on Deposit in the PSDL Trust as restricted or designated as they represent prepaid tuition and fees for the students. The schools also may have excess operating funds or excess funds from fundraising efforts which are used to fund designated accounts for new construction or endowments for tuition assistance. However, the Experts noticed a similar inconsistency of compliance with the policy requiring excess funds to be deposited with the PSDL Trust which ranged from good faith compliance to utter disregard.

Teacher salaries and benefits represent the preponderance of expenses and operational costs for the schools. For example, in 2006, these payroll expenses represented almost 98% of the total tuition collected by the 38 schools analyzed[37]. The payment of teacher payroll and benefits are administered through the diocese in the same manner as the payroll for the parishes.

Results of Parish/School Visits and Analysis

The Expert reviewed the financial operations of a total of 48 parishes and 26 schools. Detailed reports for each parish and school which document the audit results are located in 74 separate Appendices designated as Appendices B.1 through B.74. The information below is intended to highlight some findings of the Expert as a result of those audits:

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[36] As previously stated, the Expert audited only 26 schools but reviewed the Annual Reports for the 38 schools mentioned.

Bank Accounts

As outlined on Exhibit 24, the 74 parishes and schools the Expert chose to audit had reported a total of 511 bank accounts as listed on Schedule K. This exhibit contains the information as outlined in Schedule K.

Exhibit 25 utilizes the previous Exhibit 24 and denotes corrections which are required in the original Schedule K for updates, new accounts, closed accounts and other changes which were uncovered during the course of the Expert's audit. These changes have been highlighted in order to be easily identified. (The Expert has used the date of February 28, 2007 for all of this information to establish consistency) It is evident from the attached corrections that Schedule K, which was provided in response to a request for further clarifications as to outstanding cash balances in the parishes from the Court, had a significant number of errors. Based on the Expert's audit analysis 9 accounts were found that should have been included on Schedule K but were omitted as well as 51 accounts that listed the incorrect tax identification number ("TIN"). This exhibit also includes a list of those bank accounts identified by the banks pursuant to the subpoena process not listed on Schedule K or given to the Expert as a result of his requests during the audit process. This list is constantly increasing as banks are continuing to respond to the subpoenas requesting additional information. Based on the most recent information available this list identifies 19 additional bank accounts.

Exhibit 26 lists 21 accounts, discovered during the Expert's audits of the 74 parishes and schools, which were opened post-petition. Almost all of these new accounts used new tax identification numbers applied for and received by the parishes and/or schools.

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[37] There are additional income streams which flow into a school, such as parish subsidies, fees, and special fundraisers and other fund raising efforts. Even taking those supplemental fund sources into consideration, teacher salaries and benefits consume 75% of all revenue sources, including tuition.

Exhibit 27 is a summary of the 74 parishes and schools audited by the Expert and information regarding application for and use of new tax identification numbers. As shown on Exhibit 27, 58 parishes and schools applied for and received new tax identification numbers. Of these, 22 used their newly acquired TIN numbers to open new accounts or change existing accounts. Exhibit 27 also demonstrates that of the 74 parishes and schools audited by the Expert, 16 did not apply for or utilize a new tax identification number.

Finally, Exhibit 28 is included providing information regarding 20 bank accounts identified by the banks pursuant to the, as yet uncompleted, subpoena process which could not be identified as belonging to the Diocese or a specific parish or school. The analysis of the Expert in this area is still ongoing as banks are continuing to respond to the subpoenas and are providing additional account information.

In summary, in the Debtor's Bankruptcy Schedules and on the First Day Motion No.1 – Debtor's Motion for Order: (A) Authorizing Continued Use of Debtor's Cash Management System, Richard Mirando, Director, Office of Finance, estimated the number of parish and school bank accounts to approximate 766. Pursuant to the Court's *Order on Order to Show Cause Re: Contempt*, entered on April 17, 2007, the Court ordered the Debtor to provide subsequent schedules concerning the actual number of bank accounts currently held in the name of the "various parishes of RCBSD and reported under the taxpayer identification number of RCBSD (the "Alleged Parish Accounts")." The Debtor provided a subsequent schedule, referred to as Schedule K, which was submitted to the Court listing the Alleged Parish Accounts. The number of accounts listed upon Schedule K was 862, approximately 100 more accounts than originally estimated in the Debtor's bankruptcy schedules. As of the date of this report, the Expert estimates the total number of Alleged Parish Accounts to be at least 940. (See Exhibit

35) Thus, the Expert has located 78 additional accounts not listed upon Schedule K. As detailed above, the 78 new accounts were uncovered from the following sources:

- Through the audits of the 48 parishes and 26 schools, the Expert uncovered the following information:
  - 21 new accounts opened in the post petition period.
  - 9 accounts which had been in existence in the pre petition period but had not been included in Schedule K.
- The Court has issued subpoenas to a number of financial institutions requesting bank account information of entities affiliated with the RCBSD. As previously stated, the Expert has not concluded his analysis of all of the account information received in response to the subpoenas and is continuing to encourage financial institutions to satisfactorily respond to those requests. Nevertheless, the subpoenas have provided the following information concerning accounts not listed on Schedule K:
  - 19 new accounts for those entities previously audited by the Expert.
  - 9 new accounts which the Expert has determined belong to those parishes and schools which were not audited by the Expert.
  - 20 new accounts which the Expert cannot identify with any of the parishes or schools as he has not received sufficient information which would allow him to do so[38].

[38] It is possible that some of these accounts are not actually Alleged Parish Accounts.

Questionable Transactions

As more fully detailed within the attached appendices, most of the audits conducted by the Expert yielded occasional lapses in judgment and intermittent deficiencies in accounting expertise. Nonetheless , the preponderance of pastors and the lay personnel assisting them demonstrated a good faith attempt to comply with the general parameters of the Handbook. However, a few parishes engaged in openly questionable activities which the Expert feels should be brought to the attention of the Court as detailed below:

- Our Lady of Guadalupe Parish, Calexico
    - (See Appendix B.2)

    On February 21, 2007, just days prior to the bankruptcy petition, but clearly after the parish was made aware of a possible bankruptcy filing, Our Lady of Guadalupe Parish set in motion a series of transactions which deliberately concealed $49,685.47 from the Bankruptcy Court. The February 21, 2007, transactions include the following:

        - $4,000 was withdrawn (possibly in the form of cash; the bank statement simply shows it as a withdrawal) from a Sun Community Federal Credit Union (“SCFCU”) account #4993950. This account is not included in the parish general ledger, nor was the account listed on Schedule K since it was closed February 21, 2007, following the four transactions described herein. The general ledger does not reflect that this $4,000 was deposited or transferred to another parish bank account. Following this withdrawal the balance in this SCFCU account was $27,636.32.

- $12,726.00 was transferred from the general checking of the parish into the SCFCU account #4993950. This amount represents the exact amount of an ACA rebate which was deposited into the general checking the same day.
- $9,323.15 was transferred from the Union Bank designated gifts account #3710005477 into the SCFCU account #4993950.
- As a result of the three items above the balance in the SCFCU account #4993950 was $49,685.47. This amount was then withdrawn in the form of a cashiers check. This check was then held by the parish for approximately 30 days, during which time bankruptcy filing took place.

These monies held in the form of a cashiers check by the parish are not disclosed on Schedule K.

On or about March 20, 2007, Our Lady of Guadalupe Parish changed the tax identification number for only one of its bank accounts. Previously, the monies deposited into this account originated from the rental of the Parish Hall and all expenses required to operate the hall were paid from this account. During the audit, the Expert uncovered a $49,685.47 deposit and a $40,000 withdrawal the same day. Back-up documentation was requested concerning the purpose of the two transactions. Despite repeated calls, two weeks lapsed prior to the receipt of requested documents. Following a review of the documents, the Expert determined the $49,685.47 deposit was received from funds raised during a festival held in early

2007. The parish finance council and fundraising committee decided that the funds raised would be used to make repairs to the church and offices. A $40,000.00 withdrawal was in the form of a cashiers check drawn in the name of Our Lady of Guadalupe.

Upon further review, the Expert was still unable to ascertain the ultimate destination of the $40,000 cashiers check. On June 29, 2007, the Expert ascertained through a conversation with Lenna Ivie, the parish office manager, and Rev. Fernandez the $40,000 check had been re-deposited into the parish hall bank accounts on June 22, 2007. However, during the period from March 20, 2007 until June 22, 2007, the check had been held in the church safe and was only re-deposited when uncovered during the course of the Expert's audit[39].

It is the Expert's opinion that the withdrawal of $40,000 through the issuance of a cashiers check was a purposeful attempt on the part of Rev. Fernandez, who has the ultimate responsibility for the parish funds, to evade the direction of the Court to report all cash available. With a $40,000 cashier's check safely secured in the safe, during that period, the parish need not list the $40,000 as cash being maintained by the parish, thereby escaping the control of the Court[40].

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[39] The Expert has subsequently received documentation reflecting the re-deposit of the $40,000 into the same account from which it was withdrawn.

[40] A detailed report on this transaction, including supporting documentation provided by the parish, is included in Appendix B.2.

- St. Mary of El Centro Parish[41]

In the course of the Expert's audit of the financial records of St. Mary of El Centro Parish he discovered the following transactions:

In late December 2006, prior to the Debtor's filing date of February 2007, the parish received a $300,000 donation supposedly for the building fund. The money was deposited into the building fund account at Union Bank of California. On March 7, 2007, eight days following the Debtor's bankruptcy filing on February 27, 2007, in two separate transactions, $290,000 was withdrawn from this account to purchase six (6) cashiers checks; five (5) cashiers' checks each for $50,000 and one (1) check in the amount of $40,000. As of the date of the Expert's audit, it was determined that the aforementioned 6 cashier's checks were being held in the parish safe and according to parish personnel the money is intended to be used for new carpet and remodeling. It was also asserted by parish personnel, that the Parish Finance Council made the decision to handle these funds in this manner.

It is the Experts view that the parceling of the $300,000 donation into 6 separate cashier checks totaling $290,000 was a purposeful attempt on the part of the parish and the Parish Finance Council to circumvent the intent and direction of the Court requesting transparency in the recognition of financial cash balances by all of the parishes. It is especially unfortunate that just eight (8) days after the Debtor's

[41] See Appendix B.15

bankruptcy the pastor and the Parish Finance Council would engage in such deliberately misleading behavior.

The Expert has received subsequent confirmation from the Diocese that the entire sum of $290,000 has been re-deposited into the parish accounts and later, the funds were transferred to the PSDL Trust.

- Our Lady of Mt. Carmel San Ysidro Parish ("San Ysidro Parish")[42]

The financial condition of the San Ysidro Parish and financial concessions provided by the Diocese are somewhat contradictory and are therefore perplexing to the Expert.

The parish has consistently maintained that they are one of the poorest parishes in the Diocese, yet the parish held $1.2 million in the local banking accounts of the parish at the petition date, which sum is only exceeded by one other parish in the entire Diocese. The parish also holds the largest number of private bank accounts (22) which far exceeds the normal range of parish bank accounts. In fact, there are a few parishes who maintain only one general account. In addition, Our Lady of Mt. Carmel, the San Ysidro Parish asserts that nineteen (19) of the accounts hold restricted funds while only three (3) hold unrestricted funds.

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[42] See Appendix B.58

The Expert believes that the parish inappropriately designates the preponderance of funds flowing into the parish as restricted. For example, the parish owns rental property which is rented for $1,800 a month. All of the rental proceeds are designated as restricted yet almost all of the expenses associated with the rental property, including property taxes are included as normal operating expenses and are paid from the ordinary donations of the parish. In addition, the parish holds weekly Sunday breakfasts and all proceeds from the Sunday breakfasts are designated as restricted, yet almost all of the expenses associated with the breakfasts are categorized as ordinary expenses and paid from ordinary donations. It is a common practice for many parishes to hold specialized events for specific fund raising activities and designate those funds as restricted. However, the holding of a weekly breakfast event wherein all of the funds are designated as restricted is unprecedented in the Diocese.

The Diocesan Bank loaned money for the construction of a school which is associated with the parish. As of June 30, 2004, the outstanding debt to the parish was $436,326.52 on this interest free loan[43]. The debt, under normal Diocesan procedure, is the responsibility of the parish. Therefore, an agreement for repayment was made between the parish and the Diocese which provided for an annual payment of $12,000. Three payments of $12,000 were made in 2005, 2006, and 2007 for a total reduction of $36,000. In addition, the parish requested payments of $5,000 a month from the school to reduce the parish obligation to the Diocesan Bank. In furtherance of that agreement, the school paid $50,000 directly to the Diocesan Bank in 2002/2003 to reduce the debt. In addition, during October 2003, the school paid the Diocesan Bank another $48,000 which was applied to the debt. Finally, during June 2006, the school changed their previous procedure and paid $40,000 directly to the parish for ultimate transmittal to the Diocesan Bank to further reduce the debt. Instead of sending the funds to reduce the debt, the parish retained the funds. In addition, during the year ended June 30, 2006, while the parish was holding close to $1 million in their parish bank accounts, the Diocese granted the parish rebates of $96,000 thereby further reducing the loan. Also, from the period 2004 through 2007, interest free loans have been made by the parish to two parish employees in the total amount of $13,520 of which $10,491 still remain outstanding. The Expert finds this to be troubling and certainly not indicative of an impoverished parish unable to pay their obligations to the Debtor.

Perhaps the most disconcerting aspect of the Expert's audit concerns the JCCG Foundation. On February 20, 2007, one week prior to the bankruptcy filing the parish received and deposited into the foundation bank account $100,290 from the Most Reverend Gilbert E. Chavez,[44] Auxiliary Bishop of San Diego until his retirement on May 31, 2007 and previous pastor of the parish. An additional $15,000 was transferred to the JCCG Foundation bank account from another San Ysidro Parish account which had recently received $40,000 from Bishop Chavez. The funds for the

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[43] Since the parish has an outstanding interest free loan, it is not entitled to interest on funds deposited in the PSDL Trust, which may explain the retention of $1.2 million in parish bank accounts.

JCCG Foundation were placed in a restricted bank account at the parish on February 20, 2007. Subsequent to the bankruptcy filing, from March 2, 2007 through March 8, 2007, seven (7) checks, each for $8,572 and another check for $9,959 (for a total of $69,963) were written from the restricted account. According to the personnel at the parish, the checks were written directly to Raul Gonzalez, a deacon at the San Ysidro Parish, who supposedly transferred the funds to an individual named Mauro Tovar, who had expertise in importing and exporting goods from Columbia. Again according to personnel at the parish, Mr. Tovar was to facilitate the transfer of funds to the sister parish in Columbia in order to allow them to purchase 67 computers and several printers, which was the former home of Reverend Castillo, the present Pastor of the San Ysidro parish. An additional $23,000 was also disbursed from the JCCG Foundation account later in March and early April 2007, but the Expert has not received any supporting documentation for those transfers.

The Expert appreciates the kindhearted intentions of the parishioners of the San Ysidro parish towards their sister parish in Columbia. Notwithstanding such generosity, the Expert believes that the transparency inherent in the bankruptcy system does not allow for such transfers to occur while the parish still maintains a significant obligation to the Diocese. The Expert also believes the San Ysidro parish manifestly violated the standards established in the Handbook regarding such transfers.

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[44] According to our analysis, since August 2006, Reverend Chavez has donated a total of approximately $490,000 of

Annual Catholic Appeal ("ACA") and Designated Special Collections

Since 1991, the goal of the Roman Catholic Bishop of San Diego has been successful in raising an annual sum of $2.5 million[45]. Among other things, the ACA[46] proceeds, at the direction of the Diocese, are to be used to benefit schools, religious education, care of priests, and other Catholic charities.

Each year, each parish is assessed an allocable amount by the Diocese for the ACA. This amount is based on a calculation of each individual parish's total plate and envelope collections for the previous fiscal year as compared proportionally to the total plate and envelope collection from all parishes in the Diocese, less approved deductions.

III.

The Roman Catholic Bishop of San Diego/San Diego Diocese

<u>The following material represents the entirety of the Expert Report in an all-inclusive format. The material included hereafter provides greater detail and more substantive exhibits than outlined in the previously titled Executive Summary. Accordingly, the Court may note some level of repetition due to the inclusion of similar material in the Executive Summary.</u>

Organizational Structure

The Roman Catholic Bishop of San Diego, a corporation sole, ("Debtor" or "Diocese") covers a geographical area including the San Diego and Imperial counties of California. The

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his own monies to the parish.

[45] In addition, the Diocese includes in the ACA assessment to each parish an additional 10% administrative charge. This charge is to cover the costs incurred by the Diocese to administer the program.

[46] See further description of the ACA procedures in Section VI - Audit Results of Parish and School Accounting – Annual Catholic Appeal and Designated Special Collections

Diocese was incorporated March 29, 1937 (Exhibit 1) and filed its petition for bankruptcy on February 27, 2007 ("Petition Date").

The purpose of the Diocese is declared in the Articles of Incorporation and amendments thereto, which were filed January 4, 1967 (Exhibit 2), February 24, 1976 (Exhibit 3) and December 19, 2005 (Exhibit 4).

From the "Catholic Directory Diocese of San Diego – 2007" (Appendix C) and the "Diocese of San Diego" included in the *Official Catholic Directory 2005* the Expert has prepared Exhibit 29[47], which lists all the religious institutions, which may or may not be associated with the RCBSD, within the geographical boundaries of the Diocese. The Expert has indicated the ownership of each institution based upon the information obtained from the Debtor[48] and if the institution's asset and liabilities are a part of the bankruptcy.

The Debtor has chosen not to include the preponderance of the institutions which are listed on Exhibit 29, including the parishes, schools, and other institutions in their bankruptcy schedules as they have asserted lack of ownership. Exhibit 29 is included for informational purposes only as the Expert has not received sufficient information which would allow him to draw any meaningful conclusions, one way or the other, regarding the ultimate ownership of these referenced entities.

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[47] A more detailed description of the Diocese is contained in the Handbook

[48] Alexandria Kelly, the head of the Office of Civil Affairs ("OCA") in the RCBSD, has indicated that most of the institutions on the list are not part of their clients and she is not fully informed as to the exact ownership of each

Divisions of the Diocese

The Diocese has several different operating units or divisions. The major characteristic of each Diocesan division is their autonomy of accounting operations from the Pastoral Center. The major divisions of the Diocese are:

- Pastoral Center or Administrative Office[49]
- Holy Cross Cemetery and Mausoleum ("Holy Cross")
- Marian Catholic High School ("Marian") and Mater Dei Catholic High School ("Mater Dei")
- Vincent Memorial Catholic High School ("Vincent")
- Newman Centers:
    - San Diego State University
    - University of California, San Diego
- Catholic Secondary Education-Diocese of San Diego, Incorporated ("CSE") is a California non-profit public benefit corporation, of which the Diocese is the sole member (Exhibit 9, page 8). Cathedral Catholic High School ("CCHS") is a Diocesan Catholic high school whose facilities are owned by CSE and staffed and administered by the Roman Catholic Bishop of San Diego (Exhibit 30, page 5).

Each of the Divisions listed above will be more fully described in subsequent sections of the report.

Sources of Diocesan Revenue

The Diocese receives revenues from the following sources:

1. Parishes are assessed the Diocesan Tax (sometimes call the Parish Assessment or Chancery Tax), which is defined as 13% of their annual income[50]. The revenue from the

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institution. Her understanding is that many, if not most, of the institutions are legally formed as non-profit corporations or in another legal form and the remainder may be unincorporated associations.

[49] The Administrative Office includes a number of support functions such as accounting, legal, information technology, architectural oversight, and human resources. Bishop Brom's office is located at the Pastoral Center and, in addition to the religious programs offered at or through the Pastoral Center, the primary function of the Pastoral Center is to assist Bishop Brom in his responsibilities as Ordinary of the Diocese.

Diocesan tax totaled $6,783,611 in fiscal 2006, $6,452,541 in fiscal 2005 and $6,253,966 in fiscal 2004.

2. The Annual Catholic Appeal which generates $2.5 million a year.[51]

3. The Diocese retains earnings in excess of interest paid on deposits in the Diocesan Bank or PSDL Trust[52]. These excess earnings, accumulated over a number of years, constitute net assets[53] of the Diocesan Bank and totaled $12,439,713 as of November 30, 2006.[54] For financial reporting purposes, the Debtor allowed these earnings to accumulate in Diocesan Bank until the date of the petition, after which they were transferred, for financial reporting purposes, into the Debtor's assets and liabilities.

4. Investment income from marketable securities.

5. The Diocese earns revenue from administrative insurance and religious program fees, rental income, direct bequests, donations and interest or investment income.

<u>Accounts at the Diocese</u>

In prior hearings the Debtor has referenced in excess of 700 separate bank accounts being maintained at the parish level and an additional 500 "accounts" purportedly maintained at the Diocese level, prompting the Court to describe the accounting system at the Diocese as "Byzantine". The Expert understands the Court's frustration. The source of this frustration is

[50] Annual Income is also referred to as "Ordinary Receipts" upon the annual reports as filed by the individual parishes with the Diocese.

[51] The cash from the Annual Catholic Appeal is temporarily held at the Diocesan level but ultimately flows through to the chosen charities.

[52] The Diocese pays 3.5% interest on funds located in the PSDL Trust and periodically loans funds to parishes and schools from the PSDL, charging 4.5% for those loans, thereby earning the 1% differential. There is also a variable differential associated with investing remaining funds in the PSDL Trust. The Expert believes the PSDL Trust operates in a manner very similar to a bank, of course without the regulatory requirements, and hence the previous name of the Diocesan Bank.

[53] In a not-for-profit entity, the term "net assets" represents the amount determined by deducting total assets from total liabilities. In a normal for-profit entity, the synonymous term is "equity".

probably based upon two factors. First, the term “account” can have a number of different but distinct meanings depending upon the circumstances in which the term is used. The Expert believes the Court assumed the term “account” meant a bank account or savings account located at a financial institution which is not necessarily the same meaning ascribed to “account” by the Debtor. Secondly, for reasons described further within this Report, there truly are a massive number of bank accounts maintained at the parish or school level. The Expert believes the number of bank accounts at the parish level will exceed 900 upon completion of his analysis. The thought of analyzing 900 bank accounts is a daunting but nevertheless a manageable process. However, when any party verbally layers the potential existence of 500 separate undefined accounts supposedly maintained at the Diocese, upon the 900 accounts at the parish level, we clearly move into the realm of Byzantine.

In actuality, the number of bank accounts at the Diocese level does not even begin to approximate 500 separate bank accounts. When using the term account as being an account maintained at a financial institution, the Debtor had 35 bank or brokerage accounts at the date of petition and added three additional accounts post-petition bringing the present number of accounts to 38. (In actuality, the Administrative Office has personal control over 12 bank accounts and 8 brokerage or marketable securities accounts. The remaining accounts were controlled directly by other divisions of the Diocese.)

The following table is a summary of the 38 major financial institution’s accounts the Expert has identified in the review of the Diocese records and financial statements and other “accounts” referenced in the Debtors records:

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[54] The date of the most recent financial statement prepared post-petition by the Debtor. (Exhibit 52)

Account Type[55]	Exhibit Numbers	Number of Accounts[56]	Account Holder/Creditor
Pastoral Center bank checking	31	10	Diocese
Diocese Divisions bank checking	31	17	Diocesan Divisions
Diocese broker securities	31	6	Diocese
PSDL Trust broker securities	31	2	PSDL Trust
PSDL Trust[57] bank checking	31	1*	PSDL Trust
Servicing bank checking	31	1*	Diocese
Mater Dei Checking	31	1*	Diocesan Divisions
Total Accounts		38	

*Accounts opened post-petition

Accounts Maintained at Parishes			
Parish/School bank checking[58]	35	900 - 1000	Parishes/Schools

Depositor Accounts – Asserted Ownership in PSDL Trust Accounts			
Funds on Deposit[59] at PSDL Trust	21	218	Parishes/Schools
Funds on Deposit at Diocese	33	15	Diocese Divisions
Loans from PSDL Trust to Parish Or Schools	34	33[60]	Parishes/Schools

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[55]At the Diocesan level, all of the above accounts utilized the RCBSD taxpayer identification number ("TIN") (95-1644613) in opening bank accounts at any third party financial institutions.

[56] This is the number of accounts existing at the date of petition as well as additional accounts added subsequent to the petition filing.

[57] Previously call the Diocesan Bank. The bank account was opened in March of 2007.

[58] These accounts are found in Schedule K to the Debtor's SOFA plus all of the additional accounts uncovered by the Expert. These exclude Marina, Mater Dei and Vincent High Schools that are included in the Diocesan divisions.

[59] The Expert later refers to this as the Depositor Accounts.

The 38 bank/brokerage accounts are detailed as follows[61]:

- 10 Bank Accounts maintained at the Pastoral Center as follows:
  - 1) The Pastoral Center Main Checking Account
    - The primary checking account into which the preponderance of pre-petition monies flow from almost all sources.
    - Post-petition monies related to the PSDL Trust and servicing activities flow through two new accounts.
  - 2) Payroll Account
    - This account is used to provide payroll services to the Diocese, parishes, schools, divisions of the Diocese and CCHS.
  - 3) ACA Lock-Box Account
    - The funds from the Annual Catholic Appeal (“ACA”) are deposited into this account.
      - Prior to the bankruptcy petition, funds from the ACA were deposited directly into this account and were subsequently transferred to the Pastoral Center Main Checking Account.
      - Following the bankruptcy petition, funds from the ACA are still deposited directly into this account but are not transferred to the Pastoral Center Main Checking Account. The funds are held in the ACA lockbox until such time as the funds can be directly transmitted to the Catholic Charities.

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[60] Does not include the three separate loans to high schools.

- 4) Lay Health Checking Account
  - This account, as well as the Priest Health Checking Account below, is controlled by the third party administrator of the health plan. The Diocese, parishes and schools transmit checks directly into these accounts and the administrator pays the applicable premiums to the health insurance companies.
- 5) Priest Health Checking Account
  - This account, as well as the Lay Health Checking Account, is controlled by the third party administrator of the health plan. The RCBSD and parishes transmit checks directly into these accounts and the administrator pays the applicable premiums to the health insurance companies.
- 6) Merchant Card Account
  - This account is used to convert credit card donations and other revenue, i.e., conference registrations, tribunal payments, and Southern Cross subscriptions, to cash after which the money is transferred to the Pastoral Center Main Checking Account.
- 7) Medical Reimbursement Account
  - The Diocese funds this account through payroll withholding from the Diocese, and Service Recipients as provided under the Diocese Medical Reimbursement Plan. Employees then seek reimbursement

[61] See Exhibit 31.

from this account for qualified medical expenses not reimbursed by the insurance plan.

- 8) St. Francis Center Checking Account
  - The account is physically located at the St. Francis Center which is located near UCSD Campus. It is also the location of the Bishop's Residence and the Priest Training Center. The balances and amounts in this account have been relatively minor. The Debtor has indicated that this account will be consolidated with the Pastoral Center Main Checking Account in the future.
- 9) Inter-Parish Adult Education Checking Account
  - This account is used to receive funds and pay expenses related to certain adult education programs. There has been no activity in this account since April 2006. The Debtor has indicated that this account will be consolidated with the Pastoral Center Main Checking Account in the future.
- 10) Padre Hidalgo Center Ethnic Education Affairs Office Checking Account
  - This account has been used to receive funds and pay expenses related to a small program within the Diocese. The Debtor has indicated that this account will be consolidated with the Pastoral Center Main Checking Account in the future.

- 17 Divisional Bank Accounts
  - Holy Cross Cemetery – 1 Account
  - Marian High School – 5 Accounts

- Vincent High School – 6 Accounts
- Newman Center – 4 Accounts[62]
- Apostleship of the Sea Seafarers Center – 1 Account

- 6 Marketable Securities Accounts
    - Union Bank – 4 Accounts
        - Boston Partners Investment Manager – UBOC is the custodian of this account. The investments are made in equities.
        - Nicholas Applegate Investment Manager – UBOC is the custodian of this account. The investments are in equities.
        - PIMCO – UBOC is the custodian of this account. The investments are made in bonds.
        - UBOC Security Fund – UBOC is the custodian of this account. Investments are in Treasury bills. This account has been used as collateral for the revolving line of credit of $5 million of the Administrative. Office. The line of credit supports standby letters of credits.
    - Merrill Lynch – 2 Accounts
        - Merrill Lynch – Donation account – This brokerage account is used to convert stock gifts to cash. A minimum balance of $50,000 is required to obtain a reduction of the brokerage fees. Balances in the account have grown post-petition due to donations of stock which have been sold but proceeds have not yet been paid to the intended parish or the

Diocese. The Debtor intends to transfer money from this account to the Pastoral Center Main Checking Account prior to disbursement to the intended recipient as it did during the pre-petition period.

        - Merrill Lynch – Securities are held at Merrill Lynch who is also the investment manager. The investment manager invests in bonds.

    - UBOC – 2 accounts – PSDL Trust Securities
        - UBOC – Christian Brothers – UBOC is the custodian of this account. It is an international equity fund.
        - UBOC – UBOC is the custodian of this account. It is a growth equity fund.

Following the petition date, the Debtor opened the following three new accounts bringing the total number of accounts to 38 (See Table Above and Exhibit 31).

- PSDL Trust Checking Account – 1 Account
    - This new account, opened in March 2007, is to be used expressly for the monies deposited in the PSDL Trust by the parishes and schools. Prior to the creation of this account, all monies, including those in which the parishes and schools assert ownership interest, were deposited and commingled with all monies in the Pastoral Center Main Checking Account.
- Pastoral Center Main Checking Account – 1 Account – Now called the Pastoral Services – Main Checking II.
    - This bank account was previously the Pastoral Center Main Checking Account and was used to receive all the monies flowing through the Administrative Office.

[62] The Debtor's Bankruptcy Schedules only listed two accounts (however they referenced three additional accounts

The Administrative Office is converting the account to only receive and disburse monies related to the Service Activities for Service Recipients on a post-petition basis. This account is connected for banking purposes to the payroll account which as a zero balance account draws on the Pastoral Center Main Checking Account to cover payroll checks when they are presented for payment. Since most of the payroll paid by the Administrative Office is for the payroll obligations of the Service Recipients the Debtor finds it convenient to retain the banking relationship between the two accounts and move the Debtor's activities to the new checking account described below.

- The Debtor has not completed all of the work necessary to complete this transition. As of the May 31, 2007 Debtor's monthly operating report, over $9 million of Debtor pre petition funds remained in this account.

- New Pastoral Center Main Checking Account – 1 Account – Called Pastoral Services Main Checking Account
  - This bank account was opened in May 2007 and will receive and disburse monies of the RCBSD typically handled by the former Pastoral Center Main Checking Account with the exception of the post petition PSDL Trust money and Service Recipient money which will be handled in the two new accounts described above.
- Mater Dei Checking Account – 1 Account
  - Mater Dei High School will be operational for the 2007-2008 school year. This account has been established for receipt of tuition and fees and future payments of operating expenses.

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in a footnote) but the Expert has located four accounts.

The 500 referenced "accounts" probably relate to the individual claims the parishes and schools assert upon funds located in the PSDL Trust. As will be further explained in the report, the Diocesan Bank, or PSDL Trust received monies from parishes and schools as deposits, Funds on Deposit, upon which the parishes and schools would be paid interest. The Debtor created separate deposit accounts ("Deposit Account") for each parish or school to account for their Funds on Deposit. Most parishes and schools have multiple Deposit accounts in the PSDL Trust (as of the Petition Date the number was 201 different accounts and as of July 7, 2007 the number had increased to 218). From the monies deposited by the parishes and schools, the Diocesan Bank or PSDL Trust provides loans[63] to parishes and schools from available funds thereby creating a "loan account"[64]. As of the Petition Date loans to parishes or schools was 33 (Exhibit 16, pages 28 through 30) and as of July 7, 2007 had increased to 36. As of July 7, 2007, the total of depositor and loan "accounts" was not 500 accounts as originally estimated but 254 (218 plus 36).

There was also discussion before the Court as to the number of checking accounts maintained at the parish and school level. That number was estimated to be approximately 700. Each parish or school maintains from one to 22 individual checking accounts at banks with which the parish or school receives donations, fees, tuitions, etc, and pays operating or construction expenses or transfers excess monies to the Diocesan Bank or PSDL Trust. The Expert currently estimates the total number of checking accounts at the parish and school level to be between 900 and 1000 accounts.

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[63] These loans were subject to the approval of Bishop Brom and the Diocesan Finance Council. According to Bishop Brom (Exhibit 67), the Diocese had the authority to use these funds as the Diocese determined to be appropriate without the need to obtain approval from the parishes or schools.

Pastoral Center

From a business operations or accounting point of view, the Pastoral Center, sometimes called the Administrative Office provides the following services:

- Responsibility for the cash management of all funds flowing into the Administrative Office,
- Providing services to parishes and parochial schools in the form of centralized payroll and investments, receiving and disbursing monies for the RCBSD sponsored programs,
- Managing insurance programs,
- Accounting for Diocese transactions, assets and liabilities,
- Administration for Diocesan Bank or PSDL Trust transactions,
- Administration of Service Recipient monies,
- Human Resources,
- Financial Reviews,
- 1099 Reporting,
- Civil Affairs response to legal matters,
- Construction Services,
- Worker's Compensation and safety consulting,
- Handling of stock and investment transfers,
- Salary/Compensation guidance,
- Background checks for employees and volunteers,

[64] Assume the PSDL Trust is a stand alone entity, the loans to parishes and schools are assets of the PSDL Trust.

- Other safe environment programs including training and education, and
- Preparation of general ledgers and financial statements that report and support the other activities listed above.

Cash Management System Administration

The Pastoral Center, sometimes called the Administrative Office, maintains a cash management system ("CMS"), which is used to administer monies for its operations; monies in the PSDL Trust; and monies in servicing activities. It is intended to provided "an efficient and secure means of managing and disbursing cash for RCBSD's operations" incorporating all of the 38 banking accounts previously referenced. It contained a number of components, all of which are described in greater detail throughout the Expert Report. In its simplest terms, the CMS system provided the structure whereby the Administrative Office received and disbursed all cash flowing into the Administrative Office.

Since the Debtor's CMS revolves around the flow of cash, the report will first explain the actual flow of cash, and then explain how cash transactions are included in the Debtor's accounting system. At or about the filing of its bankruptcy petition the Debtor changed its cash management system. For reasons more fully described within the report, the Expert believes it is important to understand the comparative CMS and accounting treatment between pre-petition cash treatment vs. post-petition cash treatment.

Pre-petition Cash Management

Pre-petition the Administrative Office placed nearly[65] all cash flowing into the Administrative Center directly or indirectly into its Pastoral Center Main Checking Account at Union Bank of California. In essence, all water flowed into this pond.

The cash was received from three general sources .[66] Disbursements made from this account generally correlated to the requirements or purpose of the initial underlying receipt. (i.e., Service Activity monies from Service Recipients paid Service Activity obligations, etc.) In order to visualize the general manner in which cash flowed into the accounts of the Debtor, the Expert has prepared Chart #1 (in the following pages) with the following types of receipts (denoted in green or yellow) and disbursements (denoted in red):

1. Cash receipts from parishes and schools for deposit into the Diocesan Bank.
2. Cash disbursements from the Diocesan Bank.
3. Cash receipts for the Servicing Activities performed on behalf of parishes and schools.
4. Cash disbursements for the Servicing Activities.
5. Cash receipts for Diocese activities.
6. Cash disbursements for Diocese activities.

The arrows in Chart #1 represent the flow of cash or “in’s and out’s” from the various accounts.

[65] Relatively minor deposits were made directly into the lay or Priest Health checking accounts from Service Recipients rather than going through the Pastoral Center Main Checking Account and then being deposited into this account. Some exceptions existed for example ACA donations were first received by the ACA lockbox account where the bank cashed the check and the money was then transferred into the Pastoral Center Main Checking account. Credit card donations were “cashed” in the Merchant Credit Card account then the money was transferred into the Pastoral Center Main Checking account.

[66] The three sources are (1) Service Recipient monies, (2) inflows to Diocesan Bank or the PSDL Trust from parish and school deposits, loan repayments and investment income, and, (3) normal Diocesan receipts from other sources including the 13% Chancery tax.

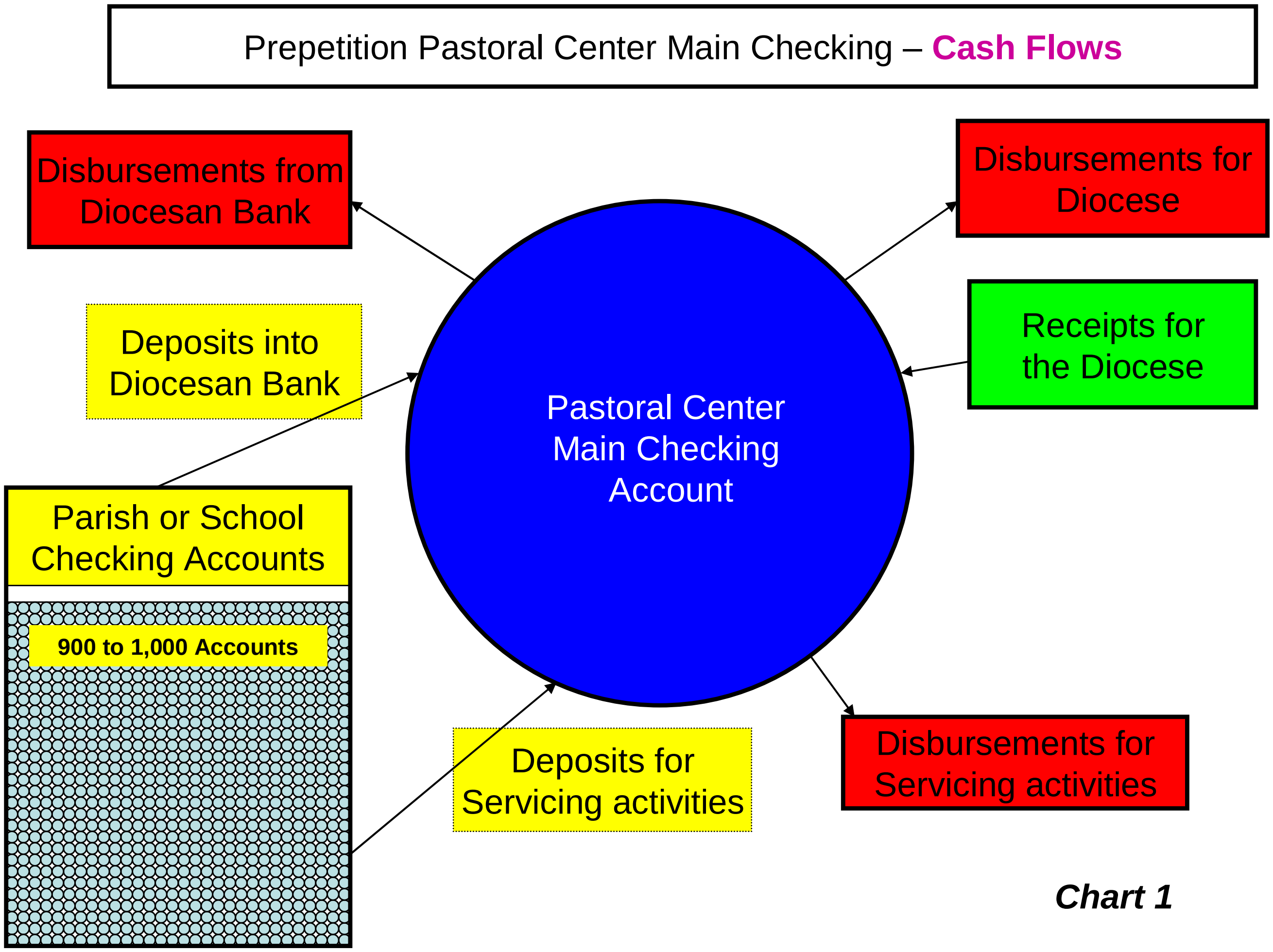


Chart 1

A separate group of bank checking accounts (approximately 900 to 1000 - see current list at Exhibit 35) accounts denoted as small circles under the yellow parish or School checking accounts heading) existed at individual parishes or schools. The parishes or schools received donations into their Parish or School Checking Accounts and used the money for their operating, religious or construction activities. These accounts were to be managed by each local parish or school pursuant to guidelines established by the Diocese (Exhibit 36).

There were two primary purposes which would cause the parishes or schools to forward funds to the Diocese into Pastoral Center Main Checking Account of the Diocese. The first was to place Funds on Deposit in the Diocesan Bank or the PSDL Trust. The second was to pay the Diocese for Servicing Activities. Those disbursements are represented by two arrows flowing from the parish or school checking accounts into the Pastoral Center Main Checking account for both Servicing activities and placing Funds on Deposit with the Diocesan Bank or the PSDL Trust.

The amount of receipts for each of the three main activities for the fourteen months prior to the petition is depicted in Chart 2 below:

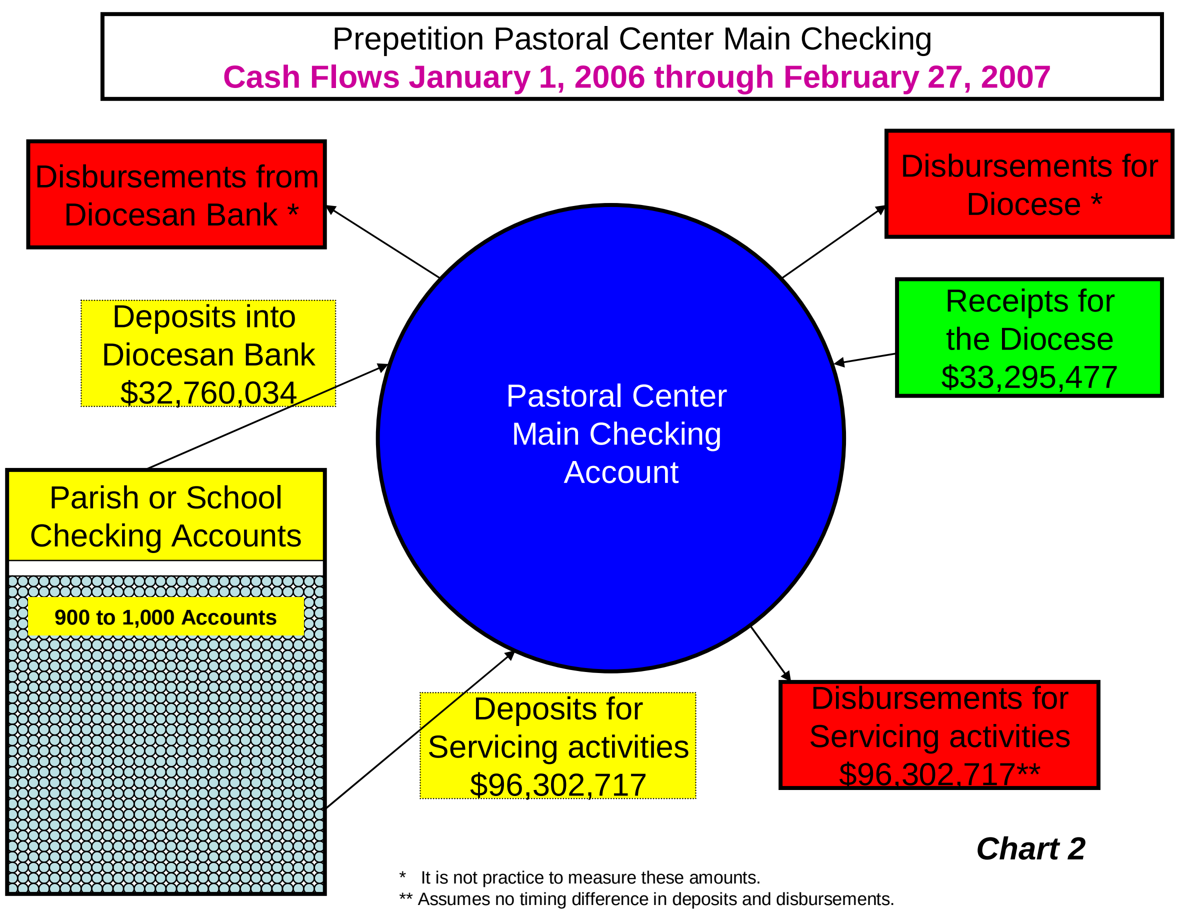
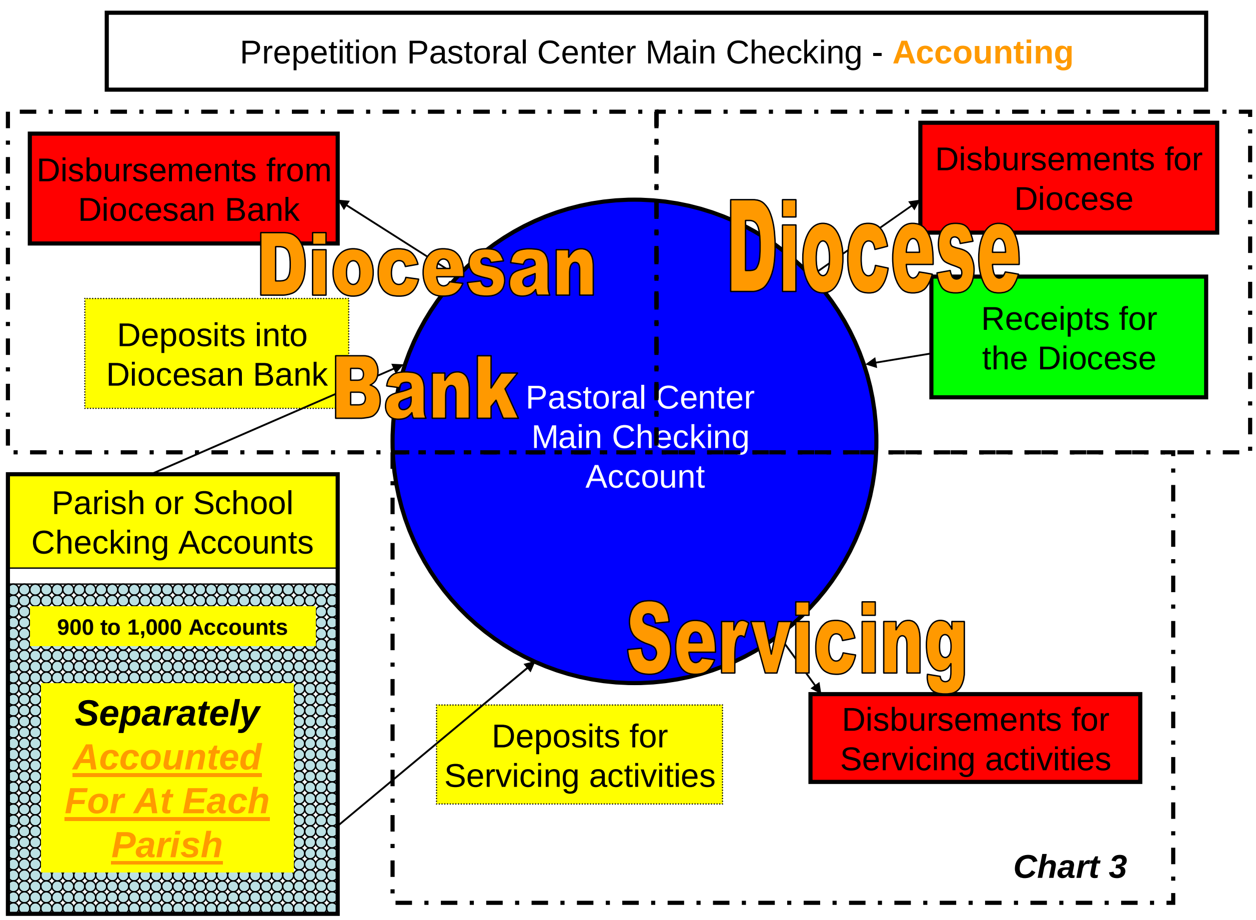


Chart 2

* It is not practice to measure these amounts.
** Assumes no timing difference in deposits and disbursements.

Another element of equal importance is the accounting treatment afforded those receipts and disbursements upon the accounting records of the Diocese. In other words, when cash flowed into this “communal pool” of cash, how was it recorded? What general ledger accounts were charged (debited or credited) to reflect the transaction?

The Expert has prepared Chart #3, which is a depiction of how the general ledger accounts were accumulated by activity to provide an accounting for the Diocesan Bank, Servicing Activities and the Diocese. The general ledger accounts were numbered or named in such a way that the receipts and disbursements could be grouped by activity. The black dashed lines represent the groups which were accumulated by activity for accounting purposes.



The other divisions of the Diocese presently maintain their own accounting systems separate from the Administrative Office and it should be noted that the Debtor's Monthly Operating Report for March 31, 2007 was the first time, other than the Debtor's bankruptcy schedules, that the Debtor prepared a consolidated financial statement including all of the Divisions of the Diocese.

Post Petition Cash Management

The general cash flows of the Debtor have remained approximately the same in the post-petition period with similar receipts and disbursements by activities[67] with two exceptions. The Debtor opened two new bank accounts at the Administrative Office as previously described. The first account is the PSDL Trust Checking Account and appears to have been established to avoid commingling monies in the Pastoral Center Main Checking Account. The second account is called the Servicing Checking Account and also appears to have been established to avoid commingling those funds in the Pastoral Services - Main Checking II Account. The Pastoral Services - Main Checking II Account now receives automatic withdrawals from the parish or school checking accounts. The Diocese handles its own funds through the Pastoral Services Main Checking Account. In essence, there are now three separate checking account pools into which the water of these entities now flow. The CMS, on a post-petition basis, is summarized in Chart #4 below:

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[67] There was a period after the Petition Date when transfers from the PSDL Trust were frozen and then later released.

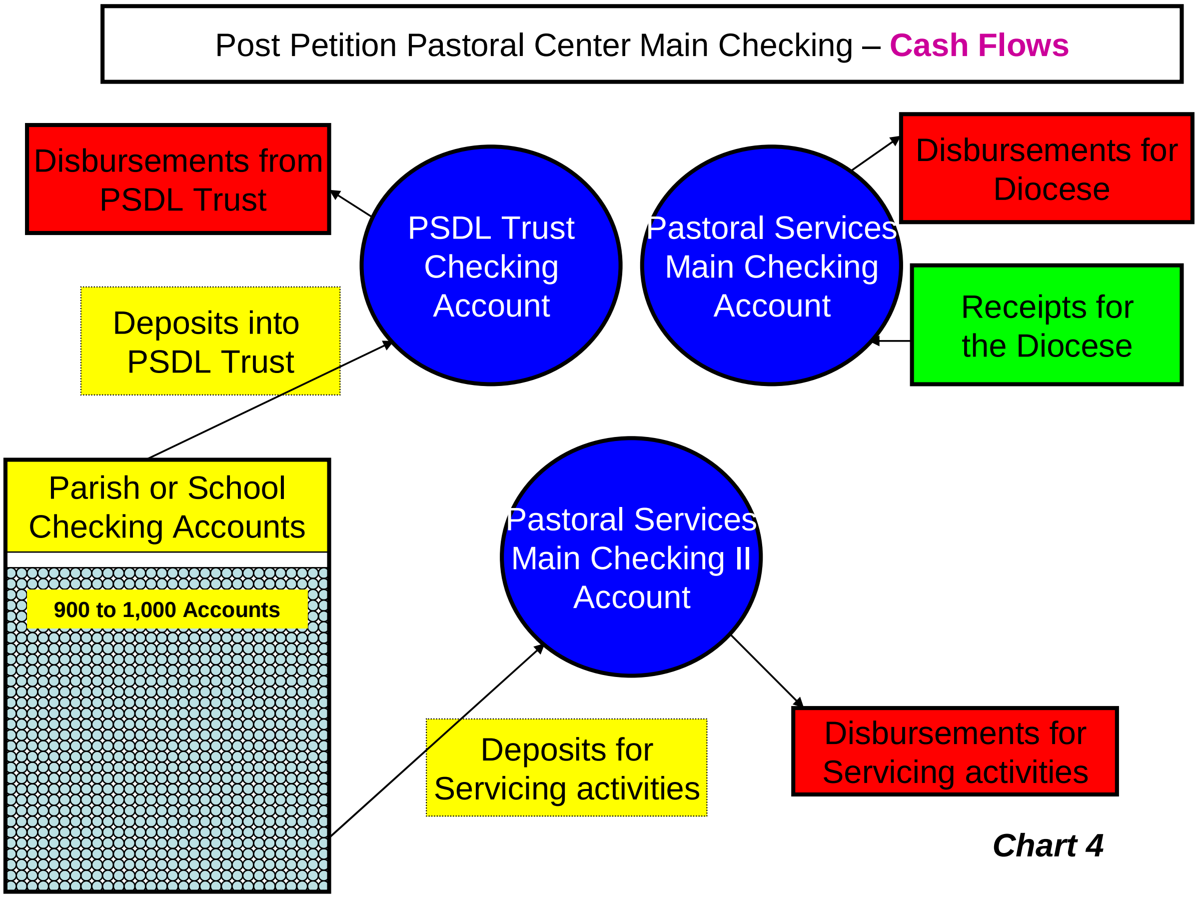
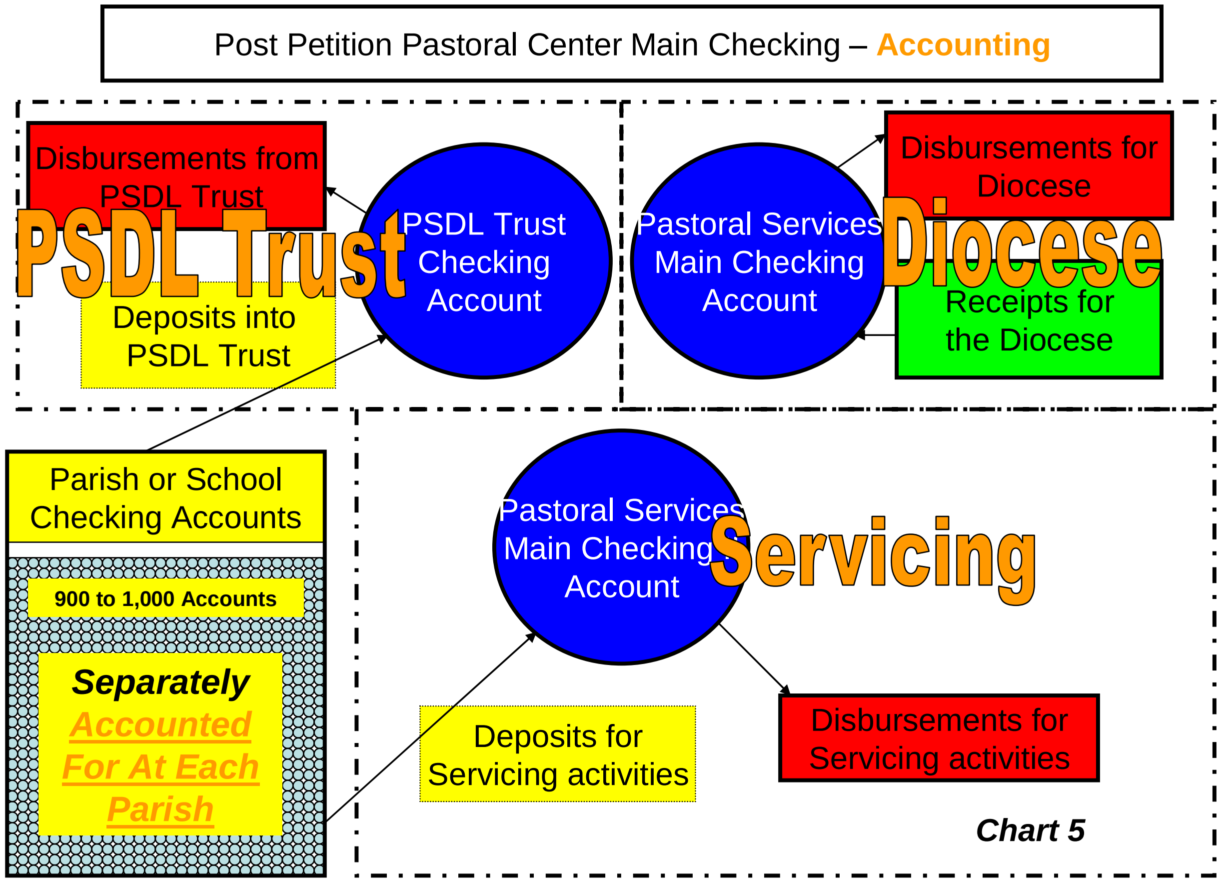


Chart 4

While the post-petition cash flow procedures have been adjusted to allow for cash to be sequestered into new bank accounts, the manner of recording those receipts and disbursements on the general ledger of the Diocese has not substantially changed (See Chart #5). The Debtor utilizes the same general ledger accounts and accumulations by activity in order for a separate accounting to be given to the PSDL Trust, Service Recipients and the Diocese.



The ACA Lockbox account is also handled somewhat differently during the post petition period. Donations were received directly into the ACA Lockbox and the balances were swept into the Pastoral Center Main Checking Account wherein the ACA monies were commingled with other monies prior to the disbursement to the affected charities. Following the bankruptcy, donations are now received directly into the ACA Lockbox and the Debtor intends to hold the funds in that account until disbursements are made to third parties, thereby avoiding the commingling of funds in the Pastoral Services Main Checking Account.

Debtor's Declarations With Regard to the First Day Motions

It is the opinion of the Expert that the representations made by Mr. Mirando (See Exhibit 5), Mr. Linscott, (See Exhibit 6) and Mrs. Jassoy (See Exhibit 7) within their declarations as attached to the FIRST DAY MOTION NO. 1 DEBTOR'S MOTION FOR ORDER: (A) AUTHORIZING CONTINUED USE OF DEBTOR'S CASH MANAGEMENT SYSTEM, are by and large correct with the following clarifications:

Linscott Declaration:

Paragraph #12 - "RCBSD has traditionally subsidized parishes. Contrary to the allegations in the Unsecured Committee's Objection, this is not part of the Debtor's cash management system. Parish subsidies are active conscious gifts made pursuant to RCBSD's mission as a faith-based non-profit organization."

> The Expert disagrees with the portion of Linscott's declaration wherein he asserts that the subsidies were not part of the Debtor's cash management system. The Expert believes all subsidizations, "gifts" or any transfers involving the PSDL Trust or Diocesan Bank were, by definition, a portion of the Debtor's Cash Management System.

Paragraph #15 - The PSDL Trust is not a component of the Debtor's operational cash management.

> The Expert disagrees with the statement contained in the Linscott declaration, Paragraph 15, concerning the PSDL Trust not being a component of the Debtor's operational cash management. The Expert believes the PSDL Trust to be an integral element of the Debtor's Cash Management System.

Mirando Declaration;

Paragraph #10 – “The Service Recipients carry on their own activities and functions and maintain and control their own bank accounts into which deposits are made and expenses paid. No one at RCBSD has access to or control over any of the Service Recipients’ accounts, any knowledge of location or depository for such accounts or the activity in those accounts.”

It is the opinion of the Expert that this portion of the declaration is not fully inclusive of the operational and audit capabilities present within the Diocese. It is true that no one at the Diocese is a signatory or actively controls disbursements or receipts into the parish or school local checking accounts and accordingly, at any given time, the Diocese may be unaware of parish and school local checking account information. However, annual reports provided by the parish to the Diocese contain bank account information. Also, although the audits of the parishes by the Diocese are only conducted every five (5) years, the audit reports provide a limited amount of banking information. In addition, in accordance with the Handbook – Diocese of San Diego – 2007 (“Handbook”), see Appendix A, the Diocese can obtain information as to the location and activity within any of the parish and school local checking accounts should they choose to do so.

Jassoy Declaration;

The Expert has no comments or clarifications concerning Mrs. Jassoy’s declaration.

Holy Cross Cemetery

Holy Cross cemetery is located at 4470 Hilltop Drive, San Diego, California. The cemetery covers approximately 40 acres and currently has approximately 65,000 buried at the cemetery and approximately 2,300 available sites in the form of graves, crypts and niches. Approximately twenty-five houses surrounding the cemetery have been acquired with the intention to expand the cemetery when sufficient demand requires. Some of the acquired houses are currently being rented. The existing cemetery layout is presented in Exhibit 37.

Mario DeBlasio is the Executive Director and General Manager. Before taking his current position with Holy Cross, Mr. DeBlasio was employed by a large commercial cemetery company. Holy Cross has approximately 25 employees and has a sales team of 4 family counselors, which negotiate terms of purchase for the burial sites.

The accounting system of Holy Cross operates autonomously from the Pastoral Center. The cemetery maintains a stand alone general ledger system and prepares financial statements separate from other divisions of the Diocese. The cemetery maintains a general bank account into which deposits from sales of burial sites, burial services and related items are placed. Expenses of the cemetery are paid from that account as well, including payroll[68] and related employee benefits. The bank account of Holy Cross is under the control of its director and not the Administrative Office of the Diocese.

When Holy Cross had accumulated surplus monies to be set aside for perpetual care or wanted to hold money separate for any reason, it transferred the money to the Diocesan Bank and designated it for the purpose for which it was being held. The Funds on Deposit were placed

[68] The Holy Cross Cemetery is the only Diocesan division that process and pays their own payroll.

in the Pastoral Center Main Checking account and commingled with other monies in that account.

Prior to the bankruptcy petition, the Holy Cross Funds on Deposit were included in the Diocesan Bank for financial reporting purposes. Following the bankruptcy, the Holy Cross Funds on Deposit are held by the Diocese and the Diocese[69] credits the Holy Cross Deposit Account with interest. Post-petition basis, the Holy Cross monies are no longer commingled with parish and school monies in the PSDL Trust.

Copies of the financial statements for Holy Cross as of the fiscal years ended June 30, 1999 through 2001 and as of April 30, 2007 are contained in Exhibits 38, 39 and 40. Ernst & Young LLP performed reviews of the financial statements up to the fiscal years ended June 30, 2001. No audits (external or internal) have been performed on Holy Cross since June of 2001. The former bookkeeper retired in 2006 and has been replaced by Bella Hael.

Examples of the purchase contract are contained in Exhibit 41 and 42. Prices vary depending on what is purchased and, almost always[70], include a fee for the future upkeep of the cemetery. According to Mr. DeBlasio the cemetery is not subject to regulation under the California Cemetery Act (the "Act") because it is owned by a religious organization. The Act requires non-religious owned cemeteries to set aside funds for future upkeep ("perpetual care"). Though he is not obligated to do so, Mr. DeBlasio has indicated that he uses the guidelines for perpetual care in the Act to determine the amounts to be charged to customers. He acknowledged that this has not always been the practice at the cemetery. The balance in the Holy Cross perpetual care fund as of the Petition Date is $6,537,885 and is listed as restricted in the Debtor's Bankruptcy

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[69] This is an interdivision obligation of the Debtor and hence does not appear as a creditor's claim on the Debtor's schedules as an unsecured claim.
[70] The ability to pay is a consideration.

Schedules. A corresponding amount was transferred to the Diocese and held as Funds on Deposit, and is commingled with the other assets of the Diocese.

Holy Cross also carries what it calls "Deferred Revenue" as a liability in its balance sheet. This represents sales that have been made and booked but Holy Cross still needs to provide the goods or services. In some cases the purchaser still owes amounts to Holy Cross. As of the Petition Date the Debtor listed $3,197,475 of Deferred Revenue and as restricted assets. (See discussion on Restricted Assets below.)

Holy Cross uses the Diocesan tax identification number 95-1644613 for each of their accounts and no changes have been made post-petition.

Marian Catholic High School and Mater Dei Catholic High School

Marian is located at 1002 18th St, San Diego, California. It is a high school covering grades 9 through 12, with approximately 750 students. The school recently completed its last year of operations and the students will be transferred to Mater Dei commencing with the new school year. The Marian property is being prepared for sale.

Mater Dei is located at 1615 Mater Dei Drive, Chula Vista, California. It has a capacity of 2,000 students. First year attendance is estimated at 750. A copy of the map of the school property is contained in Exhibit 43.

The Mater Dei facility has been substantially funded from a loan of $22.8 million from the Diocesan Bank or PSDL Trust and advances from a loan the Debtor asserts is secured by the property of $50 million from Alsam Foundation. The loan with Alsam Foundation requires the Diocese to establish a $25 million scholarship fund for needy students of the school (see Footnote 15 to Exhibit 9).

The accounting function of Marian (as will Mater Dei) operates autonomously from the Pastoral Center. It maintains it own bank accounts through which it receives tuition and fee income along with income from various activities including the booster club and donations for an English second language class.

Marian has been audited by Ernst & Young LLP up to the fiscal year ended June 30, 2004. Copies of the financial statements for the fiscal years ended June 30, 2004, 2003 and 2002 are contained in Exhibits 44 and 45 and for the ten months ended April 30, 2007 in Exhibit 46.

Marian has the following five (5) bank accounts which are listed on Exhibit 31.

<u>Marian Main Checking</u> – This account receives tuition and fees and is used to pay the operating expenses of Marian. Excess funds were sent to the Diocese where they were deposited in the Pastoral Center Main Checking Account and held as Funds on Deposit in the Diocesan Bank. The Diocese accrues interest on these monies.

<u>Marian San Juan Diego Checking</u> – This account represents the donations toward an English second language program at Marian. The expenses associated with the program are advanced by Marian from the Marian Main Checking account and is then reimbursed from this account. The Debtor lists the funds in this account as restricted in the Debtor's Bankruptcy Schedules in the amount of $280,294. Marian had expended approximately $109,344 as of the Petition Date for which it had not been reimbursed.

<u>Mater Dei Checking</u> – This account has been created post petition to handle the tuition and other fees for schooling at Mater Dei. The balance in the account represents tuition for the next school year and is considered restricted by the Debtor.

<u>Marian Student Body Checking</u> – The money from student body activities are deposited into this account and the expenses related to such activities are paid from the account.

Marian Education Fund Checking – This account contains scholarship funds for needy students.

Marian Booster Club Checking – Money collected from booster club activities are deposited into this account and expenses related these activities are paid from the account.

Marian Funds on Deposit with Diocese – Marian had Funds on Deposit with the RCBSD of $1,380,216 as of the Petition Date. Pre-petition these funds were listed as Funds on Deposit with the Diocesan Bank. Because Marian is a division of the Diocese, post-petition Funds on Deposit are the responsibility of the Diocese and are not included in the PSDL Trust.

Mater Dei, the successor school to Marian, has $1,532,170 of Funds on Deposit with the RCBSD which represent donations through the Secondary Education Initiative which have been designated as such by the donors for Mater Dei. This amount is considered restricted by the Debtor.

Marian and Mater Dei both use the Diocesan tax identification number 95-1644613 for each of their accounts and no changes have been made post-petition.

Vincent Memorial Catholic High School

Vincent is located at 525 West Sheridan St., Calexico, California. It is a high school with a maximum enrollment of 350 students of which 52% of the students enrolled come from Mexico.

The accounting system of Vincent operates autonomously from the Pastoral Center. It maintains its own bank accounts through which it receives tuition and fee income, and income from various activities including the booster club, cafeteria, and other fund raising projects. The Debtor bankruptcy schedules show no restricted funds at Vincent even though it had prepaid tuition and deferred revenue in a manner similar to Marian. These two positions appear inconsistent to the Expert. The Debtor's May 31, 2007 Monthly Operating Report now shows $120,000 as restricted.

Vincent has the following six (6) bank accounts which are detailed in Exhibit 31.

<u>Vincent Main Checking</u> – Tuition and fees are deposited into this account and recurring expenses are disbursed from this account.

<u>Vincent Cafeteria Checking</u> – Proceeds from the sale of food at the school's cafeteria are deposited into this account and operational expenses of the cafeteria, including food, are disbursed from this account.

<u>Vincent Booster Club Checking</u> – Proceeds from fundraisers for sports and concession sales at sporting events are deposited into this account. The money is utilized for the purchase of equipment and new uniforms for the sporting teams.

<u>Vincent PTG</u> – This account contains a required contribution of $300 per family plus funds which result from fundraiser events. Expenses of approximately $4,000 are paid from the account and the excess is used to repay the non-interest bearing debt owing to the Diocese.

<u>Vincent 2001 Savings</u> – Funds paid by parents as a required part of tuition for facilities maintenance along with prepaid registration fees are deposited into this account. The registration fees are held within this account until the new school year arrives after which the fees are transferred into the Vincent Main Checking account. Maintenance expenses are also paid from this account.

<u>Vincent Gym Project Savings</u> – The balance in this account has accumulated from surplus funds over time. It is not restricted by the Debtor and it is intended for refurbishment of the Gym. The Gym did not have air conditioning until 2007.

Vincent has no Funds on Deposit at the Diocese. As of the petition date, Vincent owed the PSDL Trust $285,911.84 in a non-interest bearing obligation. The tax identification number for each of these accounts is the Diocesan tax number of 95-1644613 and has not been changed.

The financial statements provided to the Expert from Vincent are included herein as Exhibits 85 through 89.

<u>Newman Centers</u>

The Diocese sponsors Catholic activities for college age students at San Diego State University and the University of California, San Diego. Each center has maintained their own checking accounts and produces a general ledger and financial statement. Some of the checking accounts contain funds which were raised or collected for special projects such as a house building activity that is held annually in Tijuana, Mexico, the Hurricane Fund, and the Rice Bowl fund, which provides food to the poor. Each of the Newman Centers maintains a checking account which holds receipts from collections at Mass, the subsidy from the Diocese and other contributions. An account for the rectory is maintained at the Newman Center located on the campus of San Diego State University. The special projects monies are listed as restricted as of the Petition Date, but no balances are remaining as of the May 31, 2007 Monthly Operating Report[71] (Exhibit 47)

<u>Cathedral Catholic High School (“CCHS”)</u>

According to the financial statements of CSE, for the year ended June 30, 2006 (Exhibit 30), CCHS is owned by CSE, which is a separate not-for-profit corporation. CCHS is located at 5555

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[71] The Debtor reports that this was an oversight and will be changed in subsequent reports.

Del Mar Heights Road, San Diego, California. In addition to CCHS, according to its financial statements, CSE owns the land and facilities of the University of San Diego High School ("USDHS").

According to the financial statements of the USDHS for the years ended June 30, 2005 (Exhibit 49), the USDHS was a part of The Roman Catholic Bishop of San Diego, a corporation sole and had no separate legal status or existence and the USDHS was subsumed by CCHS July 1, 2005. It appears that the USDHS land and buildings were transferred into CSE for which the Debtor received no consideration.

The Debtor shows a contingent reversionary interest in the land and buildings of the USDHS upon the dissolution of CSE worth $65 million as part of its assets as of the Petition Date (Exhibit 50). The Debtor has indicated that upon sale of the USDHS land and buildings, the proceeds will be paid to the Debtor and available for creditor payments.

CSE received $29.6 million of California Statewide Communities Development Authority issued Variable Rate Demand Revenue Bonds on May 1, 2003 for the purpose of financing the construction of CCHS. Allied Irish Bank issued an irrevocable direct pay letter of credit on behalf of CSE for the purpose of paying principal and interest due on the bonds. The Debtor entered into a guarantee agreement with Allied Irish Bank to guarantee the repayment of amounts due by CSE (Exhibit 30, Footnote 6).

The RCBSD, as administrator of the Diocesan Bank, agreed to accept a non-interest bearing demand note payable from CSE in the amount of $14,551,403 for funds loaned to purchase the land for CCHS. The demand note is subordinated to the bonds (Exhibit 30, Footnote 6). The Debtor carried the $14,551,403 demand note as an asset of the Diocesan Bank up to the Petition Date and the PSDL Trust post petition (Exhibits 9 through 12, pages 2 and 3).

CSE had Funds on Deposit with the Diocesan Bank and the PSDL Trust in the in the amounts of $633,299 and $1,138,886 as of March 31, 2007 and June 30, 2006 respectively (Exhibit 48, third page).

IV.

Diocesan Trust Relationship and the PSDL Trust

<u>Diocesan Bank – Pre-Petition</u>

Prior to the Debtor's bankruptcy, the Debtor received money from parishes, schools, CSE and Diocesan divisions for deposit into their Deposit Account at the Diocesan Bank. The Debtor would physically deposit the check into the Pastoral Center Main Checking account and credit the respective parish Deposit Account.

The Debtor's general ledger system uses a unique series of numbers (231, 232 or 145) to identify Depositor Accounts from other accounts of the Debtor. An additional series of numbers are added to one of the three series above to identify the individual owner of the Depositor Account. For example St. John's account number might be 0452 <u>231</u> 00, 0452 being the identifier for St. John, "231" for the Diocesan Bank, and "00" for the number of accounts of St. John in the Diocesan Bank. If St. John's had more than one account the last digit would be changed to a "1" or "2" for each new account. (0452 231 <u>01</u> or 0452 231 <u>02</u>) The Debtor provides a listing (Exhibit 16 Page 19-29) of Depositor Account balances in its Statements of Financial Affairs ("SOFA"). Some depositor accounts were closed pre-petition and accordingly they are not included in Exhibit 16. A complete activity report for each Depositor Account from January 1, 2006 through March 31, 2007 is contained in Appendix E.

The balances of each Depositor Account were subjected annually to testing and confirmation by Ernst & Young as part of their annual audit. Parishes and schools have access to information on their accounts online. It is the Expert's opinion, from working with many of the parishes and schools, that parishes and schools have been vigilant in insuring that the balances in the Depositor Accounts are correct.

Some of the Depositor Accounts would name the purpose of the funds and be entitled "restricted", such as "building fund" while other accounts would have no indication for the purpose of the money in the account. Some of the funds deposited by parishes are designated as endowment funds. (Exhibit 16, pages 28 to 30).

The Administrative Office General Fund within the Diocesan Office Funds Financial Statements for the years ended June 30, 2002 through 2006 (Exhibits 9 through 12, page 2 and 3) and for the five months ended November 30, 2006 (Exhibit 52) have no restricted net assets. All of the net assets[72] in the Diocesan Bank are shown as unrestricted. The Debtor's unrestricted net assets in the Diocesan Bank are further broken into two groupings, one designated for Diocesan purposes, such as construction work on parishes. This amount exceeds the total of all unrestricted assets indicating the Diocese had designated more money to projects than it had available net assets.

Money in the Diocesan Bank could be borrowed by a parish or school if they met the requirements of the lending policies (Exhibit 53). The total amount owing from all parishes and schools to the Diocesan Bank for the period ending November 2006 was $16,383,068, with an allowance for uncollectible accounts of $450,249. The preponderance of the loans made to parishes and schools were for construction or renovation, but in a few instances loans were made for short term operating needs. The Debtor, as part of the Diocesan Bank, has carried a reserve

[72] Net assets are computed as total assets less total liabilities and represent the "equity" of the not-for-profit.

between $450,000 and $1,479,743 for bad debts against the loans to parishes since 2002. A history of bad debt write-offs is contained in Exhibit 54.

As explained below, according to the Diocesan Office Funds Financial

Statements prepared by the Debtor the Diocesan Bank during the fiscal years ended June 30, 2002 through 2006 and for the five months ended November 30, 2006, contained the following assets:

a) All the marketable securities of the Diocese,

b) The land and building for new high schools, and

c) Loans to parishes and schools.

The liabilities of the Diocesan Bank consisted of:

a) Parish and school Funds on Deposits,

b) Monies of Marian, Newman Centers, and CCHS Funds on Deposit, and

c) Administrative Office monies that were included in the Interfund account.[73]

The Diocesan Bank segregated no assets specifically to provide for one or more of its liabilities. In other words, all of the Funds on Deposit were commingled among the assets of the Diocesan Bank even though, on an accounting basis they maintained separate Depositor Accounts as referenced above.

[73] The Administrative Office funds are shown on the “Interfund account” line item.

PSDL Trust - Post Petition

In order to explain the changes made by the Debtor post petition, The Expert has prepared a comparative statement of financial position for the PSDL Trust/Diocesan Bank (Exhibit 55). The financial information contained in Exhibit 55 comes from the following sources:

1. For fiscal years ended June 30, 2002 through 2006 the "Diocesan Office Funds of the Roman Catholic Diocese of San Diego" audited by Ernst & Young LLP (Exhibits 9 to 12).
2. For the five months ended November 30, 2006, the "Diocesan Administrative Offices and the Diocesan Bank" unaudited, "For Internal Purposes Only Draft," unaudited and represented to be the last financial statement prepared by the Diocese accounting department prior to the Petition Date (Exhibit 52).
3. Debtor's bankruptcy Statements of Financial Affairs ("SOFA"), page 19 to 30 (Exhibit 16).
4. Debtor's Monthly Operating Report ("MOR") for May 31, 2007 (Exhibit 56).

Post petition the Debtor maintains the same deposit and recording procedures described above for the Diocesan Bank with the following changes the Debtor made as it approached the date of their filing:

1. Began referring to the Diocesan Bank as the PSDL Trust.
2. The Debtor set up a separate bank account in March 2007 to transact the receipts and disbursements which were previously handled by the Pastoral Center Main Checking account for the PSDL Trust checking account (Exhibit 31).
3. The Diocesan Office Funds Financial Statements of the Debtor provided separate columns, representing the assets, liabilities, and net assets, for the Administrative Office General Funds, Administrative Office Restricted Funds, Bishop's Burse and the Diocesan Bank. At or about the time of the petition the Debtor made the following changes to its account presentation.
    a. A majority of the marketable securities, which were listed as assets of the Diocesan Bank were transferred to the Debtor.
    b. The Depositor Accounts for Holy Cross, the Newman Centers, and Marian were withdrawn from the Diocesan Bank liabilities and were transferred to the

liabilities of the Debtor.[74]. The Funds on Deposit of CCHS remain with the PSDL Trust

c. Land and buildings for new high schools of $33,158,776 were likewise removed from the assets of the Diocesan Bank and placed into the Debtor's assets.
d. The "Interfund account", which represents a balance owed to the Debtor, in the amount of $19,284,604 was eliminated from both the Diocesan Bank and the Debtor.
e. From the Petition date forward there are no net assets in the PSDL Trust since the amount of assets and liabilities are equal. The Debtor reports that it has been and continues to be entitled to any increases in net assets[75] in the Diocesan bank or PSDL Trust.

The effect of the changes listed above is to separate the assets, liabilities and activities of the Debtor from the PSDL Trust in which it had previously been commingled.

<u>Debtor's Authority to Maintain the PSDL Trust</u>

The Diocese filed a "Certificate of Amendment to Articles of Incorporation of The Roman Catholic Bishop of San Diego, a corporation sole" on December 19, 2005 (Exhibit 4). This amendment contains an addition to Article 19 of the Articles of Incorporation of The Roman Catholic Bishop of San Diego, a corporation sole which states:

"(i) This corporation is formed for the purpose of administering and managing the affairs, property, and temporalities of the Roman Catholic Diocese of San Diego, and <u>holding in trust</u> (underline added) and managing in accord with the powers set forth in §10007 of the California Corporations Code, Canon, Law, and the other rules, regulations, laws, ordinances, and discipline of the Roman Catholic Church all of the real property, personal property, and funds of the Roman Catholic Diocese of San Diego in the name of The Roman Catholic Bishop of San Diego, a corporation sole, <u>as trustee, in</u>

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[74] The Deposit Accounts of the Diocesan divisions do not create creditor claims because they are part of the Debtor's bankruptcy estate.
[75] A question remains as to who would be responsible for any decreases in the net assets of the PSDL Trust (Ex 68)

> trust for specific beneficiaries, which are the parishes, schools, cemeteries, and laity (underline added) of the Roman Catholic Diocese of San Diego as those juridic persons and entities are defined by Canon Law and the established structure, rules, regulation, laws, ordinances, and discipline of the Roman Catholic Church, as may be amended or restated from time to time, and ensuring to said beneficiaries all of the use, benefits, rights and obligations of said property, conferred on them by Canon Law and the establishment, rules, regulations, laws, ordinances, and discipline of the Roman Catholic Church."

The Expert requested the Debtor to provide the Canon Law explanation which establishes the religious justification for parishes, as juridic persons, to be entitled to own property separate from the Diocese and the justification for the PSDL Trust. In response to that request, the Debtor provided an opinion and justification as propounded by Father William J. King, J.C.D.(Exhibit 57), wherein Father King discusses the various elements of Catholic Canon Law 1276. The Expert understands that the material quoted herein is the opinion of Father King and other similar scholars may have differing opinions. However, this was the material provided to the Expert by the Debtor with the understanding that it provided the basis for the Debtor's position concerning the proper accounting of such property.

Listed below are a few of the relevant portions of Father King's article which may pertain to the existence of a trust relationship:

1. According to Father King, Canon 1276 provides that juridic person's property held by the bishop does not imply ownership of that property:

"…Book V of the *Code of Canon Law* attributes rather broad authority for a diocesan bishop to establish either particular law or instructions regarding the administration of temporal goods in public juridic persons subject to his visitation or indirect oversight. <u>This does not imply ownership of these goods and properties by the diocese</u> (underline added), or the right of control over them by the diocesan bishop or any member of the diocesan curia, however. It does imply a structuring of administrative discretion by rule-making or the establishment of norms which broadly affect all who engage in temporal administration within a diocese…" (Exhibit 57, page 84, first paragraph)

2. Father King states that Canon 1276 provides that a bishop may mandate participation in centralized financial services and practices:

"…a diocesan bishop may mandate participation by parishes and other ecclesiastical entities subject to his temporal vigilance in centralized financial services and practices. This may include the mandate for diocesan management of parish monies through a joint investment fund, and therefore the mandate that all funds be deposited in that central fund. It may include the mandate that all parishes and other employee entities receive centralized payroll services, or centralized services for employee benefits and tax withholding. It may include as well the mandate to participate in other centralized accounting services provided for parishes and other entities, <u>even a diocesan "savings and loan" fund which services parishes and other Catholic institutions</u> (underline added). It may include services other than fiscal operations, such as management and maintenance of real property and physical plant." (Exhibit 57, page 87, top paragraph)

3. Father King says that Canon 1276 describes the independent relationship of parishes to the diocese:

"…Parishes and other independent entities <u>are not "branch offices" of the diocese (underline added)</u> and cannot be treated as such in any mandated accounting or management system. The proper autonomy and discretionary authority of pastors and other must, as a matter of law, be maintained." (Exhibit 57, page 87, third paragraph)

4. According to Father King, the four principles which "…must be respected and protected in the design and implementation of a centralized diocesan financial system" (Exhibit 57, page 86, bottom) are as follows:

1. Proper ownership (dominium),
2. Proper control,
3. Proper accounting and
4. Scrupulous attention to intentions and rights.

5. Father King believes Canon 1276 requires ownership to be reflected in a centralized accounting or financial service:

> "Proper ownership of assets – real, moveable, or financial – must be reflected in every aspect of a centralized accounting or financial service (underline added). The peril of not doing so is apparent, as it subjects the assets of any or all juridic persons to loss from any number of causes."

> "A reflection of proper ownership (dominium) in every aspect of centralized practices and in all reporting of assets and services is an absolute requirement for any mandated central service." (Exhibit 57, page 87, second paragraph)

6. It is Father King's opinion that Canon 1276 requires consolidated financial statements to distinguish between parish monies and diocesan monies:

> "Proper accounting is a requirement as well, namely that all accounting practices, methods, and reports need to indicate proper canonical ownership of properties, funds, and assets. It is not proper to issue a consolidated statement or report which does not

distinguish between, for instance, parish monies and diocesan monies, or which does not distinguish each parish's assets from all others (underline added). Not only must any centralized fiscal or property management service conduct its bookkeeping according to secular accounting standards, it must also observe rigorously the reality of its operations under canon law, and never commingle assets in accounting methods (underline added), but always reflect and observe proper ownership and control through accounting practices which make it clear that each parish or institution owns and controls its own assets and funds, even if certain services are offered or mandated by the diocese. Performing a service in managing assets and monies does not ever transfer ownership. Accounting methods and reports must be designed and carried out so that this reality is reflected and is evident…" (Exhibit 57, page 88, first paragraph)

The Debtor indicated to the Expert that the policies implementing that which is required by Canon 1276 are set forth in the *Handbook – Diocese of San Diego* (the "Handbook"). The Expert found no direct reference to a "trust" in the narrative of the Handbook. The Handbook (Appendix A) contains two pages (Exhibit 58) regarding these policies and the accounting related thereto.

Financial Statements of "The Diocesan Office Funds of The Roman Catholic Diocese of San Diego"

The Debtor prepared and issued financial statements for its fiscal years ended June 30, 2002 through 2006 (Exhibit 9 through 12). The names of the financial statements are "Diocesan Office Funds of The Roman Catholic Diocese of San Diego" ("Diocesan Office Funds Financial Statements"). The Diocesan Office Funds Financial Statements report on five different funds within the Diocese (Exhibits 9 through 12, pages 2 and 3) including the following:

1. Administrative Office General,
2. Administrative Office Restricted,
3. Property,
4. Bishop's Burse, and
5. Diocesan Bank.

1) The Administrative Office General Fund does not include the financial information for all of the divisions or programs of the Diocese. Specifically excluded are Holy Cross, Marian, Vincent, and the Newman Centers.

2) The Administrative Office Restricted Fund shows cash and cash equivalent assets equal to the amount of restricted net assets. An itemization of the restricted net assets is found in Footnote 8 (Exhibit 9, page 14). Contrary to this presentation, the Debtor did not maintain a separate bank account pre-petition which held the restricted cash[76] separate from the other assets of the Administrative Office.

3) The Property Fund existed for the years ended June 30, 2002, 2003 and 2004, representing property related to the construction of high schools in the Diocese. In later years these balances were combined with the Diocesan Bank (Exhibits 9 and 12, pages 2 and 3).

4) The Bishop's Burse Fund shows cash and cash equivalent assets equal to the amount of unrestricted designated assets. The Debtor provided no segregated assets for these amounts. This fund represents monies designated to provide a residence for the current bishop (Exhibit 9, page 10). This fund was first presented as a separate fund in the year ended June 30, 2004. Prior to that date, the Debtor did not maintain a separate cash bank account for the cash specified in this fund.

[76] See below for discussion on restricted assets vs. restricted net assets.

5) The Diocesan Bank reported that it held land which has now been utilized for the construction of parishes and schools, marketable securities, and loan receivable amounts from parishes and schools as assets. The liabilities shown in the Diocesan Bank are the Funds on Deposit from parishes, schools, and divisions of the Diocese[77].

The Diocesan Office Funds Financial Statements present each of the funds in four columns and totals them leaving the reader with the impression that the total represents the assets, liabilities and net assets of the Diocesan Office Fund.

In Footnote 6 to the audited financial statements for the years ended June 20, 2002 through 2006 the Diocesan Bank is described as:

> "The Administrative Office administers the "Diocesan Bank," *a program* (italics added) which finances the construction and renovation of parish and school facilities from deposits made by the parishes and schools of their excess fund. The deposits currently earn interest of 3 ½%. Loans to parishes and schools generally have fixed terms which can range up to 25 years…" (Exhibits 9 through 12, page 13, Footnote 6)

The Diocesan Office Funds Financial Statements were audited by Ernst & Young LLP for the years ended June 30, 2002 through 2006. In the course of their audit, Ernst & Young LLP obtained representations concerning the financial information from the management (a "management representation letter") of the Diocese (Exhibit 8). Management representation letters are obtained by an auditor in the normal course of their engagement for the purpose of obtaining written representation by the management attesting that the information in the financial statement is correct. The management representation letters were signed by Bishop Robert H. Brom, Hal Gardner, Director of Finance, (now deceased), and Karen Jassoy, Controller.

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[77] The Diocesan Bank had Funds on Deposit from Holy Cross, Marian and CCHS (Exhibit 69)

Concerning the ownership of assets in the Diocesan Bank, the Debtor's management representation letters for the year ended June 30, 2205 and 2006 state:

"Ownership and Pledging of Assets"

> "The Diocesan Office *has satisfactory title to all assets* (italics added) appearing in the statement of financial position. No security agreements have been executed under the provisions of the Uniform Commercial Code, and there are not liens or encumbrances on assets, nor has any asset been pledged." (Exhibit 8, page 2)

The Diocesan Office Funds Financial Statements make no disclosure of a trust relationship and give no indication that any asset in the Diocesan Bank belongs to anyone other than the Diocese. Should such a position be taken, it would be in direct conflict with the representations made by the Debtor's officers in the management representation letters

It appears that contrary to Father King's opinion as outlined in his article concerning Canon 1276, the Debtor issued consolidated statements or reports which do not distinguish between the ownership of parish monies and Diocesan monies (Exhibit 57, page 88, first paragraph).

The Diocesan Office Funds Financial Statements were provided to a number of financial or other institutions in connection with financing or other arrangements. From an accounting perspective, it would also be a critical misrepresentation to report that assets belonging to others are included in the Diocesan Office Funds Financial Statements as the Debtor's assets, particularly in light of the potential third parties reliance thereon[78]. Some of the entities receiving financial statements[79] are as follows:

- Union Bank of California,
- Bank of America,
- Allied Irish Bank,
- California Department of Insurance for Gift Annuities,
- California Department of Insurance – Self Insurance Plans for Workers' Comp,
- Insurance carriers CMG and CMU, and
- The Department of Motor Vehicles.

According to the minutes of the Finance Council, the Diocesan Office Funds Financial Statements were intended to be made available to the public. A printout of the current summary financial information contained on the Debtor's website (www.diocese-sdiego.org) can be found in Exhibit 59. The website presentation has been modified and only presents the funds for the Administrative Office, General and Restricted[80] which was different from the financial presentation made to the above referenced entities.

Reliance on the Diocesan Office Financial Statements to Meet Debt Guarantee

Footnote 10 of the Diocesan Office Funds Financial Statement for the years ended June 30, 2002 through 2006 (Exhibits 9 through 12) describe a guarantee between the Debtor and the revenue bonds that in part financed the construction of the Cathedral Catholic High School, originally in the amount of $29.6 million and with annual principal reductions of $600,000. Certain loan covenants of the guarantor are discussed in Footnote 10 to the financial statements

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[78] Perhaps this is acknowledged in Exhibit 57, page 87, second paragraph when Canon 1276 refers to, "…The peril of not doing so is apparent, as it subjects the assets of any or all juridic persons to loss from any number of causes."

[79] The Expert does not represent this to be a complete list of all of the parties that may have received and relied upon the Diocesan Office Funds Financial Statements of the Debtor, but these parties have been currently identified by some of the Debtor responsible parties as being recipients.

and the management of the Debtor and auditor declare the Debtor in compliance with the covenants of the guaranty.

Noting that the debt was funded in May of 2003, two of the covenants described in the Footnote 10 could not be met in subsequent years without including all the assets of the Diocesan Bank, which are supposedly held in trust by the Diocese in behalf of the parishes and schools and other claimants.

The first covenant is the requirement to maintain a minimum of $10 million in unrestricted cash and readily marketable securities[81] which was only possible in the years ended June 30, 2004 and 2006[82] with the inclusion of all of the cash and marketable securities in the Diocesan Bank. The calculations in Exhibit 13 demonstrate this fact. There is a complete absence of cash or marketable securities in the Administrative Office Fund in fiscal year 2006 sufficient to comply with this covenant without including the funds supposedly being held in trust. Even adding to the Administrative Office Fund amounts the Bishop's Burse Fund does not satisfy the financial covenant. Only by adding the cash and marketable securities in the Diocesan Bank can the covenant be met.

The second covenant mentioned in Footnote 10 is the requirement to maintain a ratio of assets of unrestricted cash and temporarily restricted cash and marketable securities[83] to debt of

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[80] The Diocesan Bank and Bishop's Burse are not included.

[81] The Guarantee Agreement (Exhibit 60, page 2) defines unrestricted cash and readily marketable securities as, "…all cash, cash equivalents, and Readily Marketable Securities held by the Guarantor and treated under GAAP in a manner consistently applied, as historically applied by the Guarantor as unrestricted and available for use for the payment of principal or premium, if any, and interest on Debt or <u>for the payment of operating expenses</u> (underline added) of the Guarantor."

[82] When the Diocesan Office Financial Statements were first issued for the year ended June 30, 2004, the Property fund was shown as a separate fund. In 2005 the Property fund was merged with the Diocesan Bank and a correction was made which moved the Accounts Receivable, CSE from the Administrative Office General fund to the Diocesan Bank. Hence, the 2005 presentation of the 2004 financial information would qualify on this loan covenant where the 2004 presentation would not.

[83] The Guarantee Agreement (Exhibit 60, page 2) defines unrestricted cash and temporarily restricted cash and marketable securities as, "…all cash, cash equivalents, and Readily Marketable Securities held by the Guarantor and

not less than .75:1. That ratio, as detailed in Exhibit 14, cannot be met without including the assets of the Diocesan Bank which are supposedly being held in trust in behalf of the parishes and schools. The Administrative Office unrestricted cash and temporarily cash and marketable securities are shown in Exhibit 14. The ratio to the then outstanding debt balance is calculated and demonstrates the failure of this loan covenant based solely upon these Administrative Office General Fund assets in 2004, 2005 and 2006. If the Bishop's Burse is added and the ratio to the then outstanding debt balance is recalculated there still exists a failure to meet the loan covenant in these three years. With the addition of the Interfund account balances, assuming them to be cash (which they probably are not for purposes of the covenant definition), there is a failure to meet the loan covenant in these three years. Only after adding the Diocesan Bank assets does the Debtor meet the required loan covenant.

The definitions in the loan covenants (Exhibits 60, page 2) refer to cash, cash equivalents, and Readily Marketable Securities held by the Guarantor that are available for the payment of "operating expenses of the Guarantor." Including the Diocesan Bank cash, cash equivalents and Readily Marketable Securities in the loan covenant implies that the assets of the Diocesan Bank are available to pay the operating expenses of the Debtor.

Ernst & Young LLP and the Debtor advised the Expert they are not in possession of a workpaper which provides their computations of compliance with the loan covenants. When the Expert spoke with Kristin Janix, manager at Ernst & Young LLP, who was assigned to the audit of the Diocese Office Funds of the Roman Catholic Diocese, she agreed that in order to comply with the loan covenants, it would be necessary to include all of the assets of the Diocesan Bank.

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treated under GAAP in a manner consistently applied, as historically applied by the Guarantor as unrestricted or temporarily restricted by the Governing Body of the Guarantor…available for use for the payment of principal or premium, if any, and interest on Debt or <u>for the payment of operating expenses</u> (underline added) of the Guarantor."

Gift Annuities Administered for Parishes for the Benefit of Others

The Diocese obtained a license from the State of California to sell annuities. Many of the annuities are managed by Union Bank of California and the newer annuities are managed by US Bank. The Debtor lists these assets as being held for others in the SOFA (see Exhibit 61). There are three types of annuities; (1) gift annuities, (2) charitable remainder unitrusts, (3) pooled income funds. Donors transfer property to the parish or Diocese in exchange for an annuity which is paid to the donor during their life and the remainder becomes a donation to the parish or Diocese.

The annuities or funds are held at and administered by a bank. A copy of the operative agreements is contained in Exhibit 62, 63 and 64. Union Bank and US Bank have served as agents for the Diocese as trustee. The information the Expert obtained is summarized in Exhibit 61. The Debtor has only been able to provide documentation for $3,295.269 of the $5,357,998 (62%) of annuities listed in the SOFA (Exhibit 16, pages 30 and 33).

Accounting Treatment for Land Held in Trust for Parishes

It is the policy of the Diocese to provide a parish, upon establishment, a sufficient amount of developable land by the Diocese on which to build their parish (Exhibit). According to statements made by Father Steven Callahan at the Debtor's 341a meeting, new parishes also received an interest free loan of $2 million for up to 10 years (Exhibit 70). With a few exceptions, which are in the start up phase, the Diocesan Office Funds Financial Statements for the years ended June 30, 2002 through 2006 (Exhibits 9 pages 2 & 3) do not include the cost or other basis for land allegedly held for the benefit of parishes.

The financial statements of the parishes the Expert analyzed do not include the cost or other basis for land used by the parish in their financial statements. At the parish level, when construction costs are incurred they are expensed and therefore no capital asset is created, including land gifted to the parish from the Diocese. Hence, the land held in the name of The Roman Catholic Bishop of San Diego which the Debtor claims is held for the benefit of the parishes (Exhibit 16, pages 1 to 19) is not carried on the books of the Diocese or the parishes.

Diocese Construction Management

The Diocese provides construction supervision and management to the parishes for all projects over $100,000. Joel King, AIA, serves as Director of Construction Services ("CS") within the Pastoral office. Parishes that wish to build facilities submit their proposals to the Building and Renovation Committee (the "BRC"). A copy of the bylaws of the committee and other policies concerning parish project construction are contained in Exhibit 17.

CS has preliminary discussions with the parishes and assists in developing the plans into a workable project. The Office of Civil Affairs assists in the acquisition of land if needed. A parish building committee is formed. The BRC is required to give approvals at two points during the course of the project; first, for concept approval and, second, for final approval. In some instances, an approval may also be needed from the Art and Architecture Committee.

After final approval of the project by the BRC, a letter is sent to the parish which indicates the approval of the project and sets forth the terms for any loan from the Diocesan Bank. Mr. King coordinates with the parish to choose a general contractor and also negotiates a construction contract.

Mr. King provided the Expert with three samples of Construction Contracts. (Exhibits 72, 73 and 74). It should be noted that all three of the sample contracts provided by Mr. King have the Roman Catholic Bishop of San Diego, a corporation sole (or variation thereof), as the owner of the project even though each of the projects were for construction of parish facilities. The Expert has seen certain contracts and documents where the individual parish is named as the owner (Exhibit 75). Mr. King indicates that some parishes wish to be named as the owner, while others have no preference or specifically do not want to be listed as owner on the contract.

V.

Restriction(s) or Limitations on Funds in the Accounts

The Court has requested that the Expert analyze "any alleged restriction(s) or limitations with respect to funds in the Accounts." (Exhibit 76, ¶5 (d)). The Expert will provide information herein concerning the restrictive accounting treatment which may, or may not, be afforded various transactions involving restricted assets. As a basis for analyzing restrictions we have used attributes that define restricted assets or net assets as promulgated by under Generally Accepted Accounting Principles. ("GAAP") [84] The Expert primarily focused on the restrictions as asserted by the Debtor in light of the aforementioned GAAP standards[85] and the understanding of the priority system of claims in bankruptcy[86].

Although GAAP does not have a dispositive relationship with the law, prior to refining their position on any accounting issue the various accounting governing bodies, such as the Financial

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[84] GAAP represents the various accounting standards and interpretations for the purpose of preparing a financial statement for presentation to third parties for their analysis, review and reliance. The GAAP standards are generally set by the Financial Accounting Standards Board of the American Institute of Certified Public Accountants and are called Financial Accounting Standards ("FAS").

[85] The FASB statements of GAAP apply to financial accounting in many legal jurisdictions in the United States and sometime outside the United States. Of course there are different laws, interpretations and precedents in different jurisdictions and the FASB can only consider the general legal principles in providing accounting guidance to accounts in jurisdictions with possible differing laws.

Accounting Standards Board ("FASB"), often take into consideration the legal elements of any restricted asset or net asset. Within this portion of the report, the Expert simply wishes to provide for the Court a review of the attributes in which GAAP may determine what restrictions as proposed by the Debtor may be recognized on the financial statements in accordance with GAAP along with his understanding of the priority system employed in the bankruptcy process. The Court may place whatever weight upon these factors as she sees deems appropriate.

The Debtor's bankruptcy schedules of assets and liabilities ("BSAL") contain a "Schedule of Restricted Assets and Assets Subject to Security Interests" (Exhibit 77). The Expert has reviewed the Debtor's underlying documentation, stated purpose, and use of funds in order to provide an opinion as to the appropriateness of designating these items as restricted under GAAP standards.

We considered the following attributes as described in GAAP which may have some relevance as to the determination of whether an asset is ultimately deemed restricted for bankruptcy purposes.

- To determine the accounting treatment for restrictions upon assets, FAS 116 states, "…a restriction on an organization's use of the assets contributed results either from a donor's explicit stipulation or from circumstances surrounding the receipt of the contribution that makes clear the donor's implicit restriction on use." (Exhibit 78, ¶14, page 3 of 7).
- Revenues from providing services, producing and delivering goods are considered to be unrestricted assets (Exhibit 79, ¶16, page 4 of 8).
- A contribution is not restricted if the imposed restriction is not more specific than the broad limits resulting from the nature of the organization, the environment in which it

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[86] Of primary interest are in this report are FAS 116, FAS 117, FAS 124 and FAS 136 (Exhibits 78, 79, 80, and 81).

operates, and the purposes specified in its articles of incorporation or bylaws (Exhibit 79, ¶7, page 2 of 7). Hence, a donation that is given for the same general purposes for which the not-for-profit exists would be unrestricted as to that entity. For example, weekly contributions without specificity as to the intended use would not be afforded a restrictive treatment.

- A restricted asset may become unrestricted if the stipulated time has elapsed or the stipulated purpose for which the resource was restricted has been fulfilled, or both (Exhibit 78, ¶17, page 4 of 7).
- A donor imposed condition requiring the return of the assets transferred after a future and uncertain event whose occurrence or failure to occur gives the donor a right of return of the assets (Exhibit 78, ¶7, page 2 of 7) is a valid restriction.
- Restrictions can be placed on assets or net assets[87]. A restricted asset designation implies that the restricted asset has been separately accounted for and separately maintained pursuant to those restrictions.
- Unrestricted funds can be designated by the governing board of an organization to designate a portion of its unrestricted net assets to a specific function (Exhibit 79, Page 4 of 8), a "self-imposed restriction." The Debtor does not assert this claim of restriction for any of the assets at the Diocese level included in Exhibit 77; however this practice appears to have been a common occurrence at some of the parishes. Taken to the extreme, allowing this type of restriction would allow a Debtor to self-impose restrictions

[87]A net asset implies the net value of assets in general without looking to one or more specific assets following the payment of liabilities or claims. A restricted asset implies that specific assets have been separately accounted for and separately maintained for the specified restriction (i.e. See Exhibit 9, page 2 Administrative Office, General or Restricted columns, noting the "Net Assets" section at the bottom).

on all of its assets, thereby preventing creditors not covered by the restrictions from being paid.

The Debtor asserts that certain of the amounts listed on Exhibit 82 represent trust funds which are being held in trust by the Debtor in behalf parishes and schools by virtue of the donor's designated intended use of payments to the Debtor (Exhibit 77). As examples of this trust relationship, the Debtor uses:

1. Trust fund employee taxes,
2. Parish payments to the Diocese to pay employees[88],
3. Tuition paid by students or parents for current year education, or
4. Payments for the perpetual care of the Holy Cross cemetery.

The Expert has inspected the documentation and evidence available to determine the intent of the donors in regards to the above referenced areas. The Expert has also considered evidence of intent if any of the following items were present:

1. Letter or document from the donor stating the intent,
2. Check with indication of intent,
3. Special fund raising events for the restricted purpose and that was coincidental with the receipt of the funds,
4. Memorandum created by the Diocese at or about the time of the donation indicating the intent, or
5. Recordation directly into the specific general ledger account for the restricted purpose at or about the time of the contribution.

In performing the analysis, the Expert has considered how the Debtor previously represented the nature of what it now calls restricted assets. Prior to bankruptcy, the Debtor prepared the

[88] The Debtor does not separate amounts paid by the parishes and schools from those of the Diocese, which amounts are described in the schedule as "Various Employees at Diocese, Parishes & Schools." However, Karen Jassoy has indicated that the amounts in these restricted funds are the obligations of the Diocese.

following financial statements, some of which were either audited or reviewed by Ernst & Young LLP:

1. The Diocesan Office Funds of The Roman Catholic Bishop of San Diego (Exhibit 9 through 12, and Exhibit 52);
2. Holy Cross (Exhibits 38 through 40);
3. Catholic Secondary Education – Diocese of San Diego, Incorporated, and The University of San Diego High School General Fund (Exhibits 30 and 49); and,
4. Marian High School (Exhibit 44 through 46).

Based upon the representation of the management of the Diocese and the work performed by Ernst & Young LLP, it appears, based on those financial statements, that more assets were designated as restricted by the Debtor in the post-petition period than were listed as restricted in the financial statements in the period just prior to the bankruptcy (Exhibit 8).

The Expert has reviewed the disbursements related to the restricted assets in order to determine if they are consistent with the intent underlying the asset. The Expert would conclude that the restricted net assets were used as intended, if the following factors were present:

1. Invoices supporting payment for the restricted purpose,
2. Entries into the general ledger account consistent with the restricted purpose or
3. Checks paid to vendors whose activities were consistent with the intended purpose.

With the general considerations described above, the Expert has analyzed the Debtor's restricted assets as presented in Exhibit 77. Our focus has been on determining if the following attributes exist for each restricted asset:

1. Did the claim arise from a donor making a contribution?
2. Were goods or services provided to the claimant in exchange for the payment?
3. Does the Debtor claim to be holding the money in trust, and, if so, on what basis?
4. Was the intended restriction documented and, if so, how?
5. What was the purpose of the donation/payment?

6. Has any stipulated time elapsed or the stipulated purpose been fulfilled?
7. Is there a donor imposed condition requiring a return of the assets?
8. Is there a specific asset separately accounted for and separately maintained to provide for the restricted intent?
9. How did the Debtor report the restriction in its audited financial statements?
10. Were the funds used as intended by the restriction?

After considering the information provided to the Expert in the books and records of the Debtor pertaining to restrictions, the Expert has summarized his findings in Exhibit 83 by placing each of the Debtor's restricted assets into one of three groups which summarize the Expert's recommendations:

1. Allowable claim as a restricted asset,
2. Allowable claim as a restricted net asset, or
3. Claims which require further legal determination.

The Expert believes that the restriction claims in the first group have separately maintained segregated assets with supporting evidence of the intent of the donor and such intent has been followed by the Debtor.

The Expert believes that the restriction claims in the second group have not separately maintained segregated assets, but do have supporting evidence of the intent of the donor and such intent has been followed by the Debtor.

The Expert believes that the third group of restriction claims, even though the Expert found evidence of the intent of the donor and such intent has been followed by the Debtor, may have problems which will require a legal determination. The problems include:

1. The Debtor represented in its financial statements that there were no restrictions for these amounts, or

2. The amounts are payable for services rendered or to be rendered by the Debtor or for services provided or to be provided to the Debtor.

Other Observations Concerning Restricted Assets

1) Unsecured creditors who provided services covered by the restricted net assets may be entitled to be paid from the proceeds of restricted net assets. In the opinion of the Expert, the Debtor's schedules did not provide sufficient clarity as to which unsecured creditors may be entitled to some form of payment from services or claims provided which fulfilled the intent of the restricted net assets.

2) Historically the Debtor has not allocated any administrative cost to restricted activities thereby granting to donors' restricted activities a cost free service. This cost has been borne by unrestricted assets and impacts the amount of unrestricted assets available to pay creditors. The Diocese charges and collects an administrative charge called the Diocesan Tax at a rate of 13% of revenue to cover the administrative cost of services provided to the parishes. Perhaps this is an appropriate amount to be charged against the restricted amounts listed in Exhibit 83.

3) The Debtor's pre-petition financial statements as of June 30, 2006 disclose unrestricted "designated" net assets, which are not listed as restricted assets[89] as of the Petition Date on the Debtor's schedules. They include earthquake reserve/future loss fund of $2,948,840, worker's compensations of $1,466,441, and employee health insurance reserve of $864,346, state unemployment insurance of $844,144 and priest health insurance reserve of $421,319.

[89] The Expert agrees these amounts should not be restricted in the context of the Debtor's bankruptcy.

The amount listed as restricted assets of the Debtor is a fluid number. Post-petition the Debtor has consumed some of the amounts in their restricted asset lists (see Exhibit 84) and continues to add to certain of the restricted amounts with additional contributions.

VI.
Audit Results of Parish and School Accounting

Since the creation of the Mission San Diego de Alcala on July 16, 1779 the Diocese has evolved to encompass 98 Parishes and 16 missions which addresses the spiritual and ecclesiastical needs of the approximately 980,000 Roman Catholics presently residing in the San Diego/Imperial County areas.

The Diocese also offers educational opportunities through 43[90] elementary schools[91] and three high schools in San Diego and Imperial counties. The three high schools are Marian Catholic High School[92] in Chula Vista, Vincent Memorial High School in El Centro, and Cathedral Catholic High School in San Diego[93].

In order to comply with the provisions of the Court's Order appointing the Expert concerning the existence, operational and informational basis regarding bank accounts as well as any restrictions which may be imposed with respect to those funds, the Expert was required to

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[90] The 2007 Catholic Directory lists 45 elementary schools which are either pre-school through 8th grade or Kindergarten through 8th grade. However, two of these elementary schools have an association through a Parish but are independently owned by separate Catholic Orders and are therefore not under Diocesan administration. Thus, there are 43 elementary schools as designated in the Directory.

[91] Our Lady's School is actually associated with two separate parishes and operates two separate campuses, one campus enrolls students in the upper grades and the other campus enrolls students in the lower grades.

[92] RCBSD is in the process of constructing a new high school, Mater Dei, which will replace Marian. The proposed enrollment in Mater Dei will approximate 2,500, substantially larger than the present enrollment of 700 in Marian High.

[93] RCBSD owns two of the high schools – St. Vincent and Marian. The other high school, Catholic Cathedral, is owned by Catholic Secondary Education – Diocese of San Diego Incorporated ("CSE") of which RCBSD is the sole member.

conduct an audit[94] (or accounting analysis) of various Diocese and Parish accounting records. The audit was also required to determine whether the Cash Management System operates in a manner consistent with declarations as provided by responsible officials in the Diocese.

Due to appropriate and understandable time constraints, the Expert was not able to audit all 98 Parishes and 43 Elementary schools. However, the Expert reviewed data related to all 98 parishes from the list below and based upon that data selected 48 parishes to review. A summary of this selection criteria information is included as Exhibit 92.

- Cash on hand at February 28, 2007 (Per Schedule K)
- Number of bank accounts (Per Schedule K)
- Whether or not the tax identification number was changed (Per Schedule K)
- Amount of Funds on Deposit at the Diocese in the PSDL as outlined in the bankruptcy schedules (Per Form 7)
- Amount of debt from the PSDL at the Diocese (Per Form 7)
- Annual ordinary contributions for 2006 (Per Diocesan Records)
- Annual extraordinary contributions for 2006 (Per Diocesan Records)
- Geographic location

The Expert also audited all of the 26 schools affiliated with these parishes.

Exhibit 18 is a schedule of all the parishes in the San Diego Diocese with a notation of the 48 parishes the Expert chose to audit. Exhibit 19 is a full schedule of the 43 schools in the San Diego Diocese and the 26 schools which were reviewed by the Expert.

[94] The Expert utilizes the terms “audits, visits, and reviews” throughout this report to describe the accounting analysis which he conducted. However, the term “audit” as well as “review”, as defined herein, is not to be

Accounting for the Parishes & Schools

Approximately $165 million flows through the annual collective coffers of the Diocese, Parishes and Schools of the RCBSD[95]. One would naturally assume that such a large financial enterprise would establish a standard system of accounting and reporting, which would allow for meaningful financial measurement standards to be imposed throughout the entire organization. If such a system were in place, an entity, such as the Diocese, should be able to access financial information concerning each of the Parishes or Schools within the Diocese in order to monitor their financial performance or adherence to established procedures. However, the Diocese has no such system and, absent a personal visit, cannot independently access Parish or School accounting information. As a result, they are often woefully unaware of the specific financial operations of the individual Parishes.

According to the Handbook, "A PARISH is a grouping of the faithful set up within a diocese and entrusted to a pastor who associates with himself all its members in accomplishing their common mission." "The PASTOR is the proper shepherd of the parish to which he is assigned, exercising pastoral care in the community entrusted to him under the authority of the diocesan bishop, in whose ministry of Christ he has been called to share;…"

In practice, each Parish and School is responsible for their individual method of accounting and bookkeeping. This lack of standardized accounting leads to an incredible array of accounting programs and methods to record their financial transactions. As a result, the accounting programs within the Parishes range from a handwritten system of ledgers[96] to an advanced Parish accounting software package. The disparity between the sophistication of

construed as complying with the standards of an audit or review as defined by the AICPA.

[95] Excluding the funds flowing from the High Schools and other separate Divisions associated with the Parish.

Parish and School accounting systems is due to a number of factors. Probably the primary reason is related to our inherent reticence to change. Rather than adopt new accounting software, there is a natural human tendency to resist that which is unfamiliar and find comfort in that which is familiar. There is also a low turnover rate among the office personnel which is mostly a desirable state but can also lead to the calcification of existing procedures.

Another reason for the disparity of standard accounting systems relates to the primary focus of the Parish upon the spiritual needs of their Parishioners. The implementation of a sophisticated accounting program is simply not a priority to those Parishes.

Regardless of the method used, the Expert determined that the parishes and schools were reasonably well organized and sufficient detail was generally available to allow the Expert to analyze the receipts and disbursements of each parish. This availability is probably due, in part, to the fact that each parish and school is required to send an annual report to the Diocese. This requirement is detailed in the Diocesan Handbook included as Appendix A. The accounting system of the Parish must be standardized and sufficiently adequate for the Parish or School to prepare these annual reports to the Diocese.[97]

The Expert reviewed all of the annual reports for the fiscal years ended 2003 through and including 2006 as provided by the Diocese and the 48 Parishes and 26 Schools which were audited by the Expert[98]. The financial data in the annual reports to the Diocese is primarily a receipt and disbursement based analysis. It also contains information concerning restricted (or extraordinary) donations, as well as a supposed list of the bank accounts maintained by the

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[96] It should be noted that the handwritten system was meticulously maintained.
[97] Some of the Parishes use specialized software for Parish accounting which allows the report to be printed from their software system.
[98] To the extent provided, copies of each of the annual reports for the 48 Parishes and 26 schools are included in the binders maintained by the Expert containing the supporting accounting information obtained during the audit.

parish. As in most parish related accounting issues, there is a wide disparity between the accuracy or inaccuracy of the information. Susan Boswell, legal counsel for the Debtor, described the annual reports provided by the Parishes to the Diocese as "incomplete and inaccurate."[99] However, the Expert found that not all of the reports were "incomplete or inaccurate." In fact, some reports were quite complete and very accurate. On the other hand, it is true that a goodly portion of the Parish annual reports were "incomplete and inaccurate" and provided limited insight, especially in the area wherein the Parish was required to list all bank accounts. The Expert found that most major Parish bank accounts were reported, however, there was often a plethora of smaller bank accounts for disparate organizations operating under the auspices of the Parish which were routinely left off the annual reports.

In conjunction with the duties of the Pastor, the guidelines, as outlined in the Handbook, regarding Parish cash state, "Accounts with financial institutions may be established <u>*only with the permission of the pastor*</u>. All accounts <u>*must be*</u> in the name of the parish. The pastor <u>*must be*</u> a signer on all such parish bank accounts. Anytime a change of signature(s) on an account is required, <u>*the pastor must*</u> sign the new signature card(s)….Separate accounts for parish organizations (altar society, etc.) are permissible. However, such accounts must contain reference to the name of the parish to which they pertain (e.g. St. Vincent Altar Society) and the pastor must be an authorized signatory on such accounts. Subsequent changes in authorized signatures must likewise be made only with the pastor's approval and signature on the new signature card(s)." (Emphasis added) The Expert is not aware of any procedures which require the Parishes or Schools to report new accounts to the Diocese other than at the end of the fiscal year as detailed within the annual report. Thus, a Parish can open and close accounts during the

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[99] Per the Debtor's response to Objections of the Creditors Committee to the CMS.

year without any notification to the Diocese. As previously stated, the Expert found that certain bank accounts of Parishes were routinely missing from the annual reports. In fact, the exclusion of such accounts was widespread throughout the Parish annual reporting system.

The most likely time for the Diocese to review any change in these bank accounts or become aware of new accounts would be in the performance of a Diocesan review[100]. However, even during that financial review the Diocese is not specifically looking for new accounts. They are primarily concerned with how many accounts are presently open, the balances being carried in those accounts, and whether bank reconciliations are being prepared in a timely manner.

As outlined above, the pastor has ultimate responsibility for the administration of the parish. He may delegate certain responsibilities but according to the Handbook he retains supervisory control. The first general responsibility outlined in the Handbook is “All parish receipts and disbursements shall be entered in the parish financial records according to the parish chart of accounts.” During the audits conducted by the Expert, it was determined that a good faith effort was made to accurately record all receipts and disbursements in accordance with the aforementioned policy. When there were deviations from the parish chart of accounts, it was generally due to the inexperience of the person making the entry as many lay personnel, who lack detailed accounting skills, are designated that task. However, those entries which were designated incorrectly did not have a material effect upon the financial reports.

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[100] The Handbook calls for a Parish financial review by the Diocese to occur at least every five years or upon the change of the Priest in the Parish. The Expert found this requirement to be intermittently ignored by the Diocese. Certain Parishes assert they have gone for as long as 10 years without any Diocesan financial review.

Collection of Donations and Designation of Restricted Funds

Within the 48 Parish audits conducted by the Expert, he found the collection of ordinary and restricted/designated donations for Parishes is generally handled in a similar manner from Parish to Parish. The collections are gathered and separated by type, i.e., ordinary or extraordinary. Ordinary receipts are those designated for the general operation of the Parish. Extraordinary donations are those which fall outside the general operational nature and may include building funds, special purpose donations such as hurricane or other disaster relief, Diocesan special collections, and ACA rebates[101]. The manner of designation or segregation is normally determined by the color, notation or other distinguishing factor on the donation envelope. Based on that designation, or occasionally through verbal directions to the Pastor, the donation is categorized as either ordinary receipts or designated/restricted receipts for specific causes[102]. The funds are generally counted by a group of at least three parishioners who verify the amount and the classification. Following that verification, count sheets are prepared which can then be used to track the money in the general ledger or accounting system.

In some cases the general collection process may be modified to create a designation. For example, the pastor might have a second collection on the first Sunday of a month and designate those collections for the building fund or some other cause. Occasionally, the Parish will contract with an outside entity to assist in carrying out a capital campaign. These companies assist in obtaining, tracking and collecting pledges. The fees are not necessarily large and the decision to use them is made on a Parish by Parish basis. Parishes with more personnel

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[101] Diocesan special collections include such pass through collections which go directly on to the Diocese, such as Peter's Pence and the Annual Lenten Appeal. The Annual Catholic Appeal (ACA) rebates represent the return of funds advanced to the Diocese as contributory amounts which are estimated by the Diocese in the first part of the year and a Parish may ultimately have advanced more than required under the final assessment.

sometimes find it easier to spread the work among their people and save the expense of raising the funds.

Occasionally, the Parish will receive a larger than normal donation that may or may not necessarily be designated for a specific purpose. Often the donor will direct the Pastor to use the funds in areas where he feels the Parish may have the greatest need. In those instances, it is not uncommon for the Pastor to designate these donations as an extraordinary contribution and allocate it to a specific purpose, such as a new construction campaign. This procedure, which is used regularly in the Parishes, is not in accordance with the handbook as when handling unspecified purpose receipts, such as those mentioned above, the handbook states, "funds that are not restricted by the donor and are internally designated by the parish are to be classified as ordinary receipts".

Most, but not all, large contributions the Expert reviewed included a letter or other documentation designating the purpose and intended use of such contribution. The Expert has retained copies of all such letters in the binders of supporting documentation for each individual audit.

In summary, with the exception of those contributions whose purpose have been supported by a specific letter detailing the intentions of the donating party, the Expert has relied upon the procedural descriptions as provided by the Pastor and the lay personnel assigned to each Parish as to which contributions have been designated for general operations or extraordinary or specifically designated contributions

[102] It should be noted that the Diocesan tax of 13% (sometimes called the Parish Assessment) is not charged against those collections designated as extraordinary. Thus, in certain instances, it is beneficial for a Parish to designate certain collections as extraordinary as it reduces the Diocesan tax due from the Parish.

Following receipt and counting by three or more Parishioners, the funds can then be deposited into one or more accounts established at the Parish. Most Parishes have separate accounts for general donations, building funds, or other designated gift accounts. The number of bank accounts maintained by the Parishes range from one general account to as many as twenty two separate accounts at the Our Lady at Mount Carmel, San Ysidro.

The above procedures generally comport with the procedures outlined in the Handbook under the section “Administration – Parish” (see Appendix A). This section contains detailed counting and accounting procedures. The pastor and parish personnel generally try to strictly follow these guidelines based on specific circumstances at each Parish. The handling of cash is one of the primary areas addressed whenever the parishes are audited by the Diocese and accordingly, Parishes attempt to comply with all of these requirements.

Likewise, with few exceptions, the Pastors and Parishes make a good faith attempt to comport with the guidelines enumerated in the Handbook regarding disbursements at the Parish level.

Actually, a significant amount of the funds spent for normal operating expenses are paid directly to the Diocese. On a post-petition basis, most clergy salary and benefits, religious and lay salaries and benefits, diocesan tax, clergy pension tax and insurance for property and auto are directly transferred to the Diocese from the parish accounts by automatic transfers twice a month. It should be noted that those withdrawals cannot occur without the express approval of the respective Parishes as the Diocese is not a signatory on any of the Parish accounts and accordingly cannot unilaterally make such withdrawals. Prior to the bankruptcy these funds were paid to the Diocese with checks written from the parish accounts. According to Diocesan policy, as detailed in the handbook, all personnel are to be paid from the Diocesan payroll system.

Based on Exhibit 20, which shows the operating expense analysis for the 48 parishes visited by the Expert, these operational expense transfers to the Diocese account for approximately 71.15% of the total general operating expenses. The results from Exhibit 20 can be analyzed as follows:

Clergy salary and benefits	$ 3,166,395
Religious & lay salaries and benefits	16,957,768
Diocesan tax & clergy pension	5,271,475
Insurance – property & auto	944,820
Totals	$ 26,340,458
Total operating expenses of all Parishes	$ 37,023,119
Percentage paid to the Diocese	71.15%

Parishes and the PSDL

The Parish Administration section of the handbook provides the following clear direction as to the procedure for transfer of surplus funds from the Parish to the Diocese. "Surplus funds must be on deposit with the diocese in accordance with diocesan policy. Surplus funds are amounts above what is needed for normal operations for a two month period, which is estimated to be $50,000". The Expert has found a veritable plethora of interpretations at the Parish and School level of the Surplus Funds requirement which range from good faith adherence to absolute disregard. The designation of surplus funds as being those funds in excess of $50,000 and an additional two months operating expenses was the most common interpretation of the surplus funds procedure the Expert received from the parishes during the course of his review.

Thus, if a parish were to adopt that interpretation and had monthly operating expenses of $60,000, then surplus funds would be those funds greater than $170,000, or two times $60,000 plus $50,000. A goodly number of the Parishes visited by the Expert tried to comply, at least to some degree, with their interpretation of this policy. There were also a significant number of Parishes, such as Our Lady of Mt. Carmel, San Ysidro Parish, who demonstrated a willful disregard of this procedure.

The Diocesan policy dated November 1, 2006, and referenced above, regarding Funds on Deposit and surplus funds offers further clarity to the issue. It states, “Parishes are required to deposit with the diocese (i.e. in the “Diocesan Bank”) all parish funds, including those generated and/or held for the benefit of parish operations, organizations, project or programs over and above funds needed for normal operations. This policy also applies to parochial schools and Diocesan high schools.” The definition becomes even clearer under the implementation section of the policy, wherein it states, “”Funds needed for normal daily business” is defined as the normal operating expenses for a two-month period, which for most parishes is approximately $50,000”. Very few, if any, parishes or schools strictly adhere to this diocesan policy as outlined herein.

To further cloud this issue, the general handbook, in the Parish section as outlined in the recommended chart of accounts, states, “Parish funds and investments in excess of current needs (normally 3 months) are to be on deposit with the Diocese”. While there is some similarity between these requirements, it is easy to see why multiple interpretations may arise as to the meaning of surplus funds and the required amount of funds to be sent to the Diocese for deposit into the Diocesan Bank/PSDL Trust.

The audits of the Parishes and schools demonstrated this wide variation as strict adherence to this policy would mean that each of the 74 parishes and schools audited should have each had approximately $50,000, while only nine (9) of the seventy-four (74) parishes and schools visited by the Expert had less than $100,000 on hand at the petition date and three (3) had more than $1.1 million. Another eighteen (18) had between $400,000 and $1,100,000, and seventeen more had between $250,000 and $400,000. If this policy were construed to limit each of the 74 parishes and schools the Expert reviewed to a total of $50,000, the amount remaining at the Parish level would be approximately $3.70 million ($50,000 X 74). However, the total cash on hand at the petition date, as reported on Schedule K, for the same 74 parishes and schools is $25.46 million, which results in excess or surplus funds of approximately $21.76 million being held by the 74 parishes and schools in their 511 bank accounts. Even if the base amount was raised to $100,000, the surplus funds at the parishes and schools would still be in excess of $18 million.

The transfer of funds from the parishes to the Diocese PSDL account is almost always transacted through a check. The Expert is not aware of any parishes or schools that consistently[103] used wire transfers or any other form of electronic transfer to send funds to the Diocesan bank. Withdrawals made from the Diocesan bank are also almost always made in the form of checks. They are generally written to third parties for construction costs or to the parish or school for redeposit into their bank accounts. The Diocese may use Funds on Deposit for assessments, insurance and other obligations, but only with the consent of the parish or school[104].

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[103] During the Expert's review of records only one instance of a wire transfer between the Parishes and the Diocesan Bank was found.
[104] Per Handbook guidelines.

Loans to Parishes

There is a separate diocesan policy dated November 1, 2006, that addresses loans from the Diocesan Bank to individual parishes which is primarily used for construction of new projects, but may also include purchases of assets, maintenance projects and even the purchase of Rectories.

As of the date of petition, there are 30 separate loans from the PSDL Trust to the parishes and schools totaling $21,929,960[105].

The requirements and implementation procedures imposed by the Diocese are generally designed to protect the financial well-being of the individual parishes and to assure some form of repayment.

In order for a loan to be given the parish must have obtained the following:

- The approval of the parish finance council,
- All the required approvals of the Building and Renovation Committee and the Bishop have been obtained,
- One-third of the approved cost of the project must be on deposit with the Diocesan Bank or PSDL Trust; evidence that the loan will not jeopardize the pastoral and financial responsibilities of the parish and
- An agreed upon plan for repayment.

In order to obtain authorization for a loan from the Diocesan Bank, the provisions must be strictly adhered to. By way of example, the records reflected that one of the parishes which had been audited by the Expert had applied for a construction loan but was unable to secure approval from the Diocese as they had not actually deposited their funds with the Diocesan

Bank, although they had accumulated over $1.5 million in their own parish building fund bank account. In late 2006 and early 2007 these funds were transferred to the Diocesan Bank in order to fully comply with the 1/3 Funds on Deposit requirement to have their loan request approved.

Although a number of previous and present loans from the Diocese to the parishes were intended for parochial school construction only the parishes have outstanding loans from the Diocesan bank or PSDL Trust as the parishes assume responsibility for the financial viability of the parochial schools[106]. Of the 30 outstanding loans at the petition date, eight were interest free loans. Generally, the parishes have been very diligent in paying off outstanding loans. As would be expected, of the parishes visited by the Expert with outstanding loans, most had smaller combined cash balances in the parish accounts. This trend is demonstrated as shown on Exhibit 92, where the selection criteria is set forth.

The Expert has included as Exhibits 93 , 94 ,95 and 21 summaries of all parish and school accounts in the Diocesan Bank/PSDL Trust for the years ended June 30, 2005, June 30, 2006, July 1, 2006 through February 28, 2007, and March 1, 2007 through early July 2007, respectively. These summaries include funds on deposit, endowment funds and loan accounts in the Diocesan Bank/PSDL Trust.

Parish to Parish Loans

The Expert has found one instance where a parish borrowed funds from other parishes. The parish that borrowed the funds was St. Brigid Parish. The Expert visited St. Brigid on May

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[105] These 30 loans include two relatively small loans to Cathedral Catholic High School and Vincent Memorial High School.

[106] There is only one loan that is assigned to a parochial school which resulted from a capital project related to a convent and was assigned to the school by the parish. The school was unsure why they were responsible, but they were making payments, and had sufficient cash to pay off the entire loan. They chose not to do so as the loan was interest free.

31, 2007. At the time of the bankruptcy petition, St. Brigid had a new rectory construction project underway which was scheduled for completion in July 2007.

At the petition date, the parish had three accounts in the PSDL Trust. In the PSDL Trust the parish had an Organ Fund #0640-231-08 with a balance of $99,570.04 at February 28, 2007. The second account in the PSDL Trust was the “New Rectory” account #0640-231-01 with a balance of $47,504.34. Finally, the parish’s third account in the PSDL Trust was the “Funds on Deposit” account #0640-231-00 with a balance of $1,869,380.80. The parish made consistent deposits to the various funds in the Diocesan Bank in a good faith effort to comply with the Diocesan policy.

According to parish personnel, because of the bankruptcy, they were unable to access the funds in these three accounts in the PSDL Trust. The construction was ongoing for the new rectory and the parish didn’t have sufficient funds on hand to pay for construction costs. St. Brigid had only one parish bank account with a balance of $69,179 as listed on the Schedule K.

Because of the financial constraints described above, St. Brigid borrowed funds from three parishes in March 2007. The parish borrowed $50,000 each from St. Therese of Carmel, St. Gregory and Guardian Angel. The parish also borrowed $20,000 from a retired priest associated with the parish during March 2007. As of the date of our visit these loans had not been repaid. Subsequent to our visit the parish was able to access its funds in the PSDL Trust. The parish subsequently withdrew $38,722.70 from the “Funds on Deposit” account in the PSDL Trust and $47,000 from the “New Rectory” account in the PSDL Trust.

The Expert spoke with parish personnel on July 11, 2007, and was informed that the three loans from the parishes remain unpaid. The $20,000 loan from the retired priest has been repaid.

Post Petition PSDL Trust Activity

The Expert was provided a schedule of activity relating to the PSDL Trust for all parishes and parochial schools from the petition date through early July 2007. This information is summarized in Exhibit -. The following summarizes the activity in the PSDL Trust for this period:

Deposits & credits to Funds on Deposit	$ 4,521,870
Payments on Debt	1,415,237
Total Receipts	$ 5,937,107
Withdrawals & Debits from Funds on Deposit	$ 3,475,733
Draws	3,425,018
Total Withdrawals	$ 6,900,751

From the 74 parishes and schools the Expert selected for review he looked at the fifteen with the most cash on hand at the petition date based on Schedule K. The fifteen all had more than $500,000 in their parish or school accounts according to Schedule K. As a combined group these 15 parishes and schools had $11,965,094 on hand at the petition date according to Schedule K. Six of the fifteen had principal activity in the PSDL Trust from February 28, 2007 through early July 2007. As a group, these fifteen parishes and schools had no withdrawals of Funds on Deposit or draws on debt from the PSDL Trust during this time frame. During this same period, as a combined group, the six parishes and schools either deposited into the PSDL Trust or made debt payments to the PSDL Trust totaling $902,126.

It appears the parishes and schools continued to ignore the Diocesan policy regarding the deposit of excess funds into the PSDL Trust. This disregard for the policy is even more troubling given a memorandum sent to the Pastors, Administrators and Principals on Mary 24, 2007 by Monsignor Steven Callahan. This memorandum has been included as Exhibit 22. The document states, "At a hearing in the bankruptcy court on May 10, 2007, both the Diocese of San Diego and the Organization of Parishes agreed to comply with the diocesan policy that surplus funds be deposited in the Parish and School Deposit and Loan (PSDL) Trust (formerly known as the diocesan bank)…*Therefore, you are directed to deposit surplus funds no later than May 31, 2007"* (emphasis added). The memo closes with the statement, "Your cooperation is essential so that the diocese and parishes are in compliance with the commitment to the Court". It is apparent, according to the most recent information available to the Expert that most parishes and schools continued to ignore the diocesan policy, the direction of this memo and their commitment to the court.

School Accounting

The Pastor of the sponsoring parish has the primary responsibility for the financial administration of the school, as stated in the handbook, "The pastor shall have the responsibility for the financial administration of the school in consultation with the parish Finance Council. This responsibility may be delegated to the school principal". According to the handbook, the pastor of the sponsoring parish is also a member of the executive board of the school. In addition, the pastor must be a signatory on all school bank accounts and has approval responsibility for fundraising and activities that involve publicity. The parish also assumes responsibility for the building and maintenance of the school and equipment following construction.

The same accounting and internal control procedures which apply to the parishes as outlined above also apply to the schools. Schools have reporting requirements similar to the parishes which include an annual report in a standard format issued by the diocese or in a form substantively equivalent to that form.

The major source of revenues for the school is tuition and student fees. The tuition rate is usually set by the principal with input and approval of the pastor and parish Finance Council with due consideration for the local economic conditions. A summary of the tuition charged by the schools audited by the Expert is included as Exhibit 23. The Expert did not specifically request this information from the schools, but most provided it as an act of courtesy. Accordingly, Exhibit 23 contains information for only 19 of the 26 schools the Expert audited. The schools receive a limited amount of restricted gifts and those gifts generally relate to tuition assistance or equipment needs of the school. For the fiscal year 2006, 38[107] of the schools analyzed had total restricted gifts of just under $900,000. By way of comparison, the total tuition and fees for the 38 schools was $44.61 million.

The parish may have the responsibility to supplement tuition and fees with parish funds if required by the approved budget. Many of the parishes visited by the Expert provide at least some subsidy to the school. As reported by 38 of the 43 schools in fiscal year 2006, the parishes provided total subsidies of $1.22 million. However, many of the schools have established reputations and accordingly generate sufficient tuition and fees to cover all expenses and often generate excess operating funds. In fact, the aforementioned 38 schools generated excess

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[107] The Expert audited only 20of the schools but reviewed the annual reports of 38 schools.

operating revenues of approximately $2.86 million. During fiscal year 2006, those schools increased their funds on deposit in the Diocesan Bank by a net amount of approximately $760,000.

Schools are entitled and required to participate in the PSDL Trust in the same manner as the parishes. The diocesan policy is clear that surplus funds of the schools must also be on deposit in the Diocesan Bank/PSDL Trust. It is common for the schools to deposit tuition funds in the PSDL Trust because substantial amounts are collected at the beginning of the school year and at mid-year. These funds are then sent to the PSDL Trust and drawn as required by the school to meet ordinary operating expenses. The schools generally designate these Funds on Deposit in the PSDL Trust as restricted or designated as they represent prepaid tuition and fees for the students. The schools also may have excess operating funds or excess funds from fundraising efforts which are used to fund designated accounts for new construction or endowments for tuition assistance.

The major fundraising vehicle for the school is the parent teacher group, parent teacher guild or parent student association, collectively known as the "PTG". Regardless of their designated name, their function is similar in all schools. Some of the fees collected from the students are deposited to an account or accounts of the PTG. The PTG can also hold additional fundraisers which they use to fund normal school operations or meet special needs of the school. Some of the PTG's and the schools the Expert audited have contributed to the building campaign of new school facilities being handled by the parish. For the 38 schools mentioned above, the various PTG's generated and donated a total of $2.87 million to the individual schools.

Teacher salaries and benefits represent the preponderance of expenses and operational costs for the schools. For example, in 2006, these payroll expenses represented almost 98% of the total tuition collected by the 38 schools analyzed[108]. The payment of teacher payroll and benefits are administered through the diocese in the same manner as the payroll for the parishes.

Results of Parish/School Visits and Analysis

The Expert reviewed the financial operations of a total of 48 parishes and 26 schools. Prior to the Expert's visit to a parish or school a written request for documents was sent to each entity. A sample of the request is included as Exhibit 96. Detailed reports for each parish and school which document the audit results are located in 74 separate Appendices designated as Appendices B.1 through B.74. The information below is intended to highlight some findings of the Expert as a result of those audits:

Bank Accounts

As outlined on Exhibit 24, the 74 parishes and schools the Expert chose to audit had reported a total of 511 bank accounts as listed on Schedule K. This exhibit contains the information as outlined in Schedule K.

Exhibit 25 utilizes the previous Exhibit 24 and denotes corrections which are required in the original Schedule K information for updates, new accounts, closed accounts and other issues which were uncovered during the course of the Expert's audit. These changes have been highlighted so they can be easily identified. (The Expert has used the date of February 28, 2007 for all of this information to establish consistency) It should be evident from the attached corrections that Schedule K, which was provided in response to a request for further

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[108] There are additional income streams which flow into a school, such as parish subsidies, fees, and special fundraisers and other fund raising efforts. Even taking those supplemental fund sources into consideration, teacher salaries and benefits consume 75% of all revenue sources, including tuition.

clarifications as to outstanding cash balances in the Parishes from the Court, had a significant number of errors. Based on the Expert's audit analysis he found 9 accounts that should have been included on Schedule K but were omitted as well as 51 accounts that listed the incorrect tax identification number ("TIN"). This exhibit also includes a list of those bank accounts identified by the banks pursuant to the subpoena process not listed on Schedule K or given to the Expert as a result of his requests during the audit process. This list is constantly increasing as banks are continuing to respond to the subpoenas requesting additional information. Based on the most recent information available this list identifies 19 additional bank accounts.

Exhibit 26 lists 21 accounts, discovered during our audits of the 74 parishes and schools, which were opened post-petition. Almost all of these new accounts used new tax identification numbers applied for and received by the parishes and/or schools.

Exhibit -27 is a summary of the 74 parishes and schools the Expert audited and information regarding application for and use of new tax identification numbers. As shown on this Exhibit 58 parishes and schools applied for and received new tax identification numbers. Of these, 22 used their newly acquired TIN numbers to open new accounts or change existing accounts. Exhibit 27 also demonstrates that of the 74 parishes and schools audited by the Expert, 16 did not apply for a utilize a new tax identification number.

Exhibit 97 is a summary of the 67 parishes and schools the Expert did not audit and information regarding the use of new tax identification numbers as outlined in Schedule K. This exhibit demonstrates that 22 of the 67 parishes and schools applied for and used new TIN's

The Expert has included as Exhibit 98, Schedule K information for the 351 bank accounts for the 50 parishes and 17 schools that were not subjected to an audit by the Expert. He has included the information from Schedule K regarding changes in tax identification numbers. This exhibit also includes a list of those bank accounts identified by the banks pursuant to the subpoena process which were not listed on Schedule K. This list is constantly increasing as banks are continuing to respond to the subpoenas requesting additional information. Based on the most recent information available to the Expert, 9 additional bank accounts have been uncovered.

Finally, he has included as Exhibit 28, information regarding twenty bank accounts identified by the banks pursuant to the subpoena process which could not be identified as belonging to the Diocese or a specific parish or school. This list is constantly increasing as banks are continuing to respond to the subpoena and provide additional information.

Bank Reconciliations & Cash Control

Pursuant to the Handbook, "Parish related organizations should reconcile their bank accounts on a timely basis and the reconciliation and the bank statements (or copies thereof) should be kept in the parish office." During the course of the Experts audits it was apparent that this policy was not strictly followed. The Diocese does not request, nor as a matter of course receive, the Parish reconciliations. In fact, the Diocese has no way of knowing whether or not the reconciliations are being prepared until they ask for copies of Parish reconciliations as part of their 5-year financial review for compliance testing of internal controls.

The general handbook also states that the pastor must be an authorized signatory on parish organization bank accounts. Based on our visits the Expert found that this policy was not always followed.

The Handbook has detailed procedures for the parishes for counting cash and donations and safeguarding cash. While each parish may differ slightly, the Expert found that the parishes make a sincere effort to comply with these procedures.

Parish & School Cash Management

Under Handbook guidelines, each parish and school is requested to deposit their excess funds in the Diocesan Bank/PSDL Trust at the Diocese. As previously stated, there are wide variations of the manner in which the individual parishes and schools choose to comply with those guidelines. The Expert has provided below a number of illustrative examples, including a few of the Parishes and Schools with the largest comparative cash balances, to provide the Court with a descriptive analysis of the full range and manner in which Parishes and Schools interact with the PSDL Trust or the Diocesan Bank[109].

- Our Lady of Guadalupe Academy
  - (See Appendix B.3)

  The school with the largest amount of funds held in their school accounts is Our Lady of Guadalupe Academy in Calexico. According to school personnel this school is highly profitable as the student body is primarily made up of children from wealthy families in Mexico who commute from across the Mexican border to pursue their studies at the school. According to Schedule K the school had a total of $1,628,804 on hand at February 28, 2007, in three separate accounts. As part of the audit, the Expert determined that Schedule K was incorrect and overstated the cash on hand by $90,000. The actual amount on hand as of February 28, 2007, was $1,538,804. The school has had a substantial increase in available funds over the past few years. According to the annual school reports filed with the Diocese, the cash balances at June 30, 2004, totaled approximately $659,691. For the year ended June 30, 2005, the school had excess operating revenues of just over $500,000, including capital improvements thereby increasing the school's cash balances to $1,050,741. For the year ended June 30, 2006, the school had excess operating revenues of approximately $428,987 and the cash balances subsequently increased to 1,451,937. Due to further excess operating revenues the balance increased over the next 8 months to $1,538,804. Thus, from June 2004 to February 2007, the cash balances available at the school increased by close to $1 million. Almost all of these monies are being held in a non-interest bearing checking account.

The only "Funds on Deposit" in the PSDL Trust for Our Lady of Guadalupe Academy was approximately $34,573 in an endowment account. The deposit to fund this account was made during late 2002. As of the date of the Expert's audit, July 7, 2007, no other funds have been transferred to the Diocese in accordance with the Handbook and Diocesan policy.

- St. James Parish - includes the St. Leo Mission
    - (See Appendix B.60)

The parish with the most cash on hand is St. James Parish, which includes the St. Leo Mission. The detailed report for this parish is located in Appendix B.60. According

[109] A full report of each parish or school audit results for all of the examples listed hereafter can be found in

to Schedule K the parish had a total of $1,336,822 deposited in 15 separate parish accounts as of February 28, 2007. According to the 2006 annual report as filed with the Diocese a significant amount of this cash came from the building funds collected as part of the capital campaign. For the year ended June 30, 2006, the parish had excess operating funds of $256,519 and excess extraordinary income (primarily building fund) of $897,190.

The parish had "Funds on Deposit" in the PSDL Trust of $346,418 in three accounts at February 28, 2007. From June 30, 2004, to February 28, 2007, the parish sent $111,807 to the Diocesan Bank. Through July 7, 2007, the Expert was not aware of any additional funds sent to the Diocese in accordance with the Handbook and Diocesan policy.

- Church of Nativity Parish
    - (See Appendix B. 68)

The Church of Nativity Parish stands in stark contrast to the St. James Parish as described above. The detailed report for this parish is located in AppendixB.68. According to Schedule K the parish had $222,865 on hand at February 28, 2007, in three bank accounts. From June 30, 2003, through February 27, 2007, the parish sent $1,755,000 to the Diocesan Bank for a gymnasium fund. A portion of these funds came from designated building fund donations and the remainder from excess operating revenues. As of each of the years ended June 30, 2003, June 30, 2004, June

Appendices B.1 through B.74.

30, 2005, June 30, 2006 and February 28, 2007, the parish only maintained total funds in their bank accounts of approximately $200,000 to $250,000.

While the parish may not have strictly adhered to the two month operating expense or $50,000 limit established by the Diocese[110], they consistently transferred significant excess funds to the Diocesan Banking accordance with the Handbook policy.

- Corpus Christi Parish
  - (See Appendix B.67)

A designated building fund account with the Diocesan Bank was established to sequester funds for a new parish hall and classrooms, and eventually to build a new school. The building fund campaign has been underway since approximately late 1999 or early 2000. As of the petition date, Corpus Christi had $2,357,884.77 on deposit with the Diocese. Checks were written to the Diocese for deposit from the main checking account whenever a large balance of designated building funds accumulated.

The following is a summary of Corpus Christi Parish designated funds on deposit with the Diocesan Bank. The account is identified by the parish as a designated building fund account   Records from the Diocese refer to this account as simply “Funds on Deposit”. The account is earning interest at a rate of 3.5% annually.

[110] The actual monthly operating expenses for the parish were $37,500.

Corpus Christi – Funds on Deposit (900-231-00)

Period Ended	Deposits	Interest	Withdrawals	Balance
6/30/02				240,472
6/30/03	515,000	8,206	-	763,678
6/30/04	445,000	20,525	-	1,229,203
6/30/05	375,000	49,357	-	1,653,560
6/30/06	1,166,529	54,382	852,600	2,021,871
2/27/07	285,000	51,014	-	2,357,885

The Corpus Christi parish accounts recorded the following transactions during the similar period:

For the year ended June 30, 2003, the parish received building fund donations of $533,061. Disbursements from this account for new property & construction totaled $10,368. The amount sent to the Diocesan Bank for funds on deposit was $515,000 (see schedule above). Included in the building fund donations is approximately $125,000 representing rental income from an adjacent building being used as a daycare center. The parish categorizes these receipts as being specifically designated for building fund contributions. Approximately this same amount is included each year in the building fund donations. Because the parish is operating at an operating deficit some of the designated funds are also being used to supplement the operating shortfalls. Also based on the above, all of the funds deposited into the account in the Diocesan Bank represent building fund donations[111].

[111] It should be noted that the Diocesan or Chancery tax is to be computed as 13% (with minor adjustments) of "ordinary" receipts. When income is designated as building fund donations or extraordinary receipts, as is the case

For the year ended June 30, 2004, the parish received building fund donations of $566,669. Disbursements from this account for new property & construction totaled $26,195. The amount sent to the Diocesan Bank for funds on deposit was $445,000. Included in the building fund donations is approximately $125,000 representing rental income from an adjacent building being used as a daycare center. As in prior years, the parish designates these receipts as building fund contributions. Approximately this same amount is included each year in the building fund donations. Because the parish is operating at a deficit some of the designated funds are being used to supplement the operating shortfalls. Also based on the above, all of the funds deposited into the Diocesan Bank represent building fund donations.

For the year ended June 30, 2005, the parish received building fund donations of $527,104. Disbursements from this account for new property & construction totaled $19,379. The amount sent to the Diocesan Bank for funds on deposit was $375,000. Included in the building fund donations is approximately $125,000 representing rental income from an adjacent building being used as a daycare center. The parish designates these receipts as building fund contributions. Approximately this same amount is included each year in the building fund donations. In a similar manner to prior years, because the parish is operating at a deficit some of the designated funds

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with this designation, the Parish is not charged a Diocesan or Chancery tax upon those receipts. Thus, each year with this designation of rental receipts as building fund or extraordinary receipts, the parish avoids a yearly Diocesan tax of $16,250. ($125,000 X 13%)

are being used to supplement the operating shortfalls. Also based on the above, all of the funds deposited into the Diocesan Bank represent building fund donations.

For the year ended June 30, 2006, the parish received building fund donations of $601,630. Disbursements from this account for new property & construction totaled $80,230. The amount sent to the Diocesan Bank for funds on Deposit was $450,000. Again, included in the building fund donations is approximately $125,000 representing rental income from an adjacent building being used as a daycare center and the parish designates these receipts as building fund contributions. Approximately this same amount is included each year in the building fund donations. Because the parish is operating at a deficit some of the designated funds are being used to supplement the operating shortfalls. Also based on the above, all of the funds deposited into the account in the Diocesan Bank represent building fund donations.

In November 2005, $852,600 was paid from the designated building fund account in the Diocesan Bank to purchase a new home for the pastor. Proceeds from the sale of the old home totaling $715,970 were deposited in the Diocesan Bank in March 2006.

For the period ended February 28, 2007, the parish received building fund donations of $571,582. Disbursements from this account for new property & construction totaled $109,051. The amount sent to the Diocesan Bank for funds on deposit was $285,000. Included in the building fund donations is approximately $125,000 representing rental income from an adjacent building being used as a daycare center. The parish designates these receipts as building fund contributions. Approximately this same amount is included each year in the building fund donations. Because the parish is operating at a deficit some of the designated funds are being used to supplement the operating shortfalls. Also based on the above, all of the funds deposited into the account in the Diocesan Bank represent building fund donations.

The above activity is summarized as follows:

For the Period Ended	Designated Building Fund Receipts	Proceeds from Property Sales	Withdrawals from accounts in the Diocesan Bank	Spent for new construction & Property	Deposited to Accounts in the Diocesan Bank		Over/(Under) Available Designated Funds
6/30/03	533,061	-	-	(10,368)	(515,000)		7,693
6/30/04	566,669	-	-	(26,195)	(445,000)		95,474
6/30/05	527,104	-	-	(19,379)	(375,000)		132,725
6/30/06	601,630	715,970	852,600	(932,830)	(1,166,529)		70,841
5/14/07	571,582		-	(109,051)	(285,000)		177,531
Totals	2,800,046	715,970	852,600	(1,097,823)	(2,786,529)		484,264

From July 1, 2002 through February 28, 2007, the parish received more donations to the capital campaign than it has spent on new construction and major furniture and fixtures and/or advanced into the designated building fund in the Diocesan Bank. Accordingly, all funds in the designated account in the Diocesan Bank represent designated proceeds from the building fund campaign and the rental income designated as building funds by the parish. The parish has been operating at a loss for several years and has used designated building fund donations to supplement operations of the parish.

- St. Therese of Carmel Parish
    - (See Appendix B.71)

  A building fund on deposit with the Diocesan Bank was established to hold funds for the new chapel and a new pastoral office. There were two separate capital campaigns in which pledges were made for donations to be used for the new chapel and the new pastoral office. In the first capital campaign, $5,895,257 was pledged and $5,508,493 has been collected as of 5/21/07. For the second capital campaign, $6,512,456 was pledged of which $4,310,675 has been collected as of 5/21/07. In addition to the capital campaigns, several large donations have been made from individuals, which have been designated for the building campaign. The largest of these individual donations was for $2,000,000. This donation and other large donations were reflected in donor letters and/or other supporting documents.

  In addition to the activity in the Diocesan Bank for the building fund, significant funds were raised and spent on an ongoing basis at the Parish level for construction of new facilities. During the period July 1, 2003 through May 31, 2007, in excess of $12.29 million was spent on construction of new facilities. A significant portion of this amount was raised and spent in the same period without being deposited or withdrawn from the Diocesan Bank. The designated funds held on deposit in the PSDL Trust will be used to build new parish offices/hall.

The following is a summary of St. Therese of Carmel Parish funds on deposit in the Diocesan Bank. The first account identifies general non-designated amounts held for the parish, although the parish has treated these funds as restricted and used the withdrawals for construction. The second account identifies designated building funds held awaiting ongoing construction needs. Both accounts are earning interest at a rate of 3.5% annually. The funds withdrawn from the designated building funds account were either paid directly to contractors for the new construction or were deposited into the parish accounts and used to pay construction related expenses.

St. Therese of Carmel – Funds on Deposit – 1000-231-00 (Not-Designated)

Period ended	Deposits	Interest	Withdrawals	Balance
6/30/02				347,975
6/30/03	200,000	6,122	-	554,097
6/30/04	1,539,128	13,677	189,700	1,917,202
6/30/05	12,005	68,413	-	1,997,620
6/30/06	-	61,381	500,000	1,559,001
2/27/07	-	36,699	-	1,595,700

St. Therese of Carmel - Building Fund – 1000-231-02 (Designated)

Period ended	Deposits	Interest	Withdrawals	Balance
6/30/02				2,591,540
6/30/03	1,334,054	55,783	-	3,981,377
6/30/04	127,303	64,034	-	4,172,714
6/30/05	491,106	153,077	477,225	4,339,672
6/30/06	1,427,834	149,973	1,830,605	4,086,874
2/27/07	311,057	96,618	100,000	4,394,549

The Parish activity regarding the building fund campaigns, new construction and Funds on Deposit can be summarized in the following chart:

For the Period Ended	**Designated Building Fund Receipts (a)**	**Decrease (Increase) in Parish Building Fund Bank Account (b)**	**Amounts Withdrawn from accounts in the Diocesan Bank (c)**	**Amounts Spent for new construction from Parish and Diocesan Bank (d)**	**Amounts Deposited to Accounts in the Diocesan Bank (e)**		**Over/(Under) (f)**
6/30/03	1,252,751	488,471		(338,416)	(1,534,054)		**(131,248)**
6/30/04	2,670,318	(718,775)	189,700	(580,043)	(1,666,430)		**(105,230)**
6/30/05	1,984,375	(440,747)	477,225	(2,510,102)	(503,111)		**(992,360)**
6/30/06	4,888,015	(235,029)	2,330,605	(5,758,670)	(1,427,834)		**(202,913)**
5/14/07	1,639,760	1,208,518	100,000	(3,110,943)	(311,057)		**(473,722)**
Totals	12,435,219	302,438	3,097,530	(12,298,174)	(5,442,486)		**(1,905,473)**

The amounts included in column (a) represent amounts collected by the parish as designated building funds and deposited into parish accounts. The amounts shown in column (b) represent the increase or decrease in parish building fund bank accounts. If the number in this column is positive this means that the parish building fund bank account balances decreased providing a source of funds. If the number in this column is negative this means that the parish building fund bank account balances increased signifying a use of funds. The amounts shown in column (c) represent withdrawals from the Diocesan Bank accounts for construction expenses. These amounts were either paid directly to third parties for construction related costs or were deposited into the parish accounts and used for construction related expenses. The amounts shown in column (d) represent the total amount spent for new construction by the parish. The amounts shown in this column represent amounts paid from parish bank accounts as well as payments made directly to third party vendors from accounts in the Diocesan Bank. The amounts reflected in column (e) represent amounts deposited to the two accounts in the Diocesan Bank. These amounts were paid from parish bank accounts. Finally, the amounts shown in column (f) represent the net of all sources and uses of funds related to the building campaign, construction costs and Diocesan Bank account activity. For each year the amounts are negative. The negative amount means that parish used excess operating proceeds or non-designated funds on hand to fund construction costs or transfer funds to the Diocesan Bank. In other words, the designated sources of cash were insufficient to pay the ongoing construction costs and fund the amounts deposited into the Diocesan Bank accounts.

- Our Mother of Confidence Parish
    - (See Appendix B.44)

    There have been three main capital campaigns in recent years which have all been conducted in a similar manner, i.e., parishioners fill out pledge cards, and make their donations via envelopes or by mailing a check within a designated envelope to the parish office.

Capital Campaign for Building Fund "Share the Vision, Meet the Challenge"

This campaign began in November 2002. Phase 1 included the redesign of the church interior, building a larger gathering plaza, building a baptismal font, constructing a Eucharistic chapel, building larger bathrooms, and installing an elevator. Phase 2 will include building a parish hall, and Phase 3 will be to develop a larger garden.

Memorials Campaign

This campaign began in October 2005 to pay for various items for the church (statues, crucifix, candle stands, chalices, etc.) Parishioners could specify the item and have it dedicated in memory of a loved one.

Debt Reduction

This campaign began in October 2006 to raise funds to pay down the original $3 million loan used for church renovation.

A building fund on deposit with the Diocesan Bank was established to hold funds for major renovations and construction. According to the general ledger and other internal accounting documents provided by the parish, it appears that this account was designated for renovation and construction. All funds from the account were used for construction. The account activity is summarized below.

Our Lady of Confidence – Funds on Deposit – 0600-231-00 (Designated)

Period Ended	Deposits	Interest	Withdrawals	Balance
6/30/02				1,259,926
6/30/03	1,007,766	29,963	-	2,297,655
6/30/04	375,000	49,064	51,840	2,669,879
6/30/05	350,000	76,676	2,228,793	867,762
6/30/06	694	1,083	869,539	-
2/27/07	-	-	-	-

The following is a summary of Our Mother of Confidence Parish loan from the Diocesan Bank. These funds were loaned to the parish after all funds on deposit in the Diocesan Bank were consumed to fund the renovations and construction. The draws were all paid directly to third party vendors for renovations and construction costs.

Our Mother of Confidence – Debt – 0600-145-00

Period Ended	Payments	Interest	Draws	Balance
6/30/04	-	-	-	-
6/30/05	-	-	-	-
6/30/06	565,696	60,764	2,929,388	2,434,456
2/27/07	542,000	67,526	-	1,959,982
4/30/07	90,000	7,490	-	1,877,472

The following is a summary of the capital campaign and construction activity for the years 2003 through April 30, 2007.

Period Ended	Designated Building Funds Collected (a)	Funds Deposited to the Diocesan Bank (b)	Funds Withdrawn from the Diocesan Bank (c)	Funds Spent for New Construction (d)	Funds Drawn from Diocesan Bank Debt (e)	Payments made on Diocesan Bank Debt (f)		(Over) Under (g)
6/30/03	1,087,581	(1,007,766)	-	(163,060)	-	-		(83,245)
6/30/04	653,681	(375,000)	51,840	(460,067)	-	-		(129,546)
6/30/05	560,265	(350,000)	2,228,793	(2,633,149)	-	-		(194,091)
6/30/06	632,021	(694)	869,539	(4,117,333)	2,929,388	(565,696)		(252,775)
4/30/07	425,205	-	-	(130,913)	-	(632,000)		(337,708)
Totals	3,358,753	(1,733,460)	3,150,172	(7,504,522)	2,929,388	(1,197,696)		(997,365)

The amounts included in column (a) represent amounts collected by the parish as designated building funds and deposited into parish bank accounts. The amounts shown in column (b) represent amounts deposited to the funds on deposit account in the Diocesan Bank. These amounts were paid from parish bank accounts. The amounts shown in column (c) represent withdrawals from the Diocesan Bank accounts for construction expenses. These amounts were paid directly to third parties for construction related costs. The amounts shown in column (d) represent the total amount spent for new construction by the parish. The amounts shown in this column represent amounts paid from parish bank accounts as well as payments made directly to third party vendors from the funds on deposit and loan accounts in the Diocesan Bank. The amounts reflected in column (e) represent amounts drawn from the Diocesan Bank as debt. These amounts were paid directly to third party vendors from the Diocesan Bank at the diocese for construction related expenses and were included in the funds spent for new construction. The amounts shown in column (f) represents amounts paid on the Diocesan Bank debt account. These payments were made from the parish bank accounts. Finally, the amounts shown in column (g) represent the net of all sources and uses of funds related to the building campaign, construction costs and Diocesan Bank account activity. For each year the amounts are negative. The negative amount means that parish used excess operating proceeds or non-designated funds on hand to fund construction costs. In other words, the designated sources of cash were insufficient to pay the ongoing construction costs and fund payments to the Diocesan Bank.

- St. Gabriel Parish
    - (See Binder Appendix B.34)

<u>St. Gabriel Parish Building Fund</u>

As of February 28, 2007, St. Gabriel Parish had $5,220,671 on deposit in the PSDL Trust at the Diocese. The current building fund capital campaign started on January 1, 2003. St. Gabriel Parish's building fund balance held in the Diocesan Bank at the Diocese on June 30, 2002 was $2,616,461. The objective of the most recent campaign was to raise enough money to build a new church for the parish. To date the drive has received $4,466,631 in pledges, of which $1,718,093 has been collected and deposited into parish accounts.

The following is a summary of St. Gabriel Parish funds on deposit with the Diocesan Bank.

St. Gabriel Parish Building Fund – 0430-231-00 (Designated)

Period Ended	Deposits	Interest	Withdrawals	Balance
6/30/02				2,616,461
6/30/03	404,926	48,512	-	3,069,899
6/30/04	635,679	55,023	930,000	2,830,601
6/30/05	1,489,799	102,908	764,500	3,658,808
6/30/06	695,000	142,008	95,000	4,400,816
2/27/07	710,000	109,855	-	5,220,671

The following is a review of funds received and disbursed regarding the building fund. At the time the funds were deposited into this account the parish was using two parish bank accounts to make the transfers; the general account at Bank of America and the Building Fund account at Wells Fargo:

2006-2007

Bank of America Parish general account – This account received building fund donations of $237,363.27. Disbursements from this account for new property & construction equaled $229,826.53. The amount sent to the Diocesan Bank for funds on deposit was $230,000.00. Post petition, an additional amount of at least $100,000 was used to create a certificate of deposit for the building fund. In the Expert's opinion, this amount could have only been generated from excess operating funds.

Wells Fargo Parish building fund account – This account received building fund donations of $684,701.37. Disbursements from this account for new property & construction equaled $1,433.14. The amount sent to the Diocesan Bank at the Diocese for funds on deposit from this account was $480,000.00. An additional $130,000 was used to purchase certificates of deposit for the building fund which were retained at the parish level.

2005-2006

Bank of America Parish general account – This account received building fund donations of $210,191.89. Disbursements from this account for new property & construction totaled $98,489.52. The amount sent to the Diocesan Bank at the Diocese for funds on deposit was $540,000.00. In the Expert's opinion, the deposits in excess of the donations, less construction costs, should be more accurately designated as excess operating funds.

Wells Fargo Parish building account – This account received building fund donations of $309,923.32. Disbursements from this account for new property & construction equaled $162,361.93. The amount sent to the Diocesan Bank for funds on deposit were $155,000.00.

2004-2005

Bank of America Parish general account – This account received building fund donations of $232,727.55. Disbursements directly from this account for new property & construction totaled $47,249.38. The amount sent to the Diocesan Bank for funds on deposit were $540,000.00. In the Expert's opinion, the deposits in excess of the donations, less construction costs, should be more accurately designated as excess operating funds.

Wells Fargo Parish building fund account – This account received building fund donations of $408,935.37. Disbursements made directly from this account for new property & construction totaled $117,770.83. The amount transmitted to the Diocesan Bank for funds on deposit was $355,000.00.

Additional Transactions: Deposits to the Diocesan Bank fund include proceeds from the sale of property located at Woodhollow Lane, which the Expert believes was former Rectory property. In November 2004, the sale of this property contributed $594,197.13 to the capital campaign, and the funds were deposited directly to the PSDL at the Diocese. St. Gabriel also purchased property located at 14726 Budwin Lane, Poway, CA 92064 in July of 2004 in the amount of $769,500. This purchase of land/residence includes the new rectory and future driving access for new church. $764,500 was withdrawn directly from the Diocesan Bank to accommodate this purchase.

2003-2004

Detailed bank account activity for this year was not available to the Expert. The following information was obtained from parish annual reports filed with the Diocese. Gifts restricted by donor – for extraordinary purposes equaled $448,757, a majority of which would be allocated to the building fund. There were also withdrawals from this fund of $930,000. $878,000 of this amount was used to purchase a piece of adjacent vacant land to be used for a future church site. Funds expended for new property and construction totaled $915,777. During the same year St. Gabriel deposited $690,023 to the Diocesan Bank.

<u>Questionable Transactions</u>

As a result of the Audits the Expert discovered several questionable transactions, which he believes should be brought to the attention of the Court and are described below.

- Our Lady of Guadalupe Parish, Calexico
  - (See Appendix B.2)

  On February 21, 2007, just days before the bankruptcy petition, but clearly after the parish was made aware of a possible bankruptcy filing, Our Lady of Guadalupe Parish set in motion a series of transactions which deliberately hid $49,685.47 from the bankruptcy court. The February 21, 2007, transactions include the following:

    - $4,000 was withdrawn (possibly in the form of cash; the bank statement simply shows it as a withdrawal) from a Sun Community Federal Credit Union ("SCFCU") account #4993950 (as a side note the activity from this account is not included in the parish general ledger, nor was the account listed on Schedule K since it was closed February 21, 2007, following the four transactions described). The general ledger does not reflect that this $4,000 was deposited or transferred to another parish bank account. Following this withdrawal the balance in the account was $27,636.32.

- $12,726.00 was transferred from the general checking of the parish into the SCFCU account #4993950. This amount represents the exact amount of an ACA rebate which was deposited into the general checking the same day.
- $9,323.15 was transferred from the Union Bank designated gifts account #3710005477 into the SCFCU account #4993950. This left a $100 balance in the designated gift account.
- As a result of the three items above the balance in the SCFCU account #4993950 was $49,685.47. This amount was then withdrawn in the form of a cashiers check. This check was then held by the parish for approximately 30 days, during which time bankruptcy filing took place.

These funds held in the form of a cashiers check by the parish are not disclosed on Schedule K.

On or about March 20, 2007, Our Lady of Guadalupe Parish changed the tax identification number for only one of its bank accounts. The account changed was the Our Lady of Guadalupe Church Parish Hall Account at Sun Community Federal Credit Union #005-010430. Generally the funds deposited into this account originated from the rental of the Parish Hall. All expenses needed to operate the hall were paid from this account.

On March 20, 2007, the Parish hall bank account was used to further the series of transactions started on February 21, 2007. The before described cashiers check for $49,685.47 was deposited into the Parish Hall bank account and a $40,000 withdrawal for the purchase of another cashiers check happened the same day. These transactions became readily apparent to the Expert because the transactions in this account were normally substantially smaller. These two transactions were discovered on the day of the Expert visit and back-up documentation was requested concerning the two transactions. From June 14, 2007 through June 26, 2007, five to six telephone calls were made to Lenna Ivies, Office Manager, asking for documentation for the $49,685.47 deposit and $40,000.00 withdrawal. On June 28, 2007, the documents were received in the Los Angeles, CA office of LECG, LLC from Our Lady of Guadalupe, Calexico. The documents were received and reviewed by the Expert on June 29, 2007, at the Diocese. These documents provided detail for the two transactions. From the documents we determined that the $49,685.47 deposit was the cashiers check dated February 21, 2007. Rev. Fernandez explained the source of the funds to be from a drawing and festival held in early 2007. As more fully described above we know that some of the funds represented an ACA rebate and a transfer from the designated gift bank account. Rev. Fernandez further explained that the finance council and fundraising committee agreed that the funds raised would be used to make repairs to the church and offices. The $40,000.00 withdrawal on March 20, 2007, was in the form of a cashiers check drawn in the name of Our Lady of Guadalupe.

After reviewing the documents, we were still unable to determine what happened to the $40,000 cashiers check. On June 29, 2007, a voice message was left with Lenna Ivie regarding the whereabouts or use of $40,000.00 cashiers check. Lenna promptly returned the voice message and a discussion ensued regarding the $40,000.00 cashiers check. Lenna was unable to answer the questions, so Rev. Fernandez was contacted to provide additional information. Lenna and Rev. Fernandez participated in the conversation via the speakerphone. When asked where the funds were currently located, Rev. Fernandez replied they were deposited into the Parish hall bank account. Rev. Fernandez stated the money was re-deposited into the Parish Hall bank account last week, (week of June 22, 2007). The next question for Rev. Fernandez was where the money was held from March 20, 2007, through its re-deposit. There was no immediate response to the question. After a lengthy pause Rev. Fernandez replied he could not understand the question and Lenna would have to translate it into Spanish for him. Lenna asked Rev. Fernandez the question regarding the storage of the cashiers check and he replied he had placed the funds in the church safe. The Expert subsequently received documentation reflecting the re-deposit of the $40,000 into the same account from which it was withdrawn.

It is the Expert's opinion that the withdrawal of $49,685.47 in the form of a cashiers check and the subsequent withdrawal of $40,000 through the issuance of another cashiers check was a purposeful attempt on the part of Rev. Fernandez, who has the ultimate responsibility for the Parish funds, to evade the direction of the Court to report all cash available. With the $49,685 cashiers check and later the $40,000 cashiers check safely secured in the safe, the Parish would not need to list amount as cash being maintained by the Parish thereby escaping the control of the Court.

- St. Mary of El Centro Parish
    - (See Appendix B.15)

The following transaction was uncovered during the Expert's audit of the financial records of St. Mary of El Centro Parish:

In late December 2006, the parish received a $300,000 donation for the building fund. The money was deposited into the building fund account at Union Bank of California. On March 7, 2007, in two separate transactions, $290,000 was withdrawn from this account to purchase six (6) cashier's checks; five (5) cashier's checks for $50,000 each and one (1) for $40,000. As of the date of our visit the checks were being held in the parish safe and according to parish personnel the money will be used for new carpet and remodeling. It was also asserted by parish personnel, that the Parish Finance Council made the decision to handle these funds in this manner.

It is the Expert's view that the parceling of a $300,000 donation into 6 separate cashier's checks totaling $290,000 was a willful attempt on the part of the Parish and the Parish Finance Council to circumvent the intent and direction of the Court requesting transparency in the recognition of financial cash balances by all of the Parishes. It is unfortunate the Pastor and the Parish Finance Council would engage in such deliberately misleading behavior.

The Expert has received subsequent confirmation from the Diocese that the entire sum of $290,000 has been re-deposited into the Parish accounts and subsequently deposited into the PSDL Trust.

- Our Lady of Mt. Carmel San Ysidro Parish ("San Ysidro Parish")
    - (See Appendix B.58)

The financial condition of the San Ysidro Parish and financial concessions provided by the Diocese are somewhat contradictory and are therefore perplexing to the Expert.

The parish has consistently maintained that they are one of the poorest parishes in the Diocese, yet the parish held $1.2 million in the banking accounts of the Parish at February 28, 2007, which sum is only exceeded by one other parish in the entire Diocese. The Parish also holds the largest number of private bank accounts (22) which far exceeds the normal range of parish bank accounts. In fact, there are a few parishes who maintain only one general account. In addition, Our Lady of Mt. Carmel, San Ysidro Parish asserts that nineteen (19) of the accounts hold restricted funds while only three (3) hold unrestricted funds.

The Expert believes that the parish inappropriately designates the preponderance of funds flowing into the parish as restricted. For example, the parish owns rental property which is rented for $1,800 a month. All of the rental proceeds are designated as restricted yet almost all of the expenses associated with the rental property, including property taxes are included as normal operating expenses and are paid from the ordinary donations of the parish. In addition, the parish holds weekly Sunday breakfasts and all proceeds from the Sunday breakfasts are designated as restricted, yet almost all of the expenses associated with the breakfasts are categorized as ordinary expenses and paid from ordinary donations. It is a common practice for parishes to hold specialized events for specific fund raising activities and designate those funds as restricted. However, the holding of a weekly breakfast event wherein all of the funds are designated as restricted is unprecedented in the Diocese.

The Diocesan Bank loaned funds for the construction of a school which is associated with the parish. As of June 30, 2004, the outstanding debt to the Parish was $436,326.52 and the loan is an interest free loan[112]. The debt, under normal Diocesan procedure, is the responsibility of the parish. Therefore, an agreement for repayment was made between the parish and the Diocese which provided for an annual payment of $12,000. Three payments of $12,000 were made in 2005, 2006, and 2007 for a total reduction of $36,000. In addition, the parish requested payments of $5,000 a month from the school to reduce the parish obligation to the Diocesan Bank. In furtherance of that agreement, the school paid the Diocesan Bank $50,000 in 2002/2003 to reduce the debt. In addition, during October 2003, the school paid the Diocesan Bank another $48,000 which was applied to the debt. Finally, during June 2006, the school changed their previous procedure and paid $40,000 directly to the parish for ultimate transmittal to the Diocesan Bank to further reduce the debt. Instead of sending the funds to reduce the debt, the parish retained the funds. In addition, during the year ended June 30, 2006, while the parish was holding close to $1 million in their parish bank accounts, the Diocese granted the parish rebates of $96,000 further reducing the loan from the Diocesan Bank. Also, from the period 2004 through 2007, interest free loans have been made by the parish to two employees in the total amount of $13,520 of which $10,491 still remain outstanding. The Expert finds this to be confusing and certainly not indicative of an impoverished parish unable to pay their obligations to the Diocese.

Perhaps the most disconcerting aspect of the Experts audit concerns the JCCG Foundation. On February 20, 2007, one week prior to the bankruptcy filing the Parish received and deposited into the foundation bank account $100,290 from the Most Reverend Gilbert E. Chavez,[113] Auxiliary Bishop of San Diego until his retirement on May 31, 2007 and previous pastor of the parish. An additional $15,000 was transferred to the JCCG Foundation bank account from another parish account which had recently received $40,000 from Bishop Chavez. The funds for the JCCG Foundation were placed in a restricted bank account at the parish on February 20, 2007. Subsequent to the bankruptcy filing, from March 2, 2007 through March 8, 2007, seven (7) checks, each for $8,572 and another check for $9,959 (for a total of $69,963) were written from the restricted account. According to the personnel at the parish, the checks were written directly to Raul Gonzalez, a deacon at the same

[112] Since the Parish has an outstanding interest free loan, it is not entitled to interest on funds deposited in the PSDL Trust, which may explain the retention approximately $1.2 million in parish bank accounts.

parish, Our Lady of Mt. Carmel, who supposedly transferred the funds to an individual named Mauro Tovar who had expertise in importing and exporting goods from Columbia. Again according to personnel at the parish, Mr. Tovar was to facilitate the transfer of funds to the sister parish in Columbia in order to allow them to purchase 67 computers and several printers. This sister parish in Columbia, was the former parish of Reverend Castillo, the present Pastor of the San Ysidro parish. An additional $23,000 was also disbursed from the JCCG Foundation account later in March and early April 2007, but the Expert has not received any supporting documentation for those transfers.

The Expert understands the compassionate service which has been graciously provided to the parishioners of the San Ysidro parish and the sister parish in Columbia. Notwithstanding such generosity, the Expert believes that the transparency inherent in the bankruptcy system does not allow for such transfers to occur while the parish still maintains a significant obligation to the Diocese.

The Diocese has informed the Expert that they are in the process of responding to the Expert's comments. At this stage the Expert has not been able to independently confirm those actions.

[113] According to our analysis, since August 2006, Reverend Chavez has donated a total of approximately $490,000

Annual Catholic Appeal and Designated Special Collections

Since 1991, the goal of the Roman Catholic Bishop of San Diego has been to raise an annual sum of $2.5 million[114]. Among other things, the ACA proceeds, at the direction of the Diocese, are to be used to benefit schools, religious education, care of priests, and other Catholic charities.

Each year, each parish is assessed an allocable amount by the Diocese for the ACA. This amount is based on a calculation of each individual parish's total plate and envelope collections for the previous fiscal year as compared proportionally to the total plate and envelope collection from all parishes in the Diocese, less approved deductions. The approved deductions include:

- Parish contributions from ordinary sources to its Catholic school or the Catholic school attended by its children,
- Interest paid on indebtedness to the Diocese and
- Donations to other parishes and other charitable religious organizations.

The Finance Officer at the Diocese, and Msgr. Callahan (Vicar General), decide if any adjustments are required in the calculated ACA amounts[115]. For example, if a parish is holding a building campaign, plate and envelope collections may be less than normal, therefore an increase may be made to their assessed amount. Special adjustments are also made if the parish experiences a disaster or emergency, or is in a particularly poor area. The parish also has the opportunity to appeal any fair-share adjustment within ten days of notification.

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of his own funds to the parish.

[114] In addition, the Diocese includes in the ACA assessment to each parish an additional 10% administrative charge. This charge is to cover the costs incurred by the Diocese to administer the program.

The ACA is generally collected in one of two ways and Parish involvement differs depending on the method selected. According to Diocesan personnel it can be collected in a “regular” or “irregular” way.

The “regular” method commences during the first few weeks of February when the pastor makes an appeal to all parishioners for contributions to the ACA. The parish is responsible for creating their own individual pledge cards. Parishioners complete the pledge cards and return them during mass or at a later point in time to the parish office. The pledge card usually gives the option to pay in full, pay installments over ten months, charge immediately with a credit card, and also gives instructions on how to pay over the phone or online. The parish normally records the amount of individual pledges, then sends the payments and pledge cards to the bank. The bank processes the payments and the credit cards, and forwards the pledge card information to the Diocese. The Diocese is then responsible for billing the individual parishioners, tracking collections, and providing monthly reports to the parish.

If the Diocese collects any amounts exceeding the original parish assessed amount (which is regularly done), rebates are forwarded to the parish. The parish is then free to use the rebated money in any manner they feel is appropriate. In the case of a shortfall, the parish will be billed and requested to remit the shortfall directly to the Diocese.

The “irregular way” requires the parishes to assume primary responsibility to collect their entire ACA assessment utilizing the methods they feel are most effective. Historically, parishes

[115] Such adjustments are called “fair share adjustments”.

using this approach typically generate more money, which in turn, may benefit the parish as they are allowed to retain all funds in excess of the assessed amount.

Designated Donations - Special Collections

The Diocese sponsors seven special collections. They are approved, but not mandated, by the U.S. Conference of Catholic Bishops. All parishes generally participate in these seven special collections. The Diocese receives a 3% administrative fee for all collections except items 4 and 7 listed below. The seven special collections are outlined below:

1. Annual Lenten Collection – 4th Sunday of Lent

   Charities selected for collection efforts:

   - Catholic Relief Services,
   - Operation Rice Bowl (encouraged),
   - Church in Africa and
   - Church in Latin America (including Dioceses of Tijuana and Mexicali).

2. Church in the Holy Land (recommended) – Good Friday.

3. Missions of the Holy Father (Peter's Pence) – 4th Sunday of June.

4. Mission Sunday (Propagation of Faith) – Next to last Sunday of October.

5. Collection for National Needs – Sunday before Thanksgiving

   Charities selected for collection efforts:

   - Black and Indian Mission,
   - Catholic Campaign for Human Development,
   - Catholic Communication Campaign,
   - Catholic Home Missions and
   - Catholic University of America

6. Retirement Fund for Religious – 2^{nd} Sunday of December.

7. Missionary Cooperative Plan – Various.

<u>(#1) Annual Lenten Collection and (#5) Collection for National Needs</u>

The Diocese administers two collections internally: the Annual Lenten Collection and the Collection for National Needs. As noted above, a number of charities benefit from these collections. The Diocese creates and prints an envelope which allows the parishioner check a box next to the specific charity of their choice. In the alternative, the parishioner may choose not to check a specific charity, in which the case the Diocese will make the decision as to the manner of allocation from among the charities. The parish collects the envelopes and deposits all of the checks into a parish account. Next, the parish will prepare a form provided to them by the Diocese, and forward to the Diocese an amount equal to the entire collection. The parish discards all opened envelopes with no specific charity selected; those envelopes with specific charities designated are forwarded to the Diocese for tracking purposes

The Diocese determines in advance the amount (“predetermined amount”) they wish to allocate to each of the charities selected. The envelopes with the marked boxes are tallied, and if the totals exceed the predetermined amounts, there is an adjustment to those amounts. Additionally, if over time there seems to be a shift in amounts chosen or designated by parishioners to specific charities, the Finance Officer will adjust the predetermined amounts. Finally, because parishioners are more inclined to check the box listed first, every year the order of the charities listed is altered. After the Diocese receives all of money from the parishes, they disburse the funds to the individual charities.

<u>(#4) Mission Sunday (Propagation of Faith) and (#7) Missionary Cooperative Plan</u>

The Mission Sunday and the Missionary Cooperative Plan collections are handled by the Missions Office at the Diocese. They send envelopes to the parishes, and the parishes send the parishioners’ checks directly to the Mission Office. If the donation is made in cash, the parish deposits the cash and prepares a check to the Missions Office. The funds are then sent to the office of the Pontifical.

<u>(#3) Missions of the Holy Father (Peter’s Pence) and (#6) Retirement Fund for Religious</u>

These collections are organized by the respective organizations, but are overseen by the Diocese. The Diocese collects the money from the parishes on behalf of the organizations, and submits a single check to the organization.

(#2) Church in the Holy Land

There are no envelopes for this collection. It is simply a second collection held on Good Friday, if the pastor chooses to participate. If they participate, the parish prepares a check to the Diocese for the full amount of the donations, which is ultimately sent to the organization.

Parish Finance Council

According to the Parish Administration section of the Handbook, "Every parish in the Diocese of San Diego is to have a PARISH FINANCE COUNCIL as required by canon 537." Under the Parish Finance Council Charter, Article II, it states, "The Parish Finance Council is consultative. It is not the function of the Parish Finance Council to implement policies. Policy implementation is the domain of the pastor, parish staff and members of the parish who assist them." The charter then outlines ten specific responsibilities of the council.

The Expert did not require specific evidence from each parish which was audited that a parish finance council was functioning, although almost all of the parishes had finance councils with varying degrees of activity and involvement. There seemed to be a direct correlation between the size and activity of the parish and the activity of the finance council. Within the larger parishes there was a greater tendency to have a more active parish finance council.

Diocesan Financial Review of Parishes

In the Handbook, "Guidelines for Parish Financial Procedures and Controls," it states, "The purpose of this guideline is to provide parishes with the basic controls and procedures that should be employed by each parish and parish-related organization…."

"At least every five years, the internal auditor of the diocese will perform a financial review of each parish. Financial reviews will also be performed whenever a parish has a change in pastors. The internal auditor will be going over these procedures with the pastor and others on his staff and will be in a position to recommend how internal controls may be improved and how procedures may be performed more efficiently. These recommendations will be sent to the pastor after the review is complete."

From our discussions with the various parishes and pastors the Expert has concluded that the Diocesan reviews were not always conducted following a pastor change and were only sporadically performed during each five years. In fact, some parishes contend they have not experienced a Diocesan review in over 10 years.

Attached as Exhibit 99 is a copy of a Diocesan form letter routinely sent to a parish setting forth the information required for the review. As detailed in Exhibit 99, the letter sets forth 12 areas of specific information and additionally informs the pastor he will be required to provide a knowledgeable person to be interviewed regarding accounting procedures. The pastor is also required to provide access to canceled checks, paid invoices and personnel files of the parish.

During the Expert's review of the parishes and schools he found few parishes able to provide copies of previous diocesan financial reviews. In some cases the parishes informed the Expert that reviews had been performed, but the parish was unable to locate copies of the supporting documentation. The parishes often contacted the Diocese who was also unable to locate copies. The Expert was able to review copies of several parish financial reviews maintained on file at the Diocese, although not necessarily for the parishes visited by the Expert. These reviews provided specific "recommendations" but not directives to the parish. Routinely, the parish was sent a copy of these recommendations but not the complete review file. As far as the Expert could ascertain, the Diocese conducted no follow-up in order to determine whether their "recommendations" were implemented and what changes, if any, were made at the parish level.

One of the functions of the parish finance council, as delineated in the Handbook, is to annually assess internal controls and procedures for compliance with Diocesan policies and review the recommendations resulting from Diocesan directed financial reviews. The Expert only rarely found any written reports from the parish finance council regarding an assessment of internal controls. The Expert believes that an active Parish Finance Council often provides significant input, but that input was almost always provided in a verbal format during finance council meetings and not in the form of formal written reports.

The Expert appreciates the opportunity to be of service to the Court and other interested parties.

Respectfully submitted,

R. Todd Neilson, CPA
Expert

July 30, 2007

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