Supplemental narrative to 2013 Archdiocesan Financial Report

This narrative is intended to be used in connection with a review of the Archdiocese of Philadelphia – Office for Financial Services ("OFS") financial statements in order to provide a reader a more general understanding of the financial situation of OFS.

OFS provides programs to the parishes, schools and other related ecclesiastical entities of the Archdiocese. While OFS provides services to multiple entities, for financial reporting purposes, it is considered a wholly-owned subsidiary of the Archdiocese.

A description of the offices and funds that are included in the OFS financial statements can be found in Note A in the audited financial statements for OFS which are available on CatholicPhilly.com.

Please note that the OFS financial statements do not include financial results for the Office for Catholic Education, Catholic Healthcare Services, Catholic Social Services, Saint Charles Borromeo Seminary, Catholic Charities Appeal or the Heritage of Faith-Vision of Hope Capital Campaign. Audited financial statements for those entities will be posted in the coming weeks.

Also note that none of these reports will include financial statements for parishes – and for good reason. All parishes are autonomous entities. The Archdiocese has no authority over their assets.

Discussion of FY 2012 Operating Deficit

In his earlier column ("***Looking Ahead to the Archdiocesan Financial Report***") Archbishop Chaput referenced the seriousness of our results for FY 2012. This reference was primarily to the operating deficit that we experienced in OFS. This deficit is reflected in the Statement of Activities and Changes in Net Assets under the caption "Change in Net Assets before other Items" in the "Unrestricted" column. The $39.2 million reflected at that caption represents the operating deficit for OFS incurred during the fiscal year ended June 30, 2012.

We believe the followings items, which are included in the deficit, are non-recurring in nature:

	(in millions)
Net gain on sale of assets (includes gains on sales of the Northeast Catholic High School and Cardinal Dougherty High School properties)	$ 15.8
Interest Rate Swap Loss	(8.9)
Increase in Self-Insurance Reserve	(13.0)
Legal and other professional fees	(11.9)
Total Non-Recurring Items	($ 18.0)

Excluding the non-recurring items, the deficit incurred was $21.2 million, which included depreciation expense of $3.8 million. Excluding the non-recurring items and depreciation expense the deficit incurred was $17.4 million.

Regarding the non-recurring legal and other professional fees noted above, the costs were incurred in connection with the following matters:

	(in 000's)
Investigation of actions by former CFO	$534.2
Investigations related to Priests on Administrative Leave	4,652.7
Fees associated with Independent Legal and Financial Assistance/Review; External Debt Retirement; and Criminal Trial	6,691.4
	$11,878.1

Discussion of Prior Period Adjustments

Due to a significant number of prior period adjustments (summarized below and detailed in Note R in the financial statements), single year financial statements are presented for the year ended June 30, 2012. We expect that in future years we will present two year, comparative financial statements. The table below summarizes the impact of the prior period adjustments.

		(in millions)
	Net Assets as Reported at July 1, 2011	$ 34.5
❶	Inclusion of certain assets A	43.8
❷	Funds held for charities A	(1.8)
❸	Depreciation B	(43.4)
❷	Fixed asset adjustments A	(7.8)
❸	Conditional asset retirement obligation A	(1.9)
❹	Allowance for doubtful accounts B	(26.4)
	Net Assets as Restated at July 1, 2011	($ 3.0)

A Further explanation can be found in Note R in the financial statements.

B Further explanation provided below and in Note R in the financial statements.

Reasons for Prior Period Adjustments

❶ Include Assets that should have been included
❷ Exclude assets that should have been excluded
❸ Comply with Generally Accepted Accounting Principles
❹ Adjustment to properly record the allowance for doubtful accounts

- Note R further explains that in previous years, depreciation expense was not recorded for long lived tangible assets. During the year ended June 30, 2012 we adopted the appropriate accounting for long lived tangible assets. The impact of this change for all years prior to the year ended June 30, 2012 is recorded as a prior period adjustment.

- Note R in the financial statements details that for the year ended June 30, 2012 the Archdiocese made an adjustment to properly record the allowance for doubtful accounts for parish accounts and loans receivable. The methodology used in FY 2012 to determine the allowance for doubtful accounts focuses on the aging of amounts past due and also assesses each parish's ability to pay.

  Had we used the current methodology in prior years, as of June 30, 2011 the allowance for doubtful accounts would have been higher by $26.4 million. The $26.4 million has been recorded as a prior period adjustment.

Discussion of Other Significant Matters

- Note G in the financial statements explains that during the year ended June 30, 2012 the Archdiocese paid off outstanding bonds in Montgomery County, PA and Chester County, PA. This transaction resulted in principal payments of approximately $97.7 million plus costs associated with terminating interest rate swap obligations totaling $15.75 million.

- Included in the financial statements for the Office for Financial Services are all assets and liabilities of the Archdiocesan Trust and Loan Fund. The Trust and Loan Fund is a cooperative deposit and loan program established for the benefit of parishes and to assure continuation of the ecclesial goals of the Archdiocese and the parishes. If a parish deposits funds in the Trust and Loan Fund, it receives a competitive interest rate. In turn, these funds are loaned by the Fund to other parishes for construction and other projects. (See Note C for more discussion of loans outstanding). As of May 31, 2012, the Archdiocese executed a promissory note to the Trust and Loan Fund in the amount of $78.9 million, which represented the excess of deposits over assets at May 31, 2012. As of June 30, 2012, deposits in the Trust and Loan Fund exceeded fund assets – excluding the impact of the promissory note – by $82.0 million, as follows:

	(**in millions**)
Deposits	$167.1 *
Trust & Loan Fund Assets (excl. promissory note)	85.1
Excess of Deposits over Assets	$ 82.0

* includes approximately $100K in Trust and Loan Fund liabilities.

Subsequent to June 30, 2012 the promissory note has been amended to increase the principal amount to $82.0 million. The promissory note is collateralized by specific pledged real estate assets which are documented in the note. As pledged properties are sold or monetized, net proceeds from these Trust and Loan collateral transactions will be deposited into the Trust and Loan Fund, in accordance with the provisions of the promissory note. In the event a transaction generates in excess of $20 million in net proceeds, the Archdiocese has discretion regarding alternative uses for the excess so long as remaining pledged assets are at least equal to the then outstanding principal amount owed.

- The insurance fund is used to account for the risk management program of the Archdiocese. As part of the risk insurance program, levels of self-insurance risk are retained. (See Notes B, F and I in the financial statements for more information regarding the self-insurance liability and how it is determined). As of June 30, 2012 insurance related liabilities exceeded dedicated insurance assets, as follows:

	(**in millions**)
Insurance Related Liabilities	$ 43.9
Insurance Related Assets	13.5
Excess of liabilities over assets	$ 30.4

- Note K in the financial statements describes our pension plans, in particular the Priests' Plan and also the Lay Employees' Retirement Plan. Separate audits are performed for each of these plans. As described in Note K both of these plans are considered multiemployer plans for financial reporting purposes. As such, the assets and actuarially determined liabilities for these plans are not included in the OFS financial statements.

  While not direct liabilities of OFS, the amount the plan liabilities exceed plan assets in both plans are liabilities of the Archdiocese. As of June 30, 2012 the Priests' Plan liabilities exceeded assets by approximately $90 million and the Lay Employees' Retirement Plan liabilities exceeded assets by approximately $152 million.

Looking Forward

Because of the passage of time between the completion of the audit and June 30, 2012, the information described here and presented in the financial statements is almost a full year behind us. The deficit that we experienced in fiscal year 2012 was staggering, and the overall negative impact on our financial position was even greater when the prior period adjustments are taken into account.

There is a clear way forward. In June 2012 we took significant steps to begin reducing our core operating deficit, which excludes extraordinary and non-recurring items. In June 2012, we also paid off all of our external debt greatly reducing our balance sheet risk. During the fourth quarter of 2012, we completed the sales of the Archbishop's residence and the property known as "Villa St. Joseph by the Sea" in Ventnor, New Jersey which generated additional cash flow and improved our short term liquidity situation. These transactions generated approximately $14 million in net proceeds as more fully explained in the "Subsequent Events" section of Note B in the financial statements. We believe that our "core" (excludes items of a non-recurring nature and depreciation) run rate deficit as we enter FY 2014 is below $5 million. We will take additional steps to reduce the core deficit further and acknowledge the need to eliminate the operating deficit completely in the very near future.

We are also focused on the balance sheet issues described above – namely the Trust and Loan Fund, the insurance fund and the pension plans. As we sell or monetize assets we will continue to provide timely updates so that we clearly communicate to the faithful of the Archdiocese how we are applying the proceeds from these transactions to address these issues. Regarding the pension plans specifically, while additional future funding is certainly needed, we also need to take a critical look at our retirement programs. We need to consider all possible options regarding the retirement needs of our priests and employees as we move forward.