



**SAINT MARY'S HEALTH SYSTEM, INC.**

Consolidated Financial Statements and  
Consolidating Information

September 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

**SAINT MARY'S HEALTH SYSTEM, INC.**

Consolidated Financial Statements and  
Consolidating Information

September 30, 2010 and 2009

**Table of Contents**

	<b>Page</b>
Independent Auditors' Report	1
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Changes in Net Assets	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6
<b>Exhibits</b>	
1 Consolidating Balance Sheet as of September 30, 2010	29
2 Consolidating Statement of Operations for the year ended September 30, 2010	31



**KPMG LLP**  
One Financial Plaza  
755 Main Street  
Hartford, CT 06103

## **Independent Auditors' Report**

The Board of Directors  
Saint Mary's Health System, Inc.:

We have audited the accompanying consolidated balance sheets of Saint Mary's Health System, Inc. (the System) as of September 30, 2010 and 2009, and the related statements of operations, changes in net assets, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Saint Mary's Health System, Inc. as of September 30, 2010 and 2009, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information as of and for the year ended September 30, 2010 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position and results of operations of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the 2010 consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the 2010 consolidated financial statements taken as a whole.

**KPMG LLP**

January 28, 2011

**SAINT MARY'S HEALTH SYSTEM, INC.**

Consolidated Balance Sheets

September 30, 2010 and 2009

(In thousands)

<b>Assets</b>	<b>2010</b>	<b>2009</b>
Current assets:		
Cash and cash equivalents	\$ 26,358	23,213
Short-term investments	1,182	1,082
Current portion of assets whose use is limited	4,714	4,739
Accounts receivable, net of estimated uncollectibles of \$7,367 in 2010 and \$7,486 in 2009	26,752	25,784
Other current assets	4,560	3,966
Total current assets	<u>63,566</u>	<u>58,784</u>
Marketable securities	<u>15,804</u>	<u>14,032</u>
Assets whose use is limited:		
By donor and held in trust by others	13,375	12,785
For estimated self-insurance liability	27,548	25,793
By bond indenture	5,078	5,873
Other	6	6
Total assets whose use is limited	<u>46,007</u>	<u>44,457</u>
Less current portion of assets whose use is limited	<u>4,714</u>	<u>4,739</u>
Noncurrent assets whose use is limited	<u>41,293</u>	<u>39,718</u>
Property and equipment, net	<u>55,878</u>	<u>55,753</u>
Other assets:		
Investments in joint venture arrangements	9,372	8,614
Deferred financing costs, net	214	250
Other noncurrent assets	501	682
Total other assets	<u>10,087</u>	<u>9,546</u>
Total assets	<u>\$ 186,628</u>	<u>177,833</u>
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Current portion of long-term obligations	\$ 3,124	2,736
Accounts payable	12,644	11,432
Salaries, wages, and payroll withholdings	6,499	7,104
Due to third-party payors, net	5,935	6,847
Accrued expenses and other current liabilities	10,146	8,605
Total current liabilities	<u>38,348</u>	<u>36,724</u>
Long-term liabilities:		
Long-term obligations, net of current portion	26,789	28,263
Estimated self-insurance liability	19,334	16,848
Pension and deferred compensation	67,434	71,557
Other long-term liabilities	8,363	9,443
Total long-term liabilities	<u>121,920</u>	<u>126,111</u>
Minority interest in subsidiaries	<u>1,663</u>	<u>1,855</u>
Net assets (deficit):		
Unrestricted	7,737	(3,025)
Temporarily restricted	2,582	2,387
Permanently restricted	14,378	13,781
Total net assets	<u>24,697</u>	<u>13,143</u>
Total liabilities and net assets	<u>\$ 186,628</u>	<u>177,833</u>

See accompanying notes to consolidated financial statements.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Consolidated Statements of Operations

Years ended September 30, 2010 and 2009

(In thousands)

	<b>2010</b>	<b>2009</b>
Revenues:		
Net revenue from patient services	\$ 243,847	238,143
Other operating revenues	7,572	7,585
Total revenues	251,419	245,728
Expenses:		
Salaries and wages	105,443	102,507
Employee benefits	28,308	27,782
Supplies and other expenses	89,706	83,457
Provision for uncollectible accounts, net of recoveries	13,281	13,161
Depreciation and amortization	8,767	8,750
Interest	1,812	1,903
Total expenses	247,317	237,560
Operating income	4,102	8,168
Nonoperating gains (losses):		
Investment gains (loss), net	1,723	(1,271)
Equity in earnings of joint ventures	1,311	2,051
Minority interest in subsidiaries	(863)	(1,043)
Net loss on disposal of assets	(89)	(91)
Other	353	639
Total nonoperating gains, net	2,435	285
Excess of revenues over expenses	6,537	8,453
Net assets released from restriction for capital expenditures	328	150
Change in unrealized gains on marketable securities and other assets whose use is limited	890	638
Change in accumulated pension charges to unrestricted net assets	3,007	(13,120)
Increase (decrease) in unrestricted net assets	\$ 10,762	(3,879)

See accompanying notes to consolidated financial statements.

**SAINT MARY'S HEALTH SYSTEM, INC.**  
Consolidated Statements of Changes in Net Assets  
Years ended September 30, 2010 and 2009  
(In thousands)

	<b>2010</b>	<b>2009</b>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 6,537	8,453
Net assets released from restriction for capital expenditures	328	150
Change in unrealized gains on marketable securities and other assets whose use is limited	890	638
Change in accumulated pension charges to unrestricted net assets	3,007	(13,120)
Increase (decrease) in unrestricted net assets	10,762	(3,879)
Temporarily restricted net assets:		
Net assets released from restriction	(588)	(286)
Restricted contributions	901	504
Change in net assets of Cancer Center, including releases for capital expenditures	(118)	(183)
Increase in temporarily restricted net assets	195	35
Permanently restricted net assets:		
Net earnings on assets held in trust by others	1,199	226
Appropriation for expenditure	(602)	(486)
Increase (decrease) in permanently restricted net assets	597	(260)
Increase (decrease) in net assets	11,554	(4,104)
Net assets – beginning of year	13,143	17,247
Net assets – end of year	\$ 24,697	13,143

See accompanying notes to consolidated financial statements.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Consolidated Statements of Cash Flows  
Years ended September 30, 2010 and 2009  
(In thousands)

	<b>2010</b>	<b>2009</b>
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 11,554	(4,104)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	8,767	8,750
Net loss on disposal of assets	89	91
Change in unrealized gains on investments	(890)	(638)
Change in net assets of Cancer Center	118	183
Change in accumulated pension charges to unrestricted net assets	(3,007)	13,120
Investment (income) loss, net	(1,723)	1,271
Equity in earnings of joint ventures and partnerships	(1,311)	(2,051)
(Increase) decrease in operating assets:		
Accounts receivable, net	(968)	(2,013)
Other current assets	(558)	1,620
Other non current assets	181	514
Increase (decrease) in operating liabilities:		
Due to third-party payors, net	(912)	1,419
Accounts payable and other current liabilities	2,148	(991)
Estimated self-insurance liability	2,486	298
Minority interest in subsidiaries	(192)	(209)
Pension, accrued compensation, and other long-term liabilities	(2,196)	1,278
Net cash provided by operating activities	13,586	18,538
Cash flows from investing activities:		
Purchases of property and equipment	(7,031)	(7,938)
Distributions from joint ventures and partnerships	485	1,072
Investments in joint venture arrangements	(50)	(117)
Change in other assets whose use is limited	(2,345)	(1,377)
Net decrease (increase) in investments	741	(1,102)
Net cash used in investing activities	(8,200)	(9,462)
Cash flows from financing activities:		
Decrease (increase) in assets whose use is limited by bond indentures	795	(807)
Borrowings under long-term obligations	—	494
Payments on long-term obligations	(3,036)	(3,019)
Net cash used in financing activities	(2,241)	(3,332)
Net increase in cash and cash equivalents	3,145	5,744
Cash and cash equivalents – beginning of year	23,213	17,469
Cash and cash equivalents – end of year	\$ 26,358	23,213
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,754	1,885
Supplemental disclosure of noncash item:		
Assets acquired under capital lease	1,950	—

See accompanying notes to consolidated financial statements.

## SAINT MARY'S HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

September 30, 2010 and 2009

#### (1) Organization

Saint Mary's Health System, Inc. (SMHS or the System) is a not-for-profit, nonstock Connecticut holding company. It is the sole member of Saint Mary's Hospital, Inc. (the Hospital) and Saint Mary's Hospital Foundation, Inc. (the Foundation).

The Hospital is an acute care hospital located in Waterbury, Connecticut. The Hospital was founded in 1907 and is licensed for 347 beds and 32 newborn bassinets. The Hospital currently staffs 175 beds and 20 newborn bassinets. The Hospital provides a broad range of inpatient and outpatient services including a number of medical and surgical specialties, obstetrics, pediatrics, mental health, alcohol and substance abuse rehabilitation (outpatient) and off-site ambulatory services.

The Hospital has six consolidated subsidiaries: Franklin Medical Group, P.C. (Franklin), a for-profit Connecticut corporation; Scovill Medical Group, P.C. (Scovill), a for-profit Connecticut corporation; Primary Care Partners, P.C. (Partners), a for-profit Connecticut corporation; Saint Mary's Indemnity Company, LLC (the Indemnity Company) a Vermont limited liability company; Naugatuck Valley Surgical Center, LP (the Surgical Center), a Connecticut limited partnership and Diagnostic Imaging of Southbury, LLC (the Diagnostic Center), a for-profit Connecticut corporation.

Franklin, consisting of certain Hospital based physicians, provides mainly outpatient services. Scovill owns and operates physician practices in the greater Waterbury area. Partners was formed during December 2008 to own and operate additional physician practices.

The Indemnity Company was formed during June 2009 to provide professional and general liability insurance to the Hospital, Franklin, Scovill, Partners, and community physicians.

The Hospital has approximately an 85% equity interest in the Surgical Center, which provides ambulatory surgery services. The Hospital has a 60% equity interest in the Diagnostic Center, which provides diagnostic imaging services. The remaining interests are accounted for as a minority interest in the accompanying consolidated financial statements.

The Foundation was organized to raise funds to support the Hospital.

The assets, liabilities and operations of the Hospital's Auxiliary have not been reflected in the accompanying consolidated financial statements. Such amounts are not considered significant to the Hospital's consolidated financial position or results of its operations.

#### (2) Community Benefit (Unaudited)

The Hospital is a community teaching hospital that serves the healthcare needs of the Central Naugatuck Valley area. Like other healthcare providers across the nation, the Hospital is faced with the challenge of serving those in need with fewer resources. Although the Hospital cannot meet community needs alone, it is committed to seek out unmet community needs and to be a catalyst in efforts to ensure an adequate community-wide response from government and public organizations in fulfilling community needs.

##### (a) *Charity and Uncompensated Care*

As part of fulfilling its mission, the Hospital provides care to all patients in need, regardless of their ability to pay. The Hospital has a formalized charity care policy that identifies which patients are

## SAINT MARY'S HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

September 30, 2010 and 2009

deemed "charity care". During 2010 and 2009, charges foregone related to charity care were approximately \$1,044,000 and \$493,000, respectively.

In addition, the Hospital provides care to patients covered by governmental healthcare programs. During 2010 and 2009, the Hospital estimates that the cost of providing this care exceeded compensation by \$9,488,000 and \$7,845,000, respectively.

**(b) *Education, Research and Training***

As a community teaching hospital affiliated with Yale School of Medicine, the Hospital has residency programs for general surgery, internal medicine and dental. These programs educate in excess of 50 residents and medical students per year. In addition to its residency programs, the Hospital furthers its educational mission by offering allied health programs affiliated with area educational facilities.

**(c) *Wellness and Health Promotional Activities***

The Hospital provides many activities to promote the concept of healthy lifestyles, including the publishing and free distribution of *Discover*, which reaches more than 70,000 community households, health risk screenings, health fairs, support groups, speakers bureau and free telephone physician referral services through the Physician Referral program.

**(d) *Leadership, Advocacy and Voluntarism***

The Hospital's employees are responsive to the community in the areas of planning, governance and service by annually providing thousands of hours of volunteer services, participating on boards of directors and advisory councils, testifying before public policy bodies and working with other healthcare organizations to develop healthcare policies for all persons. The Hospital also provides volunteer opportunities for community residents. The Hospital recognizes donated goods and services at their appraised or estimated value if they create or enhance nonfinancial assets or require specialized skills and would typically be purchased if not provided by donation. The volunteer services the Hospital received do not meet this criteria for recognition in the accompanying consolidated financial statements, but the volunteers donate a significant amount of time to the Hospital. In fiscal years 2010 and 2009, approximately 160 and 125 volunteers spent more than 20,000 hours and 14,000 hours, respectively, of service in Hospital departments.

**(e) *Dollar, Time and In-kind Donations***

The Hospital also provides services to neighborhood schools and organizations at no cost. Contributions are made to programs, organizations and foundations for efforts on behalf of the poor, the disadvantaged and the general population. The Hospital also provides a variety of in-kind services including education on parenting and child abuse prevention and use of Hospital space for community meetings.

**(f) *Other Support Services***

The Hospital provides outreach and social support services to patients. Programs such as the Sleep Disorders Support Group and the Chronic Lung Disorders/Pulmonary Support Group are integral to the healing of patients, and represent the Hospital's overall commitment to the continuum of care.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(3) Summary of Significant Accounting Policies**

**(a) *Basis of Presentation***

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with U.S. generally accepted accounting principles. All intercompany transactions have been eliminated in consolidation.

**(b) *Net Patient Service Revenue***

The System has agreements with third-party payors that provide for payments to the System at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

**(c) *Charity Care and Provision for Uncollectible Accounts***

The System provides care to patients who meet certain criteria under its financial assistance policy without charge or at amounts less than their established rates. Because the System does not anticipate collection of amounts determined to qualify as charity care, they are not reported as net revenue.

The System grants credit without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Additions to the allowance for uncollectible accounts are made by means of the provision for uncollectible accounts. Accounts written off as uncollectible are deducted from the allowance and subsequent recoveries are added. The amount of the provision for uncollectible accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental health care coverage and other collection indicators.

**(d) *Cash and Cash Equivalents***

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less.

The System invests its surplus operating funds in overnight repurchase agreement investments. These investments are collateralized with securities issued by the United States Government or its agencies and are not covered by FDIC insurance.

**(e) *Assets Limited as to Use***

Assets limited as to use primarily include assets held by others pursuant to donor restrictions, by trustees under indenture agreements, and by a captive insurance company for professional and general liability insurance.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(f) *Marketable Securities***

Investments in equity securities, mutual funds and all investments in debt securities are reported at fair value based on readily determinable fair market values or estimated fair value in the accompanying consolidated balance sheets. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses unless the investments are trading securities or are considered to be other than temporarily impaired.

In light of the market conditions over the past several years, the System has reviewed its investments in order to determine if any decrease from cost to fair value is other than temporary. The System has followed a policy of reviewing all investments that have been below cost by at least 25% for three quarters. Unless specific evidence exists to the contrary, these investments have been reduced to fair value, which becomes the new cost basis. The System recorded \$168,000 of other than temporary impairments on investments in 2009 which is included in investment income, net in the accompanying consolidated statements of operations. The System did not record any other than temporary impairments on investments in 2010.

Investment securities, in general, are exposed to various risks. Recent market conditions have resulted in an unusually high degree of volatility and increased the risks and short term liquidity of certain investments held by the System which could impact the value of investments after the date of these consolidated financial statements.

**(g) *Property and Equipment***

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements. Costs for repairs and maintenance are expensed as incurred.

Gifts of long-lived assets are reported as unrestricted support, and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restriction that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

The System reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset exceeds its fair value and may not be recoverable.

**(h) *Investments In Joint Venture Arrangements***

Investments in joint venture arrangements, generally in the form of partnership interests, are accounted for using the equity method of accounting.

## SAINT MARY'S HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

September 30, 2010 and 2009

(i) *Fair Value of Financial Instruments*

FASB ASC 820 establishes a framework for measuring fair value which provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described below:

- *Level 1* – Inputs into the valuation methodology are the unadjusted quoted prices for identical assets or liabilities in active markets that the System has the ability to access.
- *Level 2* – Inputs into the valuation methodology include quoted prices for similar assets or liabilities in active and inactive markets, other than quoted prices that are observable for specific assets or liabilities, and values that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified contractual term, the value must be observable for substantially the full term of the asset or liability.
- *Level 3* – Inputs into the valuation methodology are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Assets held in trust by others represents a donor established perpetual trust held and administered by an outside trustee. The System owns an interest in the trust rather than in the securities underlying the trust, and therefore it is generally required to consider such investments as Level 3 for the purposes of applying ASC 820. Such classification is based on the inability to redeem the investment, even though the underlying securities may not be difficult to value or may be readily marketable. Accordingly, the inputs or methodology used for valuing or classifying investments for financial reporting purposes are not necessarily an indication of the risk associated with investing in those investments.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The carrying amount of patient accounts receivable, accounts payable, and accrued expenses approximate fair value because of the short maturity of these instruments.

## SAINT MARY'S HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(j) Net Asset Categories**

To ensure observance of limitations and restrictions placed on the use of resources available to the System, the accounts of the System are maintained in the following net assets categories:

*Unrestricted* – Unrestricted net assets represent available resources other than donor restricted contributions. Included in unrestricted net assets are assets set aside by the board of directors for future capital improvements or for other purposes, as deemed appropriate.

*Temporarily Restricted* – Temporarily restricted net assets represent contributions that are restricted by the donor either as to purpose or as to time of expenditure.

*Permanently Restricted* – Permanently restricted net assets represent contributions received with the donor restriction that the principal be invested in perpetuity and that only the income earned that the trustee does not reinvest be available for operations. The net appreciation of the value of investments held in trust by others remains in permanently restricted net assets until cash is transferred to the System.

**(k) Excess of Revenues over Expenses**

Excess of revenues over expenses included in the consolidated statements of operations reflects the System's performance measure. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments, except for losses that are deemed to be other than temporary, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets). Nonoperating gains and losses, equity in earnings of joint ventures and adjustments related to minority interest are considered in the performance measure.

**(l) Income Taxes**

The System, Hospital, and Foundation are tax-exempt organization as described in Section 501(c)(3) of the Internal Revenue Code and are generally exempt from income taxes. The accompanying consolidated financial statements have been prepared on the basis that this tax-exempt status will be maintained.

Scovill, Franklin, and Partners are for-profit organizations subject to income taxes. Each organization has experienced operating losses and have accumulated net operating loss carryforwards at September 30, 2010. A valuation allowance has been recorded as management believes realization of such carryforwards is doubtful.

The Surgical Center, Diagnostic Center, and the Indemnity Company are pass-through entities with the tax consequences of their operating results being assessed at the member level.

**(m) Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Financial statement areas where management applies the use of assumptions

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

and estimates consist primarily of the allowance for uncollectible accounts, contractual allowances and related third-party accounts, the pension liability, and the estimated self-insurance liability.

**(n) Professional and General Liability**

The liability for unpaid losses and loss adjustment expenses includes estimates for reported losses, plus supplemental amounts calculated based upon loss projections utilizing the Indemnity Company's and insureds' historical data. In establishing this reserve, the Indemnity Company utilizes the findings of an independent consulting actuary. Management believes that its aggregate liability for unpaid losses and loss adjustment expenses at year-end represents its best estimate, based upon available data, of the amount necessary to cover the ultimate cost of losses.

The ultimate liability and receivable could be significantly in excess of or less than the amount indicated in the financial statements. As adjustments to these estimates become necessary, such adjustments will be reflected in current operations.

**(o) Prior Year Reclassifications**

Certain prior year balances have been reclassified in order to be consistent with the current year presentation.

**(4) Net Revenue from Patient Services**

A substantial portion of net revenue from patient services is derived from funds provided on behalf of patients under federal and state medical assistance programs. Revenue from some of these sources is determined by the application of reimbursement principles and is subject to audit by the applicable agencies. In the opinion of management, such principles have been properly applied in the determination of net patient service revenue. Settlement notices have been received from the Medicare program and the Medicaid program through 2006 and 2000, respectively. Retrospective adjustments for items under appeal by the System or under review by the intermediary, if any, are not expected to have a material adverse effect on the System's consolidated financial position or results of operations.

Net patient service revenues consist of inpatient revenues, principally from routine patient care and ancillary services and outpatient revenues from ancillary services, after considering allowances under agreements with various third-party payors. A reconciliation of gross revenues to net revenues from patient services after allowance for the years ended September 30, 2010 and 2009, is as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Gross revenue from patient services	\$ 562,404	531,794
Contractual and other allowances	(317,513)	(293,158)
Charity care	(1,044)	(493)
Net revenue from patient services	<u>\$ 243,847</u>	<u>238,143</u>

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The System grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of gross receivables from private pay patients and third-party payors at September 30, 2010 and 2009 was as follows:

	<u>2010</u>	<u>2009</u>
Medicare (including Medicare managed care)	28.7%	28.2%
Medicaid	12.6	17.9
Other third-party payors	31.0	27.6
Private pay patients	27.7	26.3
	<u>100.0%</u>	<u>100.0%</u>

The System's exposure to risk of nonpayment from private pay patients is more significant than other payors. However, the System has recorded an estimate for uncollectible accounts, which, in management's opinion, is sufficient to provide for such risk. This estimate is based on a variety of factors including historical experience, the current economic environment and recent payment patterns.

**(5) Regulatory and Legislative Matters**

**(a) State of Connecticut Regulatory Environment**

Connecticut's acute care hospital regulatory system is currently administered by the State of Connecticut Office of Health Care Access (OHCA). The Hospital is subject to a regulatory system that includes the administration of a pool resulting in distribution of monies by the State to the Hospital. The Hospital receives interim payments from the State based upon the Hospital's payment shortfalls for certain payors relative to similar experience of all other hospitals in the State. During 2010 and 2009, the Hospital received \$2,990,000 and \$3,252,000, respectively.

**(b) Federal Regulatory Environment**

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse and security and privacy of health information. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Hospital is in compliance with fraud and abuse regulations as well as other applicable government laws and regulations. While no material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(6) Marketable Securities and Assets Whose Use is Limited**

A comparison of cost and fair values of short-term investments, marketable securities, and assets whose use is limited, including the fair value of investments with unrealized losses that are not deemed other-than-temporarily impaired and the length of time the individual securities have been in a continuous unrealized loss position, at September 30, 2010 and 2009, is as follows (in thousands):

	<b>2010</b>					
	<b>Total</b>		<b>Less than 12 months</b>		<b>12 months or more</b>	
	<b>Fair value</b>	<b>Cost</b>	<b>Fair value</b>	<b>Unrealized losses</b>	<b>Fair value</b>	<b>Unrealized losses</b>
Cash and cash equivalents	\$ 2,688	2,688	—	—	—	—
Corporate bonds	11,308	10,797	—	—	765	(16)
U.S. government and agency obligations	20,573	20,226	—	—	400	(1)
Mutual funds	12,206	10,874	—	—	511	(24)
Equity funds	853	823	—	—	—	—
Equities	8,564	7,434	—	—	—	—
	<u>\$ 56,192</u>	<u>52,842</u>	<u>—</u>	<u>—</u>	<u>1,676</u>	<u>(41)</u>

	<b>2009</b>					
	<b>Total</b>		<b>Less than 12 months</b>		<b>12 months or more</b>	
	<b>Fair value</b>	<b>Cost</b>	<b>Fair value</b>	<b>Unrealized losses</b>	<b>Fair value</b>	<b>Unrealized losses</b>
Cash and cash equivalents	\$ 13,415	13,415	—	—	—	—
Corporate bonds	6,795	6,621	154	(2)	897	(94)
U.S. government and agency obligations	7,399	7,337	—	—	5	(1)
Mutual funds	14,744	14,180	70	(7)	564	(145)
Equities	11,588	10,641	933	(41)	660	(49)
	<u>\$ 53,941</u>	<u>52,194</u>	<u>1,157</u>	<u>(50)</u>	<u>2,126</u>	<u>(289)</u>

The above tables include permanently restricted assets held by others whose fair value exceeded cost by \$1,369,000 at September 30, 2010 and \$711,000 at September 30, 2009.

Assets whose use is limited for estimated self insurance includes approximately \$4,795,000 and \$5,624,000 of other assets, substantially receivables, as of September 30, 2010 and 2009, respectively.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2010 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 2,332	—	—	2,332
Domestic corporate bonds	—	6,403	—	6,403
Foreign corporate bonds	—	1,908	—	1,908
U.S. government and agency obligations	—	19,709	—	19,709
Mutual funds	11,385	—	—	11,385
Equity funds	—	853	—	853
Preferred equity securities	—	227	—	227
<b>Total</b>	<b>13,717</b>	<b>29,100</b>	<b>—</b>	<b>42,817</b>
Assets held in trust by others:				
Perpetual trust	—	—	13,375	13,375
<b>Total</b>	<b>\$ 13,717</b>	<b>29,100</b>	<b>13,375</b>	<b>56,192</b>

The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2009 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 12,536	—	—	12,536
Domestic corporate bonds	—	2,294	—	2,294
Foreign corporate bonds	—	17	—	17
U.S. government and agency obligations	—	7,400	—	7,400
Mutual funds	14,577	—	—	14,577
Equities	4,332	—	—	4,332
<b>Total</b>	<b>31,445</b>	<b>9,711</b>	<b>—</b>	<b>41,156</b>
Assets held in trust by others:				
Perpetual trust	—	—	12,785	12,785
<b>Total</b>	<b>\$ 31,445</b>	<b>9,711</b>	<b>12,785</b>	<b>53,941</b>

Mutual funds and equities are traded actively on exchanges and price quotes for these shares are readily available.

For domestic and foreign bonds and U.S. government obligations multiple prices and price types are obtained from pricing vendors whenever possible, which enables cross-provider validations. A primary price source is identified based on asset type, class or issue for each security. The fair values of fixed-

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

income securities are based on evaluated prices that reflect observable market information, such as actual trade information of similar securities, adjusted for observable differences.

The following table presents additional information about investments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended September 30 (in thousands):

	<u>2010</u>	<u>2009</u>
Perpetual trust		
Fair value at beginning of the year	\$ 12,785	13,048
Net realized and change in unrealized gains	1,192	223
Appropriation of endowment assets for expenditure	<u>(602)</u>	<u>(486)</u>
Fair value at end of the year	<u>\$ 13,375</u>	<u>12,785</u>

Assets held in trust by others represents a donor established perpetual trust held and administered by an outside trustee. The System receives a specific portion of the return on the underlying assets of the perpetual trust. The investment income is recorded as unrestricted investment income in nonoperating gains (losses).

**(7) Property and Equipment**

A summary of property and equipment at September 30, 2010 and 2009 is as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Land and land improvements	\$ 1,484	1,484
Buildings and building improvements	68,788	68,194
Equipment	104,120	101,216
Projects in process	<u>862</u>	<u>724</u>
	175,254	171,618
Less accumulated depreciation and amortization	<u>119,376</u>	<u>115,865</u>
Property and equipment, net	<u>\$ 55,878</u>	<u>55,753</u>

Property under capital leases had a net book value of \$1,793,000 at September 30, 2010.

**(8) Long-Term Obligations**

In May 1997 the Hospital issued \$36,150,000 of CHEFA Bonds, Series E, dated May 1, 1997, 5.00% – 6.00% Serial and Term Bonds payable annually in amounts ranging from \$985,000 to \$3,000,000 through July 1, 2022.

The Hospital is required to maintain a Debt Service Reserve fund for the Bonds issued through CHEFA, of the lesser of 10% of the principal amount of the Bonds, the amount required to fund the current portion of the principal and interest payable in any year, or 125% of the average annual debt service on the Bonds. The Hospital is also required to comply with certain financial covenants for the Bonds issued through

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

CHEFA, including a Debt Service Coverage Ratio requirement of at least 1.25, a Debt Ratio requirement of no greater than .75 and a Current Ratio requirement of at least 1.40. The Bond agreements indicate that if the Current Ratio is below 1.40 but above 1.0 and the Debt Service Coverage Ratio is below 1.25 but above 1.0, a consultant is required.

Other long-term obligations consist of capital equipment financing notes and capital leases: HP Financial Services, with interest of 3.7%, beginning December 2004 and maturing November 2011 and Wells Fargo Equipment Finance, with interest of 5.75%, beginning August 2010 and maturing July 2015.

Long-term obligations at September 30, 2010 and 2009 are as follows (in thousands):

	<u>2010</u>	<u>2009</u>
CHEFA Series E Bonds, principal payable annually and interest payable in semi-annual installments	\$ 26,430	27,915
Capital equipment financing notes	1,808	3,355
Capital leases	1,911	—
	<u>30,149</u>	<u>31,270</u>
Less unamortized portion of bond discount	(236)	(271)
Less current portion	<u>(3,124)</u>	<u>(2,736)</u>
	<u>\$ 26,789</u>	<u>28,263</u>

Principal payments on the Hospital's long-term obligations and capital lease payments are as follows (in thousands):

	<u>Long-term obligations</u>	<u>Capital leases</u>
Year ending September 30:		
2011	\$ 2,745	454
2012	2,264	454
2013	1,750	454
2014	1,850	440
2015	1,960	332
Thereafter	<u>17,669</u>	—
	<u>\$ 28,238</u>	2,134
Interest payments		<u>(223)</u>
		<u>\$ 1,911</u>

The CHEFA Series E bonds and capital equipment financing notes are collateralized by substantially all of the Hospital's land, buildings and equipment.

Long-term debt is carried at cost. Fair values are estimated based on quoted market prices for the same or similar issues. The estimated fair value of the CHEFA Series E bonds and capital equipment financing notes approximates \$27,787,000 as of September 30, 2010.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(9) Line of Credit**

At September 30, 2010, the Hospital maintained a financing agreement with Webster Bank for a \$5,000,000 line of credit which has an August 15, 2011 maturity date. Interest on the line of credit was at the Hospital's choice of either the lending institution's prime rate or at the LIBOR rate plus 110 basis points. At September 30, 2010, there was no outstanding balance under this line of credit agreement. Additionally, \$450,000 of the unused line of credit secures a stand-by letter of credit.

**(10) Temporarily and Permanently Restricted Net Assets**

Temporarily restricted net assets are available for the following purposes at September 30, 2010 and 2009 (in thousands):

	<u>2010</u>	<u>2009</u>
Cancer	\$ 673	774
Building and equipment	463	225
Community services	326	395
Education	247	249
Other	873	744
	<u>\$ 2,582</u>	<u>2,387</u>

Permanently restricted net assets at September 30, 2010 and 2009 are restricted to (in thousands):

	<u>2010</u>	<u>2009</u>
Investments held by trustee in perpetuity, the income from which is expendable to support Hospital operations	\$ 13,410	12,813
Investments held by Hospital Foundation in perpetuity, the income from which is expendable to support:		
Hospital operations	818	818
Medical education	150	150
	<u>\$ 14,378</u>	<u>13,781</u>

**(11) Endowment**

Effective October 1, 2008, the System adopted FASB Staff Position No. 117-1, Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds (FSP 117-1), now part of FASB ASC 958-205, *Not-for-Profit Entities -- Presentation of Financial Statements*. On October 1, 2007 the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was adopted by the State of Connecticut (Act). The new law updated existing fundamental investment principles providing standards to guide investing in a prudent manner and eliminating the restriction that endowment funds could not be spent below its historical dollar value. The System considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds; the duration and preservation of the fund, the purposes of the System and the donor-restricted endowment funds, general economic conditions, the possible effect of inflation and deflation, the expected total return

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

from income and the appreciation of investments, other resources of the System, and the investment policies of the System.

The System's endowment consists of funds established for a variety of purposes including donor-restricted endowment funds. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions. At September 30, 2010 and 2009, the System has no funds designated by the Board of Directors as endowment.

The System has interpreted UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. The System classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the System in a manner consistent with the standard of prudence prescribed by the Act.

Endowment funds consist of the following at September 30, 2010 and 2009 (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Donor-restricted endowment funds at September 30, 2010	\$ 122	14,378	14,500
Donor-restricted endowment funds at September 30, 2009	\$ 112	13,781	13,893

Changes in endowment funds for the year ended September 30, 2010 are as follows (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, October 1, 2009	\$ 112	13,781	13,893
Investment return:			
Investment income	26	541	567
Net appreciation	61	658	719
Total investment return	<u>87</u>	<u>1,199</u>	<u>1,286</u>
Appropriation of endowment assets for expenditure	<u>(77)</u>	<u>(602)</u>	<u>(679)</u>
Endowment net assets, September 30, 2010	<u>\$ 122</u>	<u>14,378</u>	<u>14,500</u>

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

Changes in endowment funds for the year ended September 30, 2009 are as follows (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, October 1, 2008	\$ 91	14,041	14,132
Investment return:			
Investment losses	(32)	(1,995)	(2,027)
Net appreciation	65	2,221	2,286
Total investment return	<u>33</u>	<u>226</u>	<u>259</u>
Appropriation of endowment assets for expenditure	<u>(12)</u>	<u>(486)</u>	<u>(498)</u>
Endowment net assets, September 30, 2009	<u>\$ 112</u>	<u>13,781</u>	<u>13,893</u>

The System has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the System must hold in perpetuity or for a donor-specified period. Funds held in trust by others represents a donor established perpetual trust held and administered by an outside trustee and are not within the System's control as to spending and investment policies.

To satisfy its long term rate-of-return objectives, the System relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The System targets a diversified asset allocation that places emphasis on investments in equities and fixed income investments to achieve its long-term return objectives with prudent risk constraints.

The System follows a policy of spending an amount that approximates the investment income earned, in addition to specific purchases of capital equipment. Accordingly, the System expects its spending policy will allow its endowment funds to be maintained in perpetuity by growing at a rate at least equal to the planned payouts. Additional real endowment growth will be provided through new gifts and any excess investment return.

**(12) Professional and General Liability**

Prior to July 1, 2009, the Hospital purchased limits of professional and general liability from Partners Interinsurance Exchange ("PIE") to cover risks up to specified limits. Within PIE the Hospital maintained retentions net to its own account by type of coverage. A claims made reinsurance contract was purchased each fiscal year that provided coverage above these retentions. Beginning January 1, 2002, the professional liability coverage provided for total limits, with respect to professional liability, of \$18 million per claim and \$27 million in the aggregate, with a retention inside that limit of \$3,000,000 per incident applying as net to the Hospital's account within PIE. The general liability coverage provided limits of \$16 million per claim and \$19 million in the aggregate with a retention of \$1,000,000 per incident and \$4,000,000 in the

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

annual aggregate retained as net to the Hospital's account within PIE. The Hospital paid an actuarially determined premium to PIE for the purpose of setting aside assets to cover the reasonable value of ultimate expected loss retained as net within PIE.

During June 2009 the Hospital established the Indemnity Company as a successor to the Hospital's financial interest in PIE. On July 1, 2009 the Hospital's account in PIE was transferred to the Indemnity Company. The Hospital and certain affiliates continue to purchase limits of professional and general liability from the Indemnity Company at levels previously purchased from PIE. Actuarially determined premiums are paid in order to set aside assets to cover the reasonable value of ultimate expected losses. Hospital management, along with its consulting actuaries, accrued its best estimate of professional and general liabilities.

Malpractice claims that fall within the Hospital's adopted policy of self-insurance have been asserted against the Hospital by various claimants. The claims are in various stages of assessment and resolution. There are also known and unknown incidents that have occurred through September 30, 2010 that may result in the assertion of additional claims. Hospital management believes that the ultimate settlement of these claims will not have a material impact on the Hospital's consolidated financial position or results of their operations, as adequate self-insurance reserves, Indemnity Company assets and reinsurance are in place.

The Indemnity Company entered into a loss portfolio transfer (LPT) on July 1, 2009 with PIE. The losses associated with this transaction did not transfer insurance risk to the Indemnity Company. As such, this LPT is accounted for using deposit accounting, which requires offsetting assets and liabilities.

Activity in the reserves for premiums held on deposit included in self-insurance liability is summarized as follows (in thousands):

	<u>2010</u>
Reserves for premiums held on deposit at beginning of year	\$ 15,585
Add current period reserves for premiums held on deposit	(1,453)
Add additional reserve for premiums held on deposit for loss portfolio transfer	—
Deduct current period payments from reserves for premiums held on deposit	<u>1,299</u>
Reserves for premium held on deposit at end of year	<u>\$ 12,833</u>

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

Activity in the self-insurance liability for unpaid losses and loss adjustment expenses for prospective losses is summarized as follows (in thousands):

	<u>2010</u>
Balance at beginning of period	\$ 787
Less reinsurance recoverable	(202)
Net balance at beginning of period	<u>585</u>
Incurred related to:	
Current year	4,364
Prior years	747
Total incurred	<u>5,111</u>
Paid related to:	
Current year	16
Prior years	94
Total paid	<u>110</u>
Net balance at end of period	5,586
Add reinsurance recoverable	<u>900</u>
Balance at end of period	<u>\$ 6,486</u>

The provision for incurred losses related to prior year (subsequent to the loss portfolio transfer from PIE at July 1, 2009) increased by \$747,197 in 2010 due to changes in estimates of insured events.

**(13) Retirement Plans**

***Defined Benefit Plan***

The Hospital has a noncontributory, defined benefit pension plan (the Plan) for most employees, which is funded with available cash flow. The Plan is qualified as a "Church Plan" and is therefore exempt from a majority of ERISA regulations. Plan benefits are not guaranteed by the Pension Benefit Guaranty Corporation. The Plan was frozen to new entrants in 1997. In 2004, the Plan's benefits were curtailed to eliminate participants' earnings of additional benefits for future services.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The following table sets forth the Plan's funded status at September 30, 2010 and 2009, the Plan measurement date, (in thousands):

	<u>2010</u>	<u>2009</u>
Change in benefit obligation:		
Benefit obligation, beginning of year	\$ 119,194	106,805
Interest cost	6,393	6,490
Actuarial (gain) loss	(197)	11,361
Benefits paid	<u>(5,611)</u>	<u>(5,462)</u>
Benefit obligation, end of year	<u>119,779</u>	<u>119,194</u>
Change in plan assets:		
Fair value of plan assets, beginning of year	48,514	47,895
Actual return on plan assets	4,484	1,065
Contributions	5,831	5,016
Benefits paid	<u>(5,611)</u>	<u>(5,462)</u>
Fair value of plan assets, end of year	<u>53,218</u>	<u>48,514</u>
Funded status at year end	\$ <u><u>(66,561)</u></u>	<u><u>(70,680)</u></u>
Amounts recognized in consolidated balance sheets consist of:		
Noncurrent liabilities	\$ (66,561)	(70,680)
Accumulated charges to unrestricted net assets	<u>51,393</u>	<u>54,400</u>
Net amount recognized	\$ <u><u>(15,168)</u></u>	<u><u>(16,280)</u></u>

Amounts recognized as accumulated charges to unrestricted net assets consists of (in thousands):

	<u>Pension benefits</u>	
	<u>2010</u>	<u>2009</u>
Net actuarial loss	\$ <u><u>(51,393)</u></u>	<u><u>(54,400)</u></u>
	\$ <u><u>(51,393)</u></u>	<u><u>(54,400)</u></u>

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The accumulated benefit obligation for the pension plan was \$119,779,000 and \$119,194,000 at September 30, 2010 and 2009, respectively. Net periodic benefit cost recognized in 2010 and 2009 was (in thousands):

	<u>2010</u>	<u>2009</u>
Components of net periodic benefit cost:		
Interest cost	\$ 6,393	6,490
Expected return on plan assets	(4,664)	(4,465)
Net amortization and deferral	<u>2,990</u>	<u>1,642</u>
Net periodic benefit cost	<u>\$ 4,719</u>	<u>3,667</u>

Other changes in plan assets and benefit obligation recognized as charges to unrestricted net assets in 2010 and 2009 are as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Net gain (loss)	5,997	(11,478)
Net amortization and deferral	<u>(2,990)</u>	<u>(1,642)</u>
Increase (reduction) recognized in changes to unrestricted net assets	<u>\$ 3,007</u>	<u>(13,120)</u>
Decrease to unrestricted net assets associated with recognized net periodic benefit cost	<u>\$ 1,712</u>	<u>16,787</u>

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost as of and for the years end September 30, 2010 and 2009 were as follows:

	<u>2010</u>	<u>2009</u>
Weighted-average assumptions at September 30:		
Discount rate for benefit obligations	5.25%	5.50%
Discount rate for net periodic benefit cost	5.50%	6.25%
Expected return on plan assets	8.00%	8.00%

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The following table sets forth by level, within the fair value hierarchy, the pension plan's financial instruments at fair value as of September 30, 2010 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Money market funds	\$ 2,697	—	—	2,697
Domestic corporate bonds	—	8,572	—	8,572
Foreign corporate bonds	—	741	—	741
U.S. government and agency obligations	—	3,873	—	3,873
Mutual funds	37,222	—	—	37,222
Preferred equity securities	—	113	—	113
Total	<u>39,919</u>	<u>13,299</u>	<u>—</u>	<u>53,218</u>

The pension plan weighted average asset allocations at September 30, 2010 and 2009 by asset category are as follows:

	<u>2010</u>	<u>2009</u>
Mutual funds	70%	68%
Money market funds	5	4
Debt securities:		
U.S. obligations	7	10
Corporate	17	17
Fixed income mutual funds	1	1
	<u>100%</u>	<u>100%</u>

The expected long-term rate of return for the plan's total assets is based on the expected return of each of the above categories, weighted based on the target allocation of each class. Equity securities are expected to return 9% to 10% over the long-term, while debt securities are expected to return between 4% and 7%. Money market funds are held to pursue market opportunities.

The investment policy, as established by the Investment Committee, is to earn a total return in any five-year period that will have exceeded the interest assumption in the actuarial plan valuation for that five-year period. For performance evaluation purposes, all rates of return will be examined on a net-of-fee basis. The pension assets are to be broadly diversified so as to limit the impact of large losses in individual investments on the total portfolio. The asset allocation is reviewed on a quarterly basis.

In the aggregate, contributions to the pension plan are expected to be \$4,420,000 in 2011.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

The following benefit payments are expected to be paid (in thousands):

2011	\$	6,000
2012		6,300
2013		6,700
2014		7,150
2015		7,450
2016 through 2019		<u>42,000</u>
	\$	<u><u>75,600</u></u>

***Defined Contribution Plan***

The Hospital established a defined contribution plan when it reduced the benefits of the Plan via amendment in 1997. The defined contribution plan provides for a Hospital match up to a certain percentage of employee contributions. Expenses related to the defined contribution plan amounted to \$3,552,000 and \$3,459,000 in 2010 and 2009, respectively, and are included in employee benefits in the accompanying consolidated statements of operations.

***Supplemental Pension Plan***

In addition, the Hospital has an unfunded supplemental pension plan for the benefit of three retired long term employees. The Hospital recorded a liability of \$953,000 and \$957,000 at September 30, 2010 and 2009, respectively. Expenses related to the plan amounted to \$80,000 and \$80,000 in 2010 and 2009, respectively, and are included in employee benefits in the accompanying consolidated statements of operations.

**(14) Leases and Rental Expenses**

Rental expense aggregated approximately \$5,137,000 and \$4,906,000 for the years ended September 30, 2010 and 2009, respectively. Minimum future rental commitments on all noncancelable operating leases with initial or remaining terms of more than one year are as follows (in thousands):

Fiscal year:		
2011	\$	3,128
2012		2,557
2013		2,299
2014		1,614
2015		1,215
2016 and thereafter		<u>8,927</u>
	\$	<u><u>19,740</u></u>

The Hospital rents space from SMHS in a medical office building for approximately \$9,000 per month.

## SAINT MARY'S HEALTH SYSTEM, INC.

### Notes to Consolidated Financial Statements

September 30, 2010 and 2009

#### **(15) Cancer Center**

During 1997, the Hospital entered into an agreement with Waterbury Hospital to develop a joint Cancer Care Center, known as the Harold Leever Regional Cancer Center (HLRCC) that provides treatment services to cancer patients in the greater Waterbury area. The Hospital's initial investment in HLRCC was converted into a \$1,386,298 promissory note. The note accrued interest at 4% per year with principal and interest payable in quarterly installments. The note was paid off during 2010. The Hospital is entitled to distributions at the discretion of HLRCC's Board of Directors, which is selected by Waterbury Hospital and the Hospital on a 50/50 basis. The Hospital's investment in HLRCC is carried on the equity basis, and the carrying value is approximately \$8,513,000 and \$8,002,000 at September 30, 2010 and 2009, respectively. Equity in earnings was approximately \$644,000 and \$1,304,000 in 2010 and 2009, respectively.

#### **(16) Heart Center of Greater Waterbury**

In December 2003, the Hospital and Waterbury Hospital were granted permission to establish a three-year demonstration project for an advanced cardiac care program known as the Heart Center of Greater Waterbury, Inc. (HCGW). During 2009, the program was granted permanent program status. Through the program, patients at the Hospital and Waterbury Hospital are provided access to services such as angioplasty and open heart surgery. Procedures are performed at both hospitals, each recording related revenues and expenses. The HCGW, a MSO that provides administrative support and management functions to the program, has a Board of Directors selected by Waterbury Hospital and the Hospital on a 50/50 basis. HCGW incurs costs, which are funded by the hospitals, to market the program and derives no net assets from its activities. The Hospital expensed \$393,000 and \$438,000 of funding, in 2010 and 2009, respectively.

#### **(17) Investments in Joint Venture Arrangements**

##### *Naugatuck Valley MRI Limited Partnership*

The Hospital is a 1% general partner and a 47% limited partner in the Naugatuck Valley MRI Limited Partnership, which provides diagnostic imaging services in Waterbury. The investment is carried on the equity basis, and the carrying value is approximately \$628,000 and \$303,000 at September 30, 2010 and 2009, respectively. Equity in earnings was approximately \$676,000 and \$731,000 in 2010 and 2009, respectively.

**SAINT MARY'S HEALTH SYSTEM, INC.**

Notes to Consolidated Financial Statements

September 30, 2010 and 2009

**(18) Other Operating Revenues**

Components of other operating revenues for the years ended September 30, 2010 and 2009 are as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Investment income related to short-term investments and investments for self-insurance	\$ 588	432
Net assets released from restriction	151	22
Contributions	359	1,073
Cafeteria	1,032	1,009
Outside services	975	1,012
State grants	446	552
Parking fees	651	682
Day care	651	670
Rentals	1,625	1,219
Other	1,094	914
Total	<u>\$ 7,572</u>	<u>7,585</u>

**(19) Functional Expenses**

The System provides general health care services to residents within its geographic location. Expenses related to providing these services for the years ended September 30, 2010 and 2009 are as follows (in thousands):

	<u>2010</u>	<u>2009</u>
Health care services	\$ 212,412	205,042
General and administrative	34,139	31,780
Fundraising	766	738
	<u>\$ 247,317</u>	<u>237,560</u>

**(20) Activities Between Affiliates**

During 2010 and 2009, the Foundation distributed \$524,000 and \$287,000, respectively, to the Hospital to support programs and services.

In addition to the lease activity with affiliates described in note 14, all employees of SMHS and the Foundation are paid through the Hospital's payroll system, and the amounts paid are charged directly to the related affiliate. In addition, time spent by certain Hospital employees on affiliate activities is charged to the related affiliate.

**(21) Subsequent Events**

The System has evaluated events through January 28, 2011, which represents the date the financial statements were available to be issued and noted no subsequent events that would have impacted the System's financial statements.

## SAINT MARY'S HEALTH SYSTEM, INC.

## Consolidating Balance Sheet

September 30, 2010

(In thousands)

	<b>Saint Mary's Hospital, Inc. Consolidated</b>	<b>Saint Mary's Hospital Foundation Inc.</b>	<b>Saint Mary's Health System Inc.</b>	<b>Eliminations</b>	<b>Saint Mary's Health System, Inc. Consolidated</b>
Current assets:					
Cash and cash equivalents	\$ 25,089	1,259	10	—	26,358
Short-term investments	1,182	—	—	—	1,182
Current portion of assets whose use is limited	4,714	—	—	—	4,714
Accounts receivable, net	26,412	340	—	—	26,752
Other current assets	4,148	34	378	—	4,560
Total current assets	<u>61,545</u>	<u>1,633</u>	<u>388</u>	<u>—</u>	<u>63,566</u>
Marketable securities	<u>12,791</u>	<u>3,013</u>	<u>—</u>	<u>—</u>	<u>15,804</u>
Assets whose use is limited:					
By donor and held in trust by others	13,375	—	—	—	13,375
For estimated self-insurance liability	27,548	—	—	—	27,548
By bond indenture	5,078	—	—	—	5,078
Net interest in Foundation	4,509	—	—	(4,509)	—
Other	6	—	—	—	6
Total assets whose use is limited	<u>50,516</u>	<u>—</u>	<u>—</u>	<u>(4,509)</u>	<u>46,007</u>
Less current portion of assets whose use is limited	<u>4,714</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>4,714</u>
Noncurrent assets whose use is limited	<u>45,802</u>	<u>—</u>	<u>—</u>	<u>(4,509)</u>	<u>41,293</u>
Property and equipment, net	<u>54,569</u>	<u>16</u>	<u>1,293</u>	<u>—</u>	<u>55,878</u>
Other assets:					
Investments in joint venture arrangements	9,372	—	—	—	9,372
Deferred financing costs, net	214	—	—	—	214
Other noncurrent assets	260	—	241	—	501
Total other assets	<u>9,846</u>	<u>—</u>	<u>241</u>	<u>—</u>	<u>10,087</u>
Total assets	<u>\$ 184,553</u>	<u>4,662</u>	<u>1,922</u>	<u>(4,509)</u>	<u>186,628</u>

## SAINT MARY'S HEALTH SYSTEM, INC.

## Consolidating Balance Sheet

September 30, 2010

(In thousands)

	<b>Saint Mary's Hospital, Inc. Consolidated</b>	<b>Saint Mary's Hospital Foundation Inc.</b>	<b>Saint Mary's Health System Inc.</b>	<b>Eliminations</b>	<b>Saint Mary's Health System, Inc. Consolidated</b>
Current liabilities:					
Current portion of long-term obligations	\$ 3,124	—	—	—	3,124
Accounts payable	12,497	115	32	—	12,644
Salaries, wages, and payroll withholdings	6,499	—	—	—	6,499
Due to third-party payors, net	5,935	—	—	—	5,935
Accrued expenses and other current liabilities	10,108	38	—	—	10,146
Total current liabilities	<u>38,163</u>	<u>153</u>	<u>32</u>	<u>—</u>	<u>38,348</u>
Long-term liabilities:					
Long-term obligations, net of current portion	26,789	—	—	—	26,789
Estimated self-insurance liability	19,334	—	—	—	19,334
Pension and deferred compensation	67,434	—	—	—	67,434
Other long-term liabilities	8,363	—	—	—	8,363
Total long-term liabilities	<u>121,920</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>121,920</u>
Minority interest in subsidiaries	<u>1,663</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,663</u>
Net assets (deficit):					
Unrestricted	5,847	1,556	1,890	(1,556)	7,737
Temporarily restricted	2,582	1,985	—	(1,985)	2,582
Permanently restricted	14,378	968	—	(968)	14,378
Total net assets	<u>22,807</u>	<u>4,509</u>	<u>1,890</u>	<u>(4,509)</u>	<u>24,697</u>
Total liabilities and net assets	<u>\$ 184,553</u>	<u>4,662</u>	<u>1,922</u>	<u>(4,509)</u>	<u>186,628</u>

See accompanying independent auditors' report.

## SAINT MARY'S HEALTH SYSTEM, INC.

## Consolidating Statement of Operations

Year ended September 30, 2010

(In thousands)

	Saint Mary's Hospital, Inc. Consolidated	Saint Mary's Hospital Foundation, Inc.	Saint Mary's Health System Inc.	Eliminations	Saint Mary's Health System, Inc. Consolidated
Revenues:					
Net revenue from patient services:	\$ 243,847	—	—	—	243,847
Other operating revenues	6,984	581	102	(95)	7,572
Total revenues	<u>250,831</u>	<u>581</u>	<u>102</u>	<u>(95)</u>	<u>251,419</u>
Expenses:					
Salaries and wages	105,060	345	38	—	105,443
Employee benefits	28,297		11	—	28,308
Supplies and other expenses	89,353	385	70	(102)	89,706
Provision for uncollectible accounts	13,250	31	—	—	13,281
Depreciation and amortization	8,691	3	73	—	8,767
Interest	1,810	2	—	—	1,812
Total expenses	<u>246,461</u>	<u>766</u>	<u>192</u>	<u>(102)</u>	<u>247,317</u>
Operating income (loss)	<u>4,370</u>	<u>(185)</u>	<u>(90)</u>	<u>7</u>	<u>4,102</u>
Nonoperating gains (losses):					
Investment gains, net	1,723	—	—	—	1,723
Equity in earnings of joint ventures	1,311	—	—	—	1,311
Minority interest in subsidiaries	(863)	—	—	—	(863)
Change in net assets of Foundation	(252)	—	—	252	—
Net gain on disposal of assets	(89)	—	—	—	(89)
Other	353	—	—	—	353
Total nonoperating gains, net	<u>2,183</u>	<u>—</u>	<u>—</u>	<u>252</u>	<u>2,435</u>
Excess (deficiency) of revenues over expenses	<u>6,553</u>	<u>(185)</u>	<u>(90)</u>	<u>259</u>	<u>6,537</u>
Net assets released from restriction for capital expenditures	328	—	—	—	328
Capital transactions with affiliates, net	74	(77)	—	3	—
Change in unrealized gains on marketable securities and other assets whose use is limited	890	189	—	(189)	890
Change in accumulated pension charges to unrestricted net asset:	3,007	—	—	—	3,007
Increase (decrease) in unrestricted net assets	<u>\$ 10,852</u>	<u>(73)</u>	<u>(90)</u>	<u>73</u>	<u>10,762</u>

See accompanying independent auditors' report.