



FINANCIAL STATEMENTS

The Milford Hospital, Incorporated  
Years Ended September 30, 2012 and 2011  
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

The Milford Hospital, Incorporated

Financial Statements

Years Ended September 30, 2012 and 2011

**Contents**

Report of Independent Auditors.....	1
Balance Sheets .....	2
Statements of Operations and Changes in Net Assets .....	4
Statements of Cash Flows.....	6
Notes to Financial Statements.....	8

## Report of Independent Auditors

The Board of Directors  
The Milford Hospital, Incorporated

We have audited the accompanying balance sheets of The Milford Hospital, Incorporated (the Hospital) as of September 30, 2012 and 2011, and the related statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Hospital's internal control over financial reporting. Our audits included 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 Hospital'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, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of The Milford Hospital, Incorporated at September 30, 2012 and 2011, and the results of its operations and changes in net assets, and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the accompanying financial statements, in 2012 the Hospital changed its method of reporting estimated insurance claims receivables and estimated insurance claims liabilities with the adoption of the Accounting Standards Update No. 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries*.

A handwritten signature in black ink that reads 'Ernst & Young LLP'.

February 27, 2013

# The Milford Hospital, Incorporated

## Balance Sheets

	<b>September 30</b>	
	<b>2012</b>	<b>2011</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	<b>\$ 404,540</b>	\$ 956,229
Short-term investments	<b>225,160</b>	224,305
Patient accounts receivable, less allowance for uncollectible accounts of approximately \$4,369,000 in 2012 and \$4,896,000 in 2011	<b>12,293,728</b>	12,622,341
Inventories	<b>861,132</b>	774,644
Prepaid expenses and other	<b>1,443,580</b>	1,467,390
Insured claims receivable	<b>939,962</b>	–
Total current assets	<b>16,168,102</b>	16,044,909
Investments	<b>12,311,143</b>	20,575,753
Assets limited as to use	<b>1,681,166</b>	1,804,281
Property, plant, and equipment:		
Land and improvements	<b>1,427,341</b>	1,545,184
Building and improvements	<b>38,197,439</b>	38,526,752
Equipment	<b>32,734,508</b>	31,950,837
Construction-in-progress	–	36,667
	<b>72,359,288</b>	72,059,440
Less accumulated depreciation	<b>(48,777,136)</b>	(47,323,119)
	<b>23,582,152</b>	24,736,321
Beneficial interest in Milford Hospital Foundation, Inc.	<b>789,204</b>	745,924
Due from affiliates	<b>654,070</b>	676,168
Insured claims receivable, net of current portion	<b>3,038,843</b>	–
	<b>4,482,117</b>	1,422,092
Total assets	<b>\$ 58,224,680</b>	\$ 64,583,356

	<b>September 30</b>	
	<b>2012</b>	<b>2011</b>
<b>Liabilities and net assets</b>		
Current liabilities:		
Accounts payable	\$ 4,350,123	\$ 4,033,312
Accrued employee compensation	6,702,468	6,308,053
Other accrued liabilities	2,359,227	2,859,722
Due to affiliates	11,500	–
Due to third-party reimbursement agencies	895,803	2,024,212
Current portion of note payable to bank	935,367	955,684
Insured claims liabilities	939,962	–
Total current liabilities	<u>16,194,450</u>	16,180,983
Note payable to bank, less current portion	–	935,367
Insured claims liabilities, net of current portion	3,038,843	–
Accrued pension and other liabilities	31,720,924	31,971,787
Total liabilities	<u>50,954,217</u>	49,088,137
Net assets:		
Unrestricted	5,927,259	14,195,295
Temporarily restricted	669,441	626,161
Permanently restricted	673,763	673,763
Total net assets	<u>7,270,463</u>	15,495,219
Total liabilities and net assets	<u><u>\$ 58,224,680</u></u>	<u><u>\$ 64,583,356</u></u>

*See accompanying notes.*

The Milford Hospital, Incorporated

Statements of Operations and Changes in Net Assets

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
Operating revenues:		
Net revenues from services to patients	<b>\$ 84,451,715</b>	\$ 79,860,535
Other operating revenues	<b>2,505,143</b>	547,970
	<b>86,956,858</b>	80,408,505
Operating expenses:		
Salaries and wages	<b>37,965,219</b>	37,951,254
Employee benefits	<b>14,538,699</b>	13,445,501
Supplies and other	<b>28,253,961</b>	23,097,160
Provision for uncollectible accounts	<b>7,028,914</b>	7,611,773
Depreciation	<b>2,796,910</b>	3,208,305
Interest	<b>102,151</b>	168,405
	<b>90,685,854</b>	85,482,398
Operating loss	<b>(3,728,996)</b>	(5,073,893)
Nonoperating income:		
Investment income, net	<b>1,939,764</b>	2,111,457
Deficiency of revenues over expenses before change in unrealized gains and losses on investments	<b>(1,789,232)</b>	(2,962,436)
Change in unrealized gains and losses on investments	<b>3,465</b>	(2,445,378)
Deficiency of revenues over expenses	<b>(1,785,767)</b>	(5,407,814)

*Continued on next page.*

The Milford Hospital, Incorporated

Statements of Operations and Changes in Net Assets (continued)

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
Unrestricted net assets:		
Deficiency of revenues over expenses (continued)	<b>\$ (1,785,767)</b>	\$ (5,407,814)
Net assets released from restrictions for capital	<b>56,089</b>	16,991
Net asset transfers to Milford Health and Medical, Inc.	<b>(711,414)</b>	(1,205,306)
Change in net assets related to pension plan liability to be recognized in future periods	<b>(11,309,559)</b>	(4,694,052)
Pension curtailment gain	<b>5,482,615</b>	–
Decrease in unrestricted net assets	<b>(8,268,036)</b>	(11,290,181)
Temporarily restricted net assets:		
Net assets released from restrictions for capital	<b>(56,089)</b>	(16,991)
Interest income	<b>56,089</b>	16,991
Change in beneficial interest of Milford Hospital Foundation, Inc.	<b>43,280</b>	(90,045)
Increase (decrease) in temporarily restricted net assets	<b>43,280</b>	(90,045)
Permanently restricted net assets:		
Restricted gifts	–	5,000
Change in beneficial interest of Milford Hospital Foundation, Inc.	–	58,471
Increase in permanently restricted net assets	–	63,471
Decrease in net assets	<b>(8,224,756)</b>	(11,316,755)
Net assets at beginning of year	<b>15,495,219</b>	26,811,974
Net assets at end of year	<b>\$ 7,270,463</b>	\$ 15,495,219

*See accompanying notes.*

# The Milford Hospital, Incorporated

## Statements of Cash Flows

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities</b>		
Change in net assets	<b>\$ (8,224,756)</b>	\$ (11,316,755)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash items:		
Provision for uncollectible accounts	<b>7,028,914</b>	7,611,773
Depreciation	<b>2,796,910</b>	3,208,305
Change in unrealized gains and losses on investments	<b>(3,465)</b>	2,445,378
Change in net assets related to pension plan liability to be recognized in future periods	<b>11,309,559</b>	4,694,052
Pension curtailment gain	<b>(5,482,615)</b>	–
Net asset items:		
Net asset transfers to Milford Health and Medical, Inc.	<b>711,414</b>	1,205,306
Change in beneficial interest in Milford Hospital Foundation, Inc.	<b>(43,280)</b>	31,574
Restricted gifts	–	(5,000)
Changes in assets and liabilities:		
Patient accounts receivable	<b>(6,700,301)</b>	(8,007,316)
Due from affiliates	<b>22,098</b>	43,445
Inventories	<b>(86,488)</b>	(25,859)
Prepaid expenses and other	<b>23,810</b>	(124,980)
Investments classified as trading	<b>8,268,075</b>	4,772,566
Accounts payable	<b>316,811</b>	74,951
Accrued employee compensation	<b>394,415</b>	496,451
Other accrued liabilities	<b>(500,495)</b>	(274,277)
Due to affiliates	<b>11,500</b>	–
Due to third-party reimbursement agencies	<b>(1,128,409)</b>	138,810
Accrued pension and other liabilities	<b>(6,077,807)</b>	(642,475)
Net cash provided by operating activities	<b>2,635,890</b>	4,325,949
<b>Investing activities</b>		
Net purchases of property, plant, and equipment	<b>(1,642,741)</b>	(1,574,611)
Net purchases of short-term investments	<b>(855)</b>	(1,077)
Increase in assets limited as to use	<b>123,115</b>	(4,896)
Net cash used in investing activities	<b>(1,520,481)</b>	(1,580,584)

The Milford Hospital, Incorporated

Statements of Cash Flows (continued)

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
<b>Financing activities</b>		
Payments made on note payable to bank	\$ (955,684)	\$ (892,497)
Restricted gifts	-	5,000
Net asset transfers to Milford Health and Medical, Inc.	(711,414)	(1,205,306)
Net cash used in financing activities	<u>(1,667,098)</u>	<u>(2,092,803)</u>
(Decrease) increase in cash and cash equivalents	(551,689)	652,562
Cash and cash equivalents at beginning of year	956,229	303,667
Cash and cash equivalents at end of year	<u>\$ 404,540</u>	<u>\$ 956,229</u>

*See accompanying notes.*

# The Milford Hospital, Incorporated

## Notes to Financial Statements

September 30, 2012

### **1. Organization and Accounting Policies**

#### **Organization**

The Milford Hospital, Incorporated (the Hospital), a voluntary tax-exempt acute care hospital incorporated under the General Statutes of the State of Connecticut, is a subsidiary of Milford Health and Medical, Inc. (the Parent). The Board of Directors (the Board) of the Hospital, appointed by the Parent, controls the operations of the Hospital. Also, the Milford Hospital Foundation, Inc. is a subsidiary of the Parent, and functions as the fund-raising affiliate for the Hospital.

#### **Estimates and Assumptions**

The preparation of the financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities such as estimated uncollectibles for patient accounts receivable, insurance claims liabilities and receivables, and estimated receivables from and payables to third-party reimbursement agencies and disclosure of contingent assets and contingent liabilities at the date of the financial statements. The allowance for uncollectible accounts, insurance claims liabilities and receivables, and the estimated receivables from and payables to third-party reimbursement agencies, among other accounts, require significant use of estimates. Estimates also affect the reported amounts of revenues and expenses during the reported period. There is at least a reasonable possibility that certain estimates will change by material amounts in the near term. Actual results could differ from those estimates.

#### **Regulatory Matters**

The Hospital is required to file annual operating information with the State of Connecticut Office of Health Care Access.

#### **Cash and Cash Equivalents and Short-Term Investments**

The Hospital considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Short-term investments consist of bank certificates of deposit. Cash and cash equivalents are maintained with domestic financial institutions with deposits that exceed federally insured limits and, therefore, bear a risk of loss. It is the Hospital's policy to monitor the strength of these institutions.

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### **1. Organization and Accounting Policies (continued)**

#### **Inventories**

Inventories, consisting mainly of supplies, are stated at the lower of cost or market. The Hospital values its inventories using the first-in, first-out method.

#### **Fair Value of Financial Instruments**

The carrying value of financial instruments in the accompanying balance sheets as of September 30, 2012 and 2011 approximates fair value based on current market conditions. The fair value of each financial instrument is disclosed in the respective notes and in Note 4.

#### **Investments**

The Hospital's investment portfolio is classified as trading, with changes in unrealized gains and losses included in the deficiency of revenues over expenses. Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value at the balance sheet date. Assets temporarily restricted (by donor) are recorded at fair value at the date of donation, which is then considered cost.

Alternative investments (not-readily-marketable assets) are stated in the accompanying balance sheets based upon net asset values derived from the application of the equity method of accounting. Individual investment holdings within the alternative investments may, in turn, include investments in both nonmarketable and market-traded securities. Financial information used by the Hospital to evaluate its alternative investments is prepared by the investment manager or general partner and includes fair value valuations that may be based on historical cost, appraisals, or other estimates that require varying degrees of judgment. Generally, fair value reflects net contributions to the investee and an ownership share of realized and unrealized investment income and expenses. The investments may indirectly expose the Hospital to securities lending, short sales of securities, and trading in futures and forwards contracts, options, swap contracts, and other derivative products. While these financial instruments may contain varying degrees of risk, the Hospital's risk with respect to such transactions is limited to its capital balance in each investment. The financial statements of the investees are audited annually by independent auditors.

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### **1. Organization and Accounting Policies (continued)**

There is uncertainty in determining values of alternative investments arising from factors such as lack of active markets (primary and secondary), lack of transparency into underlying holdings and time lags associated with reporting by the investee companies. As a result, there is at least a reasonable possibility that estimates will change.

Investment income, including realized and changes in unrealized gains and losses on investments, interest, and dividends, is included in nonoperating income unless the income or loss is restricted by the donor or law. The cost of securities sold is based on the specific identification method.

#### **Assets Limited As To Use**

Assets limited as to use primarily consist of interest-bearing deposits in banks which have been set aside by the Board of Directors (the Board) and restricted by donors for future capital improvements or purchases of equipment. Except for the assets restricted by donors, the Board retains control of funds it has set aside and may, at its discretion, subsequently use these funds for other purposes.

#### **Patient Accounts Receivable**

Patient accounts receivable result from the health care services provided by the Hospital. Additions to the allowance for uncollectible accounts result from the provision for uncollectible accounts. Accounts written off as uncollectible are deducted from the allowance for uncollectible accounts. The amount of the allowance for uncollectible accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in Medicare and Medicaid health care coverage and other collection indicators. See Note 2 for additional information relative to third-party payor programs.

The Hospital's primary concentration of credit risk is patient accounts receivable, which consists of amounts owed by various governmental agencies, insurance companies, and private patients. The Hospital manages the receivables by regularly reviewing its patient accounts and contracts, and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross patient accounts receivable, before allowances for uncollectible accounts, include 47% and 42% for Medicare, and 6% and 8% for Medicaid, for the years ended September 30, 2012 and 2011, respectively.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**1. Organization and Accounting Policies (continued)**

**Property, Plant, and Equipment**

Property, plant, and equipment is stated on the basis of cost. Depreciation of property, plant, and equipment is provided using the straight-line method over their estimated useful lives of the related assets as follows:

Building and improvements	5 – 50 years
Equipment	3 – 25 years

**Restricted Net Assets**

Temporarily restricted net assets are those where use by the Hospital has been limited by donors to a specific time frame or purpose. All of the Hospital's temporarily restricted net assets are restricted for capital expenditures. Permanently restricted net assets are amounts to be maintained in perpetuity, the income of which can be used for capital expenditures.

**Donor-Restricted Gifts**

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. The gifts are reported as either temporarily or permanently restricted if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are included in nonoperating income in the accompanying statements of operations and changes in net assets.

**Deficiency of Revenues Over Expenses**

The statements of operations and changes in net assets include the deficiency of revenues over expenses as the performance indicator. Changes in unrestricted net assets which are excluded from the deficiency of revenues over expenses include permanent transfers of assets to and from affiliates for other than goods and services, 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, change in net assets related to pension plan liability to be recognized in future periods and the pension curtailment gain.

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### **1. Organization and Accounting Policies (continued)**

#### **Nonoperating Income**

Activities, other than in connection with providing healthcare services, are considered to be nonoperating. Nonoperating income primarily consists of income on invested funds and unrestricted gifts.

#### **Beneficial Interest in Milford Hospital Foundation, Inc.**

The interest in Milford Hospital Foundation, Inc. represents the Hospital's beneficial interest in net assets of The Milford Hospital Foundation, Inc. This investment is accounted for in accordance with the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 958-20, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.

#### **Income Taxes**

The Hospital is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code (the Code), and is exempt from federal income taxes on related income pursuant to Section 501(a) of the Code and is exempt from the State of Connecticut and local income taxes. The Hospital has a net operating loss carryforward from unrelated business activities of approximately \$6,237,000. A deferred tax asset for these losses of approximately \$2,495,000 is offset by a corresponding valuation allowance of the same amount. Operating loss carryforwards will begin to expire in 7 years.

#### **Subsequent Events**

The Hospital evaluates the impact of subsequent events, which are events that occur after the balance sheet date but before the financial statements are issued, for potential recognition in the financial statements as of the balance sheet date. For the year ended September 30, 2012, the Hospital evaluated subsequent events through February 27, 2013, which is the date the financial statements were available to be issued. No events occurred that require disclosure in or adjustment to the financial statements.

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### 1. Organization and Accounting Policies (continued)

#### New Accounting Standards

In August 2010, the FASB issued ASU 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries* (ASU No. 2010-24). ASU 2010-24 clarifies that, for medical malpractice or similar contingent liabilities, a health care entity such as the Hospital should not net insurance recoveries against related claims liabilities and that claims liabilities should be determined without consideration of insurance recoveries. Health care entities that are indemnified for these liabilities should recognize insurance receivables at the same time that they recognize the liabilities, measured on the same basis as the liabilities, subject to the need for a valuation allowance for uncollectible amounts. As a result of the adoption of ASU No. 2010-24 in 2012, the Hospital recognized insurance claims receivable and insurance claims liability of approximately \$3,979,000 (\$940,000 current and \$3,039,000 long-term) in the accompanying balance sheet at September 30, 2012. Such amounts represent the actuarially determined present value of medical malpractice and other insurance claims that are anticipated to be covered by insurance, discounted at a rate of 3.5%. As permitted, the Hospital's balance sheet as of September 30, 2011 was not restated to reflect the adoption of this accounting pronouncement, which has no effect on the Hospital's net assets.

In July 2011, the FASB issued ASU No. 2011-07, *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. The provisions of ASU No. 2011-07 require certain health care entities that recognize significant amounts of patient service revenue at the time the services are rendered without assessing the patient's ability to pay to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue in the statement of operations and changes in net assets rather than as an operating expense. Additional disclosures relating to sources of patient service revenue and the allowance for uncollectible accounts are also required. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011, with early adoption permitted. The Hospital plans to adopt the provisions of ASU No. 2011-07 in 2013.

#### Reclassifications

Certain reclassifications have been made to the 2011 balances previously reported to conform to the current year presentation.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**2. Revenues from Services to Patients and Charity Care**

The following table summarizes net revenues from services to patients:

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
Gross revenues from services to patients	<b>\$ 189,422,163</b>	\$ 184,109,979
Deductions:		
Allowances	<b>104,777,915</b>	104,061,678
Charity care	<b>192,533</b>	187,766
	<b>104,970,448</b>	104,249,444
	<b>\$ 84,451,715</b>	\$ 79,860,535

During fiscal years 2012 and 2011, the Hospital’s net revenues from services to patients were 40% and 37% from Medicare, 4% and 7% from Medicaid, and 17% and 18% from Blue Cross (governmental payors include managed Medicare and Medicaid business), respectively. Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by material amounts in the near term. The Hospital believes that it is in compliance with all applicable laws and regulations, and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. Changes in the Medicare and Medicaid programs and the reduction of funding levels could have an adverse impact on the Hospital.

Patient accounts receivable and revenues are recorded when patient services are performed. The Hospital has agreements with certain third-party payors, including health maintenance organizations, that provide for payments to the Hospital at amounts different from the Hospital’s established billing rates. These differences are accounted for as allowances. Under these agreements, the Hospital receives reimbursement based on a number of different arrangements, including fee-for-service payments.

## The Milford Hospital, Incorporated

### Notes to Financial Statements (continued)

#### **2. Revenues from Services to Patients and Charity Care (continued)**

Net revenues from services to patients 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. Revenue under third-party payor agreements is subject to audit and retroactive adjustments. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations. Retroactive adjustments related to settlements with third-party payors for previous fiscal years increased net revenues from services to patients by approximately \$2,101,000 and decreased net revenues from services to patients by approximately \$228,000 for the years ended September 30, 2012 and 2011, respectively. In prior years, the Hospital was a party to a Medicare appeal claim challenging the calculation of the rural floor budget neutrality adjustment. In fiscal 2012, the appeal was settled and the Hospital received a payment of approximately \$869,000 which is included in retroactive settlement adjustments referred to above.

The Hospital accepts all patients regardless of their ability to pay. A patient is classified as a charity patient by reference to the established policies of the Hospital. Essentially, these policies define charity services as those services for which no payment is anticipated. In assessing a patient's inability to pay, the Hospital utilizes the generally recognized poverty income levels for the state of Connecticut, but also includes certain cases where incurred charges are significant when compared to income. These charges are not included in net revenues from services to patients for financial reporting purposes.

The estimated cost of charity care provided was \$92,762 and \$87,180 for the years ended September 30, 2012 and 2011, respectively. The estimated cost of charity care is based on the ratio of cost to charges, as determined by hospital-specific data.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**3. Investments**

Investments are comprised of the following at September 30:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 2,283,664	\$ 1,928,762
Government bonds	2,015,518	2,699,287
Corporate bonds	1,541,644	1,634,084
Other fixed income	24,924	–
Equities	4,440,235	13,078,051
Commodities	702,604	–
Alternative investments	1,283,286	1,205,131
Accrued interest	19,268	30,438
	<u>\$ 12,311,143</u>	<u>\$ 20,575,753</u>

Assets limited as to use are comprised of the following at September 30:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 694,939	\$ 754,029
Government bonds	379,175	391,081
Corporate bonds	179,947	289,079
Other fixed income securities	327,947	288,955
Equities	96,355	76,429
Accrued interest	2,803	4,708
	<u>\$ 1,681,166</u>	<u>\$ 1,804,281</u>

The composition of assets limited as to use at September 30 is as follows:

	<u>2012</u>	<u>2011</u>
Internally designated	\$ 939,766	\$ 1,118,969
Temporarily restricted for capital purposes	187,400	131,312
Permanently restricted	554,000	554,000
	<u>\$ 1,681,166</u>	<u>\$ 1,804,281</u>

## The Milford Hospital, Incorporated

### Notes to Financial Statements (continued)

#### 3. Investments (continued)

The components of investment earnings, included in nonoperating income, include the following for the years ended September 30:

	2012	2011
Interest income	\$ 28,607	\$ 41,526
Dividend income	285,887	420,745
Realized capital gains and losses	1,625,270	1,649,186
Investment income, net	1,939,764	2,111,457
Change in unrealized gains and losses on investments	3,465	(2,445,378)
Total return on investments	\$ 1,943,229	\$ (333,921)

#### 4. Fair Value of Financial Instruments

As defined in ASC 820-10, fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820-10 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

*Level 1:* Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

*Level 2:* Observable inputs that are based on inputs not quoted in active markets, but corroborated by market data.

*Level 3:* Unobservable inputs are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. In determining fair value, the Hospital utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and considers nonperformance risk in its assessment of fair value.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**4. Fair Value of Financial Instruments (continued)**

Financial assets carried at fair value in the accompanying balance sheets, excluding assets invested in the Hospital's defined benefit pension plan, are classified in the table below in one of the three categories described above:

	<b>September 30, 2012</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 404,540	\$ —	\$ —	\$ 404,540
Short-term investments:				
Cash and cash equivalents	225,160	—	—	225,160
Investments:				
Cash and cash equivalents	2,283,664	—	—	2,283,664
Fixed income:				
Government bonds	—	2,015,518	—	2,015,518
Corporate bonds	—	1,541,644	—	1,541,644
Other	—	24,924	—	24,924
Equities:				
International	1,317,713	—	—	1,317,713
Small cap	24,893	—	—	24,893
Mid cap	637,840	—	—	637,840
Large cap	1,955,888	—	—	1,955,888
Emerging markets	503,901	—	—	503,901
Commodities	702,604	—	—	702,604
Assets limited as to use:				
Cash and cash equivalents	694,939	—	—	694,939
Fixed income:				
Government bonds	—	379,175	—	379,175
Corporate bonds	—	179,947	—	179,947
Other	—	327,947	—	327,947
Equities:				
International	4,350	—	—	4,350
Small cap	3,038	—	—	3,038
Mid cap	3,142	—	—	3,142
Large cap	85,825	—	—	85,825

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**4. Fair Value of Financial Instruments (continued)**

	September 30, 2011			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 956,229	\$ —	\$ —	\$ 956,229
Short-term investments:				
Cash and cash equivalents	224,305	—	—	224,305
Investments:				
Cash and cash equivalents	1,928,762	—	—	1,928,762
Fixed income:				
Government bonds	—	2,699,287	—	2,699,287
Corporate bonds	—	1,634,084	—	1,634,084
Equities:				
International	2,175,765	—	—	2,175,765
Mid cap	1,334,583	—	—	1,334,583
Large cap	8,626,927	—	—	8,626,927
Emerging markets	940,776	—	—	940,776
Assets limited as to use:				
Cash and cash equivalents	754,029	—	—	754,029
Fixed income:				
Government bonds	—	391,081	—	391,081
Corporate bonds	—	289,079	—	289,079
Other	—	288,956	—	288,955
Equities:				
International	3,860	—	—	3,860
Mid cap	2,491	—	—	2,491
Emerging markets	23,646	—	—	23,646
Other	46,432	—	—	46,432

The amounts reported in the tables above do not include alternative investments totaling \$1,283,286 and \$1,205,131 for the years ended September 30, 2012 and 2011, respectively, that are accounted for under the equity method of accounting.

Fair value for Level 1 is based upon quoted market prices. Fair value for Level 2 is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers and brokers.

## The Milford Hospital, Incorporated

### Notes to Financial Statements (continued)

#### **5. Debt**

The Hospital has a mortgage note arrangement with a bank secured by Hospital property. The Hospital pays principal and interest at a fixed rate of 6.86% over a ten-year term. At September 30, 2012 and 2011, the Hospital had an unpaid principal balance of \$935,367 and \$1,891,051, respectively. The mortgage note has a maturity date of August 15, 2013. Interest paid during fiscal years 2012 and 2011 amounted to \$97,317 and \$160,685, respectively. As of September 30, 2012 and 2011, the carrying value of the mortgage note approximates fair value.

Future minimum principal payments during the next fiscal year, and in the aggregate, were \$935,367 at September 30, 2012.

#### **6. Pension Plan**

The Hospital has a defined benefit pension plan (the Plan) covering substantially all of its employees. Plan benefits are based on years of service and the employee's compensation. Plan participants will vest in their benefits on a percentage basis with years of service.

Effective August 26, 2009, the Hospital's Executive Committee of the Board of Directors adopted a resolution to freeze the Plan for non-union employees effective December 31, 2009. Effective January 24, 2012, the Hospital's Executive Committee of the Board of Directors adopted a resolution to freeze the Plan for nursing union employees effective January 31, 2012 which resulted in a pension curtailment gain of \$5,482,615.

The Hospital recognizes the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligation) of the defined benefit pension plan in its balance sheet.

Net unrecognized actuarial losses at the reporting date will be subsequently recognized in the future as net periodic pension cost pursuant to the Hospital's accounting policy for amortizing such amounts. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic pension cost in the same periods will be recognized as a component of unrestricted net assets.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**6. Pension Plan (continued)**

Included in unrestricted net assets at September 30, 2012 and 2011 are the following amounts that have not yet been recognized in net periodic pension cost:

	<u>2012</u>	<u>2011</u>
Unrecognized actuarial loss	\$ (27,716,287)	\$ (21,666,535)
Unrecognized prior service costs	-	(222,808)
	<u>\$ (27,716,287)</u>	<u>\$ (21,889,343)</u>

The following table presents a reconciliation of the beginning and ending balances of the Plan's projected benefit obligation and the fair value of plan assets, as well as the funded status of the Plan and accrued pension cost included in the financial statements:

	<b>September 30</b>	
	<u>2012</u>	<u>2011</u>
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$ 82,488,161	\$ 80,267,273
Service cost	988,966	1,017,495
Interest cost	3,644,948	3,890,994
Benefits paid	(2,974,691)	(3,172,320)
Expenses paid	(570,708)	(453,640)
Curtailement gain	(5,482,615)	-
Actuarial loss	15,887,556	938,359
Benefit obligation at end of year	<u>93,981,617</u>	<u>82,488,161</u>
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	52,878,221	54,569,223
Contributions	7,052,981	2,500,000
Actual return on plan assets	8,487,811	(522,230)
Benefits paid	(2,974,691)	(3,172,320)
Expenses paid	(570,708)	(496,452)
Fair value of plan assets at end of year	<u>64,873,614</u>	<u>52,878,221</u>
Funded status of the plan	<u>\$ (29,108,003)</u>	<u>\$ (29,609,940)</u>

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**6. Pension Plan (continued)**

	<b>September 30</b>	
	<b>2012</b>	<b>2011</b>
<b>Components of net periodic pension cost</b>		
Service cost	\$ 988,966	\$ 1,017,495
Interest cost	3,644,948	3,890,994
Expected return on plan assets	(4,454,673)	(4,368,627)
Amortization of prior service cost	–	68,933
Curtailment loss	222,808	–
Net amortization and deferral	322,051	1,109,044
Net periodic pension cost	<u>\$ 724,100</u>	<u>\$ 1,717,839</u>

The weighted-average assumptions used to develop net periodic benefit cost, and the projected benefit obligation as of September 30, 2012 and 2011, are as follows:

	<b>2012</b>	<b>2011</b>
Discount rate used for net periodic pension cost	4.75%	5.00%
Discount rate used for projected benefit obligation	3.73	4.75
Expected long-term rate of return on plan assets	8.00	8.00
Rate of compensation increase	3.00	3.50

The accumulated benefit obligation at September 30, 2012 and 2011 was \$93,981,617 and \$76,602,288, respectively.

**Plan Assets**

To develop the expected long-term rate of return on plan assets assumption, the Hospital considers the historical return and the future expectations for return for each asset class, as well as target allocation of the plan asset portfolio. The Plan's investment objectives are to achieve long-term growth in excess of long-term inflation, and to provide a rate of return that meets or exceeds the actuarial expected long-term rate of return on plan assets over a long-term time horizon. In order to minimize the risk, the Plan aims to minimize the variability in yearly returns. The Plan also aims to diversify its holdings among sectors, industries, and companies. No more than 10% of the Plan's portfolio, excluding U.S. government securities and cash, may be held in an individual company's stocks or bonds, and no more than 20% in a single industry.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**6. Pension Plan (continued)**

The Hospital's pension plan weighted-average allocations at September 30, 2012 and 2011, by asset category, are as follows:

<b>Asset Category</b>	<b>2012</b>	<b>2011</b>
Cash and money market funds	<b>11.6%</b>	4.2%
Government bonds	<b>13.7</b>	15.8
Corporate bonds	<b>7.9</b>	8.5
Equities	<b>62.2</b>	67.4
Alternative investments	<b>4.6</b>	4.1
Total	<b>100.0%</b>	100.0%

The target allocation for the Plan's assets is 65% equity securities, 25% fixed income securities, and 10% other investments.

Financial assets carried at fair value included in the defined benefit pension plan are classified in the tables below in one of the three categories described above:

	<b>September 30, 2012</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 7,504,707	\$ —	\$ —	\$ 7,504,707
Fixed income:				
Government bonds	—	8,858,044	—	8,858,044
Corporate bonds	—	5,117,442	—	5,117,442
Equities:				
International	13,610,566	—	—	13,610,566
Mid cap	2,520,875	—	—	2,520,875
Large cap	24,274,555	—	—	24,274,555
Alternative investments	—	—	2,987,425	2,987,425
	<b>\$ 47,910,703</b>	<b>\$ 13,975,486</b>	<b>\$ 2,987,425</b>	<b>\$ 64,873,614</b>

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**6. Pension Plan (continued)**

	<b>September 30, 2011</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 2,232,417	\$ –	\$ –	\$ 2,232,417
Fixed income:				
Government bonds	–	8,380,644	–	8,380,644
Corporate bonds	–	4,496,920	–	4,496,920
Equities:				
International	9,139,673	–	–	9,139,673
Mid cap	4,174,933	–	–	4,174,933
Large cap	22,325,812	–	–	22,325,812
Alternative investments	–	–	2,127,822	2,127,822
	<u>\$ 37,872,835</u>	<u>\$ 12,877,564</u>	<u>\$ 2,127,822</u>	<u>\$ 52,878,221</u>

The changes in investments classified as Level 3 are as follows for the years ended September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Beginning balance for the year	<b>\$ 2,127,822</b>	\$ 1,842,050
Purchases	<b>687,500</b>	250,000
Net change in unrealized appreciation	<b>172,103</b>	35,772
Ending balance for the year	<u><b>\$ 2,987,425</b></u>	<u>\$ 2,127,822</u>

Assets invested in the defined benefit cash balance plan are carried at fair value based upon, as a practical expedient, net asset values derived from the application of the equity method of accounting. Debt securities and equity securities with readily determinable values are classified as Level 1 as determined based on independent published sources. Level 2 assets are valued based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets. Inputs are obtained from various sources, including market participants, dealers and brokers. Assets that are valued using

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### 6. Pension Plan (continued)

significant unobservable inputs, such as extrapolated data, proprietary models or indicative quotes that cannot be corroborated with market data are classified in Level 3 within the fair value hierarchy. Level 3 assets are valued based on the Hospital's ownership interest in the net asset value (NAV) of the fund as discussed above. As the NAV reported by each fund is used as a practical expedient to estimate the fair value of the Hospital's interest therein, its classification as Level 3 is based on the Hospital's ability to redeem its interest at or near the measurement date. The Hospital routinely monitors and assesses methodologies and assumptions used in valuing these interests.

#### Contributions

The Hospital expects to contribute approximately \$625,000 to the Plan in 2013.

#### Estimated Future Benefit Payments

Benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

Fiscal years:	
2013	\$ 3,180,417
2014	3,548,552
2015	3,660,425
2016	3,855,780
2017	4,003,178
Years 2018 – 2022	23,887,895

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### 7. Transactions With Affiliates

Amounts expected to be collected from affiliated entities are as follows:

	<b>September 30</b>	
	<b>2012</b>	<b>2011</b>
Milford Medical Lab, Inc.	<b>\$ 221,205</b>	\$ 224,110
Milford Health and Medical, Inc.	<b>364,864</b>	309,799
Home Care Plus, Inc.	<b>34,777</b>	28,702
Other affiliated entities	<b>33,224</b>	113,557
	<b><u>\$ 654,070</u></b>	<b><u>\$ 676,168</u></b>

Amounts due from Milford Medical Lab, Inc. relate to lab and related services provided by the Hospital on behalf of Milford Medical Lab, Inc. The Hospital charged Milford Medical Lab, Inc. \$692,504 and \$704,714 in 2012 and 2011, respectively, for those services. The receivable from Milford Medical Lab, Inc. is net of an allowance for uncollectible accounts of \$8,802,439 and \$8,137,743 at September 30, 2012 and 2011, respectively. Amounts due from Milford Health and Medical, Inc., Home Care Plus, Inc., and other affiliated entities are the result of allocating joint general and administrative costs incurred by the Hospital. The amounts allocated to affiliates during the years ended September 30, 2012 and 2011 were \$143,075 and \$124,304, respectively.

### 8. Medical Malpractice Insurance

Effective October 1, 2004, the Hospital became insured by the Parent through Healthcare Alliance Insurance Company, Ltd. (HAIC). HAIC is a multi-provider captive insurance company domiciled in the Cayman Islands. The Parent is a one-third owner of the captive with two other local hospitals that each hold one-third ownership. The Hospital's insurance coverage is \$1,500,000 per occurrence, and \$3,000,000 in the aggregate. The Hospital has an excess layer of indemnity coverage of \$25,000,000 per occurrence, and \$25,000,000 in the aggregate.

Management accrues its best estimate of losses as they occur. Accordingly, management has recorded a liability of approximately \$596,000 and \$594,000 at September 30, 2012 and 2011, respectively, for claims incurred but not reported which is included in accrued pension and other liabilities on the balance sheet. This liability has been discounted using a 3.5% discount rate at September 30, 2012 and 2011, respectively.

The Milford Hospital, Incorporated

Notes to Financial Statements (continued)

**8. Medical Malpractice Insurance (continued)**

Malpractice claims have been asserted against the Hospital by various claimants. These claims are in various stages of processing, and some may ultimately be brought to trial. There are known incidents that have occurred through September 30, 2012 that may result in the assertion of additional claims, and other claims may be asserted arising from services provided to patients in the past. In management's opinion, the outcome of these matters will not have a material effect on the Hospital's financial statements.

**9. Commitments and Contingencies**

The Hospital is a party to various lawsuits incidental to its business. Management believes that the lawsuits fall within the Hospital's liability insurance, and that they will not have a material adverse effect on the Hospital's financial statements.

**10. Functional Expenses**

The Hospital provides inpatient and outpatient general healthcare services to residents within its geographic location. Expenses related to providing these services are as follows:

	<b>Year Ended September 30</b>	
	<b>2012</b>	<b>2011</b>
Healthcare services	<b>\$ 81,170,301</b>	\$ 75,830,354
General and administrative	<b>9,515,553</b>	9,652,044
	<b>\$ 90,685,854</b>	<b>\$ 85,482,398</b>

# The Milford Hospital, Incorporated

## Notes to Financial Statements (continued)

### 11. Other Operating Revenues

Other operating revenues consist of the following for the years ended September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Electronic health records incentive payments	<b>\$ 2,003,647</b>	\$ –
Cafeteria	<b>237,396</b>	247,998
Pharmacy	<b>198,790</b>	190,688
Other	<b>65,310</b>	109,284
	<b><u>\$ 2,505,143</u></b>	<b><u>\$ 547,970</u></b>

The American Recovery and Reinvestment Act of 2009 included provisions for implementing health information technology under the Health Information Technology for Economic and Clinical Health Act (HITECH). The provisions were designed to increase the use of electronic health record (EHR) technology and establish the requirements for a Medicare and Medicaid incentive payment program beginning in 2011 for eligible providers that adopt and meaningfully use certified EHR technology. Eligibility for annual Medicare incentive payments is dependent on providers demonstrating meaningful use of EHR technology in each period over a four-year period. Initial Medicaid incentive payments are available to providers that adopt, implement or upgrade certified EHR technology. In subsequent years, providers must demonstrate meaningful use of such technology to qualify for additional Medicaid incentive payments. Hospitals that do not successfully demonstrate meaningful use of EHR technology are subject to payment penalties or downward adjustments to their Medicare payments beginning in federal fiscal year 2015.

The Hospital uses a grant accounting model to recognize revenue for the Medicare and Medicaid EHR incentive payments. Under this accounting policy, EHR incentive payment revenue is recognized when the Hospital is reasonably assured that the EHR meaningful use criteria for the required period of time were met and that the grant revenue will be received. EHR incentive payment revenue from Medicare and Medicaid for the year ended September 30, 2012 was approximately \$1,808,000 and \$196,000, respectively, and is included in other operating revenue. Income from incentive payments is subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were calculated. Additionally, the Hospital's attestation of compliance with the meaningful use criteria is subject to audit.

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

**About Ernst & Young**

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 167,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit [www.ey.com](http://www.ey.com)

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This Report has been prepared by Ernst & Young LLP, a client serving member firm located in the United States.

