



SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Financial Statements and
Consolidating Information

September 30, 2012 and 2011

(With Independent Auditors' Report Thereon)

SAINT MARY’S HEALTH SYSTEM, INC.

Consolidated Financial Statements and
Consolidating Information

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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, 2012 and 2011, and the related consolidated 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, 2012 and 2011, 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 conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information included in Exhibits 1 and 2 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

February 25, 2013

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Balance Sheets

September 30, 2012 and 2011

(In thousands)

Assets	2012	2011
Current assets:		
Cash and cash equivalents	\$ 23,689	25,568
Short-term investments	38	497
Current portion of assets whose use is limited	6,779	6,428
Accounts receivable, net of estimated uncollectibles of \$11,215 in 2012 and \$7,269 in 2011	34,085	28,879
Other current assets	4,813	6,116
Total current assets	69,404	67,488
Marketable securities	19,467	16,163
Assets whose use is limited:		
By donor and held in trust by others	14,299	12,673
For estimated self-insurance liability	30,069	27,114
By bond indenture	4,100	5,143
Other	6	5
Total assets whose use is limited	48,474	44,935
Less current portion of assets whose use is limited	6,779	6,428
Noncurrent assets whose use is limited	41,695	38,507
Property and equipment, net	58,350	57,801
Other assets:		
Investments in joint venture arrangements	10,396	9,867
Deferred financing costs, net	154	181
Other noncurrent assets	241	373
Total other assets	10,791	10,421
Total assets	\$ 199,707	190,380
Liabilities and Net Assets		
Current liabilities:		
Current portion of long-term obligations	\$ 2,238	2,655
Accounts payable	17,828	18,041
Salaries, wages, and payroll withholdings	5,819	5,260
Due to third-party payors, net	7,007	7,100
Accrued expenses and other current liabilities	15,626	14,213
Total current liabilities	48,518	47,269
Long-term liabilities:		
Long-term obligations, net of current portion	22,302	24,165
Estimated self-insurance liability	19,062	20,064
Pension and deferred compensation	79,738	75,051
Other long-term liabilities	9,550	9,260
Total long-term liabilities	130,652	128,540
Net assets (deficit):		
Unrestricted	2,333	(2,136)
Noncontrolling interest in subsidiaries	352	478
Total unrestricted	2,685	(1,658)
Temporarily restricted	2,546	2,554
Permanently restricted	15,306	13,675
Total net assets	20,537	14,571
Total liabilities and net assets	\$ 199,707	190,380

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Statements of Operations

Years ended September 30, 2012 and 2011

(In thousands)

	<u>2012</u>	<u>2011</u>
Revenues:		
Net revenue from patient services	\$ 259,820	248,136
Other operating revenues	6,695	7,191
Total revenues	<u>266,515</u>	<u>255,327</u>
Expenses:		
Salaries and wages	115,924	109,393
Employee benefits	31,634	28,711
Supplies and other expenses	90,283	99,628
Provision for uncollectible accounts, net of recoveries	12,846	9,592
Depreciation and amortization	9,549	8,917
Interest	1,744	1,346
Total expenses	<u>261,980</u>	<u>257,587</u>
Operating income (loss)	<u>4,535</u>	<u>(2,260)</u>
Nonoperating gains (losses):		
Investment income, net	2,112	979
Equity in earnings of joint ventures	1,537	1,573
Net loss on disposal of assets	(46)	(502)
Other	(983)	(1,497)
Total nonoperating gains, net	<u>2,620</u>	<u>553</u>
Excess (deficiency) of revenues over expenses from continuing operations	7,155	(1,707)
Discontinued operations (note 1)	<u>(508)</u>	<u>(61)</u>
Excess (deficiency) of revenues over expenses	6,647	(1,768)
Reclassification of beginning of year minority interest (note 10)	—	1,663
Net assets released from restriction for capital expenditures	338	293
Transfers to affiliates	(344)	(564)
Change in unrealized gains and (losses) on marketable securities and other assets whose use is limited	2,450	(660)
Purchase of NVSC from noncontrolling partners	—	(720)
Change in accumulated pension charges to unrestricted net assets	(4,748)	(7,639)
Increase (decrease) in unrestricted net assets	<u>\$ 4,343</u>	<u>(9,395)</u>

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.
Consolidated Statements of Changes in Net Assets
Years ended September 30, 2012 and 2011
(In thousands)

	<u>2012</u>	<u>2011</u>
Unrestricted net assets:		
Reclassification of beginning of year minority interest (note 10)	\$ —	1,663
Excess (deficiency) of revenues over expenses	6,647	(1,768)
Net assets released from restriction for capital expenditures	338	293
Transfers to affiliates	(344)	(564)
Change in unrealized gains (losses) on marketable securities and other assets whose use is limited	2,450	(660)
Purchase of NVSC from noncontrolling partners	—	(720)
Change in accumulated pension charges to unrestricted net assets	(4,748)	(7,639)
Increase (decrease) in unrestricted net assets	<u>4,343</u>	<u>(9,395)</u>
Temporarily restricted net assets:		
Net assets released from restriction	(490)	(775)
Restricted contributions	632	892
Change in net assets of Cancer Center, including releases for capital expenditures	(150)	(145)
Decrease in temporarily restricted net assets	<u>(8)</u>	<u>(28)</u>
Permanently restricted net assets:		
Net earnings on assets held in trust by others	2,273	(50)
Appropriation for expenditure	(642)	(653)
Increase (decrease) in permanently restricted net assets	<u>1,631</u>	<u>(703)</u>
Increase (decrease) in net assets	5,966	(10,126)
Net assets – beginning of year	<u>14,571</u>	<u>24,697</u>
Net assets – end of year	<u>\$ 20,537</u>	<u>14,571</u>

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Statements of Cash Flows

Years ended September 30, 2012 and 2011

(In thousands)

	2012	2011
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 5,966	(10,126)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Purchase of NVSC from noncontrolling partners	—	720
Depreciation and amortization	9,549	8,917
Net loss on disposal of assets	46	502
Change in unrealized (gains) losses on investments	(2,450)	660
Change in net assets of Cancer Center	150	145
Change in accumulated pension charges to unrestricted net assets	4,748	7,639
Investment income, net	(2,112)	(979)
Equity in earnings of joint ventures and partnerships	(1,537)	(1,573)
(Increase) decrease in operating assets:		
Accounts receivable, net	(5,206)	(2,127)
Other current assets	1,330	(1,515)
Other non current assets	132	128
Increase (decrease) in operating liabilities:		
Due to third-party payors, net	(93)	1,165
Accounts payable and other current liabilities	(233)	7,280
Estimated self-insurance liability	(1,002)	730
Minority interest in subsidiaries	—	(1,663)
Pension, accrued compensation, and other long term liabilities	229	875
Net cash provided by operating activities	9,517	10,778
Cash flows from investing activities:		
Purchases of property and equipment	(8,152)	(10,405)
Distributions from joint ventures and partnerships	858	933
Change in other assets whose use is limited	(4,582)	1,137
Purchase of NVSC from noncontrolling partners	—	(720)
Net decrease in investments	1,717	645
Net cash used in investing activities	(10,159)	(8,410)
Cash flows from financing activities:		
Decrease (increase) in assets whose use is limited by bond indentures	1,043	(65)
Borrowings under long-term obligations	345	
Payments on long-term obligations	(2,625)	(3,093)
Net cash used in financing activities	(3,158)	(3,158)
Net decrease in cash and cash equivalents	(642)	(790)
Cash and cash equivalents – beginning of year	25,568	26,358
Cash and cash equivalents – end of year	\$ 24,926	25,568
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 2,080	1,681
Assets acquired under capital lease	345	—

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2012 and 2011

(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 168 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 four consolidated subsidiaries: Franklin Medical Group, P.C. (Franklin), 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 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. On May 10, 2012, Partners merged with Franklin Medical Group and Franklin became the surviving corporation. Each share of Partners stock was converted to Franklin stock on a one-to-one ratio.

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 a 60% equity interest in the Diagnostic Center, which provides diagnostic imaging services. The remaining interest is accounted for as minority interest in the accompanying consolidated financial statements.

The Hospital sold Scovill Medical Group, P.C. (Scovill) to a group of community physicians as of February 29, 2012. The fiscal year 2012 and 2011 results are recorded in discontinued operations in the consolidated statements of operations.

The Hospital purchased the remaining interest in the Naugatuck Valley Surgical Center, LP as of July 31, 2011 for \$720,000, and established the Surgical Center as an outpatient department of the Hospital on August 1, 2011.

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.

Saint Mary's and LHP Hospital Group, Inc. (LHP) mutually agreed in August 2012 to terminate its letter of intent to form a joint venture. The Hospital is currently in the process of pursuing other opportunities to form a joint venture.

SAINT MARY'S HEALTH SYSTEM, INC.

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(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 deemed "charity care". During 2012 and 2011, the costs associated with the charges foregone, measured using a ratio of cost to charge, related to charity care were approximately \$136,000 and \$236,000, respectively.

Many patients without insurance do not complete the application for charity care. The Hospital reviews the information they have on these patients and makes a determination that the patient would have qualified for the charity care policy if an application was submitted. During 2012 and 2011, the costs associated with the charges foregone related to these patients were approximately \$1,340,000 and \$915,000, respectively.

In addition, the Hospital provides care to patients covered by governmental healthcare programs. During 2012 and 2011, the Hospital estimates that the cost of providing this care exceeded compensation by \$7,044,000 and \$9,849,000, 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

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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 2012 and 2011, approximately 140 and 150 volunteers spent more than 19,000 hours and 18,800 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.

(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 its 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

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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 Whose Use is Limited*

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

(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 (deficiency) 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 (deficiency) 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, the adjustments of these investments to fair value (i.e. new cost basis) is reflected as an other than temporary impairment. The System recorded \$0 and \$1,168,000 of other than temporary impairments on investments in 2012 and 2011, respectively, which is included in investment income, net in the accompanying consolidated statements of operations.

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

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shorter period of the lease term or the estimated useful life of the equipment. 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 (deficiency) 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.

(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

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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 accounts.

(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 asset 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 (Deficiency) of Revenues over Expenses

Excess (deficiency) 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 (deficiency) 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, 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, and equity in earnings of joint ventures 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.

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Franklin, including its predecessor Partners, are for-profit organizations subject to income taxes. Each organization has experienced operating losses. After the merger, only the accumulated net operating loss carryforwards of Franklin remain available to offset future taxable income. A valuation allowance has been recorded as management believes realization of such carryforwards is doubtful.

The Diagnostic Center is a pass-through entity. The Indemnity Company is a disregarded entity. The tax consequences of their operating results is assessed at the member level.

The System recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount of benefit that is greater than fifty percent likely to be realized upon settlement. Changes in recognition in measurement are reflected in the period in which the change in judgment occurs. The System did not recognize the effect of any income tax positions in either 2012 or 2011.

(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 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 consolidated financial statements. As adjustments to these estimates become necessary, such adjustments will be reflected in current operations.

(o) Recently Issued Accounting Pronouncements

In July 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-07, Health Care Entities (Topic 954): *Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities* (ASU 2011-07), which requires certain health care entities to change the presentation of their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenue (net of contractual allowances and discounts). Additionally, those health care entities are required to provide enhanced disclosure about their policies for recognizing revenue and

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assessing bad debts. The amendments also require disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. ASU 2011-07 is effective for the System's fiscal year beginning October 1, 2012, and the change in presentation is not expected to significantly impact the System's consolidated financial position, results of operations or cash flows.

(p) 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, 2012 and 2011, is as follows (in thousands):

	<u>2012</u>	<u>2011</u>
Gross revenue from patient services	\$ 650,487	614,167
Contractual and other allowances	(390,531)	(365,795)
Charity care	<u>(136)</u>	<u>(236)</u>
Net revenue from patient services	\$ <u>259,820</u>	<u>248,136</u>

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, 2012 and 2011 was as follows:

	<u>2012</u>	<u>2011</u>
Medicare (including Medicare managed care)	29.5%	30.0%
Medicaid	11.5	13.0
Other third-party payors	31.8	28.8
Private pay patients	<u>27.2</u>	<u>28.2</u>
	<u>100.0%</u>	<u>100.0%</u>

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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. Under a prior uncompensated care and disproportionate share program that was terminated as of June 30, 2011, the Hospital received \$4,786,000 in fiscal year 2011.

The Hospital is subject to legislation enacted in 2011 imposing a new tax on certain net patient service revenues of hospitals and changes to the disproportionate share hospital payments (DSH) pursuant to 2011 Conn. Pub. Acts 6 (145-149), as amended by 2011 Conn. Pub. Acts 44 (102-103) and Conn. Pub. Acts 61 (79). The tax was effective beginning July 1, 2011 and paid on a quarterly basis. The Hospital recorded a tax of \$8,789,072 which has been offset with \$11,096,942 of DSH payments and is recorded in net revenue from patients for the year ended September 30, 2012. The Hospital recorded a tax of \$2,197,268 for the year ended September 30, 2011.

(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.

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(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, 2012 and 2011, is as follows (in thousands):

	2012					
	Total		Less than 12 months		12 months or more	
	Fair value	Cost	Fair value	Unrealized losses	Fair value	Unrealized losses
Cash and cash equivalents	\$ 5,005	5,005	—	—	—	—
Corporate bonds	15,366	14,521	1,447	(13)	201	(4)
U.S. government and agency obligations	13,978	13,833	2,221	(6)	253	(1)
Mutual funds	17,777	15,107	—	—	—	—
Equities	12,023	9,842	—	—	—	—
	<u>\$ 64,149</u>	<u>58,308</u>	<u>3,668</u>	<u>(19)</u>	<u>454</u>	<u>(5)</u>
	2011					
	Total		Less than 12 months		12 months or more	
	Fair value	Cost	Fair value	Unrealized losses	Fair value	Unrealized losses
Cash and cash equivalents	\$ 4,697	4,697	—	—	—	—
Corporate bonds	12,739	12,389	2,064	(76)	—	—
U.S. government and agency obligations	16,706	16,325	1,349	(10)	—	—
Mutual funds	15,334	14,522	4,093	(496)	192	(20)
Equities	8,140	8,069	—	—	—	—
	<u>\$ 57,616</u>	<u>56,002</u>	<u>7,506</u>	<u>(582)</u>	<u>192</u>	<u>(20)</u>

The above tables include permanently restricted assets held by others whose fair value exceeded cost by \$1,943,000 at September 30, 2012 and \$292,000 at September 30, 2011.

Assets whose use is limited for estimated self insurance includes approximately \$3,825,000 and \$3,974,000 of other assets, substantially receivables, as of September 30, 2012 and 2011, respectively.

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The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2012 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 4,497	—	—	4,497
Domestic corporate bonds	—	11,286	—	11,286
U.S. government and agency obligations	—	12,943	—	12,943
Equity mutual funds	14,246	—	—	14,246
Fixed income mutual funds	2,990	—	—	2,990
Equity funds	3,651	—	—	3,651
Preferred equity securities	—	237	—	237
Total	25,384	24,466	—	49,850
Assets held in trust by others:				
Perpetual trust	—	—	14,299	14,299
Total	\$ 25,384	24,466	14,299	64,149

The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2011 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 4,448	—	—	4,448
Domestic corporate bonds	—	8,811	—	8,811
Foreign corporate bonds	—	1,275	—	1,275
U.S. government and agency obligations	—	15,573	—	15,573
Equity mutual funds	9,992	—	—	9,992
Fixed income mutual funds	2,652	—	—	2,652
Equity funds	1,887	—	—	1,887
Preferred equity securities	—	305	—	305
Total	18,979	25,964	—	44,943
Assets held in trust by others:				
Perpetual trust	—	—	12,673	12,673
Total	\$ 18,979	25,964	12,673	57,616

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

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price source is identified based on asset type, class or issue for each security. The fair values of fixed-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 redemption period for the System's financial instruments ranges from daily to monthly and require notification of one to five days, except for assets held in perpetual trust by others.

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>Perpetual trust</u>	<u>2012</u>	<u>2011</u>
Fair value at beginning of the year	\$ 12,673	13,375
Net realized and change in unrealized gains and losses	2,268	(50)
Appropriation of endowment assets for expenditure	<u>(642)</u>	<u>(652)</u>
Fair value at end of the year	\$ <u>14,299</u>	<u>12,673</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, 2012 and 2011 is as follows (in thousands):

	<u>2012</u>	<u>2011</u>
Land and land improvements	\$ 1,661	1,645
Buildings and building improvements	69,688	69,842
Equipment	104,743	105,710
Projects in process	<u>692</u>	<u>1,177</u>
	176,784	178,374
Less accumulated depreciation and amortization	<u>(118,434)</u>	<u>(120,573)</u>
Property and equipment, net	\$ <u>58,350</u>	<u>57,801</u>

Property under capital leases had a net book value of \$1,354,000 and \$1,429,000 at September 30, 2012 and 2011, respectively.

(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.

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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 CHEFA, including a Debt Service Coverage Ratio requirement of at least 1.25, a Debt Ratio requirement of no greater than 0.75 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, 2012 and 2011 are as follows (in thousands):

	2012	2011
CHEFA Series E Bonds, principal payable annually and interest payable in semi-annual installments	\$ 23,225	24,875
Capital equipment financing notes	—	614
Capital leases	1,486	1,532
	24,711	27,021
Less unamortized portion of bond discount	(171)	(201)
Less current portion	(2,238)	(2,655)
	\$ 22,302	24,165

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

	Long-term obligations	Capital leases
Year ending September 30:		
2013	\$ 1,720	518
2014	1,880	492
2015	1,960	402
2016	2,090	68
2017	2,215	6
Thereafter	13,360	—
	\$ 23,225	1,486
Interest payments		80
		\$ 1,566

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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 approximates \$23,249,000 as of September 30, 2012.

(9) Line of Credit

The Hospital maintains a financing agreement with Webster Bank for a \$5,000,000 line of credit which has an August 13, 2014 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, 2012 and 2011, 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) Unrestricted, Temporarily and Permanently Restricted Net Assets

The changes in consolidated unrestricted net assets attributable to the System and noncontrolling interest for the year ended September 30, 2012 were as follows (in thousands):

	<u>Total</u>	<u>Controlling interest</u>	<u>Noncontrolling interest</u>
Unrestricted net assets, beginning of year	\$ (1,658)	(2,136)	478
Excess of revenues over expenses	6,647	6,159	488
Net assets released from restriction for capital expenditures	338	338	—
Transfers (to) from affiliates	(344)	270	(614)
Change in unrealized gains and losses on marketable securities and other assets whose use is limited	2,450	2,450	—
Change in accumulated pension charges to unrestricted net assets	(4,748)	(4,748)	—
Unrestricted net assets, end of year	<u>\$ 2,685</u>	<u>2,333</u>	<u>352</u>

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The changes in consolidated unrestricted net assets attributable to the System and noncontrolling interest for the year ended September 30, 2011 were as follows (in thousands):

	<u>Total</u>	<u>Controlling interest</u>	<u>Noncontrolling interest</u>
Unrestricted net assets, beginning of year	\$ 7,737	7,737	—
Reclassification of minority interest in accordance with adoption of FAS 164	1,663	—	1,663
	<u>9,400</u>	<u>7,737</u>	<u>1,663</u>
Excess (deficiency) of revenues over expenses	(1,768)	(2,388)	620
Net assets released from restriction for capital expenditures	293	293	—
Transfers (to) from affiliates	(564)	206	(770)
Change in unrealized gains and losses on marketable securities and other assets whose use is limited	(660)	(652)	(8)
Purchase of NVSC from noncontrolling	(720)	307	(1,027)
Change in accumulated pension charges to unrestricted net assets	(7,639)	(7,639)	—
Unrestricted net assets (deficit), end of year	\$ <u>(1,658)</u>	<u>(2,136)</u>	<u>478</u>

Temporarily restricted net assets are available for the following purposes at September 30, 2012 and 2011 (in thousands):

	<u>2012</u>	<u>2011</u>
Cancer	\$ 374	519
Building and equipment	566	667
Community services	600	386
Education	160	216
Other	846	766
	<u>\$ 2,546</u>	<u>2,554</u>

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Permanently restricted net assets at September 30, 2012 and 2011 are restricted to (in thousands):

	2012	2011
Investments held by trustee in perpetuity, the income from which is expendable to support Hospital operations	\$ 14,338	12,707
Investments held by Hospital Foundation in perpetuity, the income from which is expendable to support:		
Hospital operations	818	818
Medical education	150	150
	\$ 15,306	13,675

(11) Endowment

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) adopted by the State of Connecticut (Act) provides standards to guide investing in a prudent manner and eliminated the restriction that endowment funds could not be spent below historical dollar value.

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, 2012 and 2011, 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.

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

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Endowment funds consist of the following at September 30, 2012 and 2011 (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Donor-restricted endowment funds at September 30, 2012	\$ 261	15,306	15,567
Donor-restricted endowment funds at September 30, 2011	\$ 108	13,675	13,783

Changes in endowment funds for the year ended September 30, 2012 are as follows (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, October 1, 2011	\$ 108	13,675	13,783
Investment return:			
Investment income	35	645	680
Net appreciation	118	1,628	1,746
Total investment return	153	2,273	2,426
Appropriation of endowment assets for expenditure	—	(642)	(642)
Endowment net assets, September 30, 2012	\$ <u>261</u>	<u>15,306</u>	<u>15,567</u>

Changes in endowment funds for the year ended September 30, 2011 are as follows (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, October 1, 2010	\$ 122	14,378	14,500
Investment return:			
Investment income	74	1,016	1,090
Net depreciation	(88)	(1,066)	(1,154)
Total investment return	(14)	(50)	(64)
Appropriation of endowment assets for expenditure	—	(653)	(653)
Endowment net assets, September 30, 2011	\$ <u>108</u>	<u>13,675</u>	<u>13,783</u>

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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 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, 2012 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

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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>2012</u>	<u>2011</u>
Reserves for premiums held on deposit at beginning of year	\$ 10,041	12,833
Current period payments from loss escrow	(1,330)	(930)
Change in reserve for premiums held on deposit for loss portfolio transfer	(844)	816
Current period payments from reserves for premiums held on deposit	1,210	2,678
Reserves for premium held on deposit at end of year	\$ <u>6,657</u>	<u>10,041</u>

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

	<u>2012</u>	<u>2011</u>
Balance at beginning of period	\$ 11,222	6,486
Less reinsurance recoverable	(1,545)	(900)
Net balance at beginning of period	<u>9,677</u>	<u>5,586</u>
Incurred related to:		
Current year	4,717	3,739
Prior years	173	3,000
Total incurred	<u>4,890</u>	<u>6,739</u>
Paid related to:		
Current year	104	32
Prior years	2,013	2,616
Total paid	<u>2,117</u>	<u>2,648</u>
Net balance at end of period	12,450	9,677
Add reinsurance recoverable	<u>2,300</u>	<u>1,545</u>
Balance at end of period	\$ <u>14,750</u>	<u>11,222</u>

The provision for incurred losses related to prior years totaled \$173,000 and \$3,000,000 for 2012 and 2011, respectively, the result of negative development on outstanding claims.

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(13) Retirement Plans

(a) 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.

The following table sets forth the Plan's funded status at September 30, 2012 and 2011, the Plan measurement date, (in thousands):

	2012	2011
Change in benefit obligation:		
Benefit obligation, beginning of year	\$ 124,780	119,779
Interest cost	6,080	6,129
Actuarial loss	13,456	4,737
Benefits paid	(5,834)	(5,865)
Benefit obligation, end of year	138,482	124,780
Change in plan assets:		
Fair value of plan assets, beginning of year	50,602	53,218
Actual return on plan assets	8,819	(1,194)
Contributions	6,096	4,443
Benefits paid	(5,834)	(5,865)
Fair value of plan assets, end of year	59,683	50,602
Funded status at year end	\$ (78,799)	(74,178)
Amounts recognized in consolidated balance sheets consist of:		
Noncurrent liabilities	\$ (78,799)	(74,178)
Accumulated charges to unrestricted net assets	63,780	59,032
Net amount recognized	\$ (15,019)	(15,146)

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

	Pension benefits	
	2012	2011
Net actuarial loss	\$ (63,780)	(59,032)
	\$ (63,780)	(59,032)

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The net actuarial loss that will be amortized from accumulated charges to unrestricted net assets into net periodic benefit cost over the next fiscal year is \$4,477,000.

The accumulated benefit obligation for the pension plan was \$138,482,000 and \$124,780,000 at September 30, 2012 and 2011, respectively. Net periodic benefit cost recognized in 2012 and 2011 was (in thousands):

	<u>2012</u>	<u>2011</u>
Components of net periodic benefit cost:		
Interest cost	\$ 6,080	6,129
Expected return on plan assets	(4,050)	(4,748)
Net amortization and deferral	<u>3,940</u>	<u>3,039</u>
Net periodic benefit cost	<u>5,970</u>	<u>4,420</u>
Other changes in plan assets and benefit obligation recognized as charges to unrestricted net assets in 2012 and 2011 are as follows (in thousands):		
Net loss	(808)	(4,600)
Net amortization and deferral	<u>(3,940)</u>	<u>(3,039)</u>
Charges to unrestricted net assets	<u>(4,748)</u>	<u>(7,639)</u>
Decrease to unrestricted net assets associated with recognized net periodic benefit cost and other charges	\$ <u>10,718</u>	<u>12,059</u>

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost as of and for the years end September 30, 2012 and 2011 were as follows:

	<u>2012</u>	<u>2011</u>
Weighted average assumptions at September 30:		
Discount rate for benefit obligations	4.15%	5.00%
Discount rate for net periodic benefit cost	5.00	5.25
Expected return on plan assets	8.00	8.00

The Hospital revised its approach to selecting the discount rate assumption in 2011. The discount rate is based on high-grade bond yield curve under which benefits were projected and discounted at spot rates along the curve. The discount rate was then determined as a single rate yielding the same present values.

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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, 2012 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Money market funds	\$ 3,134	—	—	3,134
Domestic corporate bonds	—	9,667	—	9,667
U.S. government and agency obligations	—	1,378	—	1,378
Equity mutual funds	35,648	—	—	35,648
Fixed income mutual funds	8,569	—	—	8,569
Preferred equity securities	—	1,287	—	1,287
Total	\$ 47,351	12,332	—	59,683

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, 2011 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Money market funds	\$ 1,466	—	—	1,466
Domestic corporate bonds	—	10,251	—	10,251
Foreign corporate bonds	—	935	—	935
U.S. government and agency obligations	—	2,753	—	2,753
Equity mutual funds	28,416	—	—	28,416
Fixed income mutual funds	5,423	—	—	5,423
Preferred equity securities	—	1,358	—	1,358
Total	\$ 35,305	15,297	—	50,602

The redemption period for the Plan's financial instruments ranges from daily to monthly and require notification of one to five days.

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 \$6,581,000 in 2012.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2012 and 2011

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

2013	\$	6,450
2014		6,794
2015		6,901
2016		7,099
2017		7,438
2018 through 2020		41,436
		41,436
	\$	76,118

(b) 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 \$3,950,000 and \$3,677,000 in 2012 and 2011, respectively, and are included in employee benefits in the accompanying consolidated statements of operations.

(c) Supplemental Pension Plan

In addition, the Hospital has an unfunded supplemental pension plan for a small group of long term employees, who are now retired. The Hospital's recorded liability was \$1,019,000 and \$873,000 at September 30, 2012 and 2011, respectively.

(14) Leases and Rental Expenses

Rental expense aggregated approximately \$6,155,000 and \$6,066,000 for the years ended September 30, 2012 and 2011, 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:		
2013	\$	3,304
2014		2,553
2015		2,255
2016		1,709
2017		1,133
2018 and thereafter		7,649
		7,649
	\$	18,603

(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 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

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2012 and 2011

approximately \$9,783,000 and \$9,192,000 at September 30, 2012 and 2011, respectively. Equity in earnings was approximately \$623,000 and \$830,000 in 2012 and 2011, respectively.

(16) Heart Center of Greater Waterbury

The Hospital and Waterbury Hospital operate an advanced cardiac care program known as the Heart Center of Greater Waterbury, Inc. (HCGW). 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 \$129,000 and \$257,000 of funding, in 2012 and 2011, 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 \$273,000 and \$330,000 at September 30, 2012 and 2011, respectively. Equity in earnings was approximately \$532,000 and \$731,000 in 2012 and 2011, respectively.

(18) Other Operating Revenues

Components of other operating revenues for the years ended September 30, 2012 and 2011 are as follows (in thousands):

	2012	2011
Investment income related to short-term investments and investments for self-insurance	\$ 267	753
Net assets released from restriction	323	283
Contributions	229	89
Cafeteria	1,174	1,147
Outside services	330	796
State grants	469	450
Parking fees	439	509
Day care	654	681
Rentals	1,381	1,707
Other	1,429	776
Total	\$ 6,695	7,191

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2012 and 2011

(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, 2012 and 2011 are as follows (in thousands):

	<u>2012</u>	<u>2011</u>
Health care services	\$ 223,587	221,277
General and administrative	37,634	35,549
Fundraising	759	761
	<u>\$ 261,980</u>	<u>257,587</u>

(20) Commitments and Contingencies

In August 2012, the Hospital entered into a commitment to purchase the former Holiday Inn property from LHP for approximately \$4.9 million. The transaction is expected to occur in 2013.

(21) Subsequent Events

The System has evaluated events through February 25, 2013, which represents the date the consolidated financial statements were available to be issued and noted no subsequent events that would have impacted the System's consolidated financial statements except as disclosed below.

The System is subject to changes in reimbursements from its payors. Due to the State of Connecticut's recent announcement regarding budget revisions, the System expects overall Medicaid reimbursements to be reduced by approximately \$2 to \$2.5 million for fiscal year 2013. The System also participates in the disproportionate share hospital (DSH) payments which are expected to be reduced by approximately \$1.5 million in fiscal year 2013.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Balance Sheet

September 30, 2012

(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
Current assets:					
Cash and cash equivalents	\$ 22,524	1,163	2	—	23,689
Short-term investments	38	—	—	—	38
Current portion of assets whose use is limited	6,779	—	—	—	6,779
Accounts receivable, net	34,017	68	—	—	34,085
Other current assets	4,482	11	446	(126)	4,813
Total current assets	<u>67,840</u>	<u>1,242</u>	<u>448</u>	<u>(126)</u>	<u>69,404</u>
Marketable securities	16,044	3,423	—	—	19,467
Assets whose use is limited:					
By donor and held in trust by others	14,299	—	—	—	14,299
For estimated self-insurance liability	30,069	—	—	—	30,069
By bond indenture	4,100	—	—	—	4,100
Net interest in Foundation	4,495	—	—	(4,495)	—
Other	6	—	—	—	6
Total assets whose use is limited	<u>52,969</u>	<u>—</u>	<u>—</u>	<u>(4,495)</u>	<u>48,474</u>
Less current portion of assets whose use is limited	6,779	—	—	—	6,779
Noncurrent assets whose use is limited	<u>46,190</u>	<u>—</u>	<u>—</u>	<u>(4,495)</u>	<u>41,695</u>
Property and equipment, net	57,197	7	1,146	—	58,350
Other assets:					
Investments in joint venture arrangements	10,396	—	—	—	10,396
Deferred financing costs, net	154	—	—	—	154
Other noncurrent assets	—	—	241	—	241
Total other assets	<u>10,550</u>	<u>—</u>	<u>241</u>	<u>—</u>	<u>10,791</u>
Total assets	<u>\$ 197,821</u>	<u>4,672</u>	<u>1,835</u>	<u>(4,621)</u>	<u>199,707</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Balance Sheet

September 30, 2012

(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
Current liabilities:					
Current portion of long-term obligations	\$ 2,238	—	—	—	2,238
Accounts payable	17,747	51	30	—	17,828
Salaries, wages, and payroll withholdings	5,819	—	—	—	5,819
Due to third-party payors, net	7,007	—	—	—	7,007
Accrued expenses and other current liabilities	15,626	126	—	(126)	15,626
Total current liabilities	<u>48,437</u>	<u>177</u>	<u>30</u>	<u>(126)</u>	<u>48,518</u>
Long-term liabilities:					
Long-term obligations, net of current portion	22,302	—	—	—	22,302
Estimated self-insurance liability	19,062	—	—	—	19,062
Pension and deferred compensation	79,738	—	—	—	79,738
Other long-term liabilities	9,550	—	—	—	9,550
Total long-term liabilities	<u>130,652</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>130,652</u>
Minority interest in subsidiaries	—	—	—	—	—
Net assets:					
Unrestricted	528	1,282	1,805	(1,282)	2,333
Noncontrolling interest in subsidiaries	352	—	—	—	352
Total unrestricted	880	1,282	1,805	(1,282)	2,685
Temporarily restricted	2,546	2,245	—	(2,245)	2,546
Permanently restricted	15,306	968	—	(968)	15,306
Total net assets	<u>18,732</u>	<u>4,495</u>	<u>1,805</u>	<u>(4,495)</u>	<u>20,537</u>
Total liabilities and net assets	<u>\$ 197,821</u>	<u>4,672</u>	<u>1,835</u>	<u>(4,621)</u>	<u>199,707</u>

See accompanying independent auditors' report.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Statement of Operations

Year ended September 30, 2012

(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	\$ 259,820	—	—	—	259,820
Other operating revenues	6,172	523	156	(156)	6,695
Total revenues	<u>265,992</u>	<u>523</u>	<u>156</u>	<u>(156)</u>	<u>266,515</u>
Expenses:					
Salaries and wages	115,595	291	38	—	115,924
Employee benefits	31,623	—	11	—	31,634
Supplies and other expenses	90,003	368	68	(156)	90,283
Provision for uncollectible accounts	12,750	96	—	—	12,846
Depreciation and amortization	9,472	4	73	—	9,549
Interest	1,744	—	—	—	1,744
Total expenses	<u>261,187</u>	<u>759</u>	<u>190</u>	<u>(156)</u>	<u>261,980</u>
Operating income (loss)	<u>4,805</u>	<u>(236)</u>	<u>(34)</u>	<u>—</u>	<u>4,535</u>
Nonoperating gains (losses):					
Investment income, net	2,112	—	—	—	2,112
Equity in earnings of joint ventures	1,537	—	—	—	1,537
Change in net assets of Foundation	(149)	—	—	149	—
Net gain on disposal of assets	(46)	—	—	—	(46)
Other	(983)	—	—	—	(983)
Total nonoperating gains, net	<u>2,471</u>	<u>—</u>	<u>—</u>	<u>149</u>	<u>2,620</u>
Excess (deficiency) of revenues over expenses from continuing operations	<u>7,276</u>	<u>(236)</u>	<u>(34)</u>	<u>149</u>	<u>7,155</u>
Discontinued operations (note 1)	<u>(508)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>(508)</u>
Excess (deficiency) of revenues over expenses	<u>6,768</u>	<u>(236)</u>	<u>(34)</u>	<u>149</u>	<u>6,647</u>
Net assets released from restriction for capital expenditures	338	—	—	—	338
Transfers to affiliates	(431)	—	—	87	(344)
Change in unrealized gains on marketable securities and other assets whose use is limited	2,450	380	—	(380)	2,450
Change in accumulated pension charges to unrestricted net assets	(4,748)	—	—	—	(4,748)
Increase (decrease) in unrestricted net assets	<u>4,377</u>	<u>144</u>	<u>(34)</u>	<u>(144)</u>	<u>4,343</u>

See accompanying independent auditors' report.