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+ KNIGHT^{PC}
Certified Public Accountants

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**Audited Consolidated Financial
Statements and Other Financial
Information**

**Mercy Health Services, Inc. and
Subsidiaries**

June 30, 2012 and 2011

Audited Consolidated Financial Statements and Other Financial Information

Mercy Health Services, Inc. and Subsidiaries

June 30, 2012 and 2011

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Audited Consolidated Financial Statements

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Report of Independent Auditors

The Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, MD

We have audited the accompanying consolidated balance sheets of Mercy Health Services, Inc. and Subsidiaries as of June 30, 2012 and 2011, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Mercy Health Services, Inc. and Subsidiaries' management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Greenleaf Insurance Company, Ltd., a wholly-owned subsidiary, which statements reflect total assets of \$52,676,013 and \$45,364,088 as of June 30, 2012 and 2011, respectively, and total revenues of \$12,718,355 and \$13,177,419 for the years ended June 30, 2012 and 2011, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Greenleaf Insurance Company, Ltd., is based solely on the report of the other auditors.

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 audits 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 Mercy Health Services, Inc. and Subsidiaries' 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 statements 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 Mercy Health Services, Inc. and Subsidiaries as of June 30, 2012 and 2011, and the results of their operations, changes in their net assets, and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in *Note 4* to the consolidated financial statements, Mercy Health Services, Inc. and Subsidiaries adopted authoritative guidance issued by the Financial Accounting Standards Board related to presentation and disclosure of patient service revenue and provision for bad debts.

Cohen, Rutherford + Knight, P.C.

September 5, 2012

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets
(Dollars in thousands)

	June 30,	
	<u>2012</u>	<u>2011</u>
ASSETS		
CURRENT ASSETS		
Cash, cash equivalents and short-term investments	\$ 85,391	\$ 86,759
Current portion of funds held by trustee or authority -- <i>Note E</i>	11,128	13,643
Resident prepayment deposits	710	763
Patient accounts receivable, net -- <i>Note B</i>	35,683	36,234
Other amounts receivable, net	3,829	2,628
Current pledges receivable, net -- <i>Note C</i>	6,426	6,197
Inventory	7,352	6,919
Other current assets	5,192	3,774
TOTAL CURRENT ASSETS	<u>155,712</u>	<u>156,917</u>
PROPERTY AND EQUIPMENT, net -- <i>Note D</i>	554,769	542,974
INVESTMENTS AND OTHER ASSETS		
Funds held by trustee or authority, less current portion -- <i>Note E</i>	24,781	23,309
Board designated and donor restricted investments -- <i>Note F</i>	119,398	95,300
Restricted cash, cash equivalents and investments	48,691	41,220
Long-term investments	27,314	48,734
Long-term pledges receivable, net -- <i>Note C</i>	11,639	16,975
Investments in and advances to affiliates -- <i>Note G</i>	329	329
Reinsurance balances receivable or recoverable -- <i>Note I</i>	2,555	2,032
Other assets -- <i>Note H</i>	13,931	14,012
TOTAL ASSETS	<u>\$ 959,118</u>	<u>\$ 941,801</u>

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets - Continued
(Dollars in thousands)

	June 30,	
	2012	2011
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Current maturities of long-term debt -- <i>Note J</i>	\$ 8,468	\$ 6,300
Accounts payable and accrued expenses	74,784	70,508
Resident prepayment deposits	710	763
Construction retainage	1,802	780
TOTAL CURRENT LIABILITIES	<u>85,764</u>	<u>78,351</u>
Long-term debt -- <i>Note J</i>	448,900	454,193
Accrued interest	3,372	3,373
Provision for outstanding losses -- <i>Note I</i>	37,258	32,587
Post-retirement obligation -- <i>Note M</i>	7,509	6,819
Other long-term liabilities -- <i>Note W</i>	54,781	34,024
TOTAL LIABILITIES	<u>637,584</u>	<u>609,347</u>
NET ASSETS		
Unrestricted	287,987	294,587
Temporarily restricted -- <i>Note P</i>	31,369	35,689
Permanently restricted -- <i>Notes P and V</i>	2,178	2,178
TOTAL NET ASSETS	<u>321,534</u>	<u>332,454</u>
COMMITMENTS AND CONTINGENCIES -- <i>Notes R and U</i>		
TOTAL LIABILITIES AND NET ASSETS	<u>\$ 959,118</u>	<u>\$ 941,801</u>

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Dollars in thousands)

	Year Ended June 30,	
	2012	2011
REVENUE		
Patient service revenue (net of allowances and discounts) -- <i>Notes B and S</i>	\$ 585,355	\$ 536,771
Provision for bad debts	(31,999)	(29,368)
Net patient service revenue	553,356	507,403
Other operating revenue	28,145	20,916
Net assets released from restriction used for operations	2,673	4,910
TOTAL REVENUE	584,174	533,230
EXPENSES -- Note Q		
Salaries and benefits	321,009	296,012
Medical and surgical supplies	49,990	44,984
Pharmacy supplies	33,125	25,671
Other expendable supplies	27,361	27,193
Professional fees	15,516	14,402
Insurance	12,218	9,737
Other purchased services	47,374	43,979
Interest expense	20,114	13,700
Repairs	10,112	9,838
Depreciation and amortization	36,726	30,404
TOTAL EXPENSES	573,544	515,919
OPERATING INCOME	10,631	17,310
OTHER INCOME (EXPENSE)		
Investment income -- <i>Note F</i>	228	3,762
Net unrealized gains (losses) on trading securities -- <i>Note F</i>	(2,073)	7,320
Loss on early extinguishment of debt	(1,290)	0
Unrealized gain (loss) on interest rate swaps	(19,551)	9,811
Equity in joint ventures -- <i>Note G</i>	571	540
Loss on asset disposal	0	(147)
New facility nonrecurring costs	0	(1,714)
Other	54	11
NET OTHER INCOME (EXPENSE)	(22,061)	19,582
EXCESS OF REVENUE OVER EXPENSES (EXPENSES OVER REVENUE)	(11,431)	36,893
Changes to post retirement plans obligations -- <i>Notes M and N</i>	(1,680)	200
Net assets released from restrictions for the purchase of property and equipment	6,810	5,096
Reclassification of net assets	(300)	0
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	\$ (6,600)	\$ 42,189

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Changes in Net Assets
(Dollars in thousands)

	<u>Unrestricted</u>	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Net assets, June 30, 2010	\$ 252,398	\$ 40,361	\$ 2,178	\$ 294,937
Excess of revenue over expenses	36,893	0	0	36,893
Net assets released from restrictions for the purchase of property and equipment	5,096	(5,096)	0	0
Restricted gifts, bequests, and contributions	0	5,334	0	5,334
Changes to post retirement plans obligations -- <i>Notes M and N</i>	200	0	0	200
Net assets released from restrictions used for operations	0	(4,910)	0	(4,910)
Change in net assets	<u>42,189</u>	<u>(4,672)</u>	<u>0</u>	<u>37,517</u>
Net assets, June 30, 2011	\$ 294,587	\$ 35,689	\$ 2,178	\$ 332,454
Excess of expenses over revenue	(11,431)	0	0	(11,431)
Net assets released from restrictions for the purchase of property and equipment	6,810	(6,810)	0	0
Restricted gifts, bequests, and contributions	0	4,790	0	4,790
Changes to post retirement plans obligations -- <i>Notes M and N</i>	(1,680)	0	0	(1,680)
Reclassification of net assets	(300)	374	0	74
Net assets released from restrictions used for operations	0	(2,673)	0	(2,673)
Change in net assets	<u>(6,600)</u>	<u>(4,320)</u>	<u>0</u>	<u>(10,920)</u>
Net assets, June 30, 2012	<u>\$ 287,987</u>	<u>\$ 31,369</u>	<u>\$ 2,178</u>	<u>\$ 321,534</u>

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Year Ended June 30,	
	2012	2011
OPERATING ACTIVITIES		
Change in net assets	\$ (10,920)	\$ 37,517
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities		
Depreciation and amortization	36,726	30,404
Loss (gain) on interest rate swaps	19,551	(9,811)
Loss on sale of assets	0	147
Gain in equity of joint ventures	(571)	(540)
Realized and unrealized losses (gains) on board designated and donor restricted investments	3,072	(8,895)
Restricted gifts, bequests, contributions, and restricted investment income	(9,896)	(9,349)
Loss on early extinguishment of debt	1,290	0
Provision for bad debts	31,999	29,368
Decrease (increase) in:		
Patient accounts receivable, net	(31,448)	(27,213)
Other amounts receivable and investments in and advances to affiliates	(1,725)	(523)
Pledges receivable	5,106	4,015
Inventory	(433)	(1,270)
Other current assets	(1,418)	(1,764)
Increase (decrease) in:		
Accounts payable and accrued expenses	4,275	6,029
Provision for outstanding losses	4,671	3,766
Post-retirement obligation	690	1,281
Other long-term liabilities	1,206	(21)
NET CASH AND CASH EQUIVALENTS PROVIDED BY OPERATING ACTIVITIES	52,174	53,140
INVESTING ACTIVITIES		
Net decrease (increase) in short-term investments	(1,207)	273
Net purchases of property and equipment	(46,807)	(97,691)
Net decrease (increase) in restricted cash, cash equivalents and investments	(7,472)	6,243
Net decrease in funds held by trustee or authority	1,043	47,508
Net decrease (increase) in board designated and donor restricted investments	(27,171)	9,503
Net decrease (increase) in long term investments	21,420	(13,237)
Increase in other assets	(2,119)	(1,823)
NET CASH AND CASH EQUIVALENTS USED IN INVESTING ACTIVITIES	(62,311)	(49,224)

(continued)

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows - Continued
(Dollars in thousands)

	Year Ended June 30,	
	2012	2011
FINANCING ACTIVITIES		
Proceeds from restricted gifts, bequests, contributions, and restricted investment income	\$ 9,896	\$ 9,349
Debt retirement	(49,480)	(70,000)
Proceeds from issuance of long term debt	51,737	74,399
Repayment of long term debt	(5,457)	(5,311)
Deferred financing cost	867	147
NET CASH AND CASH EQUIVALENTS PROVIDED BY FINANCING ACTIVITIES	7,563	8,584
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(2,574)	12,500
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	85,503	73,003
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 82,930	\$ 85,503

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements

(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies

Organization, Basis of Presentation and Principles of Consolidation

Mercy Health Services, Inc. (MHS) was formed for the purpose of supporting, benefiting, or carrying out some or all of the purposes of Mercy Medical Center, Inc. (Medical Center or MMC), Stella Maris, Inc. (SMI), the physician practice groups comprising the Physician Enterprise (as further described below) and Mercy Health Foundation (MHF). MHS is the sole member of the Medical Center, SMI, the Physician Enterprise and MHF. MHS prepares its consolidated financial statements on the accrual basis of accounting. The accompanying financial statements include MMC, SMI, the Physician Enterprise and MHF. All material intercompany balances and transactions have been eliminated.

1. Mercy Medical Center, Inc.

The Medical Center, a subsidiary of MHS, provides inpatient, outpatient, and emergency care services primarily for the citizens of the Baltimore metropolitan area. In addition, the following entities are wholly owned subsidiaries of the Medical Center:

<u>Name of Subsidiary</u>	<u>Tax Status</u>
Mercy Transitional Care Services, Inc (MTC) <i>Provider of subacute services</i>	Tax exempt
Greenleaf Insurance Company, Ltd. (GIC) <i>Provider of self-insured general and malpractice coverage to MHS</i>	Foreign subsidiary

2. Stella Maris, Inc.

SMI, a subsidiary of MHS, is the sole member of the Stella Maris Operating Corporation, as well as the Cardinal Sheehan Center, Incorporated (CSC). SMI provides sub-acute, hospice, long-term care and adult day care to patients in the central Maryland service area, within its 412-bed long-term care facility.

CSC is engaged in maintaining and providing care and housing of aged and infirmed persons. CSC owns St. Elizabeth Hall, a 200-unit apartment complex for the elderly.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

3. Physician Enterprise

The Physician Enterprise includes Maryland Family Care, Inc. (MFC), St. Paul Place Specialists, Inc. (SPPS), and Maryland Specialty Services, LLC (MSS). MSS is the sole member of the Lutherville Hematology and Oncology LLC, and is the sole stockholder of Vascular Specialty Services, Inc. These entities provide primary care and specialty services within the Baltimore area. MFC, SPPS and MSS are wholly owned/controlled subsidiaries of MHS.

4. Mercy Health Foundation, Inc.

MHF, a subsidiary of MHS, was formed to coordinate and strengthen the fundraising function on behalf of MHS.

Income Taxes

MHS, MMC, SMI, MFC, SPPS, MHF, and MSS are not-for-profit organizations exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, and are therefore not subject to federal income tax under current income tax regulations. MHS subsidiaries otherwise exempt from federal and state taxation are nonetheless subject to taxation at corporate tax rates at both the federal and state level on their unrelated business income.

Current accounting standards define the threshold for recognizing uncertain income tax return positions in the financial statements as “more likely than not” that the position is sustainable, based on its technical merits, and also provide guidance on the measurement, classification and disclosure of tax return positions in the financial statements. Management believes there is no impact on MHS’s accompanying consolidated financial statements related to uncertain income tax positions.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Unrestricted, Temporarily Restricted, and Permanently Restricted Net Assets

Unrestricted net assets represent contributions, gifts, and grants which have no donor-imposed restrictions or which arise as a result of operations. Temporarily restricted net assets are subject to donor-imposed stipulations that may or will be met either by satisfying a specific purpose and/or the passage of time. Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity. Generally, the donors of these assets permit the use of all or part of the income earned on related investments for specific purposes (see *Notes P and V*).

Cash Equivalents and Short-Term Investments

MHS and certain of its subsidiaries invest in money market funds and U.S. Treasury Bills, which are highly liquid and have an original maturity of ninety days or less. These financial instruments are considered cash and cash equivalents and are recorded at cost, which approximates fair value. Short-term investments are highly liquid assets that have an original maturity between three months and one year.

Restricted Cash, Cash Equivalents, and Investments

Restricted cash, cash equivalents and investments represent funds required for interest rate swap collateral and that have been set aside to cover a portion of GIC's estimated outstanding claims and donor restricted funds from permanently and temporarily restricted net assets. At June 30, 2012, restricted cash, cash equivalents and investments of \$13,951 was set aside for interest rate swap collateral and \$34,740 was set aside to cover estimated outstanding claims and donor restricted funds. At June 30, 2011, restricted cash, cash equivalents and investments of \$10,450 was set aside for interest rate swap collateral and \$30,770 was set aside to cover estimated outstanding claims and donor restricted funds.

Reclassification

Certain prior year amounts have been classified to conform to the current year's presentation.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Investments

Investments include marketable equity securities with readily determinable fair values based on quoted market prices. Unrestricted investment income or losses are reported in the consolidated statements of operations as part of excess of revenues and gains over expenses and losses unless the income is restricted by donor or law. Investments received by gift or bequest are reported at fair value at the date of the donation. Investment income and changes in the fair value of temporarily restricted and permanently restricted investments are recorded as increases or decreases in unrestricted, temporarily restricted or permanently restricted net assets in accordance with the terms of the donor's original gift or bequest.

Investments also include investments in limited partnerships and other alternative investments, which are made in accordance with the investment policies of MHS and are monitored through quarterly performance reviews. The limited partnerships acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities are valued using generally accepted pricing services selected by the fund managers of the limited partnerships. Securities not valued by such pricing services will be valued upon bid quotations obtained from independent dealers in the securities. In the absence of any independent quotations, securities will be valued by the fund managers on the basis of data obtained from the best available sources.

Although the various fund managers use their best judgment at estimating the fair value of the alternative investments, there are inherent limitations in any valuation technique. Therefore, the value is not necessarily indicative of the amount that could be realized in a current transaction. Future events will also affect the estimates of fair value, and the effect of such events on the estimates of the fair value could be material (see *Note K*).

Donor-Restricted Gifts

Unconditional promises to give cash and other assets are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support 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 to unrestricted net assets and reported in the statement of operations as net assets released from restrictions.

Inventories

Inventories are stated at the lower of cost, determined by the first-in, first-out method, or market.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies – Continued

Deferred Financing Costs

Costs incurred in obtaining and issuing the Maryland Health and Higher Educational Facilities Authority bonds have been capitalized. These expenses are being amortized over the term of the bonds using the straight-line method. Accumulated amortization amounted to \$2,125 and \$1,961 at June 30, 2012 and 2011, respectively.

Subsequent Events

Management has evaluated subsequent events through September 5, 2012, the date that the financial statements were available to be issued.

Net Patient Service Revenues and Allowances

Net patient service revenues are reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered. MMC charges are based on rates established by the State of Maryland Health Services Cost Review Commission; accordingly, revenue reflects actual charges to patients based on rates in effect during the period in which the services are rendered (see *Note J*). SMI and Physician Enterprise are paid for services based on negotiated contracts with commercial payers and fee schedules with Medicare and Medicaid.

Contractual adjustments represent the difference between amounts billed as patient service revenue and amounts allowed by third-party payers, and are accrued in the period in which the related services are rendered.

The provision for bad debts is based upon management's assessment of historical and expected net collections. This estimate considers business and general economic conditions, trends in healthcare coverage and other collection indicators. Throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon its review of accounts receivable and collections to date. Other factors, such as payer mix, account aging, approved discounts, denial rates, and payment cycles are considered when estimating the allowances. The results of these assessments are used to determine the provision for bad debts and to estimate an appropriate allowance for uncollectible accounts. MHS follows established guidelines for placing its self-pay patient accounts with an outside collection agency. After collection efforts are exhausted, the uncollected balances are returned to the appropriate MHS entities to be written off to bad debts. MHS does not maintain a material allowance for uncollectible accounts from third-party payers, nor did it have significant write offs from third-party payers.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Net Patient Service Revenues and Allowances - Continued

The MHS allowance for uncollectible accounts was approximately 90% and 86% of self-pay patient accounts receivable as of June 30, 2012 and 2011. The growth in allowances was mainly driven around MMC outsourcing its collection of self-pay accounts, including balance after insurance. Two vendors were selected, and the majority of accounts with private pay balances were placed with the vendors. Normal collection activities, such as calls and statements, were performed by the vendors for a period of 120 days before returning the accounts with a remaining balance. The return process was not completed by the end of the fiscal year, so accounts that would have historically been transferred to a bad debt agency were still included in patient accounts receivable. Management continued to reserve for the estimated uncollectible accounts, making the allowance for doubtful accounts higher than historical levels. The bad debt process will be restored in fiscal year 2013, and management fully expects the allowances for doubtful accounts to return to a more normalized amount.

Medicare reimburses MTC and SMI under a prospective payment system (PPS) for skilled nursing facility services, under which facilities are paid a fixed fee for virtually all covered services. Under PPS, each patient's clinical status is evaluated and placed into a payment category. The patient's payment category dictates the amount that the provider will receive to care for the patient on a daily basis. The per diem rate covers (i) all routine inpatient costs currently paid under Medicare Part A; (ii) certain ancillary and other items and services previously covered separately under Medicare Part B on a "pass-through" basis; and (iii) certain capital costs.

The composition of patient service revenue (net of contractual allowances and discounts) as of June 30, 2012 is as follows:

Federal programs (Medicare/Medicaid)	\$ 290,218
Other third party payers	271,639
Self pay	<u>23,498</u>
	<u>\$ 585,355</u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Charity Care

The Medical Center provides medically necessary services without charge, or at amounts less than its established rates, to patients who qualify for charity care under its financial assistance policy. Because the Medical Center does not pursue collection of those amounts determined to qualify as charity care, they are not reported as a component of net patient service revenue or patient accounts receivable (see *Note B*).

The criteria for qualifying for charity care applied by the Medical Center include family income, net assets, and the size of the patient's bill relative to the patient's ability to pay. Discounts are provided to patients who are unable to pay based on a sliding scale that is applied for family incomes up to approximately 400% above the U.S. Department of Health and Human Services (HHS) Poverty Guidelines. Free care is provided to patients with family incomes up to approximately 200% above the HHS Poverty Guidelines.

Charity care will be provided to patients who qualify under the Medical Center's financial assistance policy at any time. Once the Medical Center determines that the patient qualifies for charity care, the Medical Center makes no further attempt to collect on the amount qualifying for charity care.

Certain other controlled subsidiaries of MHS also provide services without charge, or at amounts less than their established rates, to patients who qualify for charity care under their respective financial assistance policies.

Impairment of Long-Lived Assets

MHS accounts for long-lived assets in accordance with the FASB's guidance on accounting for impairment or disposal of long-lived assets. This requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Management believes that no asset impairment existed at June 30, 2012 and 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Property and Equipment

Property and equipment are recorded at cost. Donated property and equipment are recorded at fair value at the date of the donation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, which is forty years for buildings and the parking center and ranges from three to ten years for machinery and equipment.

Resident Prepayment Deposits

SMI's private pay residents are required to make a non-interest bearing prepayment of two months' room and board at the time of admission. At the time of discharge or acceptance by Medical Assistance or similar government assistance programs, any prepayment remaining after application to the resident's outstanding bill will be refunded. At June 30, 2012 and 2011, resident prepayment deposits of approximately \$710 and \$763, respectively, were invested in short-term investments.

Derivative Instruments

Current accounting standards require that an entity recognize all derivative instruments as either assets or liabilities in the statement of financial position and measure those instruments at fair value. MHS has entered into interest rate swap agreements to manage its interest rate risk (see *Notes J and K*). The interest rate swaps do not qualify for hedge accounting under current accounting standards; therefore, management accounts for the derivative instruments as speculative derivative instruments with the change in the fair value reflected in the accompanying consolidated statements of operations as a component of other non-operating income. Net settlement payments are reported as a component of interest cost, with the exception of the payments associated with construction activities that are capitalized.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Accordingly, actual results could differ from those estimates.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Excess of Revenue Over Expenses (Expenses over Revenue)

The consolidated statements of operations include excess of revenue over expenses (expenses over revenue). Changes in unrestricted net assets which are excluded from excess of revenue over expenses (expenses over revenue), consistent with industry practice, include unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services, and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

Activities that result in gains or losses unrelated to the primary operations of MHS are considered to be nonoperating.

Note B – Patient Accounts Receivable, Allowances, and Charity Care

Patient accounts receivable consist of the following at June 30:

	<u>2012</u>	<u>2011</u>
Gross patient accounts receivable	\$ 139,944	\$ 108,730
Less:		
Allowance for doubtful accounts and contractual adjustments	(71,462)	(48,243)
Third party advances	(32,799)	(24,253)
	<u>\$ 35,683</u>	<u>\$ 36,234</u>

Approximately 32% and 33% of gross patient accounts receivable were due from Medicare and Medicaid at both June 30, 2012 and 2011, respectively.

The net cost of charity care provided by MHS totaled \$17,148 and \$14,544 for the years ended June 30, 2012 and 2011, respectively. The cost of charity care was calculated by applying the cost-to-charge ratio to the total amount of charges foregone for each of the controlled subsidiaries of MHS that provide charity care. The net cost of charity care was determined net of any patient-related revenue due to sliding scale payments or other patient-specific sources, and includes both direct and indirect cost of rendering care.

Additionally, MHS and certain of its controlled subsidiaries provide structured repayment plans to patients without collateral.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note C - Pledges Receivable, Net

At June 30, 2012, pledges receivable were \$20,051 less an allowance for uncollectible pledges of \$614 and a discount of \$1,371. The expected payment of the pledges receivable less the uncollectible pledges at June 30, 2012 are as follows:

2013	\$	6,426
2014		2,773
2015		2,773
2016		1,889
2017		3,825
Thereafter		379
		<u>18,065</u>
Less current portion		6,426
Long-term portion	\$	<u><u>11,639</u></u>

Note D - Property and Equipment

Property and equipment, at cost, consists of the following at June 30:

	<u>2012</u>	<u>2011</u>
Buildings and improvements	\$ 530,806	\$ 523,292
Machinery and equipment	204,952	193,197
Construction-in-progress	40,575	13,612
Parking center	41,221	41,214
Land	10,772	10,772
	<u>828,326</u>	<u>782,087</u>
Accumulated depreciation	(273,557)	(239,113)
	<u><u>\$ 554,769</u></u>	<u><u>\$ 542,974</u></u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note E - Funds Held by Trustee or Authority

Funds held by trustee or authority, which consist primarily of cash and government obligations (at fair value), are limited as to use as follows at June 30:

	<u>2012</u>	<u>2011</u>
Debt service fund	\$ 11,128	\$ 13,643
Debt service reserve	22,991	21,641
Reserve for replacements and residual receipts	<u>1,790</u>	<u>1,668</u>
	35,909	36,952
Less current portion	<u>11,128</u>	<u>13,643</u>
Long-term portion	<u>\$ 24,781</u>	<u>\$ 23,309</u>

Note F - Board Designated and Donor Restricted Investments

Board designated investments are set aside by the board of trustees for costs relating to the building program, replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs. All board designated investments are unrestricted, as the board at its discretion may undesignate the use of such funds. Donor restricted investments have been limited by donors to a specific purpose.

Board designated and donor restricted investments consist of the following at June 30:

	<u>2012</u>	<u>2011</u>
Equity	\$ 48,918	\$ 53,339
Fixed maturity	49,538	26,675
Cash	18,578	13,552
Alternatives	<u>2,364</u>	<u>1,734</u>
	<u>\$ 119,398</u>	<u>\$ 95,300</u>

Each of the alternative investments owned by MHS represents less than one-half of one percent of each respective alternative investment fund as of June 30, 2012 and 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note F - Board Designated and Donor Restricted Investments - Continued

The investments above have been allocated, by source, as follows at June 30:

	<u>2012</u>	<u>2011</u>
Board designated	\$ 106,095	\$ 82,783
Donor restricted (temporary)	13,303	12,517
	<u>\$ 119,398</u>	<u>\$ 95,300</u>

Permanently restricted donor investments at June 30, 2012 and 2011 of \$2,178 are reported as restricted cash.

Earnings on investments are as follows for the years ended June 30:

	<u>2012</u>	<u>2011</u>
Unrestricted:		
Interest and dividends	\$ 1,227	\$ 2,187
Net realized gains (losses)	(999)	1,575
Unrealized gains (losses) on trading securities	(2,073)	7,320
	<u>\$ (1,845)</u>	<u>\$ 11,082</u>

Note G - Investments In and Advances to Affiliates

Investments in and advances to affiliates including a joint venture in which the Medical Center has an ownership interest of 50%. Investments in which the ownership interest is less than 20% are carried at cost, and investments in which the ownership interest is at least 20% and less than 51% are generally carried on the equity method.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note G - Investments In and Advances to Affiliates - Continued

MHS has investments totaling \$329 at June 30, 2012 and 2011 in the following joint ventures:

Joint venture	Business purpose	Percentage of ownership		Investment	
		2012	2011	2012	2011
Premier Purchasing Partners, Inc	Capital balance in group purchasing organization	n/a	n/a	\$ 329	\$ 329
Mercy Ridge, Inc	Continuing care retirement community	50%	50%	0	0
				<u>\$ 329</u>	<u>\$ 329</u>

MHS recorded non-operating income of \$571 and \$540 related to the operations of the investments in joint ventures for the years ended June 30, 2012 and 2011, respectively.

Note H - Other Assets

Other assets consist of the following at June 30:

	2012	2011
Deferred compensation plan assets (see Note L)	\$ 6,225	\$ 6,648
Amortizable assets, net	6,251	5,613
Health insurance prepayment	810	810
Notes receivable	46	476
Other investments	599	465
	<u>\$ 13,931</u>	<u>\$ 14,012</u>

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses

GIC management based the provision for losses at June 30, 2012 on a report dated July 2012 prepared by GIC's independent actuaries, Complete Actuarial Solutions Co. of Bethesda, Maryland. In their report, the actuaries estimate outstanding losses at an expected confidence level, on an undiscounted basis, to be \$33,488 and \$29,740 net of reinsurance as of June 30, 2012 and 2011, respectively. At June 30, 2012 and 2011, GIC had \$34,703 and \$30,555, respectively, as its provision for outstanding losses net of reinsurance after factoring in actual losses paid to June 30th. The estimates provided by the actuaries are based on the historical data of the program blended together with relevant insurance industry loss development statistics.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

**Note I - Reinsurance Receivable/Recoverable and
Provision for Outstanding Losses - Continued**

In the opinion of the GIC management, the provision for outstanding losses relating to losses reported and losses incurred but not reported at the consolidated balance sheet dates is adequate to cover the expected ultimate liability of GIC. However, due to the nature of the insurance risks assumed, these provisions are necessarily estimates, and could vary from the amounts ultimately paid.

Consistent with most companies with similar insurance operations, GIC's provision for outstanding losses is ultimately based on management's reasonable expectations of future events. It is reasonably possible that the expectations associated with these amounts could change in the near term (i.e., within one year) and that the effect of such changes could be material to the consolidated financial statements.

GIC's estimated provision for outstanding losses exceeds GIC's retention limits by \$2,555 and \$2,032 for the years ended June 30, 2012 and 2011, respectively. These losses are 100% reinsured with reinsurers, and accordingly are recorded as reinsurance balances recoverable in the consolidated balance sheets.

In the event that GIC's reinsurers are unable to meet their obligations under the reinsurance agreements, GIC would still be liable to pay all losses under the insurance policies it issues, but would only receive reimbursement to the extent the reinsurers could meet their above mentioned obligations. GIC considers that all amounts included in reinsurance balances receivable and recoverable in the accompanying consolidated balance sheets will be collected in full from the reinsurers.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J-Long - Term Debt

Long-term debt consists of the following at June 30:

	<u>2012</u>	<u>2011</u>
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series A 2007, interest rate ranging from 4% to 5.50%, due July 1, 2042	\$ 151,120	\$ 152,500
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series D 2007, variable interest rate (0.18% and 0.08% at June 30, 2012 and 2011, respectively), due July 1, 2042	50,000	50,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2012, interest rate ranging from 4% to 5%, due July 1, 2031	49,995	0
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2001; interest rate 5.625%; due July 1, 2031	0	49,480
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2011, variable interest rate ranging from 3.00% to 6.25%, due July 1, 2031	40,770	40,770
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2011B, interest rate (1.65% at June 30, 2012), due July 1, 2037	34,890	34,890
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2006; interest rate 5.69%; due July 1, 2036	33,315	33,910
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2007 B, C (converted); interest rate 3.80%; due July 1, 2024	30,000	30,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008 (converted); interest rate 3.99%; due July 1, 2022	29,825	30,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 1996; interest rate ranging from 4.55% to 6.50%; due July 1, 2026	20,135	21,015
MHHEFA Revenue Bonds, Stella Maris Issue, Series 1997; variable interest rate (0.18% and 0.28% at June 30, 2012 and 2011, respectively); due 2021	13,255	14,255
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008; variable interest rate (0.09% at June 30, 2011); due July 1, 2011	0	1,985
HUD mortgage loan; interest rate 6.88%; due 2020	4,459	4,736
Other	197	225
	<u>457,961</u>	<u>463,766</u>
Total long-term debt	457,961	463,766
Less:		
Net unamortized discount	593	3,273
Current portion	8,468	6,300
	<u>8,468</u>	<u>6,300</u>
Long-term portion	\$ 448,900	\$ 454,193

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt - Continued

Principal payments on long-term debt are as follows for the years ended June 30:

2013	\$	8,468
2014		8,957
2015		9,154
2016		9,503
2017		9,888
Thereafter		<u>411,991</u>
	\$	<u>457,961</u>

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted)

In October 2007, Maryland Health and Higher Educational Facilities Authority (“MHHEFA”) authorized the issuance, sale and delivery of its \$305,000 Revenue Bonds, Mercy Medical Center Issue, Series 2007 (A, B, C and D). The proceeds were loaned by MHHEFA to MMC to finance the construction of a new replacement hospital facility. The proceeds were also used to refinance the MHHEFA Pooled Loan Revenue Bond.

On April 1, 2010, \$30,000 of the Revenue Bonds Series 2007 B and C was converted to Bank Qualified Revenue Bonds held by a commercial bank. The 2007 B and C (converted) Bonds refinanced \$18,080 of the \$50,000 2007 Series B and \$11,920 of the \$50,000 2007 Series C. Principal repayment on the converted bonds series begins July 1, 2012 and is paid annually through the termination date. The termination date is July 1, 2024. The converted bonds will be subject to mandatory purchase by MMC on April 1, 2020 at their par value, unless the bank and MMC agree to an extension. Interest accrues at a fixed rate of 3.87%. The monthly interest payments are made directly to the bank. During 2011, the remaining \$70,000 of the Series 2007 B and C Revenue Bonds were refunded with proceeds from two separate Revenue Bond issues; MMC Issue, Series 2011 and MMC Issue Series 2011B.

Principal repayment of the MMC issue Series 2007 Bonds began July 1, 2008 and is scheduled to be paid annually through July 1, 2042. On the Series 2007 A Bonds (\$155,000 Revenue Bonds), interest accrues at a fixed rate ranging from 4.0% to 5.50%. The Series 2007 A Bonds are net of an original issue discount of \$875, which is being amortized over the life of the bonds using the straight line method. The Series 2007A Bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2012 and 2011 was \$12,604 and \$12,557, respectively (see *Note E*). Interest is payable semi-annually on January 1st and July 1st.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted) - Continued

The \$50,000 Series 2007 D Bonds accrue interest at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. The variable rate of interest is set to be the lower of the Maximum Rate as defined by the Indenture and the minimum rate that would enable the Remarketing Agent to sell all of the bonds. The Series 2007 D Bonds are net of an original issue discount of \$225, which is being amortized over the life of the bonds using the straight line method. Payment on the Series 2007 D Bonds is secured by a \$50,000 irrevocable letter of credit from Wells Fargo Bank. An annual letter of credit fee equal to 0.38% is payable quarterly by MMC. The letter of credit expires November 8, 2013.

To lower the cost of capital of the hospital replacement project, MMC entered into two interest rate swap agreements. In August 2007, a fixed spread basis swap was entered into with a notional amount of \$210,000. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of the USD-LIBOR-BBA and 0.54%. The interest rate swap agreement terminates on August 20, 2037. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2012 and 2011, the fair value of the interest rate swap was (\$5,507) and (\$6,697), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. For the years ended June 30, 2012 and 2011, an unrealized gain on interest rate swap totaling \$1,190 and \$5,796, respectively, is reflected in the accompanying consolidated statements of operations.

During October 2007, MMC entered into a fixed payer swap with a notional amount of \$65,000. Pursuant to the swap agreement, MMC pays the counter party a fixed rate of 4.093% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on July 1, 2042. At June 30, 2012 and 2011, the fair value of the interest rate swap was (\$22,621) and (\$7,339), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling (\$15,282) and \$1,393 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2012 and 2011, respectively. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

Mercy Medical Center Issue, Series 2012 Bonds

In April 2012, MHHEFA authorized the issuance, sale and delivery of its \$49,995 Revenue Bonds, Mercy Medical Center Issue, Series 2012. The proceeds were loaned by MHHEFA to MMC to refund \$49,480 aggregate principal amount of the Mercy Medical Center Issue, Series 2001 Bonds. The bonds include an original issue premium of \$1,742, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service fund at June 30, 2012 is \$5,478 (see *Note E*).

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2012 Bonds - Continued

Principal repayment of the MMC Issue, Series 2012 begins July 1, 2023 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 4.0% to 5.0%. The interest is paid semi-annually on January 1st and July 1st.

On December 1, 2004, the Medical Center entered into a fixed spread basis swap agreement in order to reduce the cost of capital with respect to the Series 2001 Bonds by removing the tax risk to bond holders and transferring the risk to the Medical Center. The fixed spread basis swap matures on December 1, 2024 and the exchanges of cash flows with the counter party began March 1, 2005. The notional amount of the swap is \$50,000. Pursuant to the swap agreement, the Medical Center pays the counter party a variable rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of USD-LIBOR-BBA and 0.60%. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

At June 30, 2012 and 2011, the fair value of the interest rate swap was \$995 and \$262, respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain on interest rate swap totaling \$732 and \$950 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2012 and 2011, respectively.

Mercy Medical Center Issue, Series 2001 Bonds

In November 2001, MHHEFA authorized the issuance, sale and delivery of its \$49,480 Revenue Bonds, Mercy Medical Center Issue, Series 2001, the proceeds of which were loaned by MHHEFA to MMC, and together with fundraising receipts from MHS' capital campaign and amounts generated from MMC's operations, were used to finance and refinance the costs of the 2001 Additional Facilities. The 2001 Additional Facilities include expansion, renovation and equipping of certain hospital facilities, including construction of an ambulatory services building, acquisition of a parking garage and construction of an additional parking garage. In April 2012, the Series 2001 Revenue Bonds were refunded by the Series 2012 Revenue Bonds.

The Series 2001 Bonds were net of an original issue discount of \$1,220, which was being amortized over the life of the bonds using the straight line method. The remaining discount was written down in April 2012 as part of the refunding. The Series 2001 Bonds required a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2011 was \$5,058 (see *Note E*). Interest was paid semi-annually on January 1st and July 1st.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2008 Bonds and Series 2008 (Converted)

In July 2008, MHHEFA authorized the issuance, sale and delivery of its \$35,325 Revenue Bonds, Mercy Medical Center Issue, Series 2008, the proceeds of which were loaned by MHHEFA to MMC in order to refund the MMC Series 2003 Bonds. On December 16, 2009, \$30,000 of the Series 2008 Bonds was converted to Bank Qualified Revenue Bonds with a fixed interest rate period of approximately twelve years. The bank at its discretion has the right to call the converted bonds at the seventh and tenth year anniversary. Principal repayment of the converted bonds began July 1, 2011 and is paid annually through July 1, 2022. Interest accrues at a fixed rate of 3.9932%.

The monthly interest payments on the Series 2008 Bonds were made directly to the bank. Principal repayment of the Series 2008 Bonds began on July 1, 2009, and the portion of those bonds that was not converted to Bank Qualified Bonds was fully paid on July 1, 2011.

Mercy Medical Center Issue, Series 2011 Bonds

In February 2011, MHHEFA authorized the issuance, sale and delivery of its \$40,770 Revenue Bonds, Mercy Medical Center Issue, Series 2011. The proceeds were loaned by MHHEFA to MMC to refund \$35,110 aggregate principal amount of the MMC Issue, Series 2007 B and C Bonds. The bonds are net of an original issue discount of \$881, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2012 and 2011 was \$4,008 and \$4,026, respectively (see *Note E*).

Principal repayment of the MMC Issue, Series 2011 Bonds begins July 1, 2012 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 3.0% to 6.25%. The interest is payable semi-annually on January 1st and July 1st.

In June 2011, MHHEFA authorized the issuance, sale and delivery of its \$34,890 Revenue Bonds, Mercy Medical Center Issue, Series 2011B. The proceeds were loaned by MHHEFA to MMC to refund \$34,890 aggregate principal amount of the MMC Issue, Series 2007 B and C Bonds. The bonds were issued as non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on June 9, 2021 at which time the bonds will be subject to a mandatory purchase at their par value by MMC unless the bank and MMC agree to an extension.

The bonds bear interest at a variable rate equal to 30 day LIBOR plus 1.5% times 69%, plus 0.45%. Interest is paid monthly. Principal repayment of the Series 2011B Bonds begins July 1, 2032 and is scheduled to be paid annually through July 1, 2037.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2006 Bonds

In August 2006, MHHEFA authorized the issuance, sale and delivery of \$35,000 of Mercy Medical Center Series 2006 Revenue Bonds. The proceeds were loaned by MHHEFA to MMC in order to finance the construction of a new parking garage as well as the financing of certain routine capital expenditures.

Principal repayment of these bonds began on July 1, 2009 and is paid annually through July 1, 2036. Interest is paid semiannually on January 1st and July 1st. Interest accrues at a fixed rate of 5.69%.

Simultaneously with the issuance of the bonds, MMC entered into an interest rate swap agreement with a counter party with a notional amount of \$35,000 to convert the fixed rate structure to a variable rate. Under this agreement, MMC will receive a fixed interest rate of 5.14% and pay to the counter party the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on August 3, 2016. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. The value of this contract is based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value is equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%). The bonds are currently callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2012 and 2011, the fair value of the swap was zero.

In anticipation of the transaction, MMC entered into a forward interest rate swap agreement on June 28, 2006 with a notional amount of \$35,000 in order to convert the variable swap rate to a fixed rate. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 3.976% and receives a variable rate equal to 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2036. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2012 and 2011, the fair value of the interest rate swap was (\$10,619) and (\$5,964), respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling (\$4,655) and \$1,215 is reflected in the accompanying statements of operations for the fiscal years ended June 30, 2012 and 2011, respectively.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issues, Series 1996

In May 1996, MHHEFA authorized the issuance, sale and delivery of its \$30,000 Revenue Bonds, Mercy Medical Center Issue, Series 1996, the proceeds of which were loaned by MHHEFA to MMC in order to finance and refinance the costs of the 1996 project. The 1996 project consisted of the construction, acquisition, renovation, and equipping of certain hospital facilities including certain inpatient upgrades, ambulatory care facilities, operating rooms, building infrastructure, and administrative and support service facilities.

The Series 1996 Bonds are net of original issue discounts of \$302, which are being amortized over the life of the bonds using the straight line method. Interest is payable semi-annually on January 1st and July 1st. Principal repayment of these bonds began on July 1, 2004 and is paid annually through July 1, 2022.

In 2006, MMC entered into an agreement with a third party to run a tender process for the entire balance of the callable Series 1996 Bonds that totaled \$19,700. MMC gave investors the choice of accepting a 1% incremental premium over the existing call premium in exchange for tendering their bonds. Any investor not tendering their bonds had their bonds redeemed at the applicable redemption price. Through the execution of a traditional bond agreement, the third party agreed to purchase the bonds from those investors who tendered their bonds.

Prior to the mailing of notice of redemption for the bonds, MMC was obligated to deposit the redemption price of the bonds with the Bonds Trustee. On June 23, 2006, MMC entered into a Notes Purchase Agreement (the "Note") with Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch). MMC borrowed \$20,094 for the purpose of funding the principal (\$19,700) and premium component of the redemption price (\$394) of the Mercy Medical Center Issue Series 1996 Bonds. In August 2006, \$18,195 of the Bonds was purchased by the third party and the Note was fully repaid. The remaining \$1,505 of bonds were called and retired.

To convert the underlying fixed rate structure to a variable rate, simultaneously with the purchase of the bonds, MMC entered into two interest rate swap agreements with a counter party with notional amounts of \$13,840 and \$4,355. The two interest rate swap agreements with the counterparty were amended on July 25, 2011. Pursuant to the amended swap agreements, the counter party pays to MMC a fixed interest rate of 5.75% and 5.625% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index and 1.55%. The interest rate swap agreements terminate on July 25, 2014. The interest rate swaps did not qualify for hedge accounting under generally accepted accounting principles. The value of this contract was based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value was equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%).

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt – Continued

Mercy Medical Center Issues, Series 1996 - Continued

The bonds are currently callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2012 and 2011, the fair value of the swap was zero.

On June 28, 2006, to convert the structure back to a fixed rate, MMC entered into a forward rate swap agreement with a notional amount of \$18,741. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 4.031% and receives a variable rate of 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2026. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2012 and 2011, the fair value of the interest rate swap was (\$4,587) and (\$3,051), respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling (\$1,536) and \$458 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2012 and 2011, respectively.

Stella Maris Issue, Series 1997 Bonds

The Series 1997 Bonds were issued to finance the acquisition by SMI of Stella Maris Operating Corporation and CSC; to advance refund certain nursing home revenue bonds previously issued by MHHEFA, Stella Maris Issue, Series 1991; and to refinance certain outstanding indebtedness of the acquired corporations.

Principal repayment of these bonds began on July 1, 2001 and is paid annually through July 1, 2021. All bonds are subject to redemption prior to maturity beginning March 1, 2001. Interest is accrued at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. Interest on the bonds is payable monthly.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note J - Long-Term Debt - Continued

Stella Maris Issue, Series 1997 Bonds - Continued

Under the provisions of the bond agreement, SMI has granted to MHHEFA a security interest in all of its real property and the assignment of its leases. In addition, payments on the bonds are secured by an irrevocable letter of credit provided by M&T Bank. An annual letter of credit fee, equal to 0.9% of the letter of credit amount, is payable quarterly by SMI. The letter of credit expires June 30, 2015.

Under the terms of the bond indenture, SMI is required to maintain certain deposits with a trustee. The bond indenture agreement also requires SMI to satisfy certain measures of financial performance as long as the bonds are outstanding. As of June 30, 2012 and 2011, SMI was in compliance with the financial covenant requirements of the bond indenture.

HUD Mortgage Loan

The mortgage loan from the U.S. Department of Housing and Urban Development (HUD) was used by CSC to construct St. Elizabeth Hall. The note bears interest at 6.875% per annum and the loan is payable in monthly installments of \$43, including interest, with the final payment due November 1, 2020. Concurrent with these monthly mortgage payments, St. Elizabeth Hall is required by the mortgage agreement to make monthly payments of \$2 to a reserve fund for the replacement of property and equipment. These payments are required until the mortgage matures and are included in Board designated and donor restricted investments. All disbursements from this fund are contingent upon HUD's prior approval.

In July 1997, CSC received authorization from HUD to suspend its monthly principal and interest payments of \$43 through December 2005. In January 2006, CSC resumed making mortgage payments in accordance with the terms of the original agreement with HUD. During this deferral period, all revenue of St. Elizabeth Hall in excess of actual operating expenses, including but not limited to payments to the replacement reserve fund, were required to be segregated and deposited into a separate account for future payments of principal and interest on the mortgage.

The liability of CSC under the mortgage note is limited to the underlying value of the real estate collateral plus other amounts deposited with the lender.

Line-of-Credit

The Medical Center has a \$20,000 operating line of credit and an additional \$1,000 operating line of credit (for leases) with M&T Bank, and a \$15,000 line of credit for equipment and construction with PNC Bank. No amounts were outstanding on any of these lines of credit at June 30, 2012 and 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments

The following methods and assumptions were used by MHS in estimating the fair value of its financial instruments:

Cash and cash equivalents, patient accounts receivable, other amounts receivable, accounts payable and accrued expenses, due to third party payers and construction retainage: The carrying amounts reported in the consolidated balance sheets approximate fair value.

Short-term investments, funds held by trustee or authority and board designated and donor restricted investments: Fair values, which are the amounts reported in the consolidated balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Long-term debt: Fair values of revenue bonds and other debt are based on current traded values. At June 30, 2012 and 2011, the fair value of long-term debt was approximately \$469,338 and \$439,802, respectively.

Current accounting standards define fair value as 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, and establish a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels of inputs that may be used to measure fair value are:

Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities.

Level 2: Observable input other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange-traded instruments. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate-debt securities, and alternative investments.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private debt and equity instruments and alternative investments.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following discussion describes the valuation methodologies used for financial assets and liabilities measured at fair value. The techniques utilized in estimating the fair values are affected by the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about the business, value, or financial position of MHS based on the fair value information of financial assets and liabilities presented below.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial asset or liability, including estimates of the timing, amount of expected future cash flows, and the credit standing of the issuer. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial asset or liability. Furthermore, the disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial asset or liability. Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in the amounts disclosed.

Fair values of equity securities and fixed maturity securities have been determined by MHS from observable market quotations, when available. Private placement securities and other equity securities where a public quotation is not available are valued by using broker quotes. Cash equivalents comprise short-term fixed maturity securities and carrying amounts approximate fair values, which have been determined from public quotations, when available.

Money markets and certificates of deposit comprise short-term fixed maturity securities. The carrying amounts approximate fair values, which have been determined from public quotations, when available.

MHS holds alternative investments that are not traded on national exchanges or over-the-counter markets. MHS is provided information on a net asset value per share for these investments that has been calculated by the funds of funds' managers (who are investment advisors registered with the Securities and Exchange Commission) based on information provided by the managers of underlying funds.

Fair value of the interest rate swaps represent, or are derived from, mid-market values. Mid-market prices and inputs may not be observable, and instead valuations may be derived from proprietary or other pricing models based on certain assumptions regarding past, present and future market conditions. Some inputs may be theoretical, not empirical, and require subjective assumptions and judgments. Valuations may be based on assumptions as to the volatility of the underlying security, basket or index, interest rates, exchange rates, dividend yields, correlations between these or other factors, the impact of these factors upon the value of the security (including any embedded options), as well as issuer funding rates and credit spreads (actual or approximated) or additional relevant factors.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2012.

<u>Assets</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total Fair Value</u>
Board designated and donor restricted investments:				
Cash and cash equivalents				
Cash	\$ 249	\$ 0	\$ 0	\$ 249
Money market funds	0	32,028	0	32,028
Commercial paper	0	200	0	200
Long term investments				
Certificate of deposit	0	294	0	294
Equity securities				
Mutual funds				
International large cap core	9,118	0	0	9,118
Emerging markets	6,005	0	0	6,005
Domestic mutual fund	6,495	0	0	6,495
Common stocks				
Healthcare	2,635	0	0	2,635
Utilities	154	0	0	154
Financials	3,003	0	0	3,003
Consumer staples	1,533	0	0	1,533
Consumer discretionary	2,303	0	0	2,303
Materials	541	0	0	541
Energy	1,624	0	0	1,624
Information technology	7,898	0	0	7,898
Industrials	4,064	0	0	4,064
Miscellaneous	58	0	0	58
Foreign stocks/American deposit receipt	2,788	0	0	2,788
Equity alternative	0	0	294	294
Fixed maturity				
US treasury notes	2,633	0	0	2,633
US government and agencies				
U.S. treasury bonds	0	667	0	667
Government agency bonds	0	3,423	0	3,423
Government agency mortgage backed securities	0	3,360	0	3,360
Government agency pools	0	6,469	0	6,469
Corporate bonds				
Strip and zero coupon	0	48	0	48
Banking	0	445	0	445
Financial	0	2,017	0	2,017
Industrial	0	3,181	0	3,181
International (other global corp bonds)	0	857	0	857
Asset backed securities		1,365		1,365
Collateralized mortgage backed	0	162	0	162
Bond fund	7,550	0	0	7,550
Municipal bonds	0	3,868	0	3,868
Fixed income alternative	0	0	2,069	2,069
Total board designated and donor restricted investments	58,651	58,384	2,363	119,398

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted funds				
Cash	\$ 2,469	\$ 0	\$ 0	\$ 2,469
Equity				
Mutual fund				
Exchange traded	2,655	0	0	2,655
International exchange traded	983	0	0	983
Real estate exchange traded	1,690	0	0	1,690
Fixed maturity				
U.S. treasury notes	20,095	0	0	20,095
U.S. government and agencies				
Government agency pools	0	12,589	0	12,589
Corporate and foreign bonds				
Financial	0	1,538	0	1,538
Industrial	0	1,107	0	1,107
International	0	109	0	109
Asset backed	0	256	0	256
Municipal bonds	0	5,200	0	5,200
Total restricted funds	27,892	20,799	0	48,691
Cash and cash equivalents				
Cash	70,558	0	0	70,558
Money market fund	0	12,017	0	12,017
Fixed income mutual funds	218	0	0	218
Exchange traded fund	68	0	0	68
Domestic mutual equity funds	69	0	0	69
Total cash and cash equivalents	70,913	12,017	0	82,930
Short term investments				
Money market fund	0	1,203	0	1,203
Certificate of deposit	0	1,258	0	1,258
Total short term investments	0	2,461	0	2,461
Total cash, cash equivalents and short term investments				
	70,913	14,478	0	85,391
Long term investments				
Cash				
Foreign currency	0	101	0	101
Equity				
Real estate exchange traded	143	0	0	143
Commodity exchange traded	1,747	0	0	1,747
Fixed maturity				
U.S. treasury notes	6,739	0	0	6,739
U.S. government and agencies				
Government agency bonds	0	2,113	0	2,113
Government agency mortgage backed securities	0	5,274	0	5,274
Government agency pools	0	2,333	0	2,333
Corporate Bonds				
Financial	0	2,447	0	2,447
Industrial	0	3,530	0	3,530
International (other global corp bonds)	0	579	0	579
Asset backed securities	0	97	0	97
Municipal bonds	0	2,211	0	2,211
Total long term investments	8,629	18,685	0	27,314

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

<u>Assets</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total Fair Value</u>
Funds held by trustee (current)				
Money market	\$ 0	\$ 9,475	\$ 0	\$ 9,475
Fixed maturity				
Government agency notes	0	1,653	0	1,653
Total funds held by trustee (current)	0	11,128	0	11,128
Funds held by trustee (non-current)				
Money market	0	2,149	0	2,149
Fixed maturity				
U.S. government and agencies	0	22,272	0	22,272
Certificate of deposit	0	360	0	360
Funds held by trustee (non-current)	0	24,781	0	24,781
Total funds held by trustee	0	35,909	0	35,909
Total assets fair value	\$ 166,085	\$ 148,255	\$ 2,363	\$ 316,703
Liabilities				
Interest rate swaps	\$ 0	\$ 0	\$ 42,340	\$ 42,340
Total liabilities at fair value	\$ 0	\$ 0	\$ 42,340	\$ 42,340

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2011.

<u>Assets</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total Fair Value</u>
Board designated and donor restricted investments:				
Cash and cash equivalents				
Cash	\$ 41	\$ 0	\$ 0	\$ 41
Money market funds	0	7,359	0	7,359
Equity securities				
Mutual funds				
International large cap core	15,723	0	0	15,723
Emerging markets	3,027	0	0	3,027
Domestic mutual fund	6,471	0	0	6,471
Common stocks				
Healthcare	3,345	0	0	3,345
Utilities	287	0	0	287
Financials	2,781	0	0	2,781
Consumer staples	1,385	0	0	1,385
Consumer discretionary	2,846	0	0	2,846
Materials	769	0	0	769
Energy	1,615	0	0	1,615
Information technology	7,399	0	0	7,399
Industrials	3,434	0	0	3,434
Telecommunication service	46	0	0	46
Foreign stocks/ American deposit receipt	3,248	0	0	3,248
Investment in partnership	143	0	0	143
Fixed maturity				
US treasury notes	6,396	0	0	6,396
US government and agencies				
U.S. treasury bonds	0	233	0	233
Government agency bonds	0	210	0	210
Government agency mortgage backed securities	0	262	0	262
Government agency pools	0	4,886	0	4,886
Corporate bonds				
Strip and zero coupon	0	85	0	85
Asset backed securities	0	2,258	0	2,258
Financial	0	2,559	0	2,559
Industrial	0	2,749	0	2,749
International (other global corp bonds)	0	796	0	796
Bond fund	0	7,430	0	7,430
Municipal bonds	0	3,947	0	3,947
Alternative	0	0	3,570	3,570
Total board designated and donor restricted investments	58,956	32,774	3,570	95,300

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted funds				
Cash	\$ 2,522	\$ 0	\$ 0	\$ 2,522
Equity				
Mutual fund				
Fixed maturity exchange traded	2,000	0	0	2,000
Exchange traded	2,243	0	0	2,243
International exchange traded	825	0	0	825
Real estate exchange traded	1,510	0	0	1,510
Commodity exchange traded	1,517	0	0	1,517
Fixed maturity				
U.S. treasury notes	15,056	0	0	15,056
U.S. government and agencies				
Government agency pools	0	9,086	0	9,086
Corporate and foreign bonds	0	1,817	0	1,817
Municipal bonds	0	4,644	0	4,644
Total restricted funds	25,673	15,547	0	41,220
Cash and cash equivalents				
Cash	64,307	0	0	64,307
Money market fund	0	20,998	0	20,998
Treasury bill	200	0	0	200
Total cash and cash equivalents	64,507	20,998	0	85,505
Short term investments				
Certificate of deposit	0	1,254	0	1,254
Total short term investments	0	1,254	0	1,254
Total cash, cash equivalents and short term investments	64,507	22,252	0	86,759
Long term investments				
Equity				
Fixed maturity exchange traded	2,695	0	0	2,695
Fixed maturity				
U.S. treasury notes	18,971	0	0	18,971
U.S. government and agencies				
U.S. treasury bonds	0	69	0	69
Government agency bonds	0	2,339	0	2,339
Government agency mortgage backed securities	0	3,791	0	3,791
Government agency pools	0	8,100	0	8,100
Corporate Bonds				
Financial	0	3,144	0	3,144
Industrial	0	5,531	0	5,531
International (other global corp bonds)	0	1,614	0	1,614
Mortgage backed securities	0	0	0	0
Municipal bonds	0	2,480	0	2,480
Total long term investments	21,666	27,068	0	48,734

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

<u>Assets</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total Fair Value</u>
Funds held by trustee (current)				
Money market	\$ 12,863	\$ 0	\$ 0	\$ 12,863
Fixed maturity				
Government agency notes	0	780	0	780
Total funds held by trustee (current)	12,863	780	0	13,643
Funds held by trustee (non-current)				
Money market	3,795	0	0	3,795
Fixed maturity				
U.S. government and agencies	0	19,154	0	19,154
Certificate of deposit	0	360	0	360
Funds held by trustee (non-current)	3,795	19,514	0	23,309
Total funds held by trustee	16,658	20,294	0	36,952
Total assets fair value	\$ 187,460	\$ 117,935	\$ 3,570	\$ 308,965
Liabilities				
Interest rate swaps	\$ 0	\$ 0	\$ 22,789	\$ 22,789
Total liabilities at fair value	\$ 0	\$ 0	\$ 22,789	\$ 22,789

During fiscal year 2012, there were no significant transfers between level 1 and level 2 fair value investments. During fiscal year 2011, MHS transferred \$20,000 from level 2 fixed maturity and money market fund securities to level 1 equity securities in accordance with MHS investment committee decision to reallocate the portfolio.

Included in alternative investments as of June 30, 2012 are two classes of hedge funds of funds with fair values of \$1,494 (Fund A) and \$867 (Fund B). Fund A is redeemable semiannually with one hundred twenty days notice (receipt of proceeds in seven to fifteen days of notice), and Fund B is redeemable at the manager's discretion (receipt of proceeds in seven to fifteen days of notice). Included in alternative investments as of June 30, 2011 are three classes of hedge funds of funds with fair values of \$1,799 (Fund A), \$1,732 (Fund B) and \$39 (Fund C). Fund A is redeemable semiannually with one hundred twenty days notice (receipt of proceeds in seven to fifteen days of notice), Fund C is redeemable monthly with ninety days notice (receipt of proceeds twenty days following month end), and Fund B is redeemable at the manager's discretion (receipt of proceeds in seven to fifteen days of notice). There are no unfunded commitments for any of the hedge fund of funds for either 2012 or 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table is a rollforward of the consolidated statements of financial position amounts for financial instruments classified by MHS within level 3 of the valuation hierarchy defined above:

	<u>Investments</u>	<u>Interest rate swaps</u>
Fair value June 30, 2010	\$ 55,713	\$ (32,600)
Unrealized gains, net	1,169	9,811
Redemptions	<u>(53,312)</u>	<u>0</u>
Fair value June 30, 2011	3,570	(22,789)
Unrealized losses, net	(95)	(19,551)
Redemptions	<u>(1,112)</u>	<u>0</u>
Fair value June 30, 2012	<u>\$ 2,363</u>	<u>\$ (42,340)</u>

Note L - Pension and Profit Sharing Plans

MHS has a qualified 401(k) plan covering substantially all employees of the Medical Center and SMI who have completed at least one year of service and are at least twenty-one years of age. MHS makes an annual contribution on behalf of all eligible employees based on either the employee's contributions to the 401(k) plan or their annual compensation. MHS will match, on a dollar for dollar basis (based on age and years of service thresholds) the amount contributed by the employee, not to exceed 6% of the employee's salary. MHS' contributions to the 401(k) plan for all participants employed prior to April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees, vest at a rate of 25% annually and completely vested on April 1, 2001 for Medical Center employees and July 1, 2001 for SMI employees. MHS' contributions for all participants employed on or after April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees vest after four years of service, with no vesting prior to four years of service. Contributions under this plan totaled approximately \$4,281 and \$3,793 for the years ended June 30, 2012 and 2011, respectively.

The Medical Center has a nonqualified deferred compensation plan for certain executives and physicians. The deferred compensation plan provides for severance and supplemental retirement benefits as defined in the plan. Compensation expense related to the deferred compensation plan was \$1,065 and \$1,129 for the years ended June 30, 2012 and 2011, respectively. Total deferred compensation obligations of \$6,225 and \$6,648 are included in other long-term liabilities in the accompanying consolidated balance sheets at June 30, 2012 and 2011, respectively (see *Note W*).

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note L - Pension and Profit Sharing Plans – Continued

The fair values of deferred compensation plan assets fair value on a recurring basis as of June 30, 2012 by asset category are as follows (see *Note H and K*):

Assets	Level 1	Level 2	Level 3	Total Fair Value
Equity				
Mutual funds				
International large cap core	\$ 332	\$ 0	\$ 0	\$ 332
Emerging markets	57	0	0	57
Domestic mutual fund-equity income	4,404	0	0	4,404
Fixed maturity				
Bond fund	0	1,432	0	1,432
Total assets fair value	\$ 4,793	\$ 1,432	\$ 0	\$ 6,225

The fair values of deferred compensation plan assets on a recurring basis as of June 30, 2011 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Equity				
Mutual funds				
International large cap core	\$ 530	\$ 0	\$ 0	\$ 530
Emerging markets	72	0	0	72
Domestic mutual fund-equity income	4,811	0	0	4,811
Fixed maturity				
Bond fund	0	1,235	0	1,235
Total assets fair value	\$ 5,413	\$ 1,235	\$ 0	\$ 6,648

There were no significant transfers between level 1 and level 2 fair value investments for the years ended June 30, 2012 and 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note M - Post-Retirement Benefit Plan

MHS has an unfunded contributory health and medical post-retirement benefit plan available to all eligible employees who meet certain age and length of service requirements. The plan provides for health and medical benefits including primary care physician and specialist visits, hospitalization and emergency care, prescription drugs, vision care, and Medicare supplemental coverage.

The following table sets forth the components of the MHS obligation at June 30:

	<u>2012</u>	<u>2011</u>
Change in Benefit Obligation		
Benefit obligation at beginning of year	\$ 7,035	\$ 5,702
Service cost	174	253
Interest cost	314	342
Actuarial loss	419	957
Benefits paid	<u>(201)</u>	<u>(219)</u>
Benefit obligation at end of year	7,741	7,035
Change in Plan Assets		
Employer contribution	202	219
Plan participants' contribution	355	377
Medicare Part D reimbursement	96	87
Benefits paid	<u>(653)</u>	<u>(683)</u>
Fair value of plan assets at end of year	<u>0</u>	<u>0</u>
Fund status	(7,741)	(7,035)
Unrecognized actuarial loss	<u>0</u>	<u>0</u>
Accrued post-retirement benefit cost	(7,741)	(7,035)
Less current portion, included in accounts payable and accrued expenses	<u>(232)</u>	<u>(216)</u>
Total accrued post-retirement benefit cost, long-term portion	<u>\$ (7,509)</u>	<u>\$ (6,819)</u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note M - Post-Retirement Benefit Plan – Continued

Net periodic post-retirement benefit cost included the following for the years ended June 30:

	<u>2012</u>	<u>2011</u>
Service cost - benefits attributed to service during the period	\$ 174	\$ 253
Interest cost on accumulated post-retirement benefit obligation	314	342
Net amortization	(101)	0
Net post-retirement benefit cost	<u>\$ 387</u>	<u>\$ 595</u>

The weighted average discount rate used in determining the accumulated post-retirement benefit obligation (APBO) for the plan was 4.00% and 5.25% for the years ended June 30, 2012 and 2011, respectively. For measurement purposes, the health care cost trend rates used in determining the APBO for the plan was 7.5% in 2012 and 2011. Increasing the health care cost trend rates by 1% would increase the APBO by \$970 and aggregate service and interest cost by \$103 at June 30, 2012.

Note N - Retirement Annuity Plan

MHS had a pension plan that was terminated on April 1, 1997 and established a retirement annuity plan under which certain participants of the terminated plan were entitled to annuity payments. Participants to the plan include (a) the retirees and beneficiaries entitled to benefits from the terminated plan on April 1, 1997 and (b) other participants with benefits worth more than \$4 that elected an annuity. All benefits are vested and based on the frozen accrued benefits at April 1, 1997.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note N - Retirement Annuity Plan – Continued

The measurement dates for fiscal years 2012 and 2011 were June 30, 2012 and June 30, 2011, respectively. The following table sets forth the funded status of the retirement annuity plan and amounts recognized in accompanying consolidated financial statements:

	<u>2012</u>	<u>2011</u>
Change in Benefit Obligation		
Benefit obligation at beginning of year	\$ 10,057	\$ 10,869
Interest cost	502	511
Actuarial loss	858	35
Benefit paid	<u>(1,299)</u>	<u>(1,358)</u>
Benefit obligation at end of year	10,118	10,057
Change in Plan Assets		
Fair value of plan assets at beginning of year	6,927	6,965
Actuarial return on plan assets	(195)	1,320
Benefits paid	<u>(1,299)</u>	<u>(1,358)</u>
Fair value of plan assets at end of year	<u>5,433</u>	<u>6,927</u>
Fund status	(4,685)	(3,130)
Unrecognized actuarial loss (gain)	<u>0</u>	<u>0</u>
Accrued benefit cost	<u>\$ (4,685)</u>	<u>\$ (3,130)</u>

The discount rate was 4.00% and 5.25% for 2012 and 2011, respectively. The expected rate of return on plan assets was 6.50% for 2012 and 2011. The accompanying consolidated net pension cost was \$294 in 2012 and \$150 in 2011.

MHS' expected rate of return is evaluated annually and is based on the current interest rate environment, rate of inflation, allocation of the plan assets among various investment options and other market conditions.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair value of the plan assets as of June 30, 2012 and 2011 was \$5,434 and \$6,927, respectively. The weighted-average asset allocations in the plan as of June 30, 2012 and 2011, by asset category were as follows:

Asset Category	June 30,	
	2012	2011
Equity securities	59%	56%
Fixed income alternatives	13%	13%
Fixed income bond fund	20%	20%
Cash and cash equivalents	5%	8%
Equity alternatives	3%	3%
Total	100%	100%

MHS' asset allocation guidelines at June 30, 2012 are as follows:

	Ranges	Target Allocation
TOTAL EQUITY	30-65%	50%
Domestic equity	30-65%	40%
International equity	0-15%	10%
EQUITY ALTERNATIVES	0-50%	0%
FIXED MATURITY ALTERNATIVES	0-40%	35%
CASH	5-25%	15%

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair values of plan assets on a recurring basis as of June 30, 2012 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents				
Cash	\$ 0	\$ 3	\$ 0	\$ 3
Money market funds	0	279	0	279
Equity alternative	0	0	176	176
Fixed maturity alternative	0	0	723	723
Fixed maturity				
Bond fund	0	1,064	0	1,064
Equity securities				
Mutual funds				
International large cap core	519	0	0	519
Emerging markets	340	0	0	340
Domestic fund	0	0	0	0
Common stocks				
Healthcare	279	0	0	279
Utilities	14	0	0	14
Financials	263	0	0	263
Consumer staples	155	0	0	155
Consumer discretionary	164	0	0	164
Materials	67	0	0	67
Energy	144	0	0	144
Information technology	610	0	0	610
Industrials	363	0	0	363
Telecommunication service	0	0	0	0
Real estate investment trusts	0	0	0	0
Foreign stocks/American deposit receipt	270	0	0	270
Total assets fair value	\$ 3,188	\$ 1,346	\$ 899	\$ 5,433

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair values of plan assets on a recurring basis as of June 30, 2011 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents				
Cash	\$ 0	\$ 4	\$ 0	\$ 4
Money market funds	0	546	0	546
Equity alternative	0	0	208	208
Fixed maturity alternative	0	0	870	870
Fixed maturity				
Bond fund	0	1,397	0	1,397
Equity securities				
Mutual funds				
International large cap core	556	0	0	556
Emerging markets	366	0	0	366
Domestic fund	122	0	0	122
Common stocks				
Healthcare	377	0	0	377
Utilities	26	0	0	26
Financials	309	0	0	309
Consumer staples	186	0	0	186
Consumer discretionary	281	0	0	281
Materials	90	0	0	90
Energy	160	0	0	160
Information technology	698	0	0	698
Industrials	357	0	0	357
Telecommunication service	0	0	0	0
Real estate investment trusts	25	0	0	25
Foreign stocks/American deposit receipt	349	0	0	349
Total assets fair value	\$ 3,902	\$ 1,947	\$ 1,078	\$ 6,927

There were no significant transfers between level 1 and level 2 fair value investments for the years ended June 30, 2012 and 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

Included in alternative investments as of June 30, 2012 and 2011 are hedge funds of funds with fair values of \$899 and \$1,079, respectively. The funds are redeemable semiannually with no prior required redemption notice. There are no unfunded commitments for any of the hedge fund of funds for either 2012 or 2011.

The following table is a rollforward of the fair value amounts for financial instruments classified by the plan within level 3 of the valuation hierarchy above:

	<u>Alternative Investments</u>
Fair value June 30, 2010	\$ 1,559
Unrealized gains, net	146
Redemptions	<u>(627)</u>
Fair value June 30, 2011	1,078
Unrealized gains, net	2
Redemptions	<u>(181)</u>
Fair value June 30, 2012	<u>\$ 899</u>

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	<u>Benefit Payments</u>
2013	\$ 1,258
2014	1,193
2015	1,127
2016	1,055
2017	982
Next 5 years	3,807

Note O - Supplemental Cash Flow Information

Cash payments for interest, net of amounts capitalized and swap payments, were \$19,978 in 2012 and \$13,601 in 2011. Capitalized interest related to construction activities includes interest payments to creditors on bonds, net payments/receipts to counterparties on interest rate swap arrangements, and income received on trustee-held funds, totaling \$0 for 2012 and \$8,294 for 2011.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note P - Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following health care services at June 30:

	<u>2012</u>	<u>2011</u>
Capital improvements	\$ 17,152	\$ 22,551
Departmental expenses	7,182	6,121
Pastoral care	5,008	4,763
Indigent care	1,047	1,090
Research programs	710	860
Education programs	252	215
Other	18	89
	<u>\$ 31,369</u>	<u>\$ 35,689</u>

Permanently restricted net assets consist of the following at June 30:

	<u>2012</u>	<u>2011</u>
SMI Hospice Endowment	\$ 1,055	\$ 1,055
Weinberg Endowment	1,000	1,000
Dr. Goodman Endowment	123	123
	<u>\$ 2,178</u>	<u>\$ 2,178</u>

Note Q - Functional Expenses

MHS and its subsidiaries provide general health care services to patients within their geographic location. Expenses related to providing these services are as follows for the years ended June 30:

	<u>2012</u>	<u>2011</u>
Health care services	\$ 442,763	\$ 390,033
Administrative and support services	130,781	125,886
	<u>\$ 573,544</u>	<u>\$ 515,919</u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note R - Commitments and Contingent Liabilities

Litigation

MHS has outstanding litigation involving claims brought against it in the normal course of business. Litigation in the normal course of business, as well as responses to claims and investigations described below, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings and government investigations are difficult to predict. Attorneys for MHS are representing MHS in all of these matters. Management is currently unable to estimate, with reasonable certainty, the possible loss, or range of loss, if any, for such lawsuits and investigations. Management of MHS is unable to determine the amount of any possible settlements for such lawsuits and investigations, but is of the opinion that all of the lawsuits are covered by applicable MHS insurance.

MHS is subject to asserted and unasserted claims (in addition to litigation) encountered in the ordinary course of business. As a result of the current level of governmental and public concerns with health care fraud and abuse, management recognizes that additional investigative activity could occur in the future. In the opinion of management and after consultation with legal counsel, management believes it has established adequate accrued reserves related to all known matters. The outcome of any potential investigative, regulatory or prosecutorial activity that may occur in the future cannot be predicted with certainty, however, and any associated potential future losses resulting from such activity could have a material adverse effect on the future financial position, results of operations and liquidity of MHS.

Self-Insurance Programs

As discussed in *Notes A and I*, Greenleaf Insurance Company, Ltd. (GIC) provides general and professional liability coverage to MHS. Such coverage provides both primary and excess liability coverage. GIC retains the risk related to the primary policy and reinsures the whole of the excess policies. Insurance policy limits vary by year; however, management believes such amounts are appropriate to cover any general and professional liabilities losses, if any.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note R - Commitments and Contingent Liabilities - Continued

GIC provided coverage up to the following primary limits for the periods ending June 30:

	<u>2012</u>	<u>2011</u>
Healthcare Professional Liability	\$5,000 per occurrence \$16,500 aggregate	\$5,000 per occurrence \$16,500 aggregate
Managed Care Organization Liability	\$5,000 per occurrence \$16,500 aggregate	\$5,000 per occurrence \$16,500 aggregate
Commercial General Liability	\$5,000 per occurrence \$16,500 aggregate	\$5,000 per occurrence \$16,500 aggregate

GIC also provides an excess policy to MHS and its subsidiaries for \$75,000 per occurrence and \$75,000 in the aggregate that is reinsured with a commercial insurance company.

In management's opinion, the assets of GIC are sufficient to meet its obligations as of June 30, 2012. If the financial condition of GIC were to materially deteriorate in the future, and GIC was unable to pay its claim obligations, the responsibility to pay those claims would return to MHS.

MHS and certain of its subsidiaries are self-insured against employee medical claims. Plan expenses include claims incurred and provisions for unreported claims. However, the program has an annual aggregate stop loss provision per employee.

MHS and certain of its subsidiaries are self-insured against workers compensation claims and have surety bonds of \$2,200 (for claims arising after June 2004) as collateral for such claims. For claims that occurred between December 18, 2002 and June 2004, the surety coverage is limited to \$1,950. For claims that occurred prior to December 18, 2002, the surety coverage is limited to \$1,400.

MHS and certain of its subsidiaries are self-insured against unemployment claims and have surety bonds of \$1,475 for the Medical Center and \$350 for SMI. The amounts change each October 1st as dictated by the Maryland Department of Licensing and Regulation.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note R - Commitments and Contingent Liabilities - Continued

Lease Commitments

The Medical Center and MFC have entered into separate long term leases for commercial space. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2013	\$	3,939
2014		3,606
2015		3,482
2016		2,907
2017		1,671
Thereafter		<u>12,086</u>
	\$	<u>27,691</u>

MHS and certain of its subsidiaries have other office space leases. Rent expense for the years ended June 30, 2012 and 2011 was \$4,673 and \$4,243, respectively.

The Medical Center and MFC have entered into separate long term operating leases for equipment. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2013	\$	2,842
2014		2,519
2015		2,519
2016		2,262
2017		1,348
Thereafter		<u>975</u>
	\$	<u>12,465</u>

MHS and certain of its subsidiaries have other operating leases for equipment. Equipment lease expense for the years ended June 30, 2012 and 2011 was \$2,846 and \$2,314, respectively.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note S - Maryland Health Services Cost Review Commission

The Medical Center's charges are subject to review and approval by the State of Maryland Health Services Cost Review Commission (the Commission). Management has made the required filings with the Commission and believes the Medical Center to be in compliance with the Commission's requirements.

The Commission established an uncompensated care fund whereby all hospitals are required to contribute 0.75% of revenues to this fund to help provide for the cost associated with uncompensated care for certain Maryland hospitals above the State average. In December 2008, the Commission modified this mechanism to finance uncompensated care statewide. The policy implemented 100% pooling and all Maryland hospitals have the same percentage of uncompensated care in rates. High uncompensated care hospitals receive funds and low uncompensated care hospitals pay into the fund. The Medical Center had net receipts of \$607 and \$370 for 2012 and 2011, respectively.

The Commission's rate-setting methodology for service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for these centers within the applicable facility. The actual average unit charge for each service center is compared to the approved rate on a monthly basis. The rate variances, plus penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis.

The timing of the Commission's rate adjustments for the Medical Center could result in an increase or reduction due to the variances and penalties described above in a year subsequent to the year in which such items occur. The Corporation's policy is to accrue revenue based on actual charges for services to patients in the year in which the services are performed and billed.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note T - Housing Assistance Payment Contract

The U.S. Federal Housing Administration (FHA) has contracted with CSC under Section 8 of Title II of the Housing and Community Development Act of 1974 to make housing assistance payments to CSC on behalf of certified tenants. For fiscal year 2012 and 2011, the maximum contract commitment was \$1,092 and \$1,066 per year, respectively. During the years ended June 30, 2012 and 2011, CSC received housing assistance payments of \$554 and \$558, respectively, which are included in patient service revenue in the accompanying consolidated statements of operations. The contract has been renewed through March 2013.

Note U - Certain Risks and Uncertainties

Regulation and Reimbursement

MHS provides health care services primarily through an acute care hospital in Baltimore City and a long-term care facility in Baltimore County, Maryland.

MHS and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and State Medicaid programs;
- Regulation of hospital rates by the State of Maryland Health Services Cost Review Commission;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

Such inherent risks require the use of certain management estimates in the preparation of MHS' consolidated financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of MHS' revenues and MHS' operations are subject to a variety of other federal, state and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on MHS. Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on MHS.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note U - Certain Risks and Uncertainties - Continued

Investments

MHS and certain of its subsidiaries have funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation.

Certain alternative investments held in the MHS portfolio are exposed to potential risks in excess of the risks associated with the other investments in the MHS portfolio. These include, but are not limited to, the following potential risks:

- limited or no liquidity (including “side pocket” arrangements),
- derivative financial instruments that expose the investment funds to market risk (if the market value of the contract is higher or lower than the contract price at the maturity date) and credit risk (arising from the potential inability of counterparties to perform under the terms of the contracts),
- investment in non-marketable securities that are valued without the benefit of an active secondary market,
- substantially less regulation, and
- no current income production.

During September 2008, certain large U.S. financial institutions failed, primarily as a result of holdings in troubled subprime loans or assets collateralized with such distressed loans. These institutional failures, and the negative economic conditions that contributed to these failures, generated substantial volatility in global financial markets and substantial uncertainty regarding access to capital and the continued viability of many other financial institutions. These conditions create uncertainty regarding the MHS’s future ability to access capital and the cost of such capital. The resulting impact on the future financial position, results of operations and cash flows of MHS could be material.

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note V – Endowment

Current accounting standards provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Act of 2006 (UPMIFA) and additional disclosures about an organization's endowment funds. In 2008, the State of Maryland adopted UPMIFA.

The MHS endowments consist of three individual funds established for a variety of purposes. The endowments include both donor-restricted endowment funds and funds designated by the board of trustees to function as endowments. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the board of trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The board of trustees of MHS has interpreted the Maryland State Prudent Management of Institutional Funds Act (SPMIFA) 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. As a result of this interpretation, MHS classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts donated 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 organization in a manner consistent with the standard of prudence prescribed by SPMIFA. In accordance with SPMIFA, MHS considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- (1) The duration and preservation of the fund
- (2) The purposes of the organization and the donor-restricted endowment fund
- (3) General economic conditions
- (4) The possible effect of inflation and deflation
- (5) The expected total return from income and the appreciation of investments
- (6) Other resources of the organization
- (7) The investment policies of the organization

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note V – Endowment - Continued

MHS has adopted an investment policy for endowment assets that attempts to provide a predictable stream of funding to programs supported by its endowments while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity.

To satisfy its long term rate-of-return objectives, MHS 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). MHS targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

At June 30, 2012, the endowment net asset composition by type of fund consisted of the following:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted funds	\$ 0	\$ (131)	\$ 2,178	\$ 2,047
Total funds	<u>\$ 0</u>	<u>\$ (131)</u>	<u>\$ 2,178</u>	<u>\$ 2,047</u>

At June 30, 2011, the endowment net asset composition by type of fund consisted of the following:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Donor-restricted funds	\$ 0	\$ (44)	\$ 2,178	\$ 2,134
Total funds	<u>\$ 0</u>	<u>\$ (44)</u>	<u>\$ 2,178</u>	<u>\$ 2,134</u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note V – Endowment - Continued

Changes in endowment net assets for the fiscal year ended June 30, 2012, consisted of the following:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 0	\$ (44)	\$ 2,178	\$ 2,134
Investment return:				
Investment income	0	(103)	0	(103)
Total investment loss	0	(103)	0	(103)
Contributions	0	23	0	23
Appropriation of endowment asset for expenditure	0	(7)	0	(7)
Endowment net assets, end of year	<u>\$ 0</u>	<u>\$ (131)</u>	<u>\$ 2,178</u>	<u>\$ 2,047</u>

Changes in endowment net assets for the fiscal year ended June 30, 2011, consisted of the following:

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
Endowment net assets, beginning of year	\$ 0	\$ (435)	\$ 2,178	\$ 1,743
Investment return:				
Investment income	0	394	0	394
Total investment income	0	394	0	394
Appropriation of endowment asset for expenditure	0	(3)	0	(3)
Endowment net assets, end of year	<u>\$ 0</u>	<u>\$ (44)</u>	<u>\$ 2,178</u>	<u>\$ 2,134</u>

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note W – Other Long-Term Liabilities

Other long-term liabilities consist of the following at June 30:

	<u>2012</u>	<u>2011</u>
Interest rate swaps	\$ 42,340	\$ 22,789
Deferred compensation plan	6,225	6,648
Retirement annuity plan	4,685	3,130
GIC claims estimated tail	1,000	1,000
Other	531	457
	<u>\$ 54,781</u>	<u>\$ 34,024</u>

Report of Independent Auditors on Other Financial Information

The Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, MD

The 2012 audited consolidated financial statements of Mercy Health Services, Inc. and Subsidiaries and our report thereon are presented in the preceding section of this report. The audit was made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The supplemental consolidating information presented hereinafter as of and for the year ended June 30, 2012 is presented for purposes of additional analysis of the basic consolidated financial statements rather than to present the balance sheets and statements of operations of the individual entities, and is not a required part of the basic 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 audit of the basic consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the accompanying schedule is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

Cohen, Rutherford + Knight, P.C.

September 5, 2012

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information
June 30, 2012
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
CURRENT ASSETS							
Cash, cash equivalents and short term investments	\$ 243	\$ 1,768	\$ 76,381	\$ 6,858	\$ 141	\$ 0	\$ 85,391
Current portion of funds held by trustee or authority	0	0	10,071	1,057	0	0	11,128
Resident prepayment deposits	0	0	0	710	0	0	710
Patient receivables, net	0	0	18,397	3,613	13,673	0	35,683
Other receivables, net	564	0	3,493	(759)	694	(163)	3,829
Current pledges receivable, net	0	6,426	0	0	0	0	6,426
Inventory	0	0	6,986	172	194	0	7,352
Other current assets	0	0	4,754	97	341	0	5,192
TOTAL CURRENT ASSETS	807	8,194	120,082	11,748	15,044	(163)	155,712
PROPERTY AND EQUIPMENT	0	0	521,906	24,924	7,938	0	554,769
INVESTMENTS AND OTHER ASSETS							
Funds held by trustee or authority, less current portion	0	0	22,991	1,790	0	0	24,781
Long-term investments	6,647	0	20,667	0	0	0	27,314
Board designated and donor restricted investments	8,760	9,580	86,148	14,910	0	0	119,398
Restricted cash	0	2,055	46,636	0	0	0	48,691
Interest in net assets of MIF	0	0	23,598	5,371	0	(28,969)	(0)
Long-term pledges receivable, net	0	11,639	0	0	0	0	11,639
Investments in and advances to affiliates	10,431	(1,385)	25,238	(315)	(30,640)	(3,001)	329
Reinsurance balances receivable	0	0	2,555	0	0	0	2,555
Other assets	138	0	9,898	414	3,482	0	13,931
TOTAL ASSETS	\$ 26,783	\$ 30,084	\$ 879,719	\$ 58,842	\$ (4,176)	\$ (32,133)	\$ 959,118

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information-Continued
June 30, 2012
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
LIABILITIES AND NET ASSETS							
CURRENT LIABILITIES							
Current maturities of long-term debt	\$ 26	\$ 0	\$ 7,090	\$ 1,352	\$ 0	\$ 0	\$ 8,468
Accounts payable and accrued expenses	70	27	57,206	5,970	11,788	(278)	74,784
Resident prepayment deposits	0	0	0	710	0	0	710
Construction retainage	0	0	1,802	0	0	0	1,802
TOTAL CURRENT LIABILITIES	96	27	66,098	8,032	11,788	(278)	85,764
Long-term debt	171	0	432,367	16,362	0	0	448,900
Accrued interest	0	0	0	3,372	0	0	3,372
Provision for outstanding losses	0	0	37,258	0	0	0	37,258
Post-retirement obligation	0	0	7,509	0	0	0	7,509
Other long-term liabilities	0	204	54,577	0	0	0	54,781
TOTAL LIABILITIES	267	231	597,809	27,766	11,788	(278)	637,584
NET ASSETS							
Unrestricted	26,515	884	257,191	22,439	(16,155)	(2,887)	287,987
Temporarily restricted	0	26,913	23,596	7,582	191	(26,913)	31,369
Permanently restricted	0	2,055	1,123	1,055	0	(2,055)	2,178
TOTAL NET ASSETS	26,515	29,852	281,910	31,076	(15,965)	(31,855)	321,534
TOTAL LIABILITIES AND NET ASSETS	\$ 26,783	\$ 30,084	\$ 879,719	\$ 58,842	(\$4,176)	\$ (32,133)	\$ 959,118

Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information
Year ended June 30, 2012
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
REVENUES							
Patient service revenues	\$ 0	\$ 0	\$ 414,672	\$ 49,537	\$ 121,146	\$ 0	\$ 585,355
(net of allowances and discounts)	0	0	(24,852)	(544)	(6,603)	0	(31,999)
Provisions for bad debt	0	0					
Net patient service revenues	0	0	389,820	48,993	114,543	0	553,356
Other operating revenues	1,939	1,881	21,890	6,076	7,793	(11,435)	28,145
Net assets released from restrictions used for operations	0	0	1,708	942	23	0	2,673
TOTAL REVENUES	1,939	1,881	413,418	56,011	122,359	(11,435)	584,174
EXPENSES							
Salaries and benefits	1,259	990	186,128	37,466	98,984	(3,819)	321,009
Medical and surgical supplies	0	0	48,168	796	1,026	0	49,990
Pharmacy supplies	0	0	24,513	1,034	7,578	0	33,125
Other expendable supplies	0	407	21,628	3,741	1,584	0	27,361
Professional fees	0	0	8,576	2,955	4,869	(884)	15,516
Insurance	0	0	6,966	816	4,417	19	12,218
Other purchased services	23	284	46,369	3,444	3,817	(6,562)	47,374
Interest expense	0	0	19,190	924	0	0	20,114
Repairs	0	10	9,008	563	531	0	10,112
Depreciation and amortization	0	2	32,332	2,198	2,193	0	36,726
TOTAL EXPENSES	1,282	1,693	402,878	53,937	125,000	(11,247)	573,544
OPERATING INCOME (LOSS)	657	188	10,540	2,074	(2,641)	(188)	10,631

Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information - Continued
Year ended June 30, 2012
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Matis, Inc.	Physician Enterprise	Eliminations	Consolidated
OTHER INCOME (EXPENSES)							
Investment income	(28)	(12)	209	47	0	12	228
Equity in gains of affiliates	571	0	0		0	0	571
Net unrealized gain(loss) on trading securities	(14)	(176)	(1,928)	(131)	0	176	(2,073)
Unrealized loss on interest rate swap	0	0	(19,551)	0	0	0	(19,551)
Loss on early extinguishment of debt	0	0	(1,290)	0	0	0	(1,290)
Other	0	0	54	0	0	0	54
NET OTHER INCOME (EXPENSES)	529	(188)	(22,506)	(84)	0	188	(22,061)
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	1,186	0	(11,966)	1,990	(2,641)	(0)	(11,431)
Changes to post retirement plans obligations	0	0	(1,680)		0	0	(1,680)
Redassification of net assets	0	0	0	(300)	0	0	(300)
Net assets released from restrictions for the purchase of property and equipment	0	0	6,857	(47)	0	0	6,810
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	\$ 1,186	\$ 0	(\$6,789)	\$ 1,643	\$ (2,641)	\$ 0	(\$6,600)

MERCY MEDICAL CENTER, INC. & SUBS		TRANSITIONAL CARE, INC.		GREENLEAF INSURANCE		ELIMINATIONS		CONSOLIDATED	
STATEMENT OF REVENUE & EXPENSE - AMTS IN THOUSANDS									
FOR THE PERIOD ENDED 06/30/12									
	MERCY MED, CENTER, INC.	TRANSITIONAL CARE, INC.	GREENLEAF INSURANCE	ELIMINATIONS					
OPERATING REVENUES									
Patient Services Rev, net of bad debts	\$ 386,334	\$ 3,486	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 389,820	
Other Operating Revenues	20,297	0	10,991	(9,398)	0	0	0	21,890	
Net assets released - operations	1,709	0	0	0	0	0	0	1,709	
TOTAL OPERATING REVENUES	408,339	3,486	10,991	(9,398)				412,418	
OPERATING EXPENSES									
Salaries and Benefits	184,038	2,113	0	(23)	0	0	0	186,127	
Medical/Surgical Supplies	48,071	97	0	0	0	0	0	48,168	
Pharmacy Supplies	24,271	242	0	0	0	0	0	24,513	
Other Supplies	21,873	11	0	(256)	0	0	0	21,628	
Professional Fees	8,519	58	0	0	0	0	0	8,576	
Insurance	6,920	0	9,123	(9,078)	0	0	0	6,966	
Other Purchased Services	45,455	946	0	(41)	0	0	0	46,369	
Contingency	0	0	0	0	0	0	0	0	
Interest Expense	19,190	0	0	0	0	0	0	19,190	
Repairs	9,008	0	0	0	0	0	0	9,008	
Depreciation & Amortization	32,315	17	0	0	0	0	0	32,332	
TOTAL OPERATING EXPENSES	399,668	3,483	9,123	(9,398)				402,876	
INCOME/LOSS FROM OPERATIONS	\$ 8,671	\$ 3	\$ 1,868	\$ 0	\$ 0	\$ 0	\$ 0	\$ 10,542	
OTHER INCOME / < EXPENSES >									
Investment Income	209	0	0	0	0	0	0	209	
Net Unrealized Gains/Losses on Trading Securities	(2,408)	0	480	0	0	0	0	(1,928)	
Equity in Gain/Loss of Joint Ventures	0	0	0	0	0	0	0	0	
Market Change of Interest Rate Swap	(19,551)	0	0	0	0	0	0	(19,551)	
Gain on Interest Rate Swap	0	0	0	0	0	0	0	0	
Extinguishment of Debt	(1,290)	0	0	0	0	0	0	(1,290)	
Loss on Disposal of Assets	0	0	0	0	0	0	0	0	
Other Non Operating Items	54	0	0	0	0	0	0	54	
NET OTHER INCOME / < EXPENSE >	(22,987)	0	480	0	0	0	0	(22,507)	
EXCESS OF REVENUES OVER EXPENSES	(14,315)	3	2,348	0	0	0	0	(11,965)	
Net Assets Released from Restriction for PFE	6,857	0	0	0	0	0	0	6,857	
Changes to Post Retirement Plans Obligations	(1,680)	0	0	0	0	0	0	(1,680)	
Loss on Early Extinguishment of Debt	0	0	0	0	0	0	0	0	
INCREASE/DECREASE IN UNRESTRICTED NET ASSETS	(9,138)	3	2,348	0	0	0	0	(6,788)	

