

CONSOLIDATED FINANCIAL STATEMENTS

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE
CATHOLIC HEALTH SYSTEM, INC.)**

DECEMBER 31, 2013

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Catholic Health System, Inc.
Buffalo, New York

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Kenmore Mercy Hospital and its subsidiary (collectively, the "Hospital"), which comprise the consolidated balance sheet as of December 31, 2013, and the related consolidated statements of operations, changes in net assets and cash flows for the year then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Hospital's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Kenmore Mercy Hospital and its subsidiary as of December 31, 2013, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 15, the Hospital had significant transactions with related parties.

Other Matters

The financial statements of Kenmore Mercy Hospital and its subsidiary for the year ended December 31, 2012 were audited by other auditors whose report dated April 25, 2013, expressed an unmodified opinion on those statements.



Buffalo, New York
April 10, 2014

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

**CONSOLIDATED BALANCE SHEETS
December 31,**

ASSETS	2013	2012
Current assets:		
Cash and cash equivalents	\$ 31,914,582	\$ 28,193,288
Patient/resident accounts receivable, net of allowance for doubtful accounts of \$5,210,000 (2012 - \$5,203,000)	17,964,422	19,376,680
Other receivables	1,981,551	988,383
Inventories	2,180,672	1,887,486
Assets limited as to use	836,094	1,826,205
Prepaid expenses and other current assets	455,328	228,591
Total current assets	55,332,649	52,500,633
Interest in net assets of affiliated Foundations	4,616,215	3,914,838
Assets limited as to use	9,482,628	16,455,048
Due from affiliates	1,475,491	1,516,733
Property and equipment, net	56,723,506	46,381,047
Other assets	16,255,009	14,578,566
Total assets	\$ 143,885,498	\$ 135,346,865
LIABILITIES AND NET ASSETS		
Current liabilities:		
Current portion of long-term obligations	\$ 2,499,201	\$ 2,185,549
Long-term obligations subject to short-term remarketing arrangements	-	10,511,525
Accounts payable	7,983,418	8,492,488
Accrued expenses	7,399,238	7,473,448
Due to third-party payors	5,863,342	6,391,719
Due to affiliates	7,628,652	7,066,493
Total current liabilities	31,373,851	42,121,222
Long-term obligations, net	30,471,887	22,326,059
Long-term portion of insurance liabilities	20,719,458	18,688,189
Pension obligation	23,821,628	32,597,188
Asset retirement obligation	169,579	155,339
Interest rate swap	1,167,798	1,830,255
Other long term liabilities	352,818	152,688
Total liabilities	108,077,019	117,870,940
Net assets:		
Unrestricted	31,186,054	13,554,419
Temporarily restricted	4,622,425	3,921,506
Total net assets	35,808,479	17,475,925
Total liabilities and net assets	\$ 143,885,498	\$ 135,346,865

See accompanying notes.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

**CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Years Ended December 31,**

	<u>2013</u>	<u>2012</u>
Unrestricted revenue and other support:		
Net patient/resident service revenue	\$ 154,244,281	\$ 153,019,651
Provision for bad debts	<u>(3,284,685)</u>	<u>(4,093,804)</u>
Net patient/resident service revenue, less provision for bad debts	150,959,596	148,925,847
Other revenue	<u>2,655,226</u>	<u>2,830,966</u>
Total unrestricted revenue and other support	<u>153,614,822</u>	<u>151,756,813</u>
Expenses:		
Salaries and wages	65,965,238	63,720,378
Employee benefits	20,574,222	19,897,540
Medical and professional fees	4,594,889	5,147,592
Purchased services	12,649,026	13,003,348
Supplies	31,783,555	30,840,742
Depreciation and amortization	6,497,211	7,516,716
Interest	1,484,411	1,283,952
Insurance	1,377,145	1,028,530
Other expenses	<u>4,898,270</u>	<u>4,778,007</u>
Total expenses	<u>149,823,967</u>	<u>147,216,805</u>
Income from operations	3,790,855	4,540,008
Nonoperating revenues and losses:		
Investment income	81,372	85,333
Other, net	<u>46,125</u>	<u>(2,894)</u>
Total nonoperating revenues and losses	<u>127,497</u>	<u>82,439</u>
Excess of revenues over expenses	<u>\$ 3,918,352</u>	<u>\$ 4,622,447</u>

See accompanying notes.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

**CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS (CONTINUED)
For the Years Ended December 31,**

	<u>2013</u>	<u>2012</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 3,918,352	\$ 4,622,447
Change in pension obligation, other than net periodic cost	10,803,856	(1,795,460)
Distributions and transfers from parents and affiliates	1,937,829	99,747
Change in unrealized gain (loss) on interest rate swap	643,350	(23,096)
Distributions from Foundation	<u>328,248</u>	<u>311,009</u>
Increase in unrestricted net assets	17,631,635	3,214,647
Temporarily restricted net assets:		
Change in interest in Kenmore Mercy Foundation, Inc.	701,377	645,896
Other	<u>(458)</u>	<u>(4,883)</u>
Increase in temporarily restricted net assets	700,919	641,013
Increase in net assets	<u>18,332,554</u>	<u>3,855,660</u>
Net assets - beginning of year	<u>17,475,925</u>	<u>13,620,265</u>
Net assets - end of year	<u>\$ 35,808,479</u>	<u>\$ 17,475,925</u>

See accompanying notes.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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**CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31,**

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Increase in net assets	\$ 18,332,554	\$ 3,855,660
Adjustments to reconcile increase in net assets to net cash provided by operating activities:		
Depreciation and amortization	6,497,211	7,516,716
Provision for bad debts	3,284,685	4,093,804
Distribution and transfer from parent and affiliates	(1,937,829)	(99,747)
Undistributed portion of change in interest in Affiliated Foundations	(701,377)	(645,896)
Change in pension obligation, other than net periodic cost	(10,803,856)	1,795,460
Discount on issuance	19,776	13,945
Premium on issuance	(15,611)	(7,328)
Change in unrealized (gain) loss on interest rate swap	(662,457)	24,508
Change in unrealized gain on investments	40,305	31,100
Loss on sale of property and equipment	3,210	-
Gain on extinguishment of capital leases	-	(34,642)
(Increase) decrease in assets		
Patient accounts receivables	(1,872,427)	(8,881,401)
Other receivables	(993,168)	(180,028)
Inventories	(293,186)	(245,972)
Prepaid expenses	(226,737)	(95,384)
Other assets	(194,518)	(916,700)
Due from affiliates	44,005	(18,914)
Increase (decrease) in liabilities		
Accounts payable	(509,070)	2,260,709
Accrued expenses	(910,304)	(695,516)
Due to affiliates	3,040	1,888,259
Due to third-party payors	(528,377)	566,260
Other liabilities	2,680,682	2,268,214
Net cash and cash equivalents provided by operating activities	<u>11,256,551</u>	<u>12,493,107</u>
Cash flows from investing activities:		
Purchase of property and equipment	(15,206,254)	(7,932,329)
Purchase of assets limited as to use	-	(13,953,015)
Sale of assets whose use is limited	7,948,154	1,000,876
Other	(25,928)	6,513
Net cash and cash equivalents used in investing activities	<u>(7,284,028)</u>	<u>(20,877,955)</u>
Cash flows from financing activities:		
Distribution and transfer from parent and affiliates	1,937,829	99,747
Proceeds from issuance of long-term obligations	-	14,235,000
Discount on issuance	-	(156,812)
Premium on issuance	-	159,265
Repayments of current and long-term obligations	(2,189,058)	(1,962,718)
Net cash and cash equivalents (used in) provided by financing activities	<u>(251,229)</u>	<u>12,374,482</u>
Increase in cash and cash equivalents	3,721,294	3,989,634
Cash and cash equivalent, beginning of year	<u>28,193,288</u>	<u>24,203,654</u>
Cash and cash equivalent, end of year	<u>\$ 31,914,582</u>	<u>\$ 28,193,288</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,480,246	\$ 1,277,335
Noncash investing and financing activities:		
Assets acquired under capital lease obligations	\$ 132,848	\$ 279,576
Construction related payables	\$ 836,094	\$ 1,826,205

See accompanying notes.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

Kenmore Mercy Hospital is a not-for-profit acute care hospital and KMH Homes, Inc., whose sole member is Kenmore Mercy Hospital, is a not-for-profit corporation established to hold the property and related debt utilized by The McAuley Residence (TMR). TMR is a separate department of Kenmore Mercy Hospital operating as a not-for-profit nursing home. Kenmore Mercy Hospital, KMH Homes Inc., and TMR are collectively referred to as “the Hospital”. All operations are located in Erie County, New York and serve the community of Western New York. The Hospital provides inpatient, outpatient, and emergency services for the residents primarily in and around its surrounding area. Admitting physicians are primarily practitioners in the local area. Kenmore Mercy Hospital is part of the Catholic Health System, Inc. and Subsidiaries (“CHS” or the “System”) and its organizational structure is discussed below.

System: Catholic Health System, Inc. and Subsidiaries is an integrated healthcare delivery system in Western New York jointly sponsored by the Sisters of Mercy, Daughters of Charity and the Diocese of Buffalo. Catholic Health East (CHE), Ascension Health System and the Diocese of Buffalo are the corporate members of CHS, with equal ownership interest. CHS is the sole corporate member of the following subsidiaries:

Acute Care Subsidiaries: The Acute Care Subsidiaries (also collectively referred to as the “Hospitals”) include Mercy Hospital of Buffalo (MHB), Kenmore Mercy Hospital including The McAuley Residence (KMH), and Sisters of Charity Hospital (SCH).

Long-Term Care Subsidiaries: The Long-term Care Subsidiaries include St. Clare Manor (closed December 2003), St. Francis Geriatric and Healthcare Services, Inc. (closed December 2009), St. Francis Home of Williamsville, Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), St. Joseph’s Manor (closed August 2006), St. Luke’s Manor of Batavia (closed June 2004), St. Mary’s Manor (closed 2003), Nazareth Home of the Franciscan Sisters of the Immaculate Conception (closed 2007), St. Elizabeth’s Home and St. Vincent’s Home for the Aged.

Home Care Subsidiaries and Other: The Home Care and Other Subsidiaries include Mercy Home Care of Western New York, Inc., McAuley Seton Home Care (MSHC), Our Lady of Victory Renaissance Corporation, Catholic Health Infusion Pharmacy, Continuing Care Foundation and Catholic Health System Program of All Inclusive Care for the Elderly, Inc. (LIFE) and Trinity Medical WNY, PC.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies applied in preparing the accompanying consolidated financial statements are summarized below:

Principles of Consolidation: The consolidated financial statements of the Hospital include the accounts of Kenmore Mercy Hospital and KMH Homes, Inc. All significant intercompany balances and transactions have been eliminated to reflect the consolidated amounts.

Use of Estimates: The preparation of consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made by the Hospital include, but are not limited to, the reserves for asset retirement obligations, reserve for bad debts, reserve for third-party payor contractual adjustments and allowances, the provision for estimated receivables and payables for final settlements with those payors, the insurance reserves for workers’ compensation, professional and general liability, and actuarial assumptions used in determining pension expense.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Risks and Uncertainties: Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the fair value of investment securities, it is at least possible that changes in risks in the near term could materially affect the net assets of the Hospital.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates related to third-party payment matters will change by a material amount in the near term.

Cash and Cash Equivalents: The Hospital considers all highly liquid investments, generally with original maturities of three months or less when purchased, and short term investments (certificates of deposit), excluding amounts limited as to use, to be cash equivalents. The Hospital maintains funds on deposit in excess of amounts insured by the Federal Depository Insurance limits.

Other Receivables: Other receivables consist primarily of managed care risk sharing receivables, physician loans, and other receivables. There is no allowance for doubtful accounts established against these receivables.

Inventory Valuation: Inventory consists primarily of drugs, medical supplies and food. These inventories are generally stated at the lower of cost (first-in, first-out) or market.

Assets Limited as to Use: Assets limited as to use include assets set aside for debt service as required by trustee or indenture agreements, assets set aside by the Board of Directors for specific future purposes and unexpended bond proceeds. The Board retains control of these funds and may at its discretion subsequently use these funds for other purposes.

Investments: Investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the consolidated balance sheets.

Investment income and gains restricted by a donor are reported as increases in unrestricted net assets if the restrictions are met (either by passage of time or by use) in the reporting period in which the income and gains are recognized. Investment income or loss (including realized gains or losses on investments, interest, and dividends) is included in the excess of revenues over expenses, unless their use is restricted by donor stipulations or law. Unrealized gains and losses on investments are included in the operating measure as the investments are trading securities.

Prepaid Expenses and Other Assets: Prepaid expense and other assets consist of prepaid general expenses, deferred financing costs, insurance recoveries and other miscellaneous deferred charges. Amortization of the financing costs is provided on the effective interest method over the maturity of the bond issues.

Property and Equipment: Property and equipment are stated at cost if purchased, or if contributed, at the fair value on the date contributed. Depreciation is computed using the straight-line method over useful lives ranging from three to forty years. Equipment under capital lease is amortized on the straight-line method over the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements.

Gifts of long-lived assets such as land, building, or equipment are reported as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long these long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Impairment of Long-Lived Assets: The Hospital evaluates its long-lived assets for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

The Hospital evaluates the recoverability of long-lived assets not held for sale by measuring the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. If such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their fair values. Based on these evaluations, there were no adjustments to the carrying value of long-lived assets in 2013 and 2012.

Asset Retirement Obligations: The Hospital accrues for asset retirement obligations in the period in which they are incurred if sufficient information is available to reasonably estimate the fair value of the obligation. Over time, the liability is accreted to its settlement value. Upon settlement of the liability, the Hospital will recognize a gain or loss for any difference between the settlement amount and liability recorded. Accretion expense for the years ended December 31, 2013 and 2012 was \$14,240 and \$13,530 respectively.

Net Patient/Resident Service Revenue: Net patient service revenue is reported at the estimated net realizable amounts from third-party payors, patients, and others for services rendered. These estimated amounts include estimated adjustments under various reimbursement agreements with third-party payors and government regulations. The Hospital has agreements that provide for payments to the Hospital at amounts different from its established charges. Payment arrangements include prospectively determined rates per discharge, discounted charges, reimbursed costs, per diem payments and risk share arrangements. Third-party payors retain the right to review and propose adjustments to amounts recorded by the Hospital after initial payment of the claim. Such adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as necessary. CHS's Healthcare Assistance Program provides discounts to uninsured patients and self pay balances. In addition, the Hospital will also assist patients with the application process for free or low-cost insurance. Those uninsured patients who do not qualify for the Healthcare Assistance Program or low-cost insurance and live in New York State, a state contiguous to New York State, or the state of Ohio, are provided an uninsured discount based on a service specific uninsured rate. This uninsured rate is similar in calculation method and amount to third party payor methods and rates.

Under the New York Health Care Reform Act (NYHCRA), hospitals are authorized to negotiate reimbursement rates with certain non-Medicare payors except for Medicaid, Workers' Compensation and No-fault, which are regulated by New York State. These negotiated rates may take the form of rates per discharge, reimbursed costs, discounted charges or as per diem payments. Reimbursement rates for non-Medicare payors regulated by New York State are determined on a prospective basis. These rates also vary according to a patient classification system defined by the Health Care Reform Act (HCRA) that is based on clinical, diagnostic and other factors.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

A summary of the payment arrangements with major governmental third-party payors follows:

- **Medicare.** Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. The Hospital is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare Administrative Contractor. Cost reports have been audited and finalized by the Medicare Administrative Contractor through December 31, 2009. Disproportionate Share (DSH), Indirect Medical Education (IME), Graduate Medical Education (GME), Paramedical Education and Meaningful Use (MU) are all reconciled through settlement processes. During 2012, the system began participation with Catholic Medical Partners (CMP) as an Accountable Care Organization (ACO). The ACO places a global budget on all traditional Medicare claims (excluding e.g. DSH, IME, DME, MU) for patients associated with CMP Primary Care physicians. Claims are processed through fee for service billing and reconciled to the global budget along with quality measurement at the end of the period.
- **Non-Medicare.** The New York Health Care Reform Act of 1996, as updated, governs payments to hospitals in New York State. Under this system, hospitals and all non-Medicare payors, except Medicaid, Workers' Compensation and No-Fault insurance programs, negotiate hospital's payment rates. If negotiated rates are not established, payors are billed at hospitals established charges. Medicaid, Workers' Compensation and No-Fault payors pay hospital rates promulgated by the New York State Department of Health (DOH) on a prospective basis. Adjustments to current and prior years' rates for these payors will continue to be made in the future. Effective December 1, 2009, NYS implemented inpatient reimbursement reform. The reform updated the data utilized to calculate the NYS DRG rates and service intensity weights (SIWS) in order to utilize refined data and more current information in DOH promulgated rates. Similar type outpatient reforms were implemented effective December 1, 2008.

Amounts recognized in 2013 and 2012 related to prior years, including adjustments to prior year estimates and audit settlements, increased revenues \$871,928 and \$1,290,706, respectively. These changes in estimates related to estimates for prior years cost report reopening, appeals, and tentative final cost reports, some of which are still subject to audit, additional reopening, and/or appeals.

Approximately 50% and 51% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2013 and 2012, respectively. Approximately 37% and 36% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2013 and 2012, respectively.

There are various proposals at the federal and state level that could, among other things reduce payment rates. The outcome of these proposals, regulatory changes and other market conditions cannot presently be determined.

Provision for Bad Debts: The provision for bad debt is based upon management's assessment of expected net collections considering economic experience, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience by payor category, including those amounts not covered by insurance and history of cash collections. The results of this review are then used to make any modifications to the provision for bad debt expense to establish an appropriate allowance for uncollectible accounts. After satisfaction of amounts due from insurance and reasonable efforts to collect from the patient have been exhausted, the Hospital follows established guidelines for placing certain past-due patient balances with the collection agencies, subject to terms of certain restrictions on collection efforts as determined by the Hospital. Accounts receivable are written off after collection efforts have been followed in accordance with the Hospital's policies.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Patient and resident service revenue, net of contractual allowances and discounts, (but before the provision for bad debts), recognized in the period from these major payor sources, is as follows for the years ended December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Patient/resident service revenue (net of Contractual allowances and discounts):		
Medicare	\$ 64,782,598	\$ 66,819,715
Medicaid	12,339,543	10,065,393
Blue Cross	16,966,871	14,311,885
Other third party payors	53,985,498	54,969,819
Patients/residents	<u>6,169,771</u>	<u>6,852,839</u>
Total net patient/resident service revenue	154,244,281	153,019,651
Provision for bad debts	<u>(3,284,685)</u>	<u>(4,093,804)</u>
 Net patient/resident service revenue less provision for bad debts	 <u>\$ 150,959,596</u>	 <u>\$ 148,925,847</u>

Charity Care: The System provides services to all patients regardless of ability to pay. A patient is classified as a charity patient based on income eligibility criteria as established by the Healthcare Assistance Program (HAP) which is determined by presentation for care without insurance, while using an estimator (PARO) of each guarantor's ability to pay. Free care is determined at 110% of Federal Poverty Guidelines (FPG), whereas discounted care is also provided at 500% FPG.

Of the Hospital's total expenses, an estimated \$1,120,441 and \$1,208,229 arose from providing services to charity care patients in 2013 and 2012, respectively. Costing is a full step down methodology of cost from non-revenue producing departments to revenue producing departments, with assignment of cost to individual charge items based on volume and charge amount. Additional costs for the Hospitals include required payments for a gross receipts assessment to New York State which is used to fund the New York State Medicaid program and HCRA. Revenues that offset the costs of Charity Care include payments from the New York State Uncompensated Care Pools.

The Hospital provides care to patients at no charge or at a discounted rate who meet eligibility requirements under its Health Care Assistance Policy (charity care). In addition to charity care, the Hospital provides services to patients covered by Medicaid. The payments received for services provided to patients covered by Medicaid may be at or below costs in addition to the cost of care for patients without insurance. The Hospitals are also required to pay a gross receipts assessment to New York State which is used to fund the New York State Medicaid program and HCRA.

Collective Bargaining Agreements: The Hospital has approximately 60% of its employees working under four different collective bargaining agreements. The agreements are set to expire beginning July 25, 2015 through January 15, 2018.

Operating and Nonoperating Revenue and Losses: The Hospital's primary mission is dedicated to meeting the health care needs in the regions in which it operates. The Hospital is committed to providing a broad range of general and specialized health care services including inpatient, primary care, long-term care, outpatient services, and other health care related services. Only those activities directly associated with the furtherance of this mission are considered to be operating activities. Such activities include operation of cafeterias, parking lots, rental real estate and other ancillary activities. Other activities that result in gains or losses unrelated to the Hospital's primary mission are considered to be nonoperating.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Electronic Health Record Incentive Payments: The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments beginning in 2011 for eligible hospitals and professionals that adopt and meaningfully use certified electronic health record (EHR) technology. The Hospital recognizes income related to Medicare and Medicaid incentive payments using a gain contingency model that is based upon when the Hospital has demonstrated meaningful use of certified EHR technology for the applicable period and the cost report information for the full cost report year that will determine the final calculation of the incentive payment is available.

Medicaid EHR incentive calculations and related payment amounts are based upon prior period cost report information available at the time the Hospital adopts, implements or demonstrates meaningful use of certified EHR technology for the applicable period, and are not subject to revision for cost report data filed for a subsequent period. Thus, incentive income recognition occurs at the point the Hospital adopts, implements or demonstrates meaningful use of certified EHR technology for the applicable period, as the cost report information for the full cost report year that will determine the final calculation of the incentive payment is known at that time. Medicare EHR incentive calculations and related initial payment amounts are based upon the most current filed cost report information available at the time the Hospital demonstrates meaningful use of certified EHR technology for the applicable period. However, unlike Medicaid, this initial payment amount will be adjusted based upon an updated calculation using the annual cost report information for the cost report period that began during the applicable payment year. Thus, incentive income recognition occurs at the point the Hospital demonstrates meaningful use of certified EHR technology for the applicable period and the cost report information for the full cost report year that will determine the final calculation of the incentive payment is available.

The Hospital recognized approximately \$1,400,000 and \$2,000,000 of electronic health record incentive income related to Medicare and Medicaid incentive programs during the years ended December 31, 2013 and 2012, respectively, which is recorded in other revenue.

Other Revenues: The composition of other revenue for the years ended December 31, is set forth in the following table:

	<u>2013</u>	<u>2012</u>
Shared services	\$ 217,910	\$ 82,263
Cafeteria revenue	334,400	269,952
Rental income	325,776	257,743
Medicare and Medicaid meaningful use	1,368,595	1,964,766
Other	<u>408,545</u>	<u>256,242</u>
Total other revenues	<u>\$ 2,655,226</u>	<u>\$ 2,830,966</u>

Other Expenses: The composition of other expenses for the years ended December 31, is set forth in the following table:

	<u>2013</u>	<u>2012</u>
System dues (a)	\$ 1,275,017	\$ 1,433,701
Rents and operating leases	1,326,084	1,191,405
NYS Health Facilities Cash Receipts Assessment Program	574,331	504,352
Catholic Health System other expense	916,202	835,595
Professional fees	248,119	291,079
Other	<u>558,517</u>	<u>521,875</u>
Total other expenses	<u>\$ 4,898,270</u>	<u>\$ 4,778,007</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(a) System dues are comprised of the following expenses in 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Salaries, wages and employee benefits	\$ 269,020	\$ 243,154
Professional fees and purchase services	153,936	315,596
Dues to Catholic Health East	718,631	743,644
Other	<u>133,430</u>	<u>131,307</u>
Total system dues	<u>\$ 1,275,017</u>	<u>\$ 1,433,701</u>

Contributions: Contributions received are recorded as unrestricted, temporary restricted or permanently restricted net assets depending on the existence and nature of any donor restrictions.

Contributions and pledges that are restricted by the donor are reported as an increase in unrestricted net assets if the restrictions expire, that is, when a stipulated time restriction ends or purpose restriction is accomplished in the reporting period in which the contribution is recognized. All other donor-restricted support is reported as increases in temporarily or permanently restricted net assets, depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities and changes in net assets released from restrictions.

Excess of Revenues Over Expenses: The statement of operations and changes in net assets includes excess of revenues over expenses, commonly referred to as the performance indicator. Changes in unrestricted net assets which are excluded from the performance indicator, consistent with industry practice, include permanent transfers of assets to and from affiliates for other than goods and services, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets), and the effective portion of cash flow hedging derivatives, and pension liability adjustments.

Net Assets: Unrestricted net assets are available for the general operating purposes of the Hospital and are not subject to any donor limitations.

Temporarily restricted net assets are those whose use is limited by donors to a specific period or purpose and include the Hospital's interest in the net assets of the Kenmore Mercy Hospital Foundation, Inc. (the Foundation). Temporarily restricted net assets are released to unrestricted net assets as restrictions are met, which can occur in the same period. Gifts whose restrictions are met in the same period in which they are received are recorded as an increase in unrestricted net assets. Such restrictions include purpose restrictions where donors have specified the purpose for which the net assets are to be spent, or time restrictions imposed by donors or implied by the nature of the gift, pledges to be paid in future periods and life income funds. Investment return is included in unrestricted net assets unless the return is restricted by donor or law.

Income Taxes: The financial statements do not include a provision for income taxes, since the Hospital is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The tax-exempt organizations are subject to federal taxes on unrelated business income under section 511 of the Internal Revenue Code which are reported as other expenses in these financial statements. The Hospital's federal Exempt Organization Business Income Tax Returns for 2010, 2011, and 2012 remain subject to examination by the Internal Revenue Service.

Transactions among Subsidiaries: Common costs incurred by CHS are allocated to the subsidiaries on a pro-rata cost basis formula. The allocation of these costs is recorded as other revenue by CHS and are recorded by the subsidiaries as a component of the natural account classification. The related income and expense is eliminated in the consolidated financial statements. The respective assets and liabilities are eliminated in the consolidated financial statements.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Capitalized Software Costs: The Hospital capitalizes certain costs that are incurred to purchase or to create and implement internal-use computer software, which includes software coding, installation, testing and certain data conversion from both internal and external providers in accordance with the accounting standards. These capitalized costs are amortized on a straight-line basis over ten years and reviewed for impairment on an annual basis. The Hospital capitalized software, computer equipment, and other external costs of \$945,144 and \$1,357,786 during 2013 and 2012, respectively. Capitalized internal project labor costs amounted to \$29,308 and \$502,619 during 2013 and 2012, respectively.

Reclassifications: Certain prior year amounts were reclassified to conform to the 2013 consolidated financial statement presentation.

Subsequent Events: The Hospital evaluated subsequent events through April 10, 2014 which was the date the financial statements were available to be issued.

NOTE 3. INTEREST IN NET ASSETS OF KENMORE MERCY HOSPITAL FOUNDATION, INC.

The Hospital accounts for its interest in the net assets of the Foundation in accordance with the provisions of not-for-profit accounting guidance. This guidance establishes standards for transactions in which a not-for-profit organization (the recipient organization or the Foundation) accepts a contribution from a donor and agrees to transfer those assets, the return on investment of those assets, or both to another entity (the beneficiary, or the Hospital) that is specified by the donor. This guidance further provides that when these organizations are financially interrelated, as defined in this guidance, the beneficiary is required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets. The Foundation is a separate not-for-profit organization with its own board of directors and finances separate from those of the Hospital and is not part of the Hospital's financial reporting entity.

A summary of the Foundation assets, liabilities, net assets, and changes in net assets are as follows:

	<u>2013</u>	<u>2012</u>
Cash, investments and other assets	\$ 5,131,004	\$ 4,670,334
Total assets	<u>\$ 5,131,004</u>	<u>\$ 4,670,334</u>
Liabilities	\$ 514,789	\$ 755,496
Net assets:		
Unrestricted	3,897,537	3,128,014
Temporarily restricted	<u>718,678</u>	<u>786,824</u>
Total net assets	<u>4,616,215</u>	<u>3,914,838</u>
Total liabilities and net assets	<u>\$ 5,131,004</u>	<u>\$ 4,670,334</u>
Change in unrestricted net assets	\$ 769,523	\$ 627,966
Change in temporarily restricted net assets	<u>(68,146)</u>	<u>17,930</u>
Total change in net assets	<u>\$ 701,377</u>	<u>\$ 645,896</u>

Distributions were made to the Hospital in the amount of \$328,248 during 2013 and \$311,009 during 2012.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 3. INTEREST IN NET ASSETS OF KENMORE MERCY HOSPITAL FOUNDATION, INC.
(CONTINUED)**

In 2013, the unrestricted net assets of the Foundation, previously recorded in unrestricted net assets of the Hospital's financial statements were reclassified to temporarily restricted net assets of the Hospital. This is consistent with accounting principles generally accepted in the United States of America, in that an implied time restriction exists upon such unrestricted net assets, as the Hospital does not control the Foundation. The reclassification for the balance sheet as of December 31, 2012 amounted to \$3,128,014 from unrestricted net assets to temporarily restricted net assets.

NOTE 4. ASSETS LIMITED AS TO USE

The composition of assets limited as to use, including unspent bond proceeds, is as follows at December 31:

	<u>2013</u>	<u>2012</u>
Held by Trustee for funded depreciation:		
Cash and cash equivalents	\$ 1,120,708	\$ 1,126,691
U.S. Government obligations and other	2,178,239	2,184,669
Interest receivable	5,873	6,725
Held by Trustee under indenture agreements:		
Cash and cash equivalents	3,418,998	4,589,493
U.S. Government obligations and other	1,522,020	8,299,159
Held by Trustee for renewal and replacement:		
Cash and cash equivalents	<u>2,072,884</u>	<u>2,074,516</u>
Assets limited as to use	<u>\$ 10,318,722</u>	<u>\$ 18,281,253</u>

NOTE 5. PROPERTY AND EQUIPMENT

Property and equipment, recorded at cost, consists of the following at December 31:

	<u>2013</u>	<u>2012</u>
Land and land improvements	\$ 1,345,429	\$ 987,303
Buildings	71,614,979	55,636,925
Leasehold improvements	7,293,817	8,609,330
Equipment	26,206,704	22,175,590
Automobiles	20,978	20,978
Equipment under capital leases	<u>5,606,555</u>	<u>5,808,396</u>
	112,088,462	93,238,522
Less: Accumulated depreciation	(53,392,273)	(51,235,890)
Accumulated amortization under capital leases	<u>(2,336,371)</u>	<u>(2,058,535)</u>
	56,359,818	39,944,097
Construction in progress	<u>363,688</u>	<u>6,436,950</u>
Property and equipment, net	<u>\$ 56,723,506</u>	<u>\$ 46,381,047</u>

Depreciation expense in 2013 and 2012 amounted to approximately \$5,773,359 and \$6,747,335, respectively. Amortization expense on equipment under capital leases amounted to \$612,523 and \$676,564 in 2013 and 2012, respectively. Fully depreciated or amortized assets of \$1,421,868 and \$3,247,694 were written-off for the years ended December 31, 2013 and 2012, respectively.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. OTHER ASSETS AND OTHER RECEIVABLES

The composition of prepaid expenses, other assets and other receivables is as follows at December 31:

	<u>2013</u>	<u>2012</u>
Current prepaid expenses and other current assets:		
Prepaid general expenses	\$ 441,556	\$ 214,819
Other assets	<u>13,772</u>	<u>13,772</u>
Prepaid expenses and other current assets	<u>\$ 455,328</u>	<u>\$ 228,591</u>
Current other receivables:		
Physician loans	\$ 652,524	\$ 524,674
Managed care risk receivables	796,515	-
Other	<u>532,512</u>	<u>463,709</u>
Other receivables	<u>\$ 1,981,551</u>	<u>\$ 988,383</u>
Non-current:		
Insurance recoveries	\$ 14,442,655	\$ 12,863,642
Debt issuance costs, net accumulated amortization	1,428,554	1,525,643
Other	<u>383,800</u>	<u>189,281</u>
Other assets	<u>\$ 16,255,009</u>	<u>\$ 14,578,566</u>

Amortization expense on debt issuance costs amounted to \$97,088 and \$79,287 for the years ended December 31, 2013 and December 31, 2012, respectively. Accumulated Amortization related to the debt issuance costs amounted to \$744,673 and \$647,585 at December 31, 2013 and December 31, 2012, respectively, respectively. Amortization expense is expected to be approximately \$95,000 for the years ended December 31, 2014 to 2018.

NOTE 7. ACCRUED EXPENSES

Accrued expenses consist of the following at December 31:

	<u>2013</u>	<u>2012</u>
Workers' compensation, current portion	\$ 1,206,220	\$ 1,299,556
Payroll and benefits	5,186,755	5,204,149
Other	<u>1,006,263</u>	<u>1,039,743</u>
Accrued expenses	<u>\$ 7,399,238</u>	<u>\$ 7,473,448</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS

Long-Term Debt: Long-term debt obligations are comprised of the following at December 31:

	<u>2013</u>	<u>2012</u>
2006 Series C Bonds payable, Kenmore Mercy Hospital (a)	\$ 10,520,312	\$ 11,489,025
2012 Series A Bonds payable, Kenmore Mercy Hospital (b)	14,065,661	14,235,283
Mortgage payable, The McAuley Residence (c)	5,813,040	6,261,365
Capital lease obligations and other, at various rates of interest ranging from 3.4% to 5.0%, collateralized by equipment	2,528,348	2,986,188
Note payable to an individual, payable in monthly installments of \$988 including interest at 9%, until May 2018	<u>43,727</u>	<u>51,272</u>
Total long-term obligations	32,971,088	35,023,133
Less: Current portion	(2,499,201)	(2,185,549)
Less: Long term obligations subject to short-term remarketing arrangements (a)	<u>-</u>	<u>(10,511,525)</u>
Long-term obligations, net	<u>\$ 30,471,887</u>	<u>\$ 22,326,059</u>

- (a) In 2006, the System formed the Acute Care Obligated Group (the Obligated Group), consisting of its three primary hospitals (MHB, SCH and KMH) and the parent. No affiliates of CHS other than the Members of the Obligated Group were included in this offering. Collectively, the Obligated Group refinanced all outstanding indebtedness of the Obligated Group. On November 29, 2006, \$68,820,000 of Dormitory Authority of the State of New York (DASNY) Catholic Health System Obligated Group Revenue Bonds, Series 2006 were issued. The bonds consisted of four series. Series 2006 C Bonds for \$16,730,000 was loaned to the Hospital for the purpose of retiring the NYS Medical Care Facilities Finance Agency FHA - Insured Mortgage Project Revenue Bonds, 1995 Series B which were applied to finance the construction of a three floor patient tower, certain renovations to the the Hospital facility and to refinance outstanding indebtedness. The discount on the bonds of \$136,928 will be accreted over the life of the bonds.

In connection with the issuance of the Series 2006 Bonds, the Obligated Group entered into a Loan Agreement (the Loan Agreement) whereby the Obligated Group is required to pay funds sufficient in timing and amount to pay the principal and redemption price of the Series 2006 Bonds and related interest and administrative expenses as they come due. The Series 2006 Bonds pay interest at a variable remarketed rate and are collateralized by a letter of credit with HSBC Bank which expires on November 29, 2014. In the event the letter of credit is not renewed at expiration, and no event of default exists then, the outstanding Bonds, at the option of the members of the Obligated Group, would be subject to a mandatory tender and will then convert to a five year (initial) Term Loan. Repayment of the principal of Initial Term Loan shall be identical to the scheduled principal payments on the Bonds with the remaining amount due at the end of the five year term.

The interest borne by the Series 2006 Bonds will be determined by the Remarketing Agent to be the lowest rate that, in the judgment of the Remarketing Agent, under prevailing financial market conditions, enables such Series 2006 Bonds to be sold at a price of par. The variable interest rate was 0.06% and 0.13% at December 31, 2013 and 2012, respectively.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

The Loan Agreement specifies that the Hospital shall continuously pledge, as a security for the payment of all liabilities and the performance of all obligations of the Hospital pursuant to the loan agreement, a security interest in and assignment of the gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts. Further, the Hospital delivered a mortgage to secure all obligations and liabilities of the Hospital under the Loan Agreement. As further security to the Loan Agreement, the Hospital granted DASNY a security interest in such fixtures, furnishings and equipment as owned by the Hospital. In addition, a letter of credit in the amount of the bonds was entered into with HSBC Bank USA to provide security on the Series 2006 Bonds.

Certain financial covenants must be maintained by the Obligated Group. Failure to comply with these covenants requires a formal consultants report and quarterly progress reports demonstrating how the facility is progressing towards compliance. The Loan Agreement requires the Obligated Group to comply with certain financial covenants, including maintenance of (i) a minimum number of days cash on hand; (ii) long-term debt service coverage; (iii) a maximum leverage ratio. The Obligated Group was in compliance with these covenants at December 31, 2013 and 2012.

Prior to 2013, the letter of credit reimbursement agreement contained an acceleration clause that relied upon subjective evaluation criteria, which necessitated a current classification for the related obligations. The letter of credit reimbursement agreement has since been modified to replace the previously subjective criteria with objective and measureable criteria. Accordingly, the obligations are classified as non-current liabilities at December 31, 2013.

- (b) On July 12, 2012, \$17,315,000 of Dormitory Authority of the State of New York (DASNY) Catholic Health System Obligated Group Revenue Bonds, Series 2012 were issued. Series 2012A Bonds for \$14,235,000 were loaned to the Hospital for the purpose of financing the cost of a new two-story addition, which includes approximately 19,000 square feet on the first floor for a new emergency department, an approximately 14,794 square feet shell space on the second floor, and an approximately 16,000 square feet basement, as well as the cost of renovating existing space, expanding the existing parking lot and related demolition, and other mechanical and infrastructure improvements. Proceeds of the Series 2012A Bonds were also applied to pay certain costs of issuing the Bonds. The discount and premium on the bonds of \$156,812 and \$159,265, respectively, are attributable to the difference between the stated interest rate on these bonds and will be amortized over the life of the Bonds.

The Series 2012 Bonds were issued under the Master Trust Indenture that was created in 2006 during the formation of the Obligated Group. In connection with the issuance of the Series 2012 Bonds, the Hospital entered into a Loan Agreement whereby the Hospital is required to make monthly payments sufficient to pay, among other things, the principal and Sinking Fund Installments of and interest on the Series 2012 Bonds as they become due. The Series 2012 Bonds bear interest at a fixed rate. The interest rates, maturities, and aggregate principal amounts outstanding at December 31, 2013 are as follows:

2.00% Serial Bonds due July 1, 2014	\$ 165,000
3.00% Serial Bonds due July 1, 2015	340,000
3.00% Serial Bonds due July 1, 2016	350,000
3.00% Serial Bonds due July 1, 2017	360,000
4.00% Serial Bonds due July 1, 2018	370,000
3.50% Term Bonds due July 1, 2022	1,610,000
4.00% Term Bonds due July 1, 2027	2,385,000
5.00% Term Bonds due July 1, 2032 (i)	2,960,000
4.75% Term Bonds due July 1, 2039	<u>5,530,000</u>
Total Series 2012A bonds	<u>\$ 14,070,000</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

(i) Optional redemption on July 1, 2022 at a redemption price of 100% of the principal amount of such Series 2012 Bonds or portions thereof to be redeemed, plus accrued interest to the redemption date.

The Loan Agreement specifies that the Hospital shall continuously pledge, as a security for the payment of all liabilities and the performance of all obligations of the Hospital pursuant to the Loan Agreement, a security interest in and assignment of the gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts. Further, the Hospital delivered a mortgage to secure all obligations and liabilities of the Hospital under the Loan Agreement. As further security to the Loan Agreement, the Hospital granted DASNY a security interest in such fixtures, furnishings and equipment as owned by the Hospital.

The financial covenants required under the Loan Agreement are consistent with those of the Series 2006 Bonds.

(c) Mortgage payable to Century Health Capital. The mortgage is an FHA - Insured Mortgage revenue bonds to Century Health Capital. The mortgage is payable in monthly installments of \$65,176 including interest of 5.51%. Monthly payments commenced on July 1, 1994 and continue through maturity in July 2023. The mortgage is collateralized by the building and equipment.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2013 are as follows:

	<u>Long-Term Debt</u>	<u>Capital Leases</u>	<u>Total</u>
2014	\$ 1,834,414	\$ 732,869	\$ 2,567,283
2015	1,909,456	413,382	2,322,838
2016	1,991,083	297,856	2,288,939
2017	2,079,389	247,300	2,326,689
2018	2,158,430	158,933	2,317,363
Thereafter	<u>20,469,968</u>	<u>1,042,752</u>	<u>21,512,720</u>
Total	<u>\$ 30,442,740</u>	2,893,092	33,335,832
Less: Amount representing interest		<u>(364,744)</u>	<u>(364,744)</u>
Long-term obligations		<u>\$ 2,528,348</u>	<u>\$ 32,971,088</u>

Operating Leases

Minimum annual rental commitments at December 31, 2013 under noncancelable operating leases are as follows:

2014	\$ 1,374,564
2015	1,374,564
2016	1,374,564
2017	1,374,564
2018	1,321,823
Thereafter	<u>1,321,823</u>
	<u>\$ 8,141,902</u>

Total expense for rents and operating type leases for equipment and property was approximately \$1,326,084 and \$1,191,405 in 2013 and 2012, respectively.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. DERIVATIVE FINANCIAL INSTRUMENTS

In connection with the issuance of the Series 2006 Bonds and execution of the Loan Agreement, the Obligated Group entered into an interest rate swap agreement (a derivative agreement) with JP Morgan Chase. The Hospital entered into a derivative agreement for purposes of mitigating risk posed by the Bonds accruing interest at a variable rate. Further, the Hospital agreed not to take or omit to take any action that could reasonably be expected to result in the termination of the derivative agreement unless otherwise approved by JP Morgan Chase, provided, however, that termination of the derivative agreement shall not constitute an event of default for purposes of the Loan Agreement, but upon any such termination of the derivative agreement JP Morgan Chase may require that the Hospital direct the Series 2006 Bonds be converted to bonds that bear a fixed rate of interest. The terms of the swap require the Hospital to pay a fixed rate of 3.80% on the notional amount (\$11,095,000 at December 31, 2013) and in exchange, the Hospital will receive a variable rate payment based upon the Securities Industry and Financial Markets Association Index, calculated weekly. The notional amount of the swap is matched to the maturity schedule of the Series 2006 Bonds. The swap agreement was executed on December 13, 2006 and expires July 1, 2022. In accordance with the accounting guidance, the instrument qualifies for hedge treatment and is designated a cash flow hedge of future interest payments. The effective portion of the hedge has been excluded from excess of revenues over expenses and recorded within changes to net assets.

The fair value of derivative instruments at December 31 is as follows:

	<u>2013</u>		<u>2012</u>	
	<u>Balance Sheet Location</u>	<u>Fair Value</u>	<u>Balance Sheet Location</u>	<u>Fair Value</u>
Interest rate contracts floating to fixed	Long-term liabilities	\$ <u>1,167,798</u>	Long-term liabilities	\$ <u>1,830,255</u>

The effects of derivative instruments on the consolidated statements of operations and changes in net assets for 2013 and 2012 are as follows:

	<u>Ineffective portion in Statement of Operations</u>		<u>Effective portion in Net Assets</u>	
	<u>2013</u>	<u>2012</u>	<u>2013</u>	<u>2012</u>
Change in fair value of interest rate swaps	\$ <u>19,107</u>	\$ <u>(1,412)</u>	\$ <u>643,350</u>	\$ <u>(23,096)</u>

The Hospital measures its interest rate swaps at fair value on a recurring basis. The fair value of the interest rate swaps is determined based on financial models that consider current and future market interest rates and adjustments for nonperformance risk. The inputs utilized in the valuation process of the interest rate swaps are considered to be Level 2 within the fair value hierarchy defined in Note 14.

NOTE 10. EMPLOYEE BENEFIT PLANS

Pension Arrangements: Prior to December 31, 2001, the Hospital had a noncontributory defined benefit pension plan covering substantially all employees. Effective January 1, 2001, the System began maintaining a qualified defined benefit pension plan covering substantially all of its employees. As of that date, the Kenmore Mercy Hospital Pension Plan was merged into the Retirement Plan of the Catholic Health System (the Plan).

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Effective January 1, 2001, all nonunion employees who had met the age and service requirements under their previous plan were given the option of choosing to participate in the cash balance feature of the plan. Those who did not choose to participate in the cash balance feature accrue benefits under the same formula under the previous plan. All nonunion employees who become participants after that date automatically participate under the cash balance formula.

The Plan bases benefits upon both years of service and earnings. Participants under the Hospital formula earn benefits based on a career average formula. The cash balance formula is a hypothetical account balance formula. A participant's benefit obligation is assigned to the location at which the person works. As participants transfer around the System to other CHS subsidiaries, the obligations and a proportional amount of the plan's assets transfer.

Funded Status: The following tables summarize changes in the projected benefit obligation, the plan assets and the funded status of our pension plan as well as the components of net periodic benefit costs, including key assumptions. The disclosures below have been actuarially determined based on an allocation of the System's obligations specific to Kenmore Mercy Hospital. The measurement dates for plan assets and obligations were December 31, 2013 and 2012.

	<u>2013</u>	<u>2012</u>
Projected Benefit Obligations		
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 52,093,324	\$ 46,342,327
Service cost	2,082,927	1,885,585
Interest cost	2,010,788	2,084,957
Actuarial (gains) losses	(7,832,241)	3,828,044
Transfers (to) from CHS Subsidiaries	1,335,906	(219,535)
Benefits paid	(2,013,051)	(1,810,765)
Expenses	<u>(16,683)</u>	<u>(17,289)</u>
Projected Benefit obligation at end of year	<u>\$ 47,660,970</u>	<u>\$ 52,093,324</u>
Accumulated benefit obligations, end of year	<u>\$ 43,138,694</u>	<u>\$ 46,985,987</u>
Plan Assets		
Change in plan assets:		
Fair value of assets at beginning of year	\$ 19,496,135	\$ 17,519,262
Actual return on plan assets	3,463,740	1,931,412
Transfers (to) from CHS subsidiaries	668,201	(82,162)
Benefits paid	(2,013,051)	(1,810,765)
Hospital contributions	2,241,000	1,955,677
Expenses	<u>(16,683)</u>	<u>(17,289)</u>
Fair value of plan assets at end of year	<u>\$ 23,839,342</u>	<u>\$ 19,496,135</u>
Funded status at end of year	<u>\$ 23,821,628</u>	<u>\$ 32,597,189</u>
Amounts recognized in the consolidated balance sheets:		
Non-current liabilities	<u>\$ (23,821,628)</u>	<u>\$ (32,597,189)</u>
Net amounts recognized	<u>\$ (23,821,628)</u>	<u>\$ (32,597,189)</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Amounts recognized in unrestricted net assets consists of:

	<u>2013</u>	<u>2012</u>
Actuarial net loss	\$ (10,590,890)	\$ (21,349,982)
Prior service cost	<u>(210,859)</u>	<u>(255,623)</u>
Total amount recognized	<u>\$ (10,801,749)</u>	<u>\$ (21,605,605)</u>

Components of net periodic benefit cost:

Service cost	\$ 2,082,927	\$ 1,885,585
Interest cost	2,010,788	2,084,957
Expected return on plan assets	(1,561,004)	(1,495,644)
Amortization of prior service cost or (credit)	44,764	44,764
Recognized actuarial loss	<u>1,691,820</u>	<u>1,414,679</u>
Net periodic pension cost	<u>\$ 4,269,295</u>	<u>\$ 3,934,341</u>

Since the Hospital is a participant in the System's Plan, the following disclosures are made for the entire Plan in the aggregate, and do not represent the Hospital on a stand-alone basis.

The estimated prior service cost, and net loss that will be amortized from unrestricted net assets into net periodic pension cost over the next fiscal year for the System are \$229,260 and \$8,530,663, respectively.

The Plan's investment policies and strategies were used to develop the expected long-term rate of return on risk-free investment (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return of each asset class was then weighted based on the target asset allocation to develop the expected long-term rate of return on assets assumption.

The Plan's target asset allocation and the actual asset allocation percentages for 2013 and 2012 are as follows at the respective measurement dates:

<u>Asset Category</u>	<u>Target</u>	<u>Actual</u>	
		<u>2013</u>	<u>2012</u>
Equities	65%	61%	50%
Fixed income	25%	30%	35%
Other	<u>10%</u>	<u>9%</u>	<u>15%</u>
	<u>100%</u>	<u>100%</u>	<u>100%</u>

The portfolio is diversified among a mix of assets including large and small cap, domestic and foreign equities, fixed income, alternatives (a fund of hedge funds), and cash. Asset mix is targeted to a specific allocation, either intermediate or long-term, that is established by evaluating expected return, standard deviation, and correlation of various assets against the plan's long-term objectives. Asset performance is monitored quarterly and rebalanced if asset classes exceed explicit ranges. The investment policy governs permitted types of investments, and outlines specific benchmarks and performance percentiles. The Investment Subcommittee of the Stewardship Committee of the CHE Board oversees the pension investment program and monitors investment performance. Risk is closely monitored through the evaluation of portfolio holdings and tracking the beta and standard deviation of the portfolio performance. The use of derivative financial instruments as an investment vehicle is specifically limited.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Accounting Standards Codification Topic 820 allows for the use of a practical expedient for the estimation of fair value of investments in investment companies for which the investment does not have a readily determinable fair value. The practical expedient used by the Plan to value its investments in its Level 3 investments is the net asset value (NAV) per share, or its equivalent. For investments in non-unitized investments, the equivalent is the Plan's proportionate share of the partner's capital of the investment partnerships as reported by the general partners. Through its monitoring activities, the Plan believes that the carrying amounts of these financial instruments are reasonable estimates of fair value.

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

The following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2013 and 2012:

Cash and cash equivalents: Include certain instruments in highly liquid debt instruments with original maturities of three months or less at date of purchase.

Marketable debt securities: Valued based on yields currently available on comparable securities of issuers with similar credit rating.

Marketable equity securities: Valued at closing price reported on the active market on which the individual securities are traded.

Partnership joint venture interests: These securities are estimated using current information obtained from the general partner or investment manager for the respective funds. Investments in venture capital/private equity partnerships are generally estimated using partner's capital balances, and the fair value of investments in hedge funds are generally estimated using NAVs. In cases where the investee has provided its investors with a NAV per share or partner capital balances that have been calculated in accordance with the AICPA Audit and Accounting Guide, *Investment Companies*, the Plan has estimated its fair value by using the NAV provided by the investee as of December 31st.

Commingled funds: Valued at the NAV of units of the commingled fund. The NAV is used as a practical expedient to estimate fair value. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. This practical expedient is not used when it is determined to be probable that the fund will sell the investment for an amount different from the reported NAV.

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

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

The following tables present the Plan's financial instruments as of December 31, 2013 and 2012, measured at fair value on a recurring basis using the fair value hierarchy defined in Note 14.

At December 31, 2013	Level I	Level II	Level III	Total
Cash and cash equivalents	\$ 10,610,231	\$ 13	\$ -	\$ 10,610,244
Marketable equity securities:				
SRI large cap	36,140	-	-	36,140
Large cap flex	44,116,418	-	-	44,116,418
Small cap growth	17,695,823	-	-	17,695,823
International	11,359,573	-	-	11,359,573
Small cap value	8,722,468	-	-	8,722,468
Other	527,064	-	-	527,064
Marketable debt securities:				
US government obligations	31,735,616	-	-	31,735,616
Private placement	-	8,996,603	-	8,996,603
Banking and finance	-	9,752,736	-	9,752,736
International	-	6,203,252	-	6,203,252
Utility	-	3,897,766	-	3,897,766
Other	-	19,425,390	-	19,425,390
Alternative investments:				
Commingled funds	-	85,147,948	8,669,516	93,817,464
International hedge funds	-	-	4,825,571	4,825,571
Venture capital funds	-	-	5,179,554	5,179,554
Total	\$ 124,803,333	\$133,423,708	\$ 18,674,641	\$ 276,901,682

At December 31, 2012	Level I	Level II	Level III	Total
Cash and cash equivalents	\$ 14,491,559	\$ 50,617	\$ -	\$ 14,542,176
Marketable equity securities:				
SRI large cap	22,077	-	-	22,077
Large cap flex	26,642,255	-	-	26,642,255
Small cap growth	12,959,036	-	-	12,959,036
International	9,081,671	-	-	9,081,671
Small cap value	6,136,226	-	-	6,136,226
Other	178,292	-	-	178,292
Marketable debt securities:				
US government obligations	24,932,327	-	-	24,932,327
Private placement	-	9,259,692	-	9,259,692
Banking and finance	-	11,041,890	-	11,041,890
International	-	3,475,915	-	3,475,915
Utility	-	4,405,823	-	4,405,823
Other	-	19,683,218	-	19,683,218
Alternative investments:				
Commingled funds	-	62,498,917	18,617,733	81,116,650
International hedge funds	-	-	3,168,623	3,168,623
Venture capital funds	-	-	8,561,450	8,561,450
Total	\$ 94,443,443	\$110,416,072	\$ 30,347,806	\$ 235,207,321

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

A roll forward of pension assets classified by the defined benefit plan as Level 3 within the fair value hierarchy (defined above) is as follows:

	<u>2013</u>	<u>2012</u>
Fair value January 1	\$ 30,347,806	\$ 27,055,386
Realized and unrealized gains	1,146,712	944,022
Purchases	11,545,579	13,009,261
Sales	<u>(24,365,456)</u>	<u>(10,660,863)</u>
Fair value December 31	<u>\$ 18,674,641</u>	<u>\$ 30,347,806</u>

Contributions: Contributions to the Plan are made to make benefit payments to plan participants. The funding policy is to contribute amounts to the trusts sufficient to meet minimum funding requirements plus such additional amounts as may be determined to be appropriate. Contributions are made to benefit plans for the sole benefit of plan participants.

The System is expected to contribute an aggregate amount of approximately \$21,400,000 to the pension plan trust in 2014 to be allocated amongst participating entities.

Benefit Payments: The following table summarizes the System's estimated future benefit payments. Actual benefit payments may differ from expected benefit payments.

2014	\$ 16,945,000
2015	\$ 18,559,000
2016	\$ 20,569,000
2017	\$ 22,658,000
2018	\$ 24,425,000
2019 – 2023	\$ 158,705,000

	<u>2013</u>	<u>2012</u>
Weighted average assumptions used to determine end of the year benefit obligations:		
Discount rate	5.05%	3.95%
Rate of compensation increase	3.00%	3.00%
Weighted average assumptions used to determine net periodic pension cost:		
Discount rate	3.95%	4.60%
Expected long-term rate of return on plan assets	8.00%	8.00%
Measurement date	12/31/2013	12/31/2012

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. INSURANCE ARRANGEMENTS

The System, on the Hospital's behalf, participates in the CHE Trinity Inc. insurance program which provides coverage for healthcare professional (medical malpractice) and general liability exposures. The System had two insurance programs in 2013, as the legacy CHE program merged with Trinity Health's insurance program to form the CHE Trinity Inc. program. Prior to June 1, 2013, the primary limits for healthcare professional and general liability were \$3,000,000 per occurrence and were insured by Stella Maris Insurance Company, Ltd. (SMICL), a Cayman-domiciled insurer wholly-owned by CHE. Subsequent to June 1, 2013, the primary limits were \$20,000,000 for healthcare professional liability and \$1,000,000 for general liability per occurrence. Professional and general liabilities are insured by Venzke Insurance Company, Ltd. (Venzke), a Cayman-domiciled insurer wholly-owned by CHE Trinity, Inc.. Excess coverage was also provided to the System, and this excess coverage is fully reinsured with nonaffiliated commercial insurance companies.

The coverage provided is on a claims-made basis. The System, on the Hospital's behalf therefore retains the liability for unasserted claims resulting from incidents that occurred on services provided prior to the financial statement date. The System has independent actuaries estimate the ultimate costs of such unasserted claims, which were discounted at 3% and 4% in 2013 and 2012, respectively. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$72,400 and \$61,099 respectively, and is included in accrued expenses. The Hospital's portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$10,601,600 and \$9,271,255, respectively recorded in long-term portion of insurance liabilities. The charges to expenses for professional and general liability for 2013 and 2012 approximated \$1,192,542 and \$838,770, respectively, which has been included in insurance expenses. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for professional and general liabilities. The required liability claims and any anticipated insurance recoveries to be reported on a gross basis versus the previous practice of netting the recoveries against liability claims. Amounts recognized as insurance receivables related to the claims approximate \$9,226,000 and \$8,110,368 at December 31, 2013 and 2012, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

The System's insurance program for workers' compensation, in which the Hospital participates, has a deductible of \$350,000 per occurrence. Claims in excess of self-insurance levels are fully insured. Losses from asserted claims and from unasserted claims identified by the System's incident reporting for the Hospital were accrued on a discounted basis based on actuarial estimates of the settlement of such claims. The discount rate applied is 3% and 4% in 2013 and 2012, respectively. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$1,203,720 and \$1,124,860, respectively, and is included in accrued expenses. The Hospital's portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$10,117,858 and \$9,416,934, respectively, and is included in long-term portion of insurance liabilities.

The charges to expenses for workers' compensation costs approximated \$1,985,857 and \$2,582,741 in 2013 and 2012, respectively which has been included in employee benefits expenses. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for workers' compensation. The required liability claims and any anticipated insurance recoveries to be reported on a gross basis versus the previous practice of netting the recoveries against liability claims. Amounts recognized as insurance receivables related to the claims approximate \$5,216,655 and \$4,753,274 at December 31, 2013 and 2012, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. INSURANCE ARRANGEMENTS (CONTINUED)

The System's insurance for employee health costs, in which the Hospital participates, is self-insured up to \$350,000 per claim. Claims in excess of self-insurance levels are fully insured. Claims are accrued based upon the System's estimates of the aggregate liability for claims incurred using certain actuarial assumptions used in the insurance industry and based on the System's experience. Charges were billed monthly by the System and are included in employee benefit costs.

NOTE 12. LEGAL MATTERS

The Hospital is involved in litigation and regulatory investigations arising in the course of business. The health care industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed under Medicare and Medicaid programs in the current and preceding years. Management believes it is in compliance with such laws and regulations and no unknown or unasserted claims were known at this time, which could have a material adverse affect on the Hospital's future financial position, results from operations or cash flows.

NOTE 13. CONCENTRATIONS OF CREDIT RISK

The Hospital grants credit without collateral to its patients, most of whom are residents of Western New York and are insured under third-party agreements. The mix of receivables from patients and third-party payors at December 31 are:

	<u>2013</u>	<u>2012</u>
Medicare	32%	34%
Medicaid	7	7
Blue Cross	8	8
Other third-party payors	37	37
Patients/residents	<u>16</u>	<u>14</u>
	<u>100%</u>	<u>100%</u>

The Hospital maintains funds in excess of amounts insured by the Federal Depository Insurance limits. The Hospital has diversified its deposit amounts in a variety of institutions to reduce the level of concentrated credit risk.

NOTE 14. FAIR VALUE MEASUREMENTS

The following methods and assumptions were used by the Hospital in estimating fair value disclosures for financial statements:

Cash and Cash Equivalents: The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

Assets Limited to Use: The fair values for marketable equity, government, and fixed income securities are based on quoted market prices.

Interest Rate Swap: The fair value of the interest rate swaps is determined based on financial models that consider current and future market interest rates and adjustments for nonperformance risk. The fair value of these interest rate derivatives are based on quoted prices for similar instruments from a commercial bank, and therefore, the interest rate derivatives are considered a Level 2 item in the fair value hierarchy.

Long-term Debt: The fair value of the based on current rates offered for similar issues with similar security terms and maturities, or estimated using a discount rate that a market participant would demand. The carrying value of the long-term debt approximates fair value as of December 31, 2013 and 2012. Long-term debt would be classified as Level 2 in the fair value hierarchy.

Assets and liabilities recorded at fair value in the balance sheet are categorized based upon the level of judgment associated with the inputs used to measure their fair value. An asset or a liability's categorization within the fair value hierarchy is based on the lowest level of judgment input to its valuation Hierarchical levels, as defined by accounting guidance, are directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities as follows:

Level I - Valuations based on quoted prices in active markets for identical assets or liabilities that the Hospital has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in active market, valuation of these products does not entail a significant degree of judgment. Level I assets include cash and cash equivalents, debt and equity securities that are traded in an active exchange markets, as well as certain U.S. Treasury and other U.S. Governments and agencies bonds that are highly liquid and are actively traded in over-the counter markets.

Level II - Valuations based on quoted prices in active markets for similar assets or liabilities quoted prices in markets that are not active or for which all significant inputs are observable, directly or indirectly. Level II assets include equity and fixed income managed funds with quoted prices that are traded less frequently than exchange-traded instruments whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level III - Valuations based on inputs that are unobservable and significant to the overall fair value measurement. These are generally company generated inputs and are not market based inputs. Level III assets would 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 investment management judgment or estimation. The Hospital does not currently have any Level III assets or liabilities.

Financial instruments measured at fair value are based on one or more of the three valuation techniques noted in fair value guidance. The three valuation techniques are as follows:

Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Cost approach: Amount that would be required to replace the service capacity of an asset (i.e., replacement cost).

Income approach: Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques and option-pricing models).

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

The following tables present information about assets and liabilities that are measured at fair value on a recurring basis, and indicates the fair value hierarchy of the valuation techniques we utilized to determine such fair value as of December 31, 2013 and 2012.

At December 31, 2013	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ 1,153,611	\$ 5,458,979	\$ -	\$ 6,612,590
U.S. Government and agency obligations	2,178,239	1,522,020	-	3,700,259
Other	<u>-</u>	<u>5,873</u>	<u>-</u>	<u>5,873</u>
	<u>\$ 3,331,850</u>	<u>\$ 6,986,872</u>	<u>\$ -</u>	<u>\$ 10,318,722</u>
Interest rate swap	<u>\$ -</u>	<u>\$ 1,167,798</u>	<u>\$ -</u>	<u>\$ 1,167,798</u>
At December 31, 2012	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ 1,166,438	\$ 6,624,262	\$ -	\$ 7,790,700
U.S. Government and agency obligations	2,184,669	8,299,159	-	10,483,828
Other	<u>-</u>	<u>6,725</u>	<u>-</u>	<u>6,725</u>
	<u>\$ 3,351,107</u>	<u>\$ 14,930,146</u>	<u>\$ -</u>	<u>\$ 18,281,253</u>
Interest rate swap	<u>\$ -</u>	<u>\$ 1,830,255</u>	<u>\$ -</u>	<u>\$ 1,830,255</u>

NOTE 15. RELATED PARTY TRANSACTIONS

The Hospital is one of a group of health care providers who are affiliated as a result of their association with the System.

During 2013 and 2012, the Hospital incurred expenses from affiliates for administration services, rent and other services. These expenses approximated \$25,050,246 in 2013 and \$25,263,927 in 2012. During 2013 and 2012, the Hospital provided cost sharing services to and received reimbursement from affiliates for laboratory, computer, and other services. Revenues from these services approximated \$217,910 and \$93,666 and in 2013 and 2012, respectively.

During 2013 and 2012, distributions were received from the parent and affiliates of \$1,937,829 and \$99,747, respectively. During 2013 and 2012, the Hospital received cash payments from affiliates and made cash payments to affiliates in the normal course of operations.

Amounts due to affiliates at December 31, 2013 and 2012 were \$7,628,652 and \$7,066,493, respectively. Amounts due from affiliates at December 31, 2013 and 2012 were \$1,475,491 and \$1,516,733, respectively. The amounts due to affiliates are non-interest bearing and have no maturity date.

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16. FUNCTIONAL EXPENSES

The Hospital provides general health care services to residents within its geographic location. Expenses relating to providing these services included in the statement of operations are as follows:

	<u>2013</u>	<u>2012</u>
Healthcare services	\$ 106,994,173	\$ 104,991,611
General and administrative	<u>42,829,794</u>	<u>42,225,194</u>
	<u>\$ 149,823,967</u>	<u>\$ 147,216,805</u>



INDEPENDENT AUDITOR'S REPORT ON ACCOMPANYING SUPPLEMENTARY INFORMATION

To the Board of Directors
Catholic Health System, Inc.
Buffalo, New York

We have audited the consolidated financial statements of Kenmore Mercy Hospital and Subsidiary (the Hospital) as of December 31, 2013 and for the year then ended and our report thereon appears on page 1 of this document. The financial statements of Kenmore Mercy Hospital and its subsidiary for the year ended December 31, 2012 were audited by other auditors whose report dated April 25, 2013. That audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The Schedule of Net Cost of Providing Care of Persons Living in Poverty and Community Benefit Programs (Schedule of Social Accountability) is the responsibility of management and is provided for purposes of additional analysis of the consolidated financial statements. Such information is unaudited and therefore we do not express an opinion on the Schedule of Net Cost of Providing Care of Persons Living in Poverty and Community Benefit Programs (Schedule of Social Accountability).

Freed Maxick CPAs, P.C.

Buffalo, New York
April 10, 2014

**KENMORE MERCY HOSPITAL AND SUBSIDIARY
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

**SCHEDULE OF NET COST OF PROVIDING CARE OF PERSONS LIVING IN POVERTY AND
COMMUNITY BENEFIT PROGRAMS (SCHEDULE OF SOCIAL ACCOUNTABILITY - UNAUDITED)
Years Ended December 31, 2013 and 2012**

The total costs related to the care of the poor and benefits for the broader community as of December 31 are set forth in the following table:

	<u>2013</u>	<u>2012</u>
Charity care	\$ 1,120,441	\$ 1,208,229
Cost of community benefit programs	3,793,159	2,315,416
Unpaid cost of Medicaid programs	<u>7,509,946</u>	<u>6,534,846</u>
Social accountability costs	<u>\$ 12,423,546</u>	<u>\$ 10,058,491</u>