



**CONSOLIDATED FINANCIAL STATEMENTS**

**AND**

**SUPPLEMENTARY INFORMATION**

**SEPTEMBER 30, 2013 AND 2012**

*CPAs / ADVISORS*



# DEACONESS HEALTH SYSTEM

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## REPORT OF INDEPENDENT AUDITORS

Board of Directors  
Deaconess Health System  
Evansville, Indiana

### Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Deaconess Health System (System), which comprise the consolidated balance sheets as of September 30, 2013 and 2012, and the related consolidated statements of operations, changes in net assets, and cash flows for the years 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 these 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 these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits 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 the auditor's 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, the auditor considers internal control relevant to the System'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 System'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.

Board of Directors  
Deaconess Health System  
Evansville, Indiana

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 the System as of September 30, 2013 and 2012, and its results of operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

### Report on Supplementary Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information identified in the accompanying table of contents is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The supplementary information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the supplementary information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

*Blue & Co., LLC*

Indianapolis, Indiana  
December 12, 2013

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 52,866,996	\$ 63,419,560
Funds held by trustee, current portion	4,351,163	5,712,886
Patient accounts receivable, less allowance for estimated uncollectible amounts of \$48,269,000 in 2013 and \$45,213,000 in 2012	91,926,203	101,449,536
Inventories	6,390,227	6,362,040
Prepaid expenses and other current assets	<u>13,611,494</u>	<u>11,060,431</u>
Total current assets	169,146,083	188,004,453
<b>Investments limited as to use, less current portion</b>		
Board designated funds	338,628,898	254,201,470
Board designated funds - Foundation	6,227,279	5,653,343
Donor restricted - Foundation	<u>5,631,349</u>	<u>5,056,888</u>
Total investments limited as to use	350,487,526	264,911,701
<b>Property and equipment</b>		
Land and improvements	18,499,820	18,316,168
Buildings and improvements	512,219,948	493,491,934
Furniture, fixtures and equipment	<u>268,889,761</u>	<u>254,137,426</u>
	799,609,529	765,945,528
Less allowances for depreciation	<u>466,548,646</u>	<u>422,607,617</u>
	333,060,883	343,337,911
Construction in progress	<u>5,059,421</u>	<u>9,884,463</u>
Total property and equipment, net	338,120,304	353,222,374
<b>Other assets</b>		
Deferred financing costs	1,339,386	2,762,552
Investments in joint ventures	22,824,794	22,865,777
Goodwill	22,217,481	22,217,481
Other	<u>13,099,377</u>	<u>11,679,179</u>
Total other assets	59,481,038	59,524,989
Total assets	<u>\$ 917,234,951</u>	<u>\$ 865,663,517</u>

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2013 AND 2012

### LIABILITIES AND NET ASSETS

	2013	2012
<b>Current liabilities</b>		
Accounts payable and other current liabilities	\$ 31,702,536	\$ 33,058,097
Salaries, wages and related liabilities	42,681,091	39,843,727
Estimated third-party payor settlements	8,406,371	6,415,881
Accrued interest	659,528	651,549
Current portion of long-term debt	9,133,566	10,488,544
Total current liabilities	<u>92,583,092</u>	<u>90,457,798</u>
<b>Long-term liabilities</b>		
Long-term debt, less current portion	214,169,948	218,863,067
Other long-term liabilities	61,176,553	90,803,439
Total long-term liabilities	<u>275,346,501</u>	<u>309,666,506</u>
 Total liabilities	 367,929,593	 400,124,304
<b>Net assets</b>		
Unrestricted	534,398,299	451,746,047
Temporarily restricted	3,782,581	3,293,842
Permanently restricted	1,848,768	1,763,046
Net assets - controlling interest	<u>540,029,648</u>	<u>456,802,935</u>
Non-controlling interest	9,275,710	8,736,278
Total net assets	<u>549,305,358</u>	<u>465,539,213</u>
Total liabilities and net assets	<u>\$ 917,234,951</u>	<u>\$ 865,663,517</u>

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED STATEMENTS OF OPERATIONS YEARS ENDED SEPTEMBER 30, 2013 AND 2012

	2013	2012
<b>Unrestricted revenue and other support</b>		
Net patient service revenue	\$ 698,254,409	\$ 675,570,391
Less provision for bad debts	40,449,714	41,765,158
Net patient service revenue net of provision for bad debts	657,804,695	633,805,233
Other revenue	37,754,865	42,835,021
Total unrestricted revenue and other support	695,559,560	676,640,254
<b>Expenses</b>		
Salaries and wages	260,654,326	251,853,175
Employee benefits	76,684,011	70,832,778
Supplies	115,003,737	110,192,200
Contract services	67,198,801	69,608,219
Repairs and maintenance	20,335,459	19,689,741
Depreciation	44,914,865	39,625,915
Interest	8,722,770	9,227,267
Utilities	12,663,308	13,209,277
Other	41,023,216	51,909,459
Total expenses	647,200,493	636,148,031
Income from operations	48,359,067	40,492,223
<b>Nonoperating revenues (expenses)</b>		
Investment income	10,653,357	8,036,317
Contributions, gifts, and bequests	811,361	559,871
Grants	(1,604,543)	(1,525,180)
Loss on bond defeasance	(6,180,741)	(95,195)
Total nonoperating revenues (expenses)	3,679,434	6,975,813
Excess revenues over expenses	52,038,501	47,468,036
<b>Other changes in unrestricted net assets</b>		
Net unrealized gain on investments	7,694,976	20,183,539
Pension related changes other than net periodic pension cost	31,884,890	(20,535,930)
Net assets released from restriction	324,309	692,091
Distributions	(8,750,992)	(10,203,113)
Change in unrestricted net assets	83,191,684	37,604,623
<b>Temporarily restricted net assets</b>		
Contributions, gifts and bequests	664,129	1,122,293
Net unrealized gain on investments	93,903	57,307
Investment income	55,016	24,559
Net assets released from restriction	(324,309)	(692,091)
Change in temporarily restricted net assets	488,739	512,068
<b>Permanently restricted net assets</b>		
Contributions, gifts and bequests	85,722	1,071,042
<b>Change in net assets</b>	\$ 83,766,145	\$ 39,187,733

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2013 AND 2012

	Controlling Interest			Non-controlling Interest	Total
	Unrestricted	Temporarily Restricted	Permanently Restricted		
<b>Net assets</b>					
September 30, 2011	\$ 413,424,021	\$ 2,781,774	\$ 692,004	\$ 9,453,681	\$ 426,351,480
Excess revenues over expenses	37,982,326	-0-	-0-	9,485,710	47,468,036
Net unrealized gain on investments	20,183,539	57,307	-0-	-0-	20,240,846
Pension related changes other than net periodic pension cost	(20,535,930)	-0-	-0-	-0-	(20,535,930)
Net assets released from restriction	692,091	(692,091)	-0-	-0-	-0-
Investment income	-0-	24,559	-0-	-0-	24,559
Contributions, gifts and bequests	-0-	1,122,293	1,071,042	-0-	2,193,335
Distributions	-0-	-0-	-0-	(10,203,113)	(10,203,113)
Change in net assets	<u>38,322,026</u>	<u>512,068</u>	<u>1,071,042</u>	<u>(717,403)</u>	<u>39,187,733</u>
September 30, 2012	451,746,047	3,293,842	1,763,046	8,736,278	465,539,213
Excess revenues over expenses	42,748,077	-0-	-0-	9,290,424	52,038,501
Net unrealized gain on investments	7,694,976	93,903	-0-	-0-	7,788,879
Pension related changes other than net periodic pension cost	31,884,890	-0-	-0-	-0-	31,884,890
Net assets released from restriction	324,309	(324,309)	-0-	-0-	-0-
Investment income	-0-	55,016	-0-	-0-	55,016
Contributions, gifts and bequests	-0-	664,129	85,722	-0-	749,851
Distributions	-0-	-0-	-0-	(8,750,992)	(8,750,992)
Change in net assets	<u>82,652,252</u>	<u>488,739</u>	<u>85,722</u>	<u>539,432</u>	<u>83,766,145</u>
September 30, 2013	<u>\$ 534,398,299</u>	<u>\$ 3,782,581</u>	<u>\$ 1,848,768</u>	<u>\$ 9,275,710</u>	<u>\$ 549,305,358</u>

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2013 AND 2012

	2013	2012
<b>Operating activities</b>		
Change in net assets	\$ 83,766,145	\$ 39,187,733
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Depreciation	44,914,865	39,625,915
Provision for bad debts	40,449,714	41,765,158
Net unrealized gain on investments	(7,788,879)	(20,240,846)
Net realized gain on investments	(913,317)	(308,747)
Unrealized loss on interest rate swap	241,604	-0-
Gain on disposal of assets	(78,096)	(85,189)
Loss on bond defeasance	6,180,741	95,195
Amortization of deferred financing costs and original issue discount	102,100	211,753
Pension related changes other than net periodic pension cost	(31,884,890)	20,535,930
Restricted activity, net	(574,461)	(1,583,110)
Distributions to non-controlling interest investors	8,750,992	10,203,113
Changes in operating assets and liabilities		
Patient accounts receivable	(30,926,381)	(23,246,241)
Inventories	(28,187)	(1,192,612)
Prepaid expenses and other current assets	(2,551,063)	(1,983,935)
Investments in joint ventures and other assets	(1,379,215)	(5,271,880)
Accounts payable and other current liabilities	(1,355,561)	2,318,890
Salaries, wages and related liabilities	2,837,364	6,494,397
Estimated third-party payor settlements	1,990,490	353,224
Accrued interest	7,979	(75,345)
Other long-term liabilities	2,016,400	841,358
Net cash flows from operating activities	113,778,344	107,644,761
<b>Investing activities</b>		
Purchases of property and equipment	(29,920,774)	(31,019,808)
Proceeds from disposal of property and equipment	186,075	385,499
Net transfers from trustee assets for principal, interest and construction draws	1,361,717	1,534,443
Purchases of board designated funds	(227,521,459)	(147,589,783)
Proceeds from sale of board designated funds	151,796,236	93,197,205
Cash paid for goodwill	-0-	(36,656)
Other investing activities	(1,148,400)	(1,412,923)
Net cash flows from investing activities	(105,246,605)	(84,942,023)
<b>Financing activities</b>		
Distributions to non-controlling interest investors	(8,750,992)	(10,203,113)
Restricted activity, net	574,461	1,583,110
Payments on line of credit, net	-0-	(1,131)
Payments on long-term debt	(10,468,545)	(10,342,299)
Proceeds from long-term debt	152,021,832	28,340,000
Payments to refinance long-term debt	(151,396,840)	(28,340,000)
Cash paid for deferred financing costs	(1,064,219)	(281,467)
Net cash flows from financing activities	(19,084,303)	(19,244,900)
Change in cash and cash equivalents	(10,552,564)	3,457,838
<b>Cash and cash equivalents</b>		
Beginning of year	63,419,560	59,961,722
End of year	\$ 52,866,996	\$ 63,419,560

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

#### Nature of Operations

Deaconess Health System (System) is an integrated multi-facility health system providing comprehensive health care services to southern Indiana, southeastern Illinois and western Kentucky, employing over 5,000 within the Tri-State area.

Deaconess Health System, Inc. was formed to coordinate management and strategic planning and provide operational facilities for entities within the System, the most significant of which are Deaconess Hospital, Inc. (Hospital) and Deaconess Clinic, Inc. (Clinic), not-for-profit corporations whose missions are to provide quality health care services with a compassionate and caring spirit to persons, families and communities of the Tri-State area.

The board of Deaconess Health System, Inc. is granted the authority to provide overall direction and control of the entities through their respective bylaws. Deaconess Health System, Inc. wholly owns the Clinic and Deaconess Care Integration, LLC and is the sole corporate member of the Hospital.

The Clinic is comprised of Deaconess employed physicians practicing primary care and multi-specialty medicine within 22 outpatient physician offices located throughout southern Indiana, southeastern Illinois and western Kentucky and two urgent care centers located in Evansville, Indiana. The facilities provide illness and injury care, preventative care, lab and x-ray services. The Clinic also encompasses the Deaconess Clinical Research Institute which provides drug research studies for the pharmaceutical industry.

Deaconess Care Integration, LLC was formed during 2012 as an accountable care organization with the purpose of developing a care delivery model focused on quality metrics and reductions in cost for the Medicare population.

The Hospital, located in Evansville, Indiana, is comprised of two general acute care facilities, a mental health facility and two outpatient primary care facilities for seniors. The inpatient services have a combined capacity of 523 intensive care, pediatric, medical/surgical, orthopedic and neurosurgical beds.

The Hospital wholly owns Regional Emergency Staffing Department, LLC and holds majority ownership interests in the following entities:

- The Heart Hospital at Deaconess Gateway, LLC – 51%
- Progressive Health of Indiana, LLC – 51%

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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- Tri-State Radiation Oncology, LLC – 51%
- Deaconess Health Plans, LLC – 94%

Regional Emergency Department Staffing, LLC was formed during 2013 to assist hospitals in staffing emergency room departments and in improving the overall quality of services rendered in emergency room departments.

The Heart Hospital at Deaconess Gateway, LLC is a 24 bed hospital providing preventative care, medical care, emergent care, diagnostic testing, cardiovascular procedures, cardiovascular surgery and cardiac rehabilitation on an outpatient and inpatient basis.

Progressive Health of Indiana, LLC provides physical, occupational and speech therapy services throughout southern Indiana.

Tri-State Radiation Oncology, LLC provides oncology and cancer services, including radiation therapy, pain management, counseling and rehabilitation.

Deaconess Health Plans, LLC is a preferred provider organization – managed care network formed to encourage collaboration in providing patient service and cost management.

### Principles of Consolidation

The consolidated financial statements include the accounts of Deaconess Health System and its wholly owned and controlled subsidiaries. All material inter-company accounts and transactions have been eliminated in consolidation.

### Investments in Joint Ventures

The Hospital holds a 50% ownership in the Deaconess Women's Hospital of Southern Indiana, LLC d/b/a The Women's Hospital which is a 74-bed facility dedicated to comprehensive women's care, including obstetrics, neonatal intensive care, cancer treatment and infertility and imaging services. The Hospital recorded an investment in The Women's Hospital of approximately \$3,280,000 and \$5,280,000 as of September 30, 2013 and 2012, respectively. During 2013 and 2012, the Hospital received income distributions of approximately \$6,747,000 and \$2,221,000, respectively.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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The Hospital holds a 22% ownership interest in HealthSouth/Deaconess, LLC, d/b/a HealthSouth Deaconess Rehabilitation Hospital, an 80-bed comprehensive facility dedicated to improving, maintaining or restoring physical strength, cognition and mobility through therapeutic methods and technologies for rehabilitation. The Hospital recorded an investment in the HealthSouth Deaconess Rehabilitation Hospital of approximately \$4,787,000 and \$3,997,000 as of September 30, 2013 and 2012, respectively. During 2013 and 2012, the Hospital received income distributions of approximately \$1,567,000 and \$2,044,000, respectively.

The Hospital holds a 50% ownership interest in Evansville Surgery Center Associates, LLC providing two locations of multispecialty outpatient surgery centers dedicated to the diagnosis and preoperative, intraoperative and postoperative care of patients. The Hospital recorded an investment in Evansville Surgery Center Associates, LLC of approximately \$10,368,000 and \$10,138,000 as of September 30, 2013 and 2012, respectively. During 2013 and 2012, the Hospital received income distributions of approximately \$8,675,000 and \$9,125,000, respectively.

The Hospital holds a 12.5% ownership interest in the Indiana Healthcare Reciprocal Risk Retention Group which was formed to provide liability insurance, reinsurance and risk management services to the members. The Hospital recorded an investment in the Indiana Healthcare Reciprocal Risk Retention Group of approximately \$4,055,000 and \$3,183,000 as of September 30, 2013 and 2012, respectively. No income distributions were received in 2013 and 2012.

The Hospital holds 33.3% of the membership shares in The Healthcare Group, LLC, a preferred provider organization – managed care network, in exchange for the Hospital accepting a governance role and responsibility to share in the losses and gains and other obligations. The Healthcare Group, LLC encourages collaboration in providing patient service and cost management. The Hospital recorded an investment in the Healthcare Group, LLC of approximately \$237,000 and \$168,000 as of September 30, 2013 and 2012, respectively. No income distributions were received in 2013 and 2012.

Investments in organizations where the System's ownership percentage is equal to or less than 50% are included in investments in joint ventures on the consolidated balance sheets. The System's portion of income from unconsolidated organizations is reported with other revenue and was approximately \$16,838,000 and \$16,294,000 for 2013 and 2012, respectively.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Use of Estimates

The preparation of the 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, including the allowance for estimated uncollectible accounts, estimated third-party payor settlements, defined pension plan obligations and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

### Charity Care, Community Benefit and Assistance to the Uninsured

The System provides care to patients regardless of their ability to pay. A patient is classified as a charity patient by reference to certain established policies of the System. Essentially, these policies define charity services as those services for which no payment or reduced payment based upon a graduated scale, is anticipated, up to 300% of Federal Poverty Income Guidelines, published by the Department of Health and Human Services and where incurred charges are considered significant when compared to the income of the patient. Because collection of amounts determined to qualify as charity care is not pursued, such amounts are not reported as revenue.

The System's charity care policy reflects the current economic conditions and other factors unique to the System's customer base. Charity care provided during 2013 and 2012, measured at established rates, was approximately \$80,614,000 and \$86,824,000, respectively. In addition, other programs and services for the benefit of the community are provided. The costs of these programs are included in operating expenses. The System receives reimbursements from certain governmental payors to assist in the funding of charity care.

Of the System's total expenses reported (approximately \$647,200,000 and \$636,148,000 during 2013 and 2012, respectively), an estimated \$27,500,000 and \$30,587,000 arose from providing services to charity patients during 2013 and 2012, respectively. The estimated costs of providing patient assistance services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Hospital's total expenses divided by gross patient service revenue.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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The System has a policy for uninsured patients with discounted rates similar to contractual payors. Uninsured self pay discounts provided to patients were approximately \$16,990,000 and \$15,542,000 in 2013 and 2012, respectively.

### Statements of Cash Flows

Cash and cash equivalents are defined as investments in highly liquid debt instruments with an original maturity of three months or less, excluding amounts whose use is limited by arrangements under trust agreements, board designation or by donors. The System maintains its cash in accounts, which at times may exceed federally insured limits. The policy of the System is to collateralize deposits. The System has not experienced any losses in such accounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Additional cash flows information for 2013 and 2012 is as follows;

	<u>2013</u>	<u>2012</u>
Supplemental cash flows information:		
Cash paid for interest, net of capitalized interest	\$ 8,715,000	\$ 9,303,000
Property and equipment in liabilities	\$ -0-	\$ 2,585,000
Equipment acquired through capital leases	\$ -0-	\$ 2,665,000

### Patient Accounts Receivable, Estimated Third-Party Payor Settlements and Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Estimated retroactive adjustments under reimbursement agreements with certain third-party payors are included with estimated third-party payor settlements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

Patient accounts receivable are reduced by an allowance for uncollectible accounts based on the System's evaluation of its major payor sources of revenue, the aging of the accounts, historical losses, current economic conditions, and other factors unique to its service area and the healthcare industry. Management regularly reviews data about the major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary. For receivables associated with self-pay payments the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

During 2013, the System's allowance for uncollectible accounts increased approximately \$3,056,000 from \$45,213,000 to \$48,269,000. The uncollectible allowance for self-pay balances increased approximately \$2,836,000 as the uncollectible estimate increased to 85% of self-pay balances at September 30, 2013. The change is mainly the result of negative trends experienced in the collection of accounts during 2013. The uncollectible allowance reserved for third-party payors increased approximately \$220,000 as the uncollectible estimate increased to 6% of third-party payors at September 30, 2013. The change is mainly the result of negative trends experienced in the collection of accounts during 2013.

In addition, the System's self-pay related write-offs increased by approximately \$1,632,000 in 2013. The increase was the result of negative trends experienced in the collection of amounts from self pay patients in 2013.

As of September 30, 2013, the allowance for uncollectible accounts of \$48,269,000 was comprised of \$40,842,000 reserved for self-pay balances and \$7,427,000 reserved for third-party payor balances. As of September 30, 2012, the allowance for uncollectible accounts of \$45,213,000 was comprised of \$38,006,000 reserved for self-pay balances and \$7,207,000 reserved for third-party payor balances.

### Inventories

Inventories (principally pharmaceuticals and medical supplies) are stated at the lower of cost (first in, first out) or market.

### Property and Equipment and Depreciation

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets, ranging from 3 to 40 years, using the straight-line method. Equipment under capital leases are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, if shorter.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Investments Limited as to Use

Investments are stated at fair value. Dividends, interest income and realized gains and losses on sales of investments are recorded as nonoperating investment income. Unrealized gains (losses) on investments are reported as other changes in net assets in the consolidated statements of operations.

Investments consist of short-term investments (principally cash equivalents), US Government and government agency obligations, marketable debt securities (corporate bonds and fixed income mutual funds), marketable equity securities (common and preferred corporate stock), equity mutual funds, private equity funds, and mortgage backed securities. Fair values for investments are based on quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Private equity investments consist of limited partnerships investing in common stock of small and medium capitalization companies. Investments in those limited partnerships are reported at fair value as determined by the individual manager of each partnership. Although the manager uses its best judgment in estimating the fair value of the investments in the investment funds, there are inherent limitations in any estimation technique. Therefore, the values reported are not necessarily indicative of the amount that the investments funds could realize in a current transaction.

These estimated values may differ significantly from the values that would have been used had a ready market for the investments in the investment funds existed and the difference could be material. Private equity investments totaled approximately \$8,458,000 and \$6,778,000 (2.4% and 2.5% of investment portfolio) as of September 30, 2013 and 2012, respectively.

Investments limited as to use include assets held by trustees under indenture agreements, amounts set aside by the Board of Directors for future capital improvements, retirement of debt over which the Board retains control and may at its discretion subsequently designate for other purposes and amounts designated by for the Foundation and donor restrictions. Amounts required to meet current liabilities of the System have been classified as current assets.

### Foundation

The Hospital also encompasses a charitable Foundation supported by donations from the community. The Foundation has a separate advisory board who carry out the mission of supporting medical, charitable and educational activities as designated by the donors.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Deferred Financing Costs

Costs incurred in connection with the issuance of debt are amortized over the term of the related debt using the bonds outstanding method. Estimated annual amortization is approximately \$200,000.

### Goodwill

As of September 30, 2013 and 2012, the System recorded goodwill of approximately \$22,217,000 related to the acquisition of majority owned entities. Goodwill is tested for impairment on an annual basis, or whenever an event occurs or circumstances indicate the carrying value of the goodwill may be impaired. The System performed the required annual impairment test for goodwill as of September 30, 2013 using the income approach of calculating the present value of the future cash flows. The System determined no impairment of goodwill existed as of September 30, 2013 and 2012.

### Medical Malpractice

Malpractice insurance coverage is provided under a claims-made policy. Should the claims-made policy be terminated, the System has the option to purchase insurance for claims having occurred during its term but reported subsequently. Prior to July 1, 1999, the Indiana Medical Malpractice Act (Act) provided for a maximum recovery of \$750,000 per occurrence (\$3,000,000 annual aggregate) for professional liability, \$100,000 of which would be paid through the System's malpractice insurance coverage and the balance would be paid by the State of Indiana Patient Compensation Fund (Fund). For claims on or after July 1, 1999, the Act provides for a maximum recovery of \$1,250,000 per occurrence (\$7,500,000 annual aggregate) with the first \$250,000 covered by the System's insurance and the remainder by the Fund.

The System is a member in a Vermont captive insurance company, Indiana Healthcare Reciprocal Risk Retention Group, to fund the System's required portion of the professional, physician insurance coverage pursuant to the Act as well as its general liability insurance and excess coverage. This provides protection from liability in an amount not to exceed \$250,000 per incident and aggregate liability protection not to exceed \$7,500,000 per year. In addition, the System maintains a commercial umbrella/excess liability policy with a limit of \$15,000,000 each occurrence, \$15,000,000 aggregate per member and \$30,000,000 total policy aggregate.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Other Long-Term Liabilities

Other long-term liabilities include obligations related to the funded status of the defined benefit pension plan, other employee benefit programs and derivative liabilities related to an interest rate swap.

### Performance Indicator

The consolidated statements of operations contain a performance indicator, excess revenues over expenses. Consistent with industry practice, unrealized gain and loss on other than trading investments, pension related changes other than net periodic pension cost, equity transfers, contributions restricted for long-term purposes and certain other items are excluded from the performance indicator.

### Income Taxes

Deaconess Health System, Inc., Hospital and Clinic are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code (Code) and are exempt from Federal and state income taxes on related income pursuant to Section 501(a) of the Code. However, they are required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the System and recognize a tax liability if the System has taken an uncertain position that more likely than not would not be sustained upon examination by various Federal and state taxing authorities. Management has analyzed the tax positions taken by the System and has concluded that as of September 30, 2013 and 2012, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying consolidated financial statements. The System is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The remaining consolidated subsidiaries are organized as limited liability companies, whereby net taxable income is taxed directly to the members of the limited liability companies. Thus, the consolidated financial statements do not include any provision for Federal or state income taxes related to these entities.

These entities have filed their Federal and state income tax returns for periods through their most recent fiscal year ends (primarily December 31, 2012). These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Contribution Revenues and In-Kind Donations

Unconditional promises to give cash and other assets to the System 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 as unrestricted net assets and reported in the consolidated statements of operations as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received are included in nonoperating revenues (expenses) in the accompanying consolidated financial statements. In-kind donations are recorded as revenue and expense in the accompanying consolidated financial statements. These donations consist mainly of medical supplies and services which are recorded at their estimated fair values.

### Temporarily Restricted Net Assets

Temporarily restricted net assets include those assets whose use by the System has been temporarily limited primarily for capital projects or a specified time period or purpose.

The following is a summary of temporarily restricted net assets as of September 30, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Patient medical care	\$ 1,108,338	\$ 965,132
Education and scholarship	639,459	556,836
Capital projects	648,116	564,374
Other System support	1,386,668	1,207,500
	<u>\$ 3,782,581</u>	<u>\$ 3,293,842</u>

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Permanently Restricted Net Assets

Permanently restricted net assets are contributed with donor restrictions requiring they be held in perpetuity with income used to support the System's activities. The following is a summary of permanently restricted net assets as of September 30, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Beneficial interest in trusts	\$ 1,156,688	\$ 1,071,042
Other	692,080	692,004
	<u>\$ 1,848,768</u>	<u>\$ 1,763,046</u>

### Electronic Health Records (EHR) Incentive Payments

The System receives EHR incentive payments under the Medicare and Medicaid programs. To qualify for the EHR incentive payments, the System must meet "meaningful use" criteria that become more stringent over time. The System periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (Federal fiscal year ending September 30). The related EHR incentive payments are paid out over a four year transition schedule and are based upon data that is captured in the System's cost reports. The payment calculation is based upon an initial amount as adjusted for discharges, Medicare and Medicaid utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The System recognizes EHR incentive payments as grant income, under the ratable recognition method, when there is reasonable assurance that the System will comply with the conditions of the meaningful use objectives and any other specific requirements. In addition, the financial statement effects of the income must be both recognizable and measurable. During 2013 and 2012, the System recognized approximately \$6,000,000 and \$6,891,000, respectively, in EHR incentive payments as income.

EHR incentive income is included in other revenue in the consolidated statements of operations. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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Receipt of these funds is subject to the fulfillment of certain obligations by the Hospital as prescribed by the program, subject to future audits and may be subject to repayment upon a determination of noncompliance.

### Advertising Costs

Advertising costs are expensed as incurred. Total expense for 2013 and 2012 was approximately \$1,976,000 and \$1,736,000, respectively.

### Functional Expenses

The System provides health care services to patients in the community and the surrounding areas. Health care services and other certain related expenses approximated 93% of total expenses in 2013 and 2012. General and administrative expenses approximated 6% in 2013 and 2012. Fundraising expenses comprised less than 1% of total expenses in 2013 and 2012.

Certain costs have been allocated among health care services, general and administrative and fundraising categories based on the actual direct expenditures and cost allocations based upon time spent by the System's personnel. Although the methods used were appropriate, alternative methods may provide different results.

### Reclassification

Certain 2012 amounts in the consolidated financial statements have been reclassified to conform to the 2013 presentation.

### Subsequent Events

The System evaluated events or transactions occurring subsequent to the consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements are issued which is December 12, 2013.

## 2. NET PATIENT SERVICE REVENUE

Entities within the System have agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Medicare

Inpatient acute care services, outpatient services and physician services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic and other factors. Certain outpatient services and defined medical education costs related to Medicare beneficiaries are paid based on cost reimbursement methodologies. The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. Inpatient non-acute care services are generally reimbursed based upon cost reimbursement methodologies.

### Medicaid and Hospital Assessment Fee Program

Medicaid services are paid at prospectively determined rates per day or per discharge for inpatients or per occasion of service for outpatients. To the extent that services to Medicare and Medicaid program beneficiaries are reimbursed based on cost reimbursement methodologies, final settlement is determined after submission of annual cost reports and audits thereof by the fiscal intermediary.

During 2012, Hospital Assessment Fee (HAF) Program for the period July 1, 2011 through June 30, 2013 was approved by Centers for Medicare & Medicaid Services (CMS) retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals as reflected in the HAF Program expense reported in the consolidated statements of operations. Previously, the State share was funded by governmental entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. The Medicaid enhanced payments are designed to follow the patients and result in increased Medicaid rates. During 2013 and 2012, the Hospital recognized HAF Program expense of approximately \$15,000,000 and \$23,500,000, respectively, which resulted in Medicaid rate increases of approximately \$22,000,000 and \$30,000,000, respectively. HAF Program expense is included in other expenses on the consolidated statements of operations while the Medicaid rate increases are recorded in net patient service revenue.

The HAF Program is currently pending approval for extension by CMS from July 1, 2013 through June 30, 2017.

Estimates for final settlements of all unaudited Medicare and Medicaid cost reports through September 30, 2013 have been recorded. Cost reports through September 30, 2009 have been audited and settled as of September 30, 2013.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Entities within the System also entered into payment agreements with certain other commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

A reconciliation of the amount of services provided to patients at established rates to net patient service revenue as presented in the consolidated statements of operations for 2013 and 2012 is as follows:

	2013	2012
Patient service revenue	\$ 1,897,207,999	\$ 1,805,742,287
Adjustments		
Charity care revenue foregone	80,614,180	86,824,440
Uninsured self pay discounts	16,990,378	15,541,694
Contractual adjustments	1,101,349,032	1,027,805,762
Total adjustments	1,198,953,590	1,130,171,896
Net patient service revenue	698,254,409	675,570,391
Less provision for bad debts	40,449,714	41,765,158
Net patient service revenue net of provision for bad debts	\$ 657,804,695	\$ 633,805,233

Changes to any previous year's estimated settlement are reflected in the period the intermediary finalizes its audit of cost reports, or when additional information becomes available. Settlements related to prior year cost reports and other estimated third-party items resulted in an increase to net patient service revenue of approximately \$-0- and \$2,356,000 in 2013 and 2012, respectively.

The following is mix of gross patient accounts receivable and gross patient service revenue as of and for the years ended September 30, 2013 and 2012:

	Receivable		Revenue	
	2013	2012	2013	2012
Medicare	31%	24%	47%	46%
Medicaid	7%	13%	10%	10%
Commercial and managed care	36%	35%	36%	38%
Self pay and other	26%	28%	7%	6%
	100%	100%	100%	100%

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that recorded estimates will change in the near term.

### 3. INVESTMENTS

Investments at fair value consisted of the following as of September 30:

	2013	2012
Board designated funds		
Cash and cash equivalents	\$ 4,187,218	\$ 2,992,774
Common stock	45,396,202	35,398,383
Preferred stock	-0-	450,005
Mutual funds	186,381,596	147,400,360
US Government and government agency obligations	21,014,703	20,761,205
Corporate bonds	55,474,659	30,024,887
Private equity	8,458,162	6,777,561
Mortgage backed securities	17,716,358	10,396,295
	338,628,898	254,201,470
Funds held by trustee		
Cash and cash equivalents	4,351,163	5,712,886
Less current portion	4,351,163	5,712,886
	-0-	-0-
Board designated - Foundation and donor restricted - Foundation		
Cash and cash equivalents	346,570	169,841
Common stock	1,804,685	1,480,112
Preferred stock	-0-	57,710
Mutual funds	7,480,579	6,627,959
US Government and government agency obligations	876,959	997,321
Accrued interest and other	1,349,835	1,377,288
	11,858,628	10,710,231
Investments limited as to use, net	\$ 350,487,526	\$ 264,911,701

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Investments reported as current assets are those that the System has made available for use in operations within the next twelve months. Investments limited as to use that are required for obligations classified as current liabilities are also reported in current assets.

A detail of investment income for unrestricted and donor restricted for 2013 and 2012 is as follows:

	2013	2012
Interest and dividends	\$ 10,036,660	\$ 7,752,129
Unrealized loss on interest rate swap	(241,604)	-0-
Net realized gain	913,317	308,747
Investment income, net	\$ 10,708,373	\$ 8,060,876

See Note “Derivative Financial Instruments – Interest Rate Swaps” for additional information on unrealized loss on interest rate swap.

The following schedule summarizes the fair value of securities included in investments limited as to use that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of September 30, 2013 and 2012. The schedule further segregates the securities that have been in a gross unrealized position as of September 30, 2013 and 2012, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary.

The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in 2014. The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of September 30, 2013 and 2012.

Description of Securities	September 30, 2013					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government and government agency obligations	\$ 694,087	\$ 55,929	\$ -0-	\$ -0-	\$ 694,087	\$ 55,929
Common stocks	855,440	27,196	5,002,766	824,514	5,858,206	851,710
Mutual funds	65,761,106	1,823,587	3,167,881	385,522	68,928,987	2,209,109
Corporate bonds	602,146	23,958	595,078	40,208	1,197,224	64,166
Mortgage backed securities	442,987	6,025	190,834	14,505	633,821	20,530
Total temporarily impaired securities	\$ 68,355,766	\$ 1,936,695	\$ 8,956,559	\$ 1,264,749	\$ 77,312,325	\$ 3,201,444

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Description of Securities	September 30, 2012					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government and government agency obligations	\$ 1,725,604	\$ 3,053	\$ -0-	\$ -0-	\$ 1,725,604	\$ 3,053
Common stocks	1,069,138	55,171	6,252,512	1,672,637	7,321,650	1,727,808
Preferred stocks	112,806	712	-0-	-0-	112,806	712
Mutual funds	-0-	-0-	3,264,368	445,497	3,264,368	445,497
Corporate bonds	1,401,616	22,597	1,385,162	37,924	2,786,778	60,521
Mortgage backed securities	784,727	6,121	338,052	14,735	1,122,779	20,856
Total temporarily impaired securities	<u>\$ 5,093,891</u>	<u>\$ 87,654</u>	<u>\$ 11,240,094</u>	<u>\$ 2,170,793</u>	<u>\$ 16,333,985</u>	<u>\$ 2,258,447</u>

### 4. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

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

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

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used as of September 30, 2013 and 2012:

- *Common and preferred stocks*: Valued based on the closing price reported on the active market on which the individual securities are traded.
- *Mutual funds*: Valued based on quoted net asset values (NAV) of the shares held by the System at year-end. The NAV is based on the value of the underlying assets owned by the fund, minus its liabilities and then divided by the number of shares outstanding. The NAV is quoted in an active market.
- *US Government and government agency obligations*: Valued based on the closing price reported on the active market on which the securities are traded.
- *Corporate bonds and mortgage backed securities*: Valued using pricing models maximizing the use of observable inputs for similar securities.
- *Private equity investments*: Valued at the NAV of units of the fund. The NAV, as provided by the investment manager, is used as a practical expedient to estimate fair value. The private equity investments consist of investments in a variety of domestic and foreign equity and debt securities, managed accounts and other investment vehicles that employ diversified styles and strategies. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. Due to the nature of the investments held by the fund, changes in market conditions and the economic environment may significantly impact the NAV of the fund and, consequently, the fair value of the System's interests in the funds. Although a secondary market exists for these investments, it is not active and individual transactions are typically not observable. When transactions do occur in this limited secondary market, they may occur at discounts to the reported NAV. It is therefore reasonably possible that if the System were to sell these investments in the secondary market, a buyer may require a discount to the reported NAV, and the discount could be significant.
- *Derivative (Interest rate swap agreement)*: Valued using pricing models that are derived principally from observable market data based on discounted cash flows and interest rate yield curves at quoted intervals for the full term of the swap. See the note disclosure "Derivatives Financial Instruments – Interest Rate Swaps" for additional information related to derivatives.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 and 2012 are as follows:

	September 30, 2013			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Investments limited as to use				
Common stock				
Consumer	\$ 11,842,798	\$ 11,842,798	\$ -0-	\$ -0-
Financial services	5,810,740	5,810,740	-0-	-0-
Industrial and materials	11,721,325	11,721,325	-0-	-0-
Technology	7,613,140	7,613,140	-0-	-0-
Healthcare	4,479,982	4,479,982	-0-	-0-
Other	5,732,902	5,732,902	-0-	-0-
Total common stock	47,200,887	47,200,887	-0-	-0-
Mutual funds				
Intermediate term bond	124,089,597	124,089,597	-0-	-0-
International equity	24,600,641	24,600,641	-0-	-0-
Large cap	43,599,458	43,599,458	-0-	-0-
Mid cap	503,063	503,063	-0-	-0-
Other	1,069,416	1,069,416	-0-	-0-
Total mutual funds	193,862,175	193,862,175	-0-	-0-
US Government and government agency obligations				
	21,891,662	21,891,662	-0-	-0-
Corporate bonds				
Consumer	11,870,475	-0-	11,870,475	-0-
Financial services	15,700,658	-0-	15,700,658	-0-
Industrial and materials	13,937,654	-0-	13,937,654	-0-
International	5,005,484	-0-	5,005,484	-0-
Other	8,960,388	-0-	8,960,388	-0-
Total corporate bonds	55,474,659	-0-	55,474,659	-0-
Mortgage backed securities				
	17,716,358	-0-	17,716,358	-0-
Private equity				
	8,458,162	-0-	8,458,162	-0-
	344,603,903	\$ 262,954,724	\$ 81,649,179	\$ -0-
Cash and cash equivalents				
	8,884,951			
Accrued interest and other				
	1,349,835			
	<u>\$ 354,838,689</u>			
<b>Liabilities</b>				
Derivative				
	\$ 241,604	\$ -0-	\$ 241,604	\$ -0-

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

	September 30, 2012			
	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Investments limited as to use				
Common stock				
Consumer	\$ 9,935,385	\$ 9,935,385	\$ -0-	\$ -0-
Financial services	4,242,989	4,242,989	-0-	-0-
Industrial and materials	9,109,406	9,109,406	-0-	-0-
Technology	6,406,306	6,406,306	-0-	-0-
Healthcare	3,278,723	3,278,723	-0-	-0-
Other	3,905,686	3,905,686	-0-	-0-
Total common stock	36,878,495	36,878,495	-0-	-0-
Preferred stock				
Financial	420,747	420,747	-0-	-0-
Other	86,968	86,968	-0-	-0-
Total preferred stock	507,715	507,715	-0-	-0-
Mutual funds				
Intermediate term bond	99,949,527	99,949,527	-0-	-0-
International equity	16,820,866	16,820,866	-0-	-0-
Large cap	34,588,657	34,588,657	-0-	-0-
Small cap	1,233,567	1,233,567	-0-	-0-
Other	1,435,702	1,435,702	-0-	-0-
Total mutual funds	154,028,319	154,028,319	-0-	-0-
US Government and government agency obligations	21,758,526	21,758,526	-0-	-0-
Corporate bonds				
Consumer	4,111,625	-0-	4,111,625	-0-
Financial services	13,429,903	-0-	13,429,903	-0-
Industrial and materials	3,929,351	-0-	3,929,351	-0-
International	3,549,521	-0-	3,549,521	-0-
Other	5,004,487	-0-	5,004,487	-0-
Total corporate bonds	30,024,887	-0-	30,024,887	-0-
Mortgage backed securities	10,396,295	-0-	10,396,295	-0-
Private equity	6,777,561	-0-	6,777,561	-0-
	260,371,798	\$ 213,173,055	\$ 47,198,743	\$ -0-
Cash and cash equivalents	8,875,501			
Accrued interest and other	1,377,288			
	<u>\$ 270,624,587</u>			

The following table summarizes the private equity investments measured at fair value based on NAV per share as of September 30, 2013 and 2012:

Investment	September 30, 2013			
	Fair Value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Private equity	<u>\$ 8,458,162</u>	None	Monthly	45 days

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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	September 30, 2012			
<u>Investment</u>	<u>Fair Value</u>	<u>Unfunded Commitments</u>	<u>Redemption Frequency</u>	<u>Redemption Notice Period</u>
Private equity	<u>\$ 6,777,561</u>	None	Monthly	45 days

The System's policy is to recognize transfers between levels as of the end of the reporting period. There were no transfers during 2013 and 2012.

Realized gain and loss are reported in the consolidated statements of operations as a component of investment income. Net realized gains of approximately \$913,000 and \$309,000 were recorded during 2013 and 2012, respectively.

The market value of investments exceeded the cost by approximately \$25,222,000 and \$17,433,000 as of September 30, 2013 and 2012, respectively. The unrealized gain or loss is included in earnings for the period attributable to the change in unrealized gain or loss relating to assets held as of September 30, 2013 and 2012 and is reported in the consolidated statements of operations as net unrealized gain or loss on investments. During 2013 and 2012, the System recognized an unrealized gain of approximately of \$7,789,000 and \$20,241,000, respectively.

The System holds investments which are exposed to various risks such as interest rate, market, and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in the value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could materially affect the amounts reported in the accompanying consolidated financial statements.

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

Cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements: The carrying amount reported in the consolidated balance sheets for cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements approximate fair value based on short term maturity.

Long-term debt: Fair value of the System's fixed rate revenue bonds is based on current transacted value. The fair value of the System's remaining long-term debt approximates carrying value based upon the underlying nature of the related debt.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

### 5. LONG-TERM DEBT

The following is a summary of long-term debt as of September 30, 2013 and 2012:

	2013	2012
Hospital Revenue Bonds, Series 2009A Term bonds, payable annually from March 2036 through March 2039 in amounts ranging from \$9,890,000 to \$12,110,000 with interest; fixed rate 6.75%	\$ 43,900,000	\$ 57,340,000
Hospital Revenue Bonds, Series 2011A Term bonds, payable from March 2012 through March 2029 in amounts ranging from \$770,000 to \$1,630,000 with interest; rates ranging from 2.50% to 6.00%	18,475,000	19,305,000
Hospital Revenue Bonds, Series 2012A Term bonds, payable from March 2013 through March 2015 in amounts ranging from \$1,615,000 to \$3,370,000 with interest; fixed rate 1.58%	4,985,000	8,265,000
Hospital Revenue Bonds, Series 2012B Term bonds, payable from January 2013 through January 2022 in amounts ranging from \$880,000 to \$1,755,000 with interest; fixed rate 2.30%	12,125,000	-0-
Hospital Revenue Bonds, Series 2012C Term bonds, payable from January 2013 through January 2019 in amounts ranging from \$1,100,000 to \$1,625,000 with interest; fixed rate 2.28%	8,200,000	-0-
Hospital Revenue Bonds, Series 2013A Term bonds, payable from March 2016 through March 2035 in amounts ranging from \$470,000 to \$8,070,000 with interest; fixed rates ranging from 3.00% to 5.00%.	67,005,000	-0-
Hospital Revenue Bonds, Series 2013B Term bonds, payable from March 2014 through March 2029 in amounts ranging from \$1,000,000 to \$1,735,000 with interest; variable based on 70% of BBA LIBOR rate, 1.28% as of September 30, 2013	21,440,000	-0-
Hospital Revenue Bonds, Series 2013C Term bonds, payable from March 2016 through March 2039 in amounts ranging from \$250,000 to \$2,840,000 with interest; variable based on 67% of BBA LIBOR rate plus 90 basis points, 1.02% as of September 30, 2013	40,180,000	-0-

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

	2013	2012
Hospital Revenue Bonds, Series 1992 Serial bonds, Series 1999B Serial bonds, Series 2004A Term bonds, Series 2004B Serial bonds, Series 2009B Serial bonds all refinanced during 2013.	\$ -0-	139,155,000
Original issue premiums (discounts), net	3,033,405	(985,211)
Capital lease obligations, payable in installments ranging from \$22,000 to \$343,000 annually with interest ranging from 3.25% to 6.50%, expiring through January 2016, secured by equipment	2,062,654	4,782,061
Notes payable, due in monthly installments through September 2015; interest ranging from 4.85% to 8.00%, secured by equipment	1,897,455	1,489,761
	223,303,514	229,351,611
Less current portion	9,133,566	10,488,544
Long-term debt, net of current portion	\$ 214,169,948	\$ 218,863,067

During 2013, the System refinanced the Series 1992, Series 1999B, Series 2004A, Series 2004B and Series 2009B bonds and partially refinanced the Series 2009A bonds with the Series 2012B, Series 2012C and Series 2013A, 2013B and 2013C bonds which resulted in a loss of approximately \$6,181,000 which is recorded in nonoperating revenues (expenses) on the consolidated statements of operations.

During 2012, the System refinanced the Series 1999A bonds with the Series 2011A bonds. Also in 2012, the Series 1993 bonds were refinanced with the Series 2012A bonds. These 2012 refinancings resulted in a loss of approximately \$95,000 which is recorded in nonoperating revenues (expenses) on the consolidated statements of operations.

The Hospital Revenue Bonds were issued through the Indiana Finance Authority (Authority). During 2013 and 2012, the System, the Authority and Fifth Third Bank entered into Bond Purchase Contracts (Contracts) whereby Fifth Third purchased from the Authority all of the Series 2012A, 2012B, 2012C and 2013B bonds in a private placement. During 2013, the Series 2013C bonds were purchased from the Authority by Bank of America in a private placement.

Under the terms of the Contracts, Fifth Third and Bank of America agree to hold the Series 2012A, 2012B and 2012C bonds through the stated bond maturity dates. The Contracts for the Series 2013B and 2013C bonds are for 10 years through 2023. At the end of the Contract periods for the Series 2013B and 2013C bonds, these bonds could be remarketed to the original holders or to new investors at interest rate options as provided in the bond documents. If the Series 2013B and 2013C bonds cannot be remarketed at the end of the Contract periods, the System would be subject to payment of the remaining principal.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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During 2013, the System entered into an interest rate swap agreement with Fifth Third on the Series 2013B bonds. See the note disclosure "Derivatives Financial Instruments – Interest Rate Swaps" for additional information.

All of the Series bonds are secured by a security interest in the System's revenue. The System covenants that it will not permit any lien or security interest on the System facility other than certain permitted encumbrances. In addition, the various agreements require maintenance of certain debt service income ratios, limit additional borrowings, and require compliance with various other restrictive covenants.

The fair value of the fixed rate Hospital Revenue Bonds (Series 2009A, 2011A, 2012A, 2012B, 2012C and 2013A) approximated \$156,898,000 (carrying value of \$154,690,000) as of September 30, 2013. The fair value of the fixed rate obligations is estimated using discounted cash flow analyses, based on the Hospital's current incremental borrowing rates for similar types of borrowing arrangements. The fair value of variable rate debt (Series 2013B and 2013C) approximates its carrying value based on the underlying nature of the related debt.

The asset cost on the capital leased assets as of September 30, 2013 and 2012 was approximately \$15,675,000. The accumulated amortization on the capital leased assets as of September 30, 2013 and 2012 was approximately \$11,646,000 and \$8,327,000, respectively.

The net book value of the equipment securing the notes payable was approximately \$1,897,000 and \$1,490,000 as of September 30, 2013 and 2012, respectively.

As of September 30, 2013, the System had outstanding construction commitments of approximately \$820,000.

Aggregate maturities of long-term debt are as follows:

Year Ending September 30,	
2014	\$ 9,133,566
2015	7,080,607
2016	5,473,577
2017	5,479,744
2018	5,645,153
Thereafter	<u>190,490,867</u>
	<u><u>\$ 223,303,514</u></u>

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### 6. DERIVATIVE FINANCIAL INSTRUMENTS – INTEREST RATE SWAPS

#### Objectives and Strategies for Using Derivatives

The System makes limited use of derivative financial instruments for the purpose of managing interest rate risk. In particular, forward interest rate swaps (which are designated as cash flow hedges) are used to manage the risk associated with interest rates on variable-rate borrowings and to lower its overall borrowing costs.

As of September 30, 2013, the System had outstanding an interest rate swap agreement with Fifth Third, having a notional amount of \$21,440,000. The agreement effectively changes the System's interest rate exposure on its Series 2013B bonds through March 2029 to a fixed 2.78%. The interest rate swap agreement matures at the time the related long-term debt matures. The System is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreement. However, the System does not anticipate nonperformance by the counterparties.

The derivative is not designated as a hedging instrument, and is marked-to-market on the consolidated balance sheet at fair value. The related gains and losses are included in excess revenues over expenses, the performance indicator, for the reporting period. Cash flows from interest rate swap contracts are classified as an operating activity on the consolidated statement of cash flows.

The asset derivatives are reported in the consolidated balance sheets as other assets and liability derivatives are reported as derivative liabilities in the other long-term liabilities. As of September 30, 2013 and 2012, the fair values of derivatives recorded in the consolidated balance sheets are as follows:

	<u>2013</u>	<u>2012</u>
Other long-term liabilities		
Derivative liability	\$ 241,604	\$ -0-

During 2013 and 2012, the amount of gain or loss recognized in the consolidated statements of operations and reported as a component of investment income under nonoperating revenues (expenses) is as follows:

	<u>2013</u>	<u>2012</u>
Nonoperating revenues (expenses)		
Investment income		
Unrealized loss on derivative	\$ (241,604)	\$ -0-

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# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### 7. PENSION PLANS

The System offers a noncontributory defined benefit pension plan covering eligible employees. Benefits are based on each participant's years of service and compensation. Contributions to the plan are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants. During 2012, the defined benefit pension plan was closed to new participants. Additionally, changes were made to benefit accruals for certain participants. Participants should refer to the plan document for more complete information.

The following table sets forth the funded status of the defined benefit plan and amounts recognized in the financial statements as of and for the years ended September 30, 2013 and 2012.

	2013	2012
Change in benefit obligation		
Benefit obligation, beginning of year	\$ 239,926,176	\$ 190,785,744
Service cost	6,516,848	5,395,127
Interest cost	9,717,358	9,827,839
Benefits paid	(4,682,057)	(4,342,253)
Actuarial (gain) loss	(20,497,368)	38,259,719
Benefit obligation, end of year	\$ 230,980,957	\$ 239,926,176
Changes in plan assets		
Fair value of plan assets, beginning of year	\$ 155,437,444	\$ 126,825,040
Actual return on plan assets	17,981,000	24,950,657
Employer contributions	8,004,000	8,004,000
Benefits paid	(4,682,057)	(4,342,253)
Fair value of plan assets, end of year	\$ 176,740,387	\$ 155,437,444
Funded status		
Funded status of the plan, end of year	\$ (54,240,570)	\$ (84,488,732)
Amounts recognized in the consolidated balance sheets consist of		
Other long-term liabilities	\$ (54,240,570)	\$ (84,488,732)

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

Other pension disclosures for 2013 and 2012 include:

	2013	2012
Amounts not yet reflected in net periodic benefit cost and included in other changes in unrestricted net assets		
Prior service cost	\$ (5,784)	\$ (10,006)
Accumulated loss	(58,743,359)	(90,624,030)
Other changes in unrestricted net assets	(58,749,143)	(90,634,036)
Cumulative employer contributions in excess of net periodic pension cost	4,508,573	6,145,304
Net amount recognized in the consolidated balance sheets	\$ (54,240,570)	\$ (84,488,732)
Components of net periodic benefit cost		
Service cost	\$ 6,516,848	\$ 5,395,127
Interest cost	9,717,358	9,827,839
Expected return on plan assets	(12,883,679)	(11,519,349)
Amortization of prior year service cost	4,222	8,105
Amortization of loss	6,285,982	4,235,926
Curtailment loss recognized	-0-	48,450
Net periodic benefit cost	\$ 9,640,731	\$ 7,996,098
Other changes in unrestricted net assets		
Net loss (gain) arising during year	\$ (25,594,686)	\$ 24,828,411
Amortization of prior service cost	(4,222)	(56,555)
Amortization of loss	(6,285,982)	(4,235,926)
Total other changes in unrestricted net assets	\$ (31,884,890)	\$ 20,535,930
Estimated amounts that will be amortized from other changes in unrestricted net assets over the next fiscal year		
Amortization of prior service (cost) credit	\$ (4,222)	
Amortization of loss	\$ (6,285,982)	
Weighted-average actuarial assumptions to determine benefit obligations of September 30		
Discount rate	4.65%	4.10%
Rate of compensation increase	3.50%	3.50%
Measurement date	9/30/13	9/30/12

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

	2013	2012
Weighted-average actuarial assumptions to determine net periodic pension cost as of September 30		
Discount rate	4.10%	5.40%
Expected long-term rate of return	8.25%	8.50%
Rate of compensation increase	3.50%	3.50%
Additional year end information		
Projected benefit obligation	\$ 230,980,957	\$ 239,926,176
Accumulated benefit obligation	\$ 214,810,674	\$ 221,536,482
Fair value of plan assets	\$ 176,740,387	\$ 155,437,444

The following is a schedule by year of expected benefit payments as of September 30, 2013

Year Ending September 30,	
2014	\$ 6,410,549
2015	7,140,113
2016	7,814,409
2017	8,641,312
2018	9,643,068
2019-2023	63,718,482
	\$ 103,367,933

Determination of net periodic pension cost for the years ended September 30, 2013 and 2012 is based on assumptions and census data as of January 1, 2013 and 2012, respectively.

The principal long-term determinant of a portfolio's investment return is its asset allocation. The plan allocation includes growth assets (60%) and fixed income (40%). In addition, active management strategies have added value relative to passive benchmark returns. The expected long-term rate of return assumption is based on the mix of assets in the plan, the long-term earnings expected to be associated with each asset class, and the additional return expected through active management. This assumption is periodically benchmarked against peer plans.

The amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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The plan's weighted-average, asset allocations as of September 30, 2013 and 2012, by asset category, are as follows:

	<u>2013</u>	<u>2012</u>
Equity		
Mutual funds	37%	34%
Common/collective trusts	19%	17%
Common stocks	<u>4%</u>	<u>4%</u>
Total equity	<u>60%</u>	<u>55%</u>
Fixed income		
Mutual funds	28%	32%
Common/collective trusts	<u>8%</u>	<u>9%</u>
Total fixed income	<u>36%</u>	<u>41%</u>
Private equity	<u>4%</u>	<u>4%</u>
	<u>100%</u>	<u>100%</u>

The allocation strategy for the plan currently comprises approximately 50% to 70% growth investments (target of 60%) and 30% to 50% fixed-income investments (target of 40%). Within the growth investment classification, the plan asset strategy encompasses equity and equity-like instruments that are expected to represent approximately 60% of the System's plan asset portfolio of both public and private market investments. The largest component of these equity and equity-like instruments is public equity securities that are well diversified and invested in U.S. and international companies.

Fair value of mutual funds and marketable equity securities are based on the quoted prices in active markets. Common/collective trusts are valued at the net asset value on a private market that is not active. However, the underlying investments are traded on an active market. The fair value of the private equity funds is valued at the percentage ownership of the net asset value as reported to the plan by the individual managers.

## DEACONESS HEALTH SYSTEM

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

The following is an analysis of fair value of the major classes of plan assets of September 30, 2013 and 2012:

	2013	2012
Level 1		
Mutual funds		
Intermediate bond	\$ 48,608,483	\$ 48,159,718
Large blend	55,641,005	34,384,374
Foreign	9,049,723	18,292,164
Total mutual funds	113,299,211	100,836,256
Common stocks		
Financial services	1,946,556	1,199,403
Industrial and materials	1,653,088	1,919,907
Other	3,599,567	2,564,466
Total common stocks	7,199,211	5,683,776
Total Level 1	120,498,422	106,520,032
Level 2		
Common/collective trusts	46,970,272	39,649,817
Private equity	7,879,222	6,247,198
Total Level 2	54,849,494	45,897,015
	175,347,916	152,417,047
Cash equivalents	1,392,471	3,020,397
	\$ 176,740,387	\$ 155,437,444

The System expects to contribute in excess of the required funding amounts to its pension plan in 2014, currently approximating \$8,000,000.

The System also offers a 401k plan to eligible employees. During 2012, the System changed the 401k plan to enhance employer contributions for discretionary and matching amounts. Total expense for the System's contributions for eligible employees for 2013 and 2012 was approximately \$7,751,000 and \$6,667,000, respectively.

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### 8. RELATED PARTY TRANSACTIONS

The Hospital is a joint-owner of The Women's Hospital. The Hospital owns the building in which The Women's Hospital is located and leases the space to The Women's Hospital currently at approximately \$230,000 per month with an option to increase that amount annually through 2031. The Hospital provides ancillary services (lab, radiology) for The Women's Hospital. Ancillary services provided were approximately \$2,015,000 and \$2,241,000 in 2013 and 2012, respectively. The Hospital also has notes receivable due from The Women's Hospital for equipment. The balance of the notes receivable was approximately \$89,000 and \$152,000 as of September 30, 2013 and 2012, respectively.

The Hospital is a joint owner of Evansville Surgery Center Associates, LLC (Surgery Center). The Hospital recorded contract service expense related to the Surgery Center of approximately \$29,488,000 in 2013 and \$28,922,000 in 2012. As of September 30, 2013 and 2012, the Hospital had a liability to the Surgery Center of approximately \$3,380,000 and \$3,091,000, respectively.

The Hospital is a joint-owner of HealthSouth Deaconess Rehabilitation Hospital. The Hospital provides ancillary services (lab, radiology) to HealthSouth Deaconess Rehabilitation Hospital. Ancillary services provided were approximately \$747,000 and \$684,000 in 2013 and 2012, respectively.

### 9. COMMITMENTS AND CONTINGENCIES

#### Operating leases

The System leases various equipment and facilities under operating leases expiring at various dates through 2023. Total lease expense for 2013 and 2012 was approximately \$11,632,000 and \$11,506,000, respectively. The following are the minimum lease payments for the years after September 30, 2013:

<u>Year Ending September 30,</u>	
2014	\$ 12,530,000
2015	11,542,000
2016	8,853,000
2017	7,585,000
2018	6,221,000
Thereafter	<u>19,788,000</u>
	<u>\$ 66,519,000</u>

# DEACONESS HEALTH SYSTEM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2013 AND 2012

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### Litigation

The System is involved in litigation and regulatory matters arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the System's future financial position, results from operations or cash flows.

### Health Insurance

The System's employee health care insurance is provided through a combination of insured, self-insured and purchased re-insurance coverage from a commercial carrier. The System maintains an estimated liability for the amount of claims incurred but not reported. Substantially all employees are covered for major medical benefits. The self-insured health coverage carries a stop-loss maximum of \$300,000 per case with no aggregate limit.

SUPPLEMENTARY INFORMATION

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING BALANCE SHEETS SEPTEMBER 30, 2013

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC	Regional Emergency Department Staffing, LLC
<b>Assets</b>										
Current assets										
Cash and cash equivalents	\$ 52,866,996	\$ -0-	\$ 44,904,015	\$ -0-	\$ 853,117	\$ 2,710,951	\$ 1,762,983	\$ 2,035,930	\$ -0-	\$ 600,000
Funds held by trustee, current portion	4,351,163	-0-	4,351,163	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Patient accounts receivable, net	91,926,203	-0-	77,039,261	7,333,226	102,878	6,725,421	701,624	-0-	-0-	23,793
Inventories	6,390,227	-0-	5,518,992	-0-	3,540	867,695	-0-	-0-	-0-	-0-
Prepaid expenses and other current assets	13,611,494	(1,564,847)	11,762,045	1,881,587	1,264,216	68,619	59,249	-0-	57,375	83,250
Total current assets	169,146,083	(1,564,847)	143,575,476	9,214,813	2,223,751	10,372,686	2,523,856	2,035,930	57,375	707,043
Investments limited as to use, less current portion										
Board designated funds	338,628,898	-0-	338,628,898	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Board designated funds - Foundation	6,227,279	-0-	6,227,279	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Donor restricted - Foundation	5,631,349	-0-	5,631,349	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total investments limited as to use	350,487,526	-0-	350,487,526	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Property and equipment										
Land and improvements	18,499,820	-0-	18,499,820	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Buildings and improvements	512,219,948	-0-	511,570,647	-0-	8,046	-0-	641,255	-0-	-0-	-0-
Furniture, fixtures and equipment	268,889,761	-0-	249,123,074	8,597,097	89,491	7,811,169	3,006,528	204,402	58,000	-0-
	799,609,529	-0-	779,193,541	8,597,097	97,537	7,811,169	3,647,783	204,402	58,000	-0-
Less allowances for depreciation	466,548,646	-0-	456,320,259	4,902,034	72,823	3,391,399	1,659,429	194,902	7,800	-0-
	333,060,883	-0-	322,873,282	3,695,063	24,714	4,419,770	1,988,354	9,500	50,200	-0-
Construction in progress	5,059,421	-0-	4,690,150	216,902	-0-	152,369	-0-	-0-	-0-	-0-
Total property and equipment, net	338,120,304	-0-	327,563,432	3,911,965	24,714	4,572,139	1,988,354	9,500	50,200	-0-
Other assets										
Deferred financing costs	1,339,386	-0-	1,339,386	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Investments in joint ventures	22,824,794	(15,763,492)	38,490,468	97,818	-0-	-0-	-0-	-0-	-0-	-0-
Goodwill	22,217,481	-0-	15,522,010	36,656	-0-	6,658,815	-0-	-0-	-0-	-0-
Other	13,099,377	-0-	13,071,940	12,204	14,333	-0-	900	-0-	-0-	-0-
Total other assets	59,481,038	(15,763,492)	68,423,804	146,678	14,333	6,658,815	900	-0-	-0-	-0-
Total assets	\$ 917,234,951	\$ (17,328,339)	\$ 890,050,238	\$ 13,273,456	\$ 2,262,798	\$ 21,603,640	\$ 4,513,110	\$ 2,045,430	\$ 107,575	\$ 707,043

See report of independent auditors on pages 1 and 2.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING BALANCE SHEETS SEPTEMBER 30, 2013

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC	Regional Emergency Department Staffing, LLC
<b>Liabilities and net assets</b>										
Current liabilities										
Accounts payable and other current liabilities	\$ 31,702,536	\$ (1,564,847)	\$ 26,993,895	\$ 1,398,499	\$ 166,594	\$ 3,748,930	\$ 711,424	\$ 32,282	\$ 94,078	\$ 121,681
Salaries, wages and related liabilities	42,681,091	-0-	33,861,352	8,114,862	533,952	-0-	170,925	-0-	-0-	-0-
Estimated third-party payor settlements	8,406,371	-0-	6,224,177	-0-	-0-	2,182,194	-0-	-0-	-0-	-0-
Accrued interest	659,528	-0-	657,615	-0-	-0-	1,913	-0-	-0-	-0-	-0-
Current portion of long-term debt	9,133,566	-0-	7,934,609	-0-	-0-	229,291	969,666	-0-	-0-	-0-
Total current liabilities	92,583,092	(1,564,847)	75,671,648	9,513,361	700,546	6,162,328	1,852,015	32,282	94,078	121,681
Long-term liabilities										
Long-term debt, less current portion	214,169,948	-0-	213,223,278	-0-	-0-	862,541	84,129	-0-	-0-	-0-
Other long-term liabilities	61,176,553	-0-	61,125,664	-0-	-0-	-0-	50,889	-0-	-0-	-0-
Total long-term liabilities	275,346,501	-0-	274,348,942	-0-	-0-	862,541	135,018	-0-	-0-	-0-
Total liabilities	367,929,593	(1,564,847)	350,020,590	9,513,361	700,546	7,024,869	1,987,033	32,282	94,078	121,681
Net assets										
Unrestricted	534,398,299	(25,039,202)	534,398,299	3,760,095	1,562,252	14,578,771	2,526,077	2,013,148	13,497	585,362
Temporarily restricted	3,782,581	-0-	3,782,581	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Permanently restricted	1,848,768	-0-	1,848,768	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets - controlling interest	540,029,648	(25,039,202)	540,029,648	3,760,095	1,562,252	14,578,771	2,526,077	2,013,148	13,497	585,362
Non-controlling interest	9,275,710	9,275,710	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total net assets	549,305,358	(15,763,492)	540,029,648	3,760,095	1,562,252	14,578,771	2,526,077	2,013,148	13,497	585,362
Total liabilities and net assets	\$ 917,234,951	\$ (17,328,339)	\$ 890,050,238	\$ 13,273,456	\$ 2,262,798	\$ 21,603,640	\$ 4,513,110	\$ 2,045,430	\$ 107,575	\$ 707,043

See report of independent auditors on pages 1 and 2.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING STATEMENTS OF OPERATIONS YEAR ENDED SEPTEMBER 30, 2013

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC	Regional Emergency Department Staffing, LLC
<b>Unrestricted revenue and other support</b>										
Net patient service revenue	\$ 698,254,409	\$ -0-	\$ 582,981,238	\$ 57,665,542	\$ 960,564	\$ 49,455,253	\$ 7,168,019	\$ -0-	\$ -0-	\$ 23,793
Less provision for bad debts	40,449,714	-0-	38,264,096	1,064,642	844	1,076,889	43,243	-0-	-0-	-0-
Net patient service revenue net of provision for bad debts	657,804,695	-0-	544,717,142	56,600,900	959,720	48,378,364	7,124,776	-0-	-0-	23,793
Other revenue	37,754,865	(5,585,901)	22,989,071	4,061,160	13,981,699	1,061,141	-0-	1,161,685	2,760	83,250
Total unrestricted revenue and other support	695,559,560	(5,585,901)	567,706,213	60,662,060	14,941,419	49,439,505	7,124,776	1,161,685	2,760	107,043
<b>Expenses</b>										
Salaries and wages	260,654,326	-0-	202,885,317	48,805,223	7,155,711	-0-	1,359,801	448,274	-0-	-0-
Employee benefits	76,684,011	-0-	66,377,788	8,845,717	1,132,234	-0-	178,708	149,564	-0-	-0-
Supplies	115,003,737	-0-	94,525,891	5,702,297	61,402	14,577,272	106,678	26,444	3,753	-0-
Contract services	67,198,801	(13,979,849)	53,107,534	7,115,511	1,483,926	18,154,773	771,994	39,116	384,115	121,681
Repairs and maintenance	20,335,459	-0-	19,494,887	461,776	6,491	365,685	-0-	-0-	6,620	-0-
Depreciation	44,914,865	-0-	42,476,041	1,202,349	12,283	612,481	603,098	813	7,800	-0-
Interest	8,722,770	-0-	8,603,870	-0-	-0-	1,913	116,987	-0-	-0-	-0-
Utilities	12,663,308	-0-	10,655,692	1,616,658	42,842	277,812	57,075	12,509	720	-0-
Other	41,023,216	(2,054,132)	30,337,996	6,979,629	520,075	3,874,155	1,112,482	137,043	115,968	-0-
Total expenses	647,200,493	(16,033,981)	528,465,016	80,729,160	10,414,964	37,864,091	4,306,823	813,763	518,976	121,681
Income (loss) from operations	48,359,067	10,448,080	39,241,197	(20,067,100)	4,526,455	11,575,414	2,817,953	347,922	(516,216)	(14,638)
<b>Nonoperating revenues (expenses)</b>										
Investment income	10,653,357	-0-	10,480,803	168,509	-0-	2,568	-0-	1,477	-0-	-0-
Contributions, gifts, and bequests	811,361	-0-	811,361	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Grants	(1,604,543)	-0-	(1,604,543)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Loss on bond defeasance	(6,180,741)	-0-	(6,180,741)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total nonoperating revenues (expenses)	3,679,434	-0-	3,506,880	168,509	-0-	2,568	-0-	1,477	-0-	-0-
Excess revenues over (under) expenses	52,038,501	10,448,080	42,748,077	(19,898,591)	4,526,455	11,577,982	2,817,953	349,399	(516,216)	(14,638)
<b>Other changes in unrestricted net assets</b>										
Net unrealized gain on investments	7,694,976	-0-	7,694,976	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Pension related changes other than net periodic pension cost	31,884,890	-0-	31,884,890	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	324,309	-0-	324,309	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Capital contributions	-0-	(21,772,413)	-0-	20,613,264	-0-	-0-	-0-	-0-	559,149	600,000
Distributions	(8,750,992)	9,502,628	-0-	-0-	(4,419,140)	(10,931,171)	(2,460,000)	(443,309)	-0-	-0-
Change in unrestricted net assets	83,191,684	(1,821,705)	82,652,252	714,673	107,315	646,811	357,953	(93,910)	42,933	585,362
<b>Temporarily restricted net assets</b>										
Contributions, gifts, and bequests	664,129	-0-	664,129	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net unrealized gain on investments	93,903	-0-	93,903	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Investment income	55,016	-0-	55,016	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	(324,309)	-0-	(324,309)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Change in temporarily restricted net assets	488,739	-0-	488,739	-0-	-0-	-0-	-0-	-0-	-0-	-0-
<b>Permanently restricted net assets</b>										
Contributions, gifts, and bequests	85,722	-0-	85,722	-0-	-0-	-0-	-0-	-0-	-0-	-0-
<b>Change in net assets</b>	<u>\$ 83,766,145</u>	<u>\$ (1,821,705)</u>	<u>\$ 83,226,713</u>	<u>\$ 714,673</u>	<u>\$ 107,315</u>	<u>\$ 646,811</u>	<u>\$ 357,953</u>	<u>\$ (93,910)</u>	<u>\$ 42,933</u>	<u>\$ 585,362</u>

See report of independent auditors on pages 1 and 2.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATING BALANCE SHEETS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2013

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Assets</b>				
Current assets				
Cash and cash equivalents	\$ 44,904,015	\$ -0-	\$ 1,538,487	\$ 43,365,528
Funds held by trustee, current portion	4,351,163	-0-	-0-	4,351,163
Patient accounts receivable, net	77,039,261	-0-	-0-	77,039,261
Inventories	5,518,992	-0-	-0-	5,518,992
Prepaid expenses and other current assets	11,762,045	(154,726)	171,473	11,745,298
Total current assets	143,575,476	(154,726)	1,709,960	142,020,242
Investments limited as to use, less current portion				
Board designated funds	338,628,898	-0-	-0-	338,628,898
Board designated funds - Foundation	6,227,279	-0-	-0-	6,227,279
Donor restricted - Foundation	5,631,349	-0-	-0-	5,631,349
Total investments limited as to use	350,487,526	-0-	-0-	350,487,526
Property and equipment				
Land and improvements	18,499,820	-0-	3,460,502	15,039,318
Buildings and improvements	511,570,647	-0-	39,353,218	472,217,429
Furniture, fixtures and equipment	249,123,074	-0-	224,545	248,898,529
	779,193,541	-0-	43,038,265	736,155,276
Less allowances for depreciation	456,320,259	-0-	28,093,512	428,226,747
	322,873,282	-0-	14,944,753	307,928,529
Construction in progress	4,690,150	-0-	77,204	4,612,946
Total property and equipment, net	327,563,432	-0-	15,021,957	312,541,475
Other assets				
Deferred financing costs	1,339,386	-0-	-0-	1,339,386
Investments in joint ventures	38,490,468	-0-	3,773,590	34,716,878
Goodwill	15,522,010	-0-	-0-	15,522,010
Other	13,071,940	(73,229)	-0-	13,145,169
Total other assets	68,423,804	(73,229)	3,773,590	64,723,443
Total assets	\$ 890,050,238	\$ (227,955)	\$ 20,505,507	\$ 869,772,686

See report of independent auditors on pages 1 and 2.

## DEACONESS HEALTH SYSTEM

### CONSOLIDATING BALANCE SHEETS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2013

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Liabilities and net assets</b>				
Current liabilities				
Accounts payable and other current liabilities	\$ 26,993,895	\$ (154,726)	\$ 708,448	\$ 26,440,173
Salaries, wages and related liabilities	33,861,352	-0-	-0-	33,861,352
Estimated third-party payor settlements	6,224,177	-0-	-0-	6,224,177
Accrued interest	657,615	-0-	-0-	657,615
Current portion of long-term debt	7,934,609	-0-	-0-	7,934,609
Total current liabilities	<u>75,671,648</u>	<u>(154,726)</u>	<u>708,448</u>	<u>75,117,926</u>
Long-term liabilities				
Long-term debt, less current portion	213,223,278	-0-	-0-	213,223,278
Other long-term liabilities	<u>61,125,664</u>	<u>-0-</u>	<u>-0-</u>	<u>61,125,664</u>
Total long-term liabilities	<u>274,348,942</u>	<u>-0-</u>	<u>-0-</u>	<u>274,348,942</u>
Total liabilities	350,020,590	(154,726)	708,448	349,466,868
Net assets				
Unrestricted	534,398,299	(73,229)	19,797,059	514,674,469
Temporarily restricted	3,782,581	-0-	-0-	3,782,581
Permanently restricted	<u>1,848,768</u>	<u>-0-</u>	<u>-0-</u>	<u>1,848,768</u>
Net assets - controlling interest	540,029,648	(73,229)	19,797,059	520,305,818
Non-controlling interest	-0-	-0-	-0-	-0-
Total net assets	<u>540,029,648</u>	<u>(73,229)</u>	<u>19,797,059</u>	<u>520,305,818</u>
Total liabilities and net assets	<u>\$ 890,050,238</u>	<u>\$ (227,955)</u>	<u>\$ 20,505,507</u>	<u>\$ 869,772,686</u>

See report of independent auditors on pages 1 and 2.

# DEACONESS HEALTH SYSTEM

## CONSOLIDATING STATEMENTS OF OPERATIONS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP YEAR ENDED SEPTEMBER 30, 2013

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Unrestricted revenue and other support</b>				
Net patient service revenue	\$ 582,981,238	\$ -0-	\$ -0-	\$ 582,981,238
Less provision for bad debts	38,264,096	-0-	-0-	38,264,096
Net patient service revenue net of provision for bad debts	544,717,142	-0-	-0-	544,717,142
Other revenue (expense)	22,989,071	(1,688,564)	(17,045,601)	41,723,236
Total unrestricted revenue and other support	567,706,213	(1,688,564)	(17,045,601)	586,440,378
<b>Expenses</b>				
Salaries and wages	202,885,317	-0-	-0-	202,885,317
Employee benefits	66,377,788	-0-	-0-	66,377,788
Supplies	94,525,891	-0-	9,407	94,516,484
Contract services	53,107,534	-0-	1,165,136	51,942,398
Repairs and maintenance	19,494,887	-0-	390,181	19,104,706
Depreciation	42,476,041	-0-	984,254	41,491,787
Interest	8,603,870	-0-	-0-	8,603,870
Utilities	10,655,692	-0-	588,321	10,067,371
Other	30,337,996	(1,688,564)	255,261	31,771,299
Total expenses	528,465,016	(1,688,564)	3,392,560	526,761,020
Income (loss) from operations	39,241,197	-0-	(20,438,161)	59,679,358
<b>Nonoperating revenues (expenses)</b>				
Investment income	10,480,803	-0-	3,231	10,477,572
Contributions, gifts, and bequests	811,361	-0-	-0-	811,361
Grants	(1,604,543)	-0-	-0-	(1,604,543)
Loss on bond defeasance	(6,180,741)	-0-	-0-	(6,180,741)
Total nonoperating revenues (expenses)	3,506,880	-0-	3,231	3,503,649
Excess revenues over (under) expenses	42,748,077	-0-	(20,434,930)	63,183,007
<b>Other changes in unrestricted net assets</b>				
Net unrealized gain on investments	7,694,976	-0-	-0-	7,694,976
Pension related changes other than net periodic pension cost	31,884,890	-0-	-0-	31,884,890
Net assets released from restriction	324,309	-0-	-0-	324,309
Transfers	-0-	-0-	20,613,264	(20,613,264)
Change in unrestricted net assets	82,652,252	-0-	178,334	82,473,918
<b>Temporarily restricted net assets</b>				
Contributions, gifts, and bequests	664,129	-0-	-0-	664,129
Net unrealized gain on investments	93,903	-0-	-0-	93,903
Investment income	55,016	-0-	-0-	55,016
Net assets released from restriction	(324,309)	-0-	-0-	(324,309)
Change in temporarily restricted net assets	488,739	-0-	-0-	488,739
<b>Permanently restricted net assets</b>				
Contributions, gifts, and bequests	85,722	-0-	-0-	85,722
<b>Consolidated change in net assets</b>	<b>\$ 83,226,713</b>	<b>\$ -0-</b>	<b>\$ 178,334</b>	<b>\$ 83,048,379</b>

See report of independent auditors on pages 1 and 2.