

**Franciscan Alliance, Inc.  
and Affiliates**

**Consolidated Financial Statements  
December 31, 2013 and 2012**

**Franciscan Alliance, Inc. and Affiliates**  
**Index**  
**December 31, 2013 and 2012**

---

	<b>Page(s)</b>
<b>Independent Auditor's Report</b> .....	1
<b>Consolidated Financial Statements</b>	
Consolidated Balance Sheets .....	2
Consolidated Statements of Operations and Changes in Net Assets .....	3-4
Consolidated Statements of Cash Flows .....	5
Notes to Consolidated Financial Statements .....	6-37



## Independent Auditor's Report

Board of Trustees  
Franciscan Alliance, Inc.  
Mishawaka, Indiana

We have audited the accompanying consolidated financial statements of Franciscan Alliance, Inc. and Affiliates (collectively referred to as the "Corporation"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations and changes in net assets and of cash flows for the years then ended.

### ***Management's Responsibility for the Consolidated Financial Statements***

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

### ***Auditor's Responsibility***

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Corporation'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 Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Corporation at December 31, 2013 and 2012 and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*PricewaterhouseCoopers LLP*

April 30, 2014

**Franciscan Alliance, Inc. and Affiliates**  
**Consolidated Balance Sheets**  
**December 31, 2013 and 2012**  
(In thousands)

	2013	2012	2013	2012
<b>Assets</b>				
Current assets				
Cash and cash equivalents	\$ 42,371	\$ 44,626	\$ 22,029	\$ 22,103
Short-term investments	222,535	192,097	193,706	228,870
Patient accounts receivable, net of allowance for doubtful accounts of \$42,994 in 2013 and \$42,917 in 2012	312,109	336,243	116,456	110,656
Inventories of supplies	37,936	39,855	29,043	34,420
Other current assets	74,866	123,365	361,234	396,049
<b>Total current assets</b>	<b>689,817</b>	<b>736,186</b>	<b>1,097,229</b>	<b>1,116,075</b>
Board designated and other investments	1,872,509	1,726,697	58,491	102,208
Property, plant, and equipment, net	1,587,214	1,570,193	107,269	426,629
Investments in unconsolidated affiliates	23,355	21,378	130,293	130,132
Goodwill	24,541	21,361	46,580	57,944
Intangible assets, net of accumulated amortization of \$16,412 in 2013 and \$10,554 in 2012	11,661	19,077	2,445,725	1,904,372
Other assets	105,238	96,314	30,791	28,376
<b>Total assets</b>	<b>\$ 4,314,335</b>	<b>\$ 4,191,206</b>	<b>\$ 4,314,335</b>	<b>\$ 4,191,206</b>
<b>Liabilities and Net Assets</b>				
Current liabilities				
Current portion of long-term debt				
Accounts payable and accrued expenses				
Accrued payroll and related expenses				
Estimated third-party payor settlements				
<b>Total current liabilities</b>			<b>1,801,096</b>	<b>2,229,037</b>
Long-term debt, net of current portion				
Fair value of interest rate swap contracts				
Accrued pension liability				
Estimated insurance liabilities				
Other liabilities				
<b>Total liabilities</b>			<b>1,801,096</b>	<b>2,229,037</b>
Net assets				
Unrestricted				
Noncontrolling interests in consolidated affiliates				
<b>Total unrestricted net assets</b>			<b>2,476,516</b>	<b>1,932,748</b>
Temporarily restricted			19,415	17,559
Permanently restricted			17,308	11,862
<b>Total net assets</b>			<b>2,513,239</b>	<b>1,962,169</b>
<b>Total liabilities and net assets</b>			<b>\$ 4,314,335</b>	<b>\$ 4,191,206</b>

The accompanying notes are an integral part of these consolidated financial statements.

**Franciscan Alliance, Inc. and Affiliates**  
**Consolidated Statements of Operations and Changes in Net Assets**  
**Years Ended December 31, 2013 and 2012**  
(In thousands)

	2013	2012
<b>Unrestricted revenues, gains, and other support</b>		
Patient service revenue, net of contractual allowances and discounts	\$ 2,425,218	\$ 2,460,016
Provision for doubtful accounts	<u>(103,921)</u>	<u>(106,994)</u>
Net patient service revenue	2,321,297	2,353,022
Capitation and premium revenue	118,670	134,779
Other operating revenue	152,211	126,525
Equity in earnings of investments in unconsolidated affiliates	6,254	5,001
Net unrealized investment gains	8,408	5,533
Net assets released from restrictions used for operations	<u>1,709</u>	<u>2,001</u>
Total unrestricted revenues, gains and other support	<u>2,608,549</u>	<u>2,626,861</u>
<b>Operating expenses</b>		
Salaries	1,018,658	1,000,612
Employee benefits	316,765	290,012
Physicians' fees	56,237	52,721
Utilities	43,158	43,031
Repairs and maintenance	39,949	41,115
Drugs and pharmaceuticals	122,252	95,961
Medical supplies	195,546	189,503
Insurance	29,220	38,749
Purchased services	259,997	253,927
Other supplies and expenses	313,000	340,145
Interest	36,793	35,133
Depreciation and amortization	<u>140,287</u>	<u>136,171</u>
Total operating expenses before asset impairment	<u>2,571,862</u>	<u>2,517,080</u>
Operating income before asset impairment	36,687	109,781
Asset impairment	<u>-</u>	<u>(30,000)</u>
Operating income	<u>36,687</u>	<u>79,781</u>
<b>Other income (expense)</b>		
Investment income	67,203	82,065
Net unrealized investment gains on trading securities	117,126	76,311
Net unrealized gains (losses) and periodic settlements on interest rate swap contracts	29,486	(10,673)
Gain (loss) on sale/disposal of assets	2,504	(1,045)
Net assets released from restrictions	2,680	1,318
Contributions	1,160	431
Other, net	<u>(12,807)</u>	<u>(5,040)</u>
Total other income, net	<u>207,352</u>	<u>143,367</u>
Excess of revenues over expenses	<u>\$ 244,039</u>	<u>\$ 223,148</u>

The accompanying notes are an integral part of these consolidated financial statements.

**Franciscan Alliance, Inc. and Affiliates**  
**Consolidated Statements of Operations and Changes in Net Assets (cont.)**  
**Years Ended December 31, 2013 and 2012**  
(In thousands)

	2013	2012
<b>Unrestricted net assets, controlling interest</b>		
Excess of revenues over expenses	\$ 224,305	\$ 204,073
Change in pension and postretirement benefits other than net periodic pension costs included in accrued pension liability	319,727	(116,529)
Other, net	(4,612)	(241)
Contributions of PPE	74	-
Net assets released from restrictions used for purchase of property, plant, and equipment	<u>1,859</u>	<u>1,658</u>
Increase in unrestricted net assets, controlling interest	<u>541,353</u>	<u>88,961</u>
<b>Unrestricted net assets, noncontrolling interest</b>		
Excess of revenues over expenses	19,734	19,075
Distributions	<u>(17,319)</u>	<u>(19,082)</u>
Increase (decrease) in unrestricted net assets, noncontrolling interest	2,415	(7)
<b>Temporarily restricted net assets, controlling interest</b>		
Contributions	5,154	3,498
Investment income	194	366
Net assets released from restrictions	(6,248)	(4,977)
Net unrealized investment gains	93	100
Other, net	<u>2,663</u>	<u>774</u>
Increase (decrease) in temporarily restricted net assets, controlling interest	<u>1,856</u>	<u>(239)</u>
<b>Permanently restricted net assets, controlling interest</b>		
Contributions	16	15
Investment income	175	95
Net unrealized investment gains (losses)	247	(64)
Other, net	<u>5,008</u>	<u>(119)</u>
Increase (decrease) in permanently restricted net assets, controlling interest	<u>5,446</u>	<u>(73)</u>
Increase in net assets	551,070	88,642
Net assets, beginning of the year	<u>1,962,169</u>	<u>1,873,527</u>
Net assets, end of the year	<u>\$ 2,513,239</u>	<u>\$ 1,962,169</u>

The accompanying notes are an integral part of these consolidated financial statements.

**Franciscan Alliance, Inc. and Affiliates**  
**Consolidated Statements of Cash Flows**  
**Years Ended December 31, 2013 and 2012**  
(In thousands)

	2013	2012
<b>Cash flows from operating activities</b>		
Increase in net assets	\$ 551,070	\$ 88,642
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation of plant, property, and equipment	133,767	131,557
Amortization of bond discounts, deferred financing costs, and other intangible assets	6,520	4,614
Provision for doubtful accounts	103,921	106,994
(Gain) loss on sale/disposal of assets	(2,504)	1,045
Net investment gains	(192,737)	(163,909)
Asset impairment	-	30,000
Net unrealized gains on interest rate swap contracts	(43,717)	(3,756)
Distributions to noncontrolling interests in consolidated affiliates	17,319	19,082
Distributions from unconsolidated affiliates	4,373	8,261
Equity in earnings of investments in unconsolidated affiliates	(6,254)	(5,001)
Restricted contributions and investment income	(5,539)	(3,974)
Change in pension and postretirement benefits other than net periodic pension costs included in accrued pension liability	(319,727)	116,529
Changes in operating assets and liabilities:		
Patient accounts receivable	(79,788)	(130,699)
Inventories of supplies	2,102	(2,488)
Other assets	39,105	(42,943)
Accounts payable and accrued expenses	(37,994)	5,155
Accrued payroll and related expenses	5,716	11,528
Estimated third-party payor settlements	(5,377)	5,346
Estimated insurance liabilities	161	(6,230)
Accrued pension liability	367	(16,427)
Other liabilities	(11,364)	20,264
Total adjustments	<u>(391,650)</u>	<u>84,948</u>
Net cash provided by operating activities	<u>159,420</u>	<u>173,590</u>
<b>Cash flows from investing activities</b>		
Purchases of investments	(6,079,108)	(8,223,508)
Proceeds from sale of investments	6,095,595	8,228,260
Purchases of board designated and other investments in the HSD, net	-	(45,315)
Purchases of property, plant, and equipment	(146,877)	(208,646)
Proceeds from sale of property, plant, and equipment	5,394	2,977
Acquisition of physician practices and other healthcare service organizations	<u>(2,522)</u>	<u>(25,712)</u>
Net cash used by investing activities	<u>(127,518)</u>	<u>(271,944)</u>
<b>Cash flows from financing activities</b>		
Proceeds from issuance of long-term debt	-	88,142
Refunding of long-term debt	-	(82,620)
Principal payments on long-term debt	(22,377)	(19,753)
Distributions to noncontrolling interests of consolidated affiliates	(17,319)	(19,082)
Restricted contributions and investment income	<u>5,539</u>	<u>3,974</u>
Net cash used by financing activities	<u>(34,157)</u>	<u>(29,339)</u>
Net decrease in cash and cash equivalents	(2,255)	(127,693)
Cash and cash equivalents, beginning of year	<u>44,626</u>	<u>172,319</u>
Cash and cash equivalents, end of year	<u>\$ 42,371</u>	<u>\$ 44,626</u>

The accompanying notes are an integral part of these consolidated financial statements.

# Franciscan Alliance, Inc. and Affiliates

## Notes to Consolidated Financial Statements

### December 31, 2013 and 2012

---

#### 1. Description of Organization and Mission

##### Organization

Franciscan Alliance, Inc. and Affiliates (collectively referred to as the "Corporation"), under the sponsorship of the Sisters of St. Francis of Perpetual Adoration, Inc., is an Indiana nonprofit, Catholic health care system. The Corporation is dedicated to providing comprehensive health care services, including emergency, medical, surgical, behavioral, rehabilitative, and other health services in inpatient and outpatient settings; home health care services; and primary and specialty physician services to communities within four geographic regions in Indiana and Illinois (the "Health Centers"). Additionally, the Corporation has various accountable care organizations and physician hospital managed care networks, a nonprofit foundation, and a number of support related divisions and affiliates including a corporate office, a consolidated information technology services division, various back office/management support organizations, a construction company, and a captive insurance company. The Corporation also has various investments in consolidated and unconsolidated affiliates (see Note 10). The Corporation is incorporated as a not-for-profit corporation under the laws of Indiana and is a tax-exempt organization as described in Section 501(c)(3) of the Internal Revenue Code (the "Code").

##### Mission

The Corporation's mission statement is as follows:

*Continuing Christ's Ministry in Our Franciscan Tradition*

Consistent with its mission, the Corporation provides medical care to all patients regardless of their ability to pay. In addition, the Corporation provides services intended to benefit the poor and underserved, including those persons who are uninsured, underinsured, or cannot afford health insurance or other payments such as co-pays and deductibles because of inadequate resources, and to enhance the health status of the communities in which it operates.

The following summary has been prepared in accordance with the Catholic Health Association of the United States' policy document, *Guide for Planning and Reporting Community Benefit*, 2012 edition. The benefits provided are measured at total cost, net of any offsetting revenues, donations, or other funds used to defray cost.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

The following amounts reflect the Corporation's quantifiable community benefits for the years ended December 31, 2013 and 2012:

	<b>(Unaudited)</b>	
	<b>2013</b>	<b>2012</b>
	(in thousands)	
<b>Benefits for the poor and underserved</b>		
Unreimbursed costs of Medicaid and other indigent care programs	\$ 109,995	\$ 96,672
Cost of charity care provided	93,614	83,775
Other benefits for the poor and underserved		
Subsidized health services	2,269	2,953
Community health improvement services	802	713
Financial and in-kind contributions	1,243	584
Community building activities	3	-
Community benefit operations	10	2
	<u>4,327</u>	<u>4,252</u>
Total benefits for the poor and underserved	<u>207,936</u>	<u>184,699</u>
<b>Benefits for the broader community</b>		
Subsidized health services	41,594	30,954
Health professions education	12,850	14,349
Community health improvement services	3,667	4,380
Financial and in-kind contributions	923	2,545
Research	1,349	937
Community building activities	1,074	890
Community benefit operations	190	151
	<u>61,647</u>	<u>54,206</u>
Total benefits for the broader community	<u>61,647</u>	<u>54,206</u>
Total quantifiable community benefits	<u>269,583</u>	<u>238,905</u>
Unreimbursed costs of Medicare	<u>272,730</u>	<u>250,739</u>
Total quantifiable community benefits including unreimbursed costs of Medicare	<u>\$ 542,313</u>	<u>\$ 489,644</u>

Total quantifiable community benefits including unreimbursed costs of Medicare were approximately 21% and 20% of total operating expenses, before the asset impairment, for the years ended December 31, 2013 and 2012.

The Corporation also provides a significant amount of uncompensated care to patients which is reported as provision for doubtful accounts in the consolidated statements of operations and changes in net assets and is not reported in the summary of quantifiable community benefits. During the years ended December 31, 2013 and 2012, the Corporation reported approximately \$103.9 million and \$107.0 million, respectively, as provision for doubtful accounts based on accumulated charges.

## Franciscan Alliance, Inc. and Affiliates

### Notes to Consolidated Financial Statements

#### December 31, 2013 and 2012

---

**Benefits for the poor and underserved** include the cost of providing programs and services to persons who are economically poor or are medically indigent and cannot afford to pay for health care services because they have inadequate resources and/or are uninsured or underinsured.

**Benefits for the broader community** include the costs of providing programs and services aimed at persons and groups for reasons other than poverty. These persons and groups may include needy populations that may not qualify as poor but need special services and support or broader populations who benefit from healthy community initiatives. These programs and services are not intended to be financially self-supporting.

**Unreimbursed costs of Medicaid and other indigent care programs** represent the cost (determined using a cost to charge ratio) of providing services to beneficiaries of public programs including State Medicaid and indigent care programs in excess of any payments received.

**Charity care** represents the cost (determined using a cost to charge ratio) of health care services, provided in accordance with the Corporation's charity care policy, for which no or partial reimbursement will be received because of the recipient's inability to pay for those services, as further described in Note 2.

**Subsidized health services** are net costs for billed services that are subsidized by the Corporation. These include services offered despite a financial loss because they are needed in the community and either other providers are unwilling to provide the services or the services would otherwise not be available in sufficient amount. Examples of services include emergency services, free standing community clinics, hospice care, behavioral health services, prenatal services, women's and children's services, palliative care, and parish nurse programs.

**Community health improvement services** are activities and services for which no patient bill exists. These services are not expected to be financially self-supporting, although some may be supported by outside grants or funding, which is netted against any amounts reported. Some examples include health education, health fairs, free or low cost health screening, immunization services, prescription medication assistance programs, and other various community outreach programs. The Corporation actively collaborates with community groups and agencies to assist those in need in providing such services.

**Financial and in kind contributions** are made by the Corporation on behalf of the poor and underserved to various community agencies. These amounts include funds used for charitable activities as well as resources contributed directly to programs, organizations, and foundations for efforts on behalf of the poor and underserved. In kind services include hours donated by staff to the community while on work time, overhead expenses of space donated to community groups, and donations of food, equipment, supplies, and other direct costs.

**Health professions education** includes the unreimbursed cost of training health professionals such as medical residents, nursing students, technicians, and students in allied health professions.

**Community building activities** include the costs of programs that improve the physical environment, promote economic development, enhance other community support systems, provide leadership development skills training, and build community coalitions.

**Community benefit operations** include costs associated with dedicated staff, community health needs and/or asset assessments, and other costs associated with community benefit strategy and operations.

# Franciscan Alliance, Inc. and Affiliates

## Notes to Consolidated Financial Statements

### December 31, 2013 and 2012

---

**Research** includes the unreimbursed cost of clinical and community health research and studies on health care delivery.

**Unreimbursed costs of Medicare** represent the cost (determined using a cost to charge ratio) of providing services primarily to elderly beneficiaries of the Medicare program in excess of any payments received.

## 2. Summary of Significant Accounting Policies

### Principles of Consolidation

The consolidated financial statements include the accounts of the Corporation, and all wholly owned, majority-owned, and controlled organizations with all significant transactions and accounts between affiliates eliminated in consolidation. Investments in affiliates where the Corporation owns less than or equal to 50% and does not have operational control are recorded under the equity method of accounting unless the Corporation's control or investment percentage is insignificant in which case the Corporation uses the cost method.

### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management of the Corporation to make assumptions, estimates, and judgments that affect the amounts reported in the consolidated financial statements, including the notes thereto, and related disclosures of commitments and contingencies, if any. The Corporation considers critical accounting policies to be those that require more significant judgments and estimates in the preparation of its consolidated financial statements, including the following: recognition of net patient service revenue, which includes contractual allowances and a provision for doubtful accounts; recorded values of investments and goodwill; reserves for employee health costs and losses and expenses related to professional and general liabilities; and risks and assumptions for measurement of the pension liabilities. Management relies on historical experience and other assumptions believed to be reasonable in making its judgments and estimates. Actual results could differ materially from those estimates.

### Cash and Cash Equivalents

Cash and cash equivalents primarily consist of cash, treasuries, and other liquid marketable securities including interest bearing securities with original maturities of three months or less. Funds whose use is limited by Board designation or other restrictions are excluded. The carrying amount of cash and cash equivalents approximates fair value because of the short maturities of these instruments.

### Short-Term Investments

Short-term investments primarily consist of certificates of deposit, treasuries, and other highly liquid interest bearing securities with original maturities extending longer than three months. Adequate liquidity is maintained within short-term investments to satisfy daily cash flow needs.

### Inventories of Supplies

Inventories, consisting primarily of medical/surgical supplies and pharmaceuticals, are stated at the lower of cost (first-in, first out method) or market value.

### Board Designated, Other Investments, and Investment Income

Board designated investments represents investments set aside by the Corporation primarily for future purposes including capital expenditures, acquisitions, improvements, and amounts held for mission programs. The Corporation's Board of Trustees retains control of these investments and

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

may, at its discretion and in certain circumstances, use them for other purposes. Assets limited as to use include assets under bond indenture and swap agreements, investments maintained for the payment of estimated insurance liabilities, and amounts contributed by donors with stipulated restrictions.

As of April 1, 2012, substantially all of the Corporation's board designated and other investments are invested and managed by professional managers in accordance with agreed-upon investment and socially responsible investing guidelines and are held in custody with a financial institution. Prior to April 1, 2012, approximately 96% of the Corporation's board designated and other investments were invested in a pooled account coordinated through Ascension Health's Health System Depository (the "HSD") under an investment management agreement. The custodian-held assets in the HSD were managed by professional managers who followed agreed-upon investment and socially responsible investing guidelines.

Board designated and other investments are measured at fair value, classified as trading securities, and consist of: cash and cash equivalents; U.S. government, state, municipal, and agency obligations; asset backed securities; corporate and foreign income securities; various types of equity securities and mutual funds; and prior to April 1, 2012, the Corporation's pro-rata share of pooled investments within the HSD. Board designated and other investments also include alternative investments, consisting of investments in hedge funds, prime credit and private equity investments, and real assets, which are generally measured based on their net asset value as a practical expedient for fair value that is further described in Note 4.

Investment earnings consist of dividends, interest, realized gains and losses and, prior to April 1, 2012, the Corporation's pro-rata net earnings of the HSD. In accordance with industry practice, investment earnings and unrealized gains and losses on assets limited as to use under bond indenture and swap agreements and estimated insurance liability funds are included in other operating revenue in the consolidated statements of operations and changes in net assets. Investment earnings and unrealized gains and losses from all other unrestricted investments and board designated funds are included in other income (expense) in the consolidated statements of operations and changes in net assets. Investment earnings and any associated unrealized gains and losses restricted for specified purposes by donor or legal requirements are recorded as temporarily or permanently restricted in the consolidated statements of operations and changes in net assets.

Board designated and other investments are exposed to various risks, such as interest rate, market, liquidity, performance, and credit risk. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term may affect the amounts reported in the consolidated balance sheets and the consolidated statements of operations and net assets.

#### **Securities Lending Program**

The Corporation participates in a securities lending program through its custodian whereby the Corporation lends a portion of its investments to various brokers in exchange for collateral for securities loaned, mostly on a short-term basis. Collateral provided by these brokers consists of cash and is maintained at levels approximating 102-105% of the fair value of the securities on loan, adjusted for any market fluctuations. The Corporation maintains effective control of loaned securities through its custodian during the term of the agreement so that the securities may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. At December 31, 2013 and 2012, the fair

## Franciscan Alliance, Inc. and Affiliates

### Notes to Consolidated Financial Statements

#### December 31, 2013 and 2012

---

value of collateral for loaned securities provided on behalf of the Corporation was approximately \$5.1 million and \$30.7 million, respectively, while the fair market value of securities on loan was approximately \$5.2 million and \$30.8 million, respectively, with the net amount reported in board designated and other investments.

#### **Fair Value Measurement**

The Corporation's consolidated financial statements reflect certain assets and liabilities recorded at fair value. Assets measured at fair value on a recurring basis in the Corporation's consolidated balance sheets include: cash and cash equivalents; short-term investments; U.S. government, state, municipal, and agency obligations; asset backed securities; corporate and foreign income securities; various types of equity securities and mutual funds; hedge funds; private credit and private equity investments; real assets; benefit plan assets; and, prior to April 1, 2012, pooled investments within the HSD. Liabilities measured at fair value on a recurring basis include the Corporation's interest rate swap contracts.

Fair value measurements reflected in the consolidated financial statements conceptually represent the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Generally accepted accounting principles provide a hierarchy that prioritizes the inputs to fair value measurements based on the extent to which inputs the valuation techniques are observable in the marketplace. The hierarchy assigns a higher priority to observable inputs that reflect the Corporation's assumptions about how market participants would value an asset or liability based on the best information available. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs.

The three levels of the hierarchy of inputs used to measure fair value are described briefly as follows:

- Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities that are available at the measurement date.
- Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 Unobservable inputs for the asset or liability, used in situations in which little or no market activity exists for the asset or liability at the measurement date.

The categorization of fair value measurements by hierarchy level is based upon the lowest level input that is significant to the overall fair value measurement for a given asset or liability.

The Corporation applies the guidance in Accounting Standards Codification 820-10-15-4, *Fair Value Measurements of Investments in Certain Entities that Calculate Net Asset Value per Share (or its Equivalent)*. Under the guidance, the Corporation is permitted, as a practical expedient, to estimate the fair value of certain portfolio investments on the basis of the net asset value per share. In the normal course of business, the Corporation holds certain investments that qualify for the usage of the practical expedient. Fair value measurements of certain investment assets for which the measurement was based on net asset value ("NAV") or its equivalent as provided by an external manager are categorized within Level 2 or 3.

In the event that changes in the inputs used in the fair value measurements of an asset or liability results in a transfer of the fair value measurement to a different categorization (e.g., from Level 3 to

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

Level 2), such transfers between fair value categories are recognized at the end of the reporting period.

#### **Property, Plant, and Equipment**

Property, plant, and equipment (including internal-use software) are recorded at cost if purchased or at fair value at the date of donation, if donated. Expenditures that materially increase values, change capacities, or extend useful lives are capitalized. Routine maintenance, repairs, and minor equipment replacement costs are charged to expense when incurred. Cost incurred in the development and installation of internal-use software are expensed or capitalized depending on whether they are incurred in the preliminary project stage, application development stage, or post implementation stage. Upon sale or retirement of property, plant, and equipment, the cost and related accumulated depreciation are eliminated from the respective accounts, and the resulting gain or loss is included in the consolidated statements of operations and changes in net assets. Interest costs incurred during the period of construction or development of capital assets are capitalized as a component of the cost of acquiring those assets. Depreciation is provided over the estimated useful lives of the assets utilizing the straight-line method with a useful life range of between 3 to 60 years. Assets under capital lease obligations are amortized utilizing the straight-line method over the shorter of the lease term or estimated useful life of the asset. Amounts capitalized for internal-use software are amortized over the useful life of the developed asset following project completion.

A conditional asset retirement obligation is recorded for any legal obligation associated with the retirement of long-lived assets resulting from the acquisition, construction, development, and/or normal use of the underlying assets. The associated asset retirement costs are capitalized as part of the carrying amount of the underlying asset and depreciated over the asset's estimated useful life. The liability is accreted through charges to operating expense. If the conditional asset retirement obligation is settled for other than the carrying amount of the liability, a gain or loss on sale/disposal of assets is recognized. As of December 31, 2013 and 2012, conditional asset retirement obligations of approximately \$19.2 million and \$18.7 million, respectively, are included within other liabilities in the consolidated balance sheets.

#### **Goodwill and Intangible Assets**

Goodwill represents the excess of costs over the fair value of assets of businesses acquired. Goodwill is tested for impairment on an annual basis or when an event or change in circumstances indicates the value of a reporting unit, which for the Corporation is the individual Health Centers within its four regions, may have changed. There is a two-step process for determining goodwill impairment. Step one compares the carrying value of each reporting unit with its fair value. If step one indicates the fair value is less than the carrying value, then step two is required. Step two compares the implied fair value of the reporting unit's goodwill with the carrying value of the reporting unit's goodwill. If the carrying value of goodwill is impaired, the Corporation reduces the carrying amount to fair value. Estimates of fair value are based on appraisals, internal estimates of future net cash flows on a discounted basis, as well as other generally accepted valuation methodologies.

Intangible assets primarily consist of covenants not to compete which are amortized on a straight-line basis over periods ranging from 2 to 5 years.

#### **Asset Impairment**

The Corporation periodically evaluates the carrying value of its other long-lived assets for impairment whenever events or business conditions indicate the carrying value of such assets may not be fully recoverable. Initial assessments of recoverability are based upon estimates of

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

undiscounted future net cash flows associated with an asset or group of assets. When an impairment is indicated, the carrying amount of these long-lived assets is reduced to fair value, based on future discounted net cash flows or other estimates of fair value.

During the year ended December 31, 2012, the Corporation recognized an impairment of buildings, building equipment, and departmental equipment of \$30 million at two of its Health Centers due to declines in operating performance.

#### **Deferred Financing Costs**

Deferred financing costs incurred with the Hospital and Health System Revenue Bonds and Refunding Bonds are amortized using the bonds outstanding method. Costs associated with securing the direct pay letters of credit to support its variable rate demand bonds are amortized over the term of the associated liquidity facility. Costs associated with the issuance of direct placement bonds are amortized over the associated direct placement period. Deferred financing costs are included in other assets in the consolidated balance sheets.

#### **Estimated Insurance Liabilities**

The provision for estimated insurance liabilities includes actuarial estimates of the ultimate costs for both reported claims and claims incurred but not reported for professional liability, general liability, long-term disability insurance, excess workers' compensation, and amounts self-insured for allocated loss adjustment expenses.

#### **Net Assets**

Temporarily restricted net assets are those whose use by the Corporation has been limited by donors to a specific time period or purpose. Permanently restricted net assets have been restricted by donors to be maintained by the Corporation in perpetuity.

Unconditional promises to give cash and other assets to the Corporation are reported at fair value at the date the promise is received. 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 a purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated financial statements.

During 2013 and 2012, net assets of \$6.2 million and \$5.0 million, respectively, were released from donor restrictions by incurring expenses or capital expenditures satisfying the restricted purposes or by the passage of time.

#### **Performance Indicator**

The performance indicator is excess of revenues over expenses, which includes all changes in unrestricted net assets except for the change in pension and postretirement benefits other than net periodic pension costs which is included in accrued pension liability; contributions and distributions to noncontrolling interests in consolidated affiliates; and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets).

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

#### **Operating and Nonoperating Activities**

The Corporation's primary mission is to meet the health care needs in the communities it is privileged to operate through a broad range of general and specialized health care services, including emergency, medical, surgical, behavioral, rehabilitative, and other health services in inpatient and outpatient settings; home health care services; primary and specialty physician services. Additionally, the Corporation has various accountable care organizations and physician hospital managed care networks. Activities directly associated with the furtherance of this purpose are considered to be operating activities. Other activities that result in gains or losses peripheral to the Corporation's primary mission are considered to be nonoperating activities.

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

The Corporation has agreements with third-party payors that provide for payments at amounts different from its established rates. Patient accounts receivable and net patient service revenue are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered net of the provision for doubtful accounts and includes estimated retroactive revenue adjustments under reimbursement agreements with third-party payors and amounts received under various state Medicaid Hospital Assessment and Disproportionate Share Programs. Revenue under certain third-party payor agreements is subject to audit, retroactive adjustments, and significant regulatory actions. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as additional information becomes available and as final settlements are determined.

#### **Allowance for Doubtful Accounts**

The collection of outstanding patient accounts receivable from government, managed care, and other third party payors and patients is the Corporation's primary source of cash. The Corporation's main collection risk relates to uninsured patient accounts and to patient accounts for which the third party payor has paid amounts in accordance with the applicable agreement, however the patient's responsibility, usually in the form of deductibles, copayments, and coinsurance payments, remain outstanding ("self-pay accounts"). The Corporation's patient accounts receivable is reduced by an allowance for amounts, primarily self-pay accounts, which could become uncollectible in the future. Throughout the year, the Corporation estimates this allowance based on the aging of its patient accounts receivable, historical collection experience, and other relevant factors. These factors include changes in the economy and unemployment rates, which has an impact on the number of uninsured and underinsured patients, as well as trends in health care coverage, such as the increased burden of deductibles, copayments, and coinsurance payments to be made by patients with insurance. After satisfaction of amounts due from insurance and reasonable efforts to collect from the patient have been exhausted, the Corporation follows established procedures for placing certain past due patient balances with collection agencies, subject to the terms and certain restrictions on collection efforts as determined by the Corporation. Uncollectible patient accounts receivable are written off against the allowance for doubtful accounts with any subsequent recoveries being recorded against the provision for doubtful accounts.

#### **Charity Care**

As an integral part of its mission, the Corporation provides care to patients who meet certain criteria under its charity care and uninsured patient discount policy without charge or at amounts less than its established rates. The cost of charity care is determined based on each Health Center's total cost as a percentage of total charges and that ratio is applied to the charges incurred by patients qualifying for charity care under the Corporation's policy and is not included in net patient service revenue in the consolidated statements of operations and changes in net assets.

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

The estimated cost of charity care provided approximated \$93.6 million and \$83.8 million for the years ending December 31, 2013 and 2012, respectively. For both the years ending December 31, 2013 and 2012, no gifts or grants were received to offset or subsidize charity care services provided. The Corporation maintains records to identify and monitor the level of charity it provides.

#### **Capitation and Premium Revenue**

The Corporation has certain Health Centers that arrange for the delivery of health care services to enrollees through various contracts with providers and common provider entities. Enrollee contracts are negotiated on an annual basis. Premiums are due monthly and are recognized as revenue during the period in which the Corporation is obligated to provide services to enrollees.

Certain of the Corporation's Health Centers have entered into capitation agreements whereby they accept the risk for the provision of certain health care services to health plan members. Under these agreements, the Corporation's Health Centers are financially responsible for services provided to health plan members by other health care providers. Capitation revenue is recognized during the period for which the Health Centers are obligated to provide services to health plan enrollees under capitation contracts.

Reserves for incurred but not reported claims have been established to cover the unpaid costs of health care services under capitation and premium arrangements. Capitation and premium arrangement reserves are classified within accounts payable and accrued expenses in the consolidated balance sheets. The liability is estimated based on actuarial studies, historical reporting, and payment trends. Actual claims experience will differ from estimated liabilities due to variances in estimated and actual utilization of health care services, charge amounts, and other factors. As settlements are made and estimates revised, any differences are reflected in current operations. The Corporation limits a portion of its liabilities through stop-loss reinsurance.

#### **Accountable Care Organizations**

The Corporation has various accountable care organizations and contractual arrangements that manage and coordinate the continuum of patient care services to covered individuals on a capitated, shared savings, risk or partial risk basis under contracts with the Centers for Medicare and Medicaid Services ("CMS") and commercial payors. The Corporation was selected as a participant in the Medicare Pioneer Accountable Care Organization initiative ("Pioneer ACO") for a three year period effective January 1, 2012 and as a participant in two Medicare Shared Savings Programs ("MSSP") effective July 1, 2012 and January 1, 2013. The Pioneer ACO and the MSSP initiatives are new programs sponsored by CMS to provide Medicare beneficiaries with high-quality coordinated care at a lower cost.

The Pioneer ACO is a shared savings model in which participating organizations are eligible for additional payments from CMS if they are able to achieve medical cost savings as compared to certain benchmarks while providing high-quality, coordinated patient care for an assigned group of Medicare beneficiaries. Participants also share partial risk with CMS for any increase in medical costs and will be required to pay CMS for a portion of any cost increase over certain benchmarks. The risk share for both the medical cost savings and medical cost increases are measured based on a predetermined benchmark for the assigned beneficiary population. Also, medical cost savings under the Pioneer ACO are earned only if certain quality and administrative measures are met. In 2012, the first year of the Pioneer ACO agreement, the Corporation did not have any downside risk attributable for its performance and had not recorded a risk share receivable or revenue given delays in the receipt of claims data in order to calculate the amount of the receivable or the quality measure performance. During 2013, the Corporation received a gain sharing payment of \$6.7 million for its 2012 participation in the Pioneer ACO initiative of which \$5.6 million was recorded in

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

other operating revenue in the consolidated statements of operations and changes in net assets for the year ending December 31, 2013 and the remaining balance was paid to other participating providers. The Corporation has not received the complete year of claims information for the 2013 Pioneer ACO contract year; however based on the information provided by CMS, the Corporation has not recorded a gain or loss for the year ending December 31, 2013 for that contract year.

The Corporation's MSSP contracts are similar to the Pioneer ACO initiative however there is no downside risk sharing with CMS. The Corporation has not received the complete year of claims information for its 2012 and 2013 MSSP contract years; however based on the information provided by CMS, the Corporation has not recorded any gain for the year ending December 31, 2013 for that contract year.

#### **Electronic Health Record Incentive Payments**

Medicare and state Medicaid programs are providing incentive payments to eligible hospitals and professionals as they adopt, implement, upgrade, or demonstrate meaningful use of certified electronic health care ("EHR") technology in the first year of participation and demonstrate meaningful use for up to five remaining participation years. The Corporation recognizes income related to these incentive payments using a grant accounting model that is based upon when the Corporation has reasonable assurance that it will comply with any designated conditions set forth by Medicare and Medicaid and that the dollars will be received. For the years ended December 31, 2013 and 2012, approximately \$24.1 million and \$19.8 million, respectively, of EHR incentive income was recognized and is included in other operating revenue in the consolidated statements of operations and changes in net assets. The Corporation's attestation of compliance with the meaningful use criteria is subject to audit by the federal government or its designee. Additionally, Medicare EHR incentive payments are subject to retrospective adjustment upon final settlement of the applicable cost report from which payments were initially calculated. The Corporation has incurred and will continue to incur both capital expenditures and operating expenses in order to implement certified EHR technology and to meet meaningful use requirements. The timing of expense recognition to implement the Corporation's certified EHR technology may not correlate with the receipt of incentive payments and recognition of EHR incentive revenue.

#### **Income Taxes**

The Corporation has established its status as an organization exempt from income taxes under Code Section 501(c)(3) and the laws of the states in which it operates. Certain divisions and affiliates are subject to federal and state income taxes; however, such amounts are not material to the consolidated financial statements.

#### **Derivative Financial Instruments**

Derivative financial instruments consist of interest rate swap contracts that are measured at fair value. The Corporation accounts for any changes in the fair value of derivative financial instruments in other income (expense) in the consolidated statements of operations and changes in net assets. The Corporation has reflected the fair value of its interest rate swap contracts as a long-term liability on the consolidated balance sheets (see Note 7).

#### **Consolidated Statements of Cash Flows**

Supplemental disclosure of cash flow information and noncash investing and financing activities are summarized as follows:

Cash paid during the year for interest, net of amounts capitalized, amounted to \$38.1 million and \$38.7 million for the years ended December 31, 2013 and 2012, respectively.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

Cash paid for income taxes approximated \$0.5 million and \$0.4 million for the years ended December 31, 2013 and 2012, respectively.

Included in accounts payable and accrued expenses and other liabilities at December 31, 2013 and 2012 are approximately \$20.0 million and \$20.9 million, respectively, of costs related to construction in progress and for the acquisition of property, plant, and equipment (including internal-use software).

**Reclassifications and Revision**

Certain reclassifications were made to prior year balances to conform to current year presentation.

Subsequent to the issuance of the December 31, 2012 financial statements, the Corporation determined that \$154.9 million of certain highly liquid marketable securities were misclassified as cash and cash equivalents because their maturity at the time of purchase extended beyond three months and these securities should have been classified as short-term investments. The consolidated balance sheet and statement of cash flows for the year ended December 31, 2012 have been revised to correct this misclassification. There is no impact to operating income, operating cash flows, current assets, changes in net assets, or any financial ratios.

The revised amounts compared to previously reported amounts on the consolidated balance sheet for the year-ended December 31, 2012 are as follows:

	Original	Adjustment (in thousands)	Revised
Cash and cash equivalents	\$ 199,564	\$ (154,938)	\$ 44,626
Short-term investments	\$ 37,159	\$ 154,938	\$ 192,097

The revised amounts compared to previously reported amounts on the statement of cash flows for the year-ended December 31, 2012 are as follows:

	Original	Adjustment (in thousands)	Revised
<b>Cash flows from investing activities</b>			
Purchases of investments	\$ (8,068,570)	\$ (154,938)	\$ (8,223,508)
Proceeds from sale of investments	\$ 8,228,260		\$ 8,228,260
Net cash used by investing activities	<u>\$ (117,006)</u>	<u>\$ (154,938)</u>	<u>\$ (271,944)</u>
Cash and cash equivalents, beginning of year	\$ 172,319	\$ -	\$ 172,319
Cash and cash equivalents, end of year	\$ 199,564	\$ (154,938)	\$ 44,626

The Corporation concluded that the misclassification of cash and cash equivalents was not material to the December 31, 2012 consolidated financial statements.

**3. Net Patient Service Revenue, Patient Accounts Receivable, and Concentration of Credit Risk**

The Corporation has 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:

**Medicare** – Acute inpatient and outpatient services rendered to Medicare program beneficiaries are paid primarily at prospectively determined rates. These rates vary according to a patient

## Franciscan Alliance, Inc. and Affiliates

### Notes to Consolidated Financial Statements

#### December 31, 2013 and 2012

---

classification system that is based on clinical, diagnostic, and other factors. Certain services are reimbursed at a tentative rate with final settlement determined after submission of annual cost reports and audits thereof by the Medicare fiscal intermediaries.

**Medicaid** – Reimbursement for services rendered to Medicaid program beneficiaries includes prospectively determined rates per discharge, per diem payments, and fee schedules.

Certain of the Corporation's Health Centers qualify as State of Indiana Medicaid Acute Disproportionate Share and Medicaid Safety Net Hospitals ("DSH"). These Health Centers qualified as DSH providers under Indiana code 12-15-16-1, and, as such, are eligible to receive DSH payments linked to the State's fiscal year, which differs from the Corporation's fiscal year. The amount of these additional DSH funds is dependent on regulatory approval by agencies of the federal and state governments, and is determined by the level, extent, and cost of uncompensated care (as defined) and various other factors. The Corporation records such amounts as revenue when payments are received or based upon data from the State of Indiana that payments are determinable and probable of receipt. For the years ended December 31, 2013 and 2012, the Corporation recognized unrestricted revenue of approximately \$23.1 million and \$19.7 million, respectively, related to the DSH program in the consolidated statements of operations and changes in net assets.

During 2012, the State of Indiana established a Hospital Assessment Fee ("HAF") Program which was retroactive to July 1, 2011 and ended June 30, 2013, that increased reimbursements made under the State's fee for service and managed Medicaid programs. For the years ended December 31, 2013 and 2012, the Corporation's Indiana Health Centers were assessed a fee under the HAF program of approximately \$33.5 million and \$84.1 million (approximately \$27.1 million related to the year ended December 31, 2011), respectively, which is included as a component of other supplies and expenses in the accompanying consolidated statements of operations and changes in net assets and the Corporation's Indiana Health Centers recognized approximately \$45.1 million and \$135.2 million (approximately \$43.4 million related to the year ended December 31, 2011), respectively, in supplemental Medicaid reimbursement, which is a component of net patient service revenue in the consolidated statements of operations and changes in net assets. During 2013, the State of Indiana submitted an amendment to CMS, which was approved subsequent to year-end, to extend the HAF program to June 30, 2017. Since CMS had not approved the HAF extension as of year-end and the final calculation of the tax and the supplemental Medicaid reimbursement amount was not finalized as of year end, the Corporation did not recognize any assessment fee or supplemental Medicaid reimbursement in the consolidated statements of operations and changes in net assets from July 1, 2013 through December 31, 2013.

The Corporation's Illinois Health Centers are obligated under Illinois Public Act 95-859 to participate in the State of Illinois' Hospital Assessment Program. For the years ended December 31, 2013 and 2012, the Corporation recognized \$23.7 million and \$17.4 million, respectively, of additional reimbursement within net patient service revenue and \$14.6 million and \$10.3 million, respectively, of other expense in the consolidated statements of operations and changes in net assets related to the Illinois Hospital Assessment Program.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**Other** – Reimbursement for services to certain patients is received from commercial insurance carriers, health maintenance organizations, and preferred provider organizations. The basis for reimbursement includes prospectively determined rates per discharge, discounts from established charges, prospectively determined per diem rates, and fee schedules.

Provisions have been made in the consolidated financial statements for estimated contractual adjustments, representing the difference between the established charges for services and estimated total payments to be received from third-party payors.

A summary of gross patient service revenue, by payor, for the periods ended December 31, 2013 and 2012, is as follows:

	<b>2013</b>	<b>2012</b>
Medicare	38 %	38 %
Medicare managed care	6 %	5 %
Medicaid	9 %	8 %
Medicaid managed care	4 %	5 %
Other third-party payors	37 %	38 %
Self-pay	5 %	5 %
Other	1 %	1 %
	<u>100 %</u>	<u>100 %</u>

The Corporation grants credit without collateral to its patients, most of who are insured under third-party payor agreements. The mix of net receivables from patients and third-party payors at December 31, 2013 and 2012, is as follows:

	<b>2013</b>	<b>2012</b>
Medicare and Medicare managed care	25 %	23 %
Medicaid and Medicaid managed care	12 %	18 %
Other third-party payors	45 %	45 %
Self-pay and Other	18 %	14 %
	<u>100 %</u>	<u>100 %</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 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 regulatory action including fines, penalties, and/or exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that recorded estimates may change in the near term. Net patient service revenue increased by approximately \$2.5 million and by \$10.1 million for the years ended December 31, 2013 and 2012, respectively, due to changes in estimates related to prior-year settlements with third party payors. In addition, for the year ended December 31, 2012, net patient service revenue includes approximately \$19.1 million related to Medicare's settlement of the Rural Floor Budget Neutrality Adjustment Appeal that related to fiscal years 2007-2011.

**4. Short-Term, Board Designated, and Other Investments**

Short-term investments represent highly liquid investments with maturities extending longer than three months. Adequate liquidity is maintained within short-term investments to satisfy daily cash flow needs.

Board designated investments represents investments set aside by policy of the Corporation primarily for future purposes including capital expenditures, acquisitions, and improvements as well as amounts held for mission programs. Assets limited as to use include assets under bond indenture and swap agreements, investments maintained for the payment of estimated insurance liabilities, and amounts contributed by donors with stipulated restrictions.

The composition of short-term, board designated, and other investments, at December 31, 2013 and 2012, is as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Short-term investments	\$ 222,535	\$ 192,097
Board designated investments		
Funded depreciation and other Board projects	\$ 1,652,405	\$ 1,506,283
Other designated investments	1,691	3,190
	<u>1,654,096</u>	<u>1,509,473</u>
Assets limited as to use		
Estimated insurance liability funds	163,983	152,680
Assets under bond indenture and swap agreements	19,410	40,970
Other restricted investments	35,020	23,574
	<u>218,413</u>	<u>217,224</u>
Short-term, board designated and other investments	<u>2,095,044</u>	<u>1,918,794</u>
Less short-term investments	<u>222,535</u>	<u>192,097</u>
Board designated and other investments, classified as noncurrent	<u>\$ 1,872,509</u>	<u>\$ 1,726,697</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

Short-term, board designated, and other investments at December 31, 2013 and 2012, consist of the following:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Cash and cash equivalents	\$ 50,929	\$ 85,961
U.S. government, state, municipal, and agency obligations	420,173	359,507
Other fixed income securities	188,802	180,998
Equity securities	459,840	350,398
Asset-backed securities	134,758	153,359
Index funds, exchange traded funds, and mutual funds	761	316,183
Unregistered mutual funds	350,022	56,257
Real estate investment trusts	12,580	3,746
Hedge funds	286,227	247,699
Private credit	23,669	23,664
Private equity	88,040	79,238
Real assets	79,243	61,784
	<u>\$ 2,095,044</u>	<u>\$ 1,918,794</u>

The following tables present the fair value hierarchy of the valuation techniques utilized to determine the fair value of the Corporation's short-term, board designated, and other investments as of December 31, 2013 and 2012:

	<b>Balance as of December 31, 2013</b>	<b>Level 1 (in thousands)</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Investments</b>				
Cash and cash equivalents	\$ 50,929	\$ 50,929	\$ -	\$ -
U.S. government, state, municipal, and agency obligations	420,173	296,143	124,030	-
Other fixed income securities	188,802	-	188,802	-
Equity securities	459,840	459,840	-	-
Asset-backed securities	134,758	-	134,758	-
Index funds, exchange traded funds, and mutual funds	761	761	-	-
Unregistered mutual funds	350,022	-	350,022	-
Real estate investment trusts	12,580	12,580	-	-
Hedge funds	286,227	-	-	286,227
Private credit	23,669	-	-	23,669
Private equity	88,040	-	-	88,040
Real assets	79,243	-	-	79,243
	<u>\$ 2,095,044</u>	<u>\$ 820,253</u>	<u>\$ 797,612</u>	<u>\$ 477,179</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

	<b>Balance as of December 31, 2012</b>	<b>Level 1 (in thousands)</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Investments</b>				
Cash and cash equivalents	\$ 85,961	\$ 85,961	\$ -	\$ -
U.S. government, state, municipal, and agency obligations	359,507	290,223	68,001	1,283
Other fixed income securities	180,998	-	177,780	3,218
Equity securities	350,398	350,398	-	-
Asset-backed securities	153,359	-	153,069	290
Index funds, exchange traded funds and mutual funds	316,183	316,183	-	-
Unregistered mutual funds	56,257	-	56,257	-
Real estate investment trusts	3,746	3,746	-	-
Hedge funds	247,699	-	-	247,699
Private credit	23,664	-	-	23,664
Private equity	79,238	-	-	79,238
Real assets	61,784	-	-	61,784
	<u>\$ 1,918,794</u>	<u>\$ 1,046,511</u>	<u>\$ 455,107</u>	<u>\$ 417,176</u>

Certain investments categorized within Level 2 are not traded in active markets but are measured using pricing sources such as broker quotes, or using models with externally verifiable inputs, such as relevant interest or exchange rates.

Changes in Level 3 hierarchy assets measured at fair value for the Corporation's board designated and other investments at December 31, 2013 and 2012 are as follows:

	<b>Balance as of December 31, 2012</b>	<b>Net Unrealized Gain (Loss)</b>	<b>Net Realized Gain (Loss) (in thousands)</b>	<b>Purchases</b>	<b>Sales</b>	<b>Transfers Out</b>	<b>Balance as of December 31, 2013</b>
U.S. government, state, municipal, and agency obligations	\$ 1,283	\$ (89)	\$ 131	\$ -	\$ (1,325)	\$ -	\$ -
Other fixed income securities	3,218	(71)	(191)	7,746	(9,713)	(989)	-
Asset-backed securities	290	(22)	81	-	(349)	-	-
Hedge funds	247,699	30,580	321	25,373	(17,746)	-	286,227
Private credit	23,664	1,102	(221)	4,786	(5,662)	-	23,669
Private equity	79,238	1,394	281	13,138	(6,011)	-	88,040
Real assets	61,784	3,276	545	22,228	(8,590)	-	79,243
	<u>\$ 417,176</u>	<u>\$ 36,170</u>	<u>\$ 947</u>	<u>\$ 73,271</u>	<u>\$ (49,396)</u>	<u>\$ (989)</u>	<u>\$ 477,179</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

	Initial Contribution at Fair Value	Net Unrealized Gain (Loss)	Net Realized Gain (Loss) (in thousands)	Purchases	Sales	Balance as of December 31, 2012
U.S. government, state, municipal, and agency obligations	\$ 1,249	\$ 34	\$ -	\$ -	\$ -	\$ 1,283
Other fixed income securities	-	66	70	12,413	(9,331)	3,218
Asset-backed securities	384	(1)	7	-	(100)	290
Hedge funds	233,701	10	5,836	54,000	(45,848)	247,699
Private credit	20,083	1,763	(131)	6,293	(4,344)	23,664
Private equity	70,327	4,589	272	12,486	(8,436)	79,238
Real assets	52,007	1,414	95	17,911	(9,643)	61,784
	<u>\$ 377,751</u>	<u>\$ 7,875</u>	<u>\$ 6,149</u>	<u>\$ 103,103</u>	<u>\$ (77,702)</u>	<u>\$ 417,176</u>

There were no significant transfers to or from Levels 1 and 2 during the years ended December 31, 2013 and 2012.

The following table summarizes the Corporation's investments calculated on a net asset value per share basis (or its equivalent), the unfunded commitments, and the associated redemption provisions:

	Fair Value (in thousands)	Unfunded Commitments (in thousands)	Redemption Frequency	Redemption Notice Period
Unregistered mutual funds	\$ 350,022	\$ -	Monthly	1 day
Hedge funds	286,227	-	Monthly, quarterly, annually	5 - 180 days
Private credit	23,669	14,720	Not currently redeemable	
Private equity	88,040	35,166	Not currently redeemable	
Real assets	<u>79,243</u>	<u>56,994</u>	Monthly, quarterly, not redeemable	45 days
	<u>\$ 827,201</u>	<u>\$ 106,880</u>		

**Unregistered mutual funds** include funds that primarily invest in domestic and international equities, short-term government, investment grade, high yield, and mortgage-related fixed income securities. The fair values of the investments in this class have been estimated using the NAV per share of the investments.

**Hedge funds** include absolute return and directional hedge funds. Absolute return hedge funds pursue multiple strategies to diversify risks and reduce volatility while directional hedge funds utilize market movement, trends, and inconsistencies when selecting securities across a variety of markets. Directional hedge funds are usually less exposed to the overall market and are likely to include long equity positions hedged with short positions to cancel out short-term uncertainty. The fair values of the investments in this class have been estimated using the NAV per share of the investments.

## Franciscan Alliance, Inc. and Affiliates

### Notes to Consolidated Financial Statements

#### December 31, 2013 and 2012

---

**Private credit** includes investments that are secured by high quality assets or backed by a senior claim on stable cash flows. Investments in this asset class will be made opportunistically during periods of broad market or security specific distress. The fair values of the investments in this class have been estimated using the NAV of the Corporation's ownership interest in partners' capital. Investments within these funds cannot be currently redeemed. After the expiration of the investment period, distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of the funds will be liquidated over the next 1 to 11 years. However, the individual investments that will be sold have not yet been determined.

**Private equity** includes funds that invest globally using strategies that include leveraged buyouts, venture capital, growth capital, distressed investments, and mezzanine capital. The fair values of the investments in this class have been estimated using the NAV of the Corporation's ownership interest in partners' capital. Investments within these funds cannot be currently redeemed. After the expiration of the investment period, distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of the funds will be liquidated over the next 1 to 10 years. However, the individual investments that will be sold have not yet been determined.

**Real asset** includes energy and energy-related investments and private real estate funds that invest in both U.S. and international commercial real estate. Energy and energy-related investments exposure mainly relate to oil and gas properties which include exploration, production, processing, servicing, or transportation of oil, natural gas, and other hydrocarbon fuels. Private real estate investment strategies include core, value-add, and opportunistic real estate which typically seek to earn a return over inflation. The fair values of the investments in this class have been estimated using the NAV of the Corporation's ownership interest in partners' capital. Investments within these funds cannot be currently redeemed. Investments representing approximately 79% of the value of the investments in this class cannot be redeemed because the investments include redemption restrictions that range from 1 to 10 years after acquisition. After the expiration of the investment period, distributions from each fund will be received as the underlying investments of the funds are liquidated. It is estimated that the underlying assets of the funds will be liquidated over the next 2 to 12 years. However, the individual investments that will be sold have not yet been determined.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

Investment returns including net unrealized gains (losses) included in the consolidated statements of operations and changes in net assets for the years ended December 31, 2013 and 2012, are as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
<b>Unrestricted revenues, gains and other support</b>		
Investment income in other operating revenue	\$ 4,004	\$ 9,807
Net unrealized investment gains	8,408	5,533
	<u>12,412</u>	<u>15,340</u>
<b>Other income (expense)</b>		
Investment income	67,203	82,065
Net unrealized investment gains on trading securities	117,126	76,311
	<u>184,329</u>	<u>158,376</u>
<b>Temporarily restricted net assets, controlling interest</b>		
Investment income	194	366
Net unrealized investment gains	93	100
	<u>287</u>	<u>466</u>
<b>Permanently restricted net assets, controlling interest</b>		
Investment income	175	95
Net unrealized investment gains (losses)	247	(64)
	<u>422</u>	<u>31</u>
	<u>\$ 197,450</u>	<u>\$ 174,213</u>

**5. Property, Plant, and Equipment**

A summary of property, plant, and equipment at December 31, 2013 and 2012, is as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Land and land improvements	\$ 136,807	\$ 120,577
Buildings and building equipment	1,354,290	1,326,847
Departmental equipment	1,328,285	1,328,500
Construction in progress	68,380	72,765
	<u>2,887,762</u>	<u>2,848,689</u>
Less accumulated depreciation	<u>1,300,548</u>	<u>1,278,496</u>
	<u>\$ 1,587,214</u>	<u>\$ 1,570,193</u>

Certain leases for facilities and medical equipment are accounted for as capital leases. These leases expire in various years through 2024 and are included in property, plant, and equipment on the consolidated balance sheets. The amortization of assets under capital leases is included in depreciation and amortization expense in the consolidated statements of operations and changes in net assets.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

**6. Long-Term Debt**

Long-term debt at December 31, 2013 and 2012, consists of the following:

	<u>Year of Final Maturity</u>	<u>Interest Rate Range over Life of Bonds</u>		<u>2013</u>	<u>2012</u>
				(in thousands)	
Tax Exempt Hospital and Health System Revenue and Refunding Bonds					
Fixed rate term and serial bonds					
Series 2009	2039	4.00% - 5.375%		\$ 215,645	\$ 218,105
Series 2008C	2032	5.00% - 5.50%		269,050	278,995
Series 2006E, insured	2041	5.125% - 5.25%		84,675	84,675
Less: bond discounts and premiums, net				<u>(3,439)</u>	<u>(3,653)</u>
Total fixed rate term and serial bonds				<u>\$ 565,931</u>	<u>\$ 578,122</u>
		<u>Interest Rate Range 2013</u>	<u>Interest Rate Range 2012</u>		
Variable rate direct placement bonds					
Series 2012A	2048	0.97% - 1.00%	1.00% - 1.02%	\$ 75,000	\$ 75,000
Series 2012B	2015	0.82% - 0.85%	0.85% - 0.87%	4,000	5,855
Total variable rate direct placement bonds				<u>\$ 79,000</u>	<u>\$ 80,855</u>
Variable rate demand bonds, subject to seven-day put provision supported by direct pay bank letters of credit					
Series 2008A	2041	0.03% - 0.24%	0.03% - 0.27%	\$ 80,895	\$ 81,175
Series 2008B	2041	0.06% - 0.26%	0.04% - 0.24%	80,790	81,070
Series 2008E	2048	0.04% - 0.24%	0.04% - 0.29%	50,000	50,000
Series 2008F	2048	0.04% - 0.22%	0.04% - 0.24%	45,200	45,200
Series 2008G	2048	0.04% - 0.22%	0.04% - 0.24%	45,250	45,250
Series 2008H	2048	0.04% - 0.25%	0.05% - 0.24%	63,895	63,895
Series 2008I	2037	0.05% - 0.24%	0.03% - 0.25%	40,390	40,495
Series 2008J	2037	0.04% - 0.22%	0.04% - 0.24%	40,385	40,500
Total variable rate demand bonds				<u>\$ 446,805</u>	<u>\$ 447,585</u>
Other debt					
Capital lease obligations (excluding imputed interest of \$4,552 and \$5,498 at December 31, 2013 and 2012, respectively)				\$ 21,322	\$ 21,696
Other				6,200	9,920
Total other debt				<u>\$ 27,522</u>	<u>\$ 31,616</u>
Total long-term debt				\$ 1,119,258	\$ 1,138,178
Less current portion of long-term debt				<u>(22,029)</u>	<u>(22,103)</u>
Long-term debt, net of current portion				<u>\$ 1,097,229</u>	<u>\$ 1,116,075</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

Scheduled principal payments on long-term debt are as follows:

Years ending December 31	Fixed and Variable Rate Bonds	Capital Lease Obligations	Other	Total
		(in thousands)		
2014	\$ 15,780	\$ 4,482	\$ 1,767	\$ 22,029
2015	16,585	4,428	1,427	22,440
2016	17,370	3,921	1,384	22,675
2017	15,040	2,379	1,366	18,785
2018	18,990	865	256	20,111
Thereafter	1,011,410	5,247	-	1,016,657
	<u>\$ 1,095,175</u>	<u>\$ 21,322</u>	<u>\$ 6,200</u>	<u>\$ 1,122,697</u>

Total interest costs incurred on the long-term debt less capitalized interest are as follows:

	2013	2012
	(in thousands)	
Interest costs incurred	\$ 37,496	\$ 38,302
Less capitalized interest	<u>703</u>	<u>3,169</u>
Interest expense included in operating income	<u>\$ 36,793</u>	<u>\$ 35,133</u>

The fair value of the Corporation's long-term debt at December 31, 2013 and 2012 approximates \$1.075 billion and \$1.128 billion, respectively. The fair values of the Corporation's underlying tax exempt Hospital and Health System Revenue Bonds and Refunding Bonds are based on current traded values for similar types of borrowings which are considered Level 2 inputs as described in Note 2.

**Obligated Group and Designated Group Affiliates and Other Requirements** - The Corporation has long-term debt outstanding under a Master Trust Indenture dated November 1, 1997, as amended and supplemented ("AMTI"). The AMTI permits the Corporation to issue obligations to finance certain activities. Obligations issued under the AMTI are general, direct obligations of the Corporation and any future members of the Franciscan Alliance, Inc. Obligated Group ("Obligated Group"). All members of the Obligated Group are jointly and severally liable with respect to the payment of each obligation issued under the AMTI. In addition, the AMTI provides that certain affiliates of the Corporation may be designated as Designated Group Affiliates from time to time and the Corporation covenants to cause each of its Designated Group Affiliates to pay, loan, or otherwise transfer to the Obligated Group such amounts necessary to pay the obligations issued under the AMTI. The Designated Group Affiliates are not members of the Obligated Group and are not directly liable for payments on the obligations. The Corporation has granted a security interest in its unrestricted receivables, among others, for the benefit of the owners of the obligations. The AMTI includes covenants which require the Corporation to maintain a minimum debt service coverage ratio of 1.10 and limit the Corporation's ability to encumber certain of its assets. In determining whether the Corporation has satisfied such covenants, the AMTI requires the Corporation to include the Obligated Group and Designated Group Affiliates together in calculating the related ratios and in testing for compliance even though the Designated Group Affiliates are not directly obligated on the long-term debt issued under the AMTI. As of December 31, 2013 and 2012, the Corporation was in compliance with the terms of the AMTI and there were no other Obligated Group members nor any Designated Group Affiliates.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**Refunding of Long-Term Debt** – In April 2012, the Corporation issued at par \$82.62 million of Series 2012A and 2012B variable rate direct placement bonds. Proceeds were used to refund the Series 2008D variable rate demand bonds that were previously supported by a direct pay letter of credit and legally defeased the Series 2001 fixed rate bonds. The transaction resulted in a loss on refunding of long-term debt of approximately \$0.2 million, which is reflected in other income (expense) in the consolidated statements of operations and change in net assets.

**Variable Rate Demand Bonds**– As of December 31, 2013, the Corporation has separate direct pay letters of credit totaling \$446.8 million to fully support its Series 2008A, Series 2008B, and Series 2008E through Series 2008J variable rate demand bonds. These liquidity facilities are available to the Corporation should the holders of the obligations present such obligations for redemption and the obligations are not remarketed. Additionally, these facilities (if utilized) generally have repayment terms for bonds held by the letter of credit banks that amortize ratably over 3 to 5 years, depending on the facility used. Termination dates for the various liquidity facility agreements have expiration dates extending from April 2015 through October 2018. Since the liquidity facilities expire beyond one year from the Corporation’s balance sheet date and the Corporation has the intent to continually renew these liquidity facilities, the variable rate demand bonds are classified as long-term debt and are disclosed in accordance with the stated maturities.

**7. Other Liabilities and Commitments**

**Interest Rate Swap Contracts** – The Corporation utilizes interest rate swaps to manage interest rate risk associated with its variable rate bonds. Cash payments on the interest rate swap contracts totaled \$14.2 million and \$14.4 million for the years ended December 31, 2013 and 2012, respectively. At December 31, 2013 and 2012, the interest rate swap contracts were in a liability position with a fair value of approximately \$58.5 million and \$102.2 million, respectively. The fair value of the Corporation’s interest rate swap contracts are based on observable inputs, such as interest rates and credit risk spreads, that fall within Level 2 of the hierarchy of fair value inputs as described in Note 2. Certain of the Corporation’s interest rate swap agreements include collateral funding requirements based on the market value of these contracts. At December 31, 2013 and 2012, the Corporation had posted \$19.4 million and \$41.0 million, respectively, to satisfy its collateral funding obligations on these contracts which are included in assets under bond indenture and swap agreements within board designated and other investments on the consolidated balance sheets.

**Operating Leases** – The Corporation leases various facilities, equipment, and software. Total rental expense under operating leases approximated \$42.7 million and \$39.8 million for the years ended December 31, 2013 and 2012, respectively. Future minimum lease payments under operating leases as of December 31, 2013 that have initial or remaining lease terms in excess of one year are as follows:

<b>Years ending December 31</b>	(in thousands)
2014	\$ 34,524
2015	34,030
2016	33,799
2017	33,227
2018	32,722
Thereafter	52,638
	<u>\$ 220,940</u>

## Franciscan Alliance, Inc. and Affiliates

### Notes to Consolidated Financial Statements

#### December 31, 2013 and 2012

---

#### 8. Pension and Other Benefit Plans

Prior to 2014, the Corporation had various retirement programs due to acquisitions over the years. Effective January 1, 2014, all employees (except for those from two of its Health Centers and its construction company) will be covered by one comprehensive retirement program that administers retirement benefits under two different programs. Under the first program, future employer-provided benefits will be provided entirely through the defined benefit plan with no employer contributions provided through the defined contribution plan. Under the second program, future employer-provided benefits will be provided through both the defined benefit plan and an employer contribution provided through the defined contribution plan. Both programs include similar benefit levels even though they are being delivered through different retirement plan types.

**Noncontributory Defined Benefit Pension Plans** - The Corporation has a qualified, noncontributory defined benefit pension plan covering all eligible employees of certain of the Corporation's entities. The plan provides defined benefits based on years of service and final average salary. Certain nonqualified, supplemental plan arrangements also provide retirement benefits to specified groups of participants. Because the noncontributory defined benefit pension plan has church plan status as defined in the Employee Retirement Income Security Act of 1974 ("ERISA"), funding in accordance with ERISA is not required. The Corporation's funding policy for the qualified plan, which is reviewed annually and may be adjusted as needed, is to fund the normal service cost based on the accumulated benefit obligation for the plan's year and amortize any under or over funding over a ten year period. The retirement program redesign and associated defined benefit plan amendment resulted in a decrease in the projected benefit obligation and is included in accrued pension liability in the consolidated balance sheets. The Corporation also terminated a defined benefit pension plan related to a discontinued Health Center which resulted in a plan settlement charge in 2013.

The Corporation's measurement date for all pension calculations is December 31.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

The change in projected benefit obligation, change in plan assets, and funded status of the Corporation's pension plans as of December 31, 2013 and 2012, are as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
<b>Change in benefit obligation</b>		
Benefit obligation, beginning of year	\$ 1,403,158	\$ 1,164,705
Service cost	52,638	45,732
Interest cost	56,930	57,896
Plan amendment	(18,419)	2,766
Plan settlements	(16,270)	-
Actuarial (gain) loss	(229,395)	159,643
Benefits paid	<u>(30,404)</u>	<u>(27,584)</u>
Benefit obligation, end of year	<u>1,218,238</u>	<u>1,403,158</u>
<b>Change in plan assets</b>		
Fair value of plan assets, beginning of year	975,017	838,463
Actual gain on plan assets	104,769	85,365
Employer contributions	69,170	78,773
Plan settlements	(16,270)	-
Benefits paid	<u>(30,404)</u>	<u>(27,584)</u>
Fair value of plan assets, end of year	<u>1,102,282</u>	<u>975,017</u>
Funded status	<u>\$ (115,956)</u>	<u>\$ (428,141)</u>
<b>Amounts recognized in the consolidated balance sheets</b>		
Noncurrent assets	\$ 390	\$ -
Current liabilities	(9,077)	(1,512)
Noncurrent liabilities	<u>(107,269)</u>	<u>(426,629)</u>
Total amount recognized	<u>\$ (115,956)</u>	<u>\$ (428,141)</u>

The amounts in unrestricted net assets, including amounts arising during the year and amounts reclassified into net periodic benefit cost, are as follows:

	<b>Net</b>	<b>Prior</b>	
	<b>Gain (Loss)</b>	<b>Service</b>	<b>Total</b>
		(in thousands)	
<b>December 31, 2011</b>	\$ (323,072)	\$ (861)	\$ (323,933)
Amounts reclassified into net periodic benefit cost	22,959	(1,602)	21,357
Amounts arising during the year	<u>(137,886)</u>	<u>-</u>	<u>(137,886)</u>
<b>December 31, 2012</b>	<u>\$ (437,999)</u>	<u>\$ (2,463)</u>	<u>\$ (440,462)</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

	<b>Net Gain (Loss)</b>	<b>Prior Service Cost</b> (in thousands)	<b>Total</b>
<b>December 31, 2012</b>	\$ (437,999)	\$ (2,463)	\$ (440,462)
Amounts reclassified into net periodic benefit cost	39,676	18,904	58,580
Amounts arising during the year	261,147	-	261,147
<b>December 31, 2013</b>	<u>\$ (137,176)</u>	<u>\$ 16,441</u>	<u>\$ (120,735)</u>

The following are estimated amounts to be amortized from unrestricted net assets into net periodic pension cost in the next fiscal year:

	(in thousands)
Unrecognized prior service credit	\$ 2,024
Unrecognized loss	<u>(1,911)</u>
Total amount expected to be amortized from unrestricted net assets in 2014	<u>\$ 113</u>

The accumulated benefit obligation ("ABO") at December 31, 2013 and 2012 was \$1.139 billion and \$1.236 billion, respectively. The following information is provided for plans with an ABO in excess of plan assets at December 31, 2013 and 2012:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Projected benefit obligation	\$ 1,214,063	\$ 1,403,158
ABO	1,135,254	1,235,880
Fair value of plan assets	1,097,717	975,017

Components of net periodic pension cost for the years ended December 31, 2013 and 2012, are as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Service cost	\$ 52,638	\$ 45,732
Interest cost	56,930	57,896
Expected return on plan assets	(73,017)	(64,046)
Amortization of prior service cost	485	1,602
Amortization of net loss	29,996	22,959
Net periodic pension cost included in operating expenses	<u>67,032</u>	<u>64,143</u>
Plan settlement loss recognized in other income (expense)	<u>9,679</u>	<u>-</u>
Net periodic pension cost	<u>\$ 76,711</u>	<u>\$ 64,143</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

The following weighted-average assumptions were used to determine the Corporation's benefit obligations and net periodic pension cost for the years ended December 31:

	<b>2013</b>	<b>2012</b>
<b>Benefit obligation</b>		
Discount rate	5.25 %	4.25 %
Rate of compensation increase	4.70 %	4.50 %
<b>Net periodic pension cost</b>		
Discount rate	4.25 %	5.00 %
Expected rate of return on plan assets	7.33 %	7.31 %
Rate of compensation increase	4.50 %	4.50 %

In developing the expected rate of return on plan assets assumption, the Corporation considered the historical returns and the expectation for future returns on each asset class, as well as the target asset allocation of the pension investment portfolio. The rate of return on plan assets assumption also considers investment and administrative expenses.

The discount rate assumption reflects the yield of a portfolio of high quality bonds matched against the timing and amount of projected future benefit payments as of the measurement date.

The Corporation's pension investment policy reflects the long-term nature of the pension plans' funding obligations. Assets are invested to achieve a rate of return consistent with policy allocation targets, which significantly contributes to meeting the current and future obligations of the plans and helps to ensure solvency of the plans over time. It is expected that this objective can be achieved through a well-diversified asset portfolio and an emphasis on long-term capital appreciation as a primary source of return. The plans utilize a multi-manager structure of complementary investment styles and classes. Manager performance is judged over an investment market cycle which is generally 3 to 5 years.

Plan assets are exposed to risk and fluctuations in market value from year to year. To minimize risk, each manager is required to maintain adequate portfolio diversification to insulate the plan assets from substantial loss in any single security or market sector. Asset allocation is reviewed monthly for deviations in the allowable range and is rebalanced as necessary. The asset allocation for the Corporation's pension plans as of December 31, 2013 and 2012 and the target allocation of the pension plans, by asset category, are as follows:

<b>Asset class</b>	<b>Target Allocation</b>	<b>Percentage of Plan Assets</b>	
		<b>2013</b>	<b>2012</b>
Domestic large capitalization securities	26 %	30 %	26 %
Domestic mid capitalization securities	3	4	4
Domestic small capitalization securities	9	11	8
International equity securities	19	19	18
Fixed income securities	36	32	39
Hedge funds	7	4	5
	<u>100 %</u>	<u>100 %</u>	<u>100 %</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

**Cash Flows**

During 2014, the Corporation anticipates making contributions of approximately \$12.1 million to fund the normal service cost in accordance with its standard funding policy and an additional \$50 million to fund the third year of a four year, \$200 million total supplemental pension funding commitment approved by the Corporation's Board.

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

	(in thousands)
2014	\$ 47,243
2015	46,944
2016	51,041
2017	52,803
2018	58,141
Years 2019-2023	374,860

The following tables summarize the Corporation's pension and other benefit plans' assets, measured at fair value as of December 31, 2013 and 2012, respectively.

Asset category	Balance as of December 31,			
	2013	Level 1	Level 2	Level 3
		(in thousands)		
Cash and cash equivalents	\$ 105,437	\$ 105,437	\$ -	\$ -
U.S. government, state, municipal, and agency obligations	268,276	267,920	356	-
Other fixed income securities	22,216	-	22,216	-
Equity securities	556,171	556,171	-	-
Asset-backed securities	1,426	-	1,426	-
Unregistered mutual funds	98,134	-	98,134	-
Real estate investment trusts	6,548	6,548	-	-
Hedge funds	44,074	-	-	44,074
Total	<u>\$ 1,102,282</u>	<u>\$ 936,076</u>	<u>\$ 122,132</u>	<u>\$ 44,074</u>

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

Asset category	Balance as of December 31, 2012			
	Level 1	Level 2	Level 3	
	(in thousands)			
Cash and cash equivalents	\$ 64,917	\$ 64,917	\$ -	\$ -
U.S. government, state, municipal, and agency obligations	328,793	327,898	895	-
Other fixed income securities	33,958	-	33,958	-
Equity securities	422,878	422,878	-	-
Asset-backed securities	2,122	-	2,122	-
Registered and unregistered mutual funds	74,484	318	74,166	-
Real estate investment trusts	6,044	6,044	-	-
Hedge funds	41,821	-	-	41,821
Total	<u>\$ 975,017</u>	<u>\$ 822,055</u>	<u>\$ 111,141</u>	<u>\$ 41,821</u>

There were no significant transfers to or from Levels 1 and 2 during the years ended December 31, 2013 and 2012.

Changes in Level 3 hierarchy assets measured at fair value for the Corporation's pension and other benefit plans are as follows:

	(in thousands)
<b>Beginning balance, December 31, 2011</b>	<b>\$ 28,747</b>
Net unrealized investment gains	415
Investment losses	(10)
Purchases of investments	40,997
Sales of investments	(28,328)
<b>Ending balance, December 31, 2012</b>	<b><u>\$ 41,821</u></b>
<b>Beginning balance, December 31, 2012</b>	<b>\$ 41,821</b>
Net unrealized investment gains	2,529
Investment gains	11
Purchases of investments	174
Sales of investments	(461)
<b>Ending balance, December 31, 2013</b>	<b><u>\$ 44,074</u></b>

**Defined Contribution Benefits** - The Corporation sponsors various defined contribution benefit plans covering eligible employees. These employees may contribute a portion of their pre-tax and/or after-tax compensation to the plans, in accordance with specified guidelines. In addition to any discretionary contributions, these plans provide for established contribution percentages or a percentage match of employee contributions up to certain limits for eligible employees. Contribution expense for the years ended December 31, 2013 and 2012 aggregated \$16.7 million and \$14.3 million, respectively.

## **Franciscan Alliance, Inc. and Affiliates**

### **Notes to Consolidated Financial Statements**

#### **December 31, 2013 and 2012**

---

#### **9. Estimated Insurance Liabilities**

Hills Insurance Company, Inc. ("Hills Inc."), the wholly owned captive insurance subsidiary of the Corporation, provides certain professional and general liability coverage for the Health Centers and other corporate entities. The Corporation, through Hills Inc., has limited its liability by purchasing reinsurance and excess insurance coverage from several commercial insurance companies. In the unlikely event that any or all of the insurance or reinsurance companies might be unable to meet their obligations under the existing agreements, the Corporation, through Hills Inc., would be liable for such defaulted amounts. In addition, the Corporation is self-insured for its employee health, long-term disability, and workers' compensation employee benefit programs.

The estimated insurance liabilities provide for reported losses and for losses incurred but not reported based on projections by independent actuaries using information provided by the Corporation's management. The estimated insurance liabilities, which consist of professional liability, general liability, long-term disability insurance, workers' compensation, and amounts self-insured for allocated loss adjustment expenses, approximated \$130.3 million and \$130.1 million on an undiscounted basis at December 31, 2013 and 2012, respectively.

Claims arising from provisions of health care and other operating activities have been asserted against the Corporation by various claimants. These claims are in various stages of processing and some may ultimately be brought to trial. Counsel is unable to conclude as to the ultimate outcome of the actions. There are known incidents occurring through December 31, 2013 that may result in the assertion of additional claims and other claims may be asserted arising from services provided to patients in the past. While it is possible that settlement of asserted claims and claims which may be asserted in the future could result in liabilities in excess of amounts provided by the Corporation, management believes that the excess liability, if any, would not materially affect the consolidated financial position of the Corporation at December 31, 2013.

#### **10. Noncontrolling Interests in Consolidated Affiliates and Investments in Unconsolidated Affiliates**

The Corporation is involved in various health service entity joint ventures that support the Corporation's mission whose operations have been included in the consolidated financial statements.

##### **Noncontrolling Interests in Consolidated Affiliates**

The Corporation's consolidated financial statements include all assets, liabilities, revenues, and expenses of less than 100% owned entities that it controls. Accordingly, the Corporation has recorded the noncontrolling interests in the earnings and equities of such entities in its consolidated financial statements.

##### **Investments in Unconsolidated Affiliates**

The Corporation has investments in entities that are recorded under the cost or equity method of accounting. At December 31, 2013, the Corporation maintained investments in unconsolidated affiliates that support the Corporation's mission having noncontrolling ownership interests ranging from 8% to 50%.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

At December 31, 2013 and 2012, the Corporation had a 33%, economic interest in Alverno Clinical Laboratories, LLC ("ACL, LLC"), an Indiana limited liability company created to direct, operate, maintain, and manage a centralized clinical laboratory in Hammond, Indiana supporting the Corporation and Presence Health ("Presence"). The Corporation is also an owner of Alverno Provena Hospital Laboratories, LLC ("APHL"), a nonprofit cooperative corporation created to direct, operate, maintain, and manage the on-site laboratories of the Corporation's and Presence's health centers. Governance of ACL, LLC and APHL (collectively referred to as the "Laboratories") is shared between the health system members. The Corporation accounts for its investment in ACL, LLC under the equity method which approximated \$4.2 million and \$4.1 million at December 31, 2013 and 2012, respectively. The Corporation's capital account in APHL approximates \$50,000 at both December 31, 2013 and 2012.

The Corporation's share of the equity in earnings of investments in unconsolidated affiliates accounted for on the equity method is approximately \$6.3 million and \$5.0 million for the years ended December 31, 2013 and 2012, respectively, which is included in total unrestricted revenues, gains, and other support in the consolidated statements of operations and changes in net assets.

The unaudited summarized financial position and results of operations for the entities accounted for under the equity method as of and for the periods ended December 31 is as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Total assets	\$ 162,859	\$ 127,411
Total liabilities	102,488	71,528
Net assets	60,371	55,883
Total unrestricted revenues, gains, and other support	708,055	664,353
Excess of revenues over expenses	19,027	9,660

**11. Restricted Net Assets**

Temporarily restricted net assets are available for the following purposes at December 31, 2013 and 2012:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Capital expenditures	\$ 5,957	\$ 4,216
Medical education programs	4,572	4,785
Health care programs	4,330	5,627
Other restrictions	4,556	2,931
	<u>\$ 19,415</u>	<u>\$ 17,559</u>

Capital expenditures relate to assets held by the Corporation, its Health Centers, and its foundation which are restricted by donors or grantors to be used specifically for equipment, capital projects, or other capital needs.

Medical education programs relate to assets held by the Corporation, its Health Centers, and its foundation which are restricted by donors or grantors to be used in specific education programs or for staff education.

**Franciscan Alliance, Inc. and Affiliates**  
**Notes to Consolidated Financial Statements**  
**December 31, 2013 and 2012**

---

Health care programs relate mainly to assets held by the Corporation's Health Centers and its foundation which are restricted by donors or grantors to be used in specific health care programs for medical and patient services.

Other restrictions relate to assets held by the Corporation's foundation which are restricted by donors or grantors to be used for programs such as spiritual care, mission related activities, or employee emergencies.

Permanently restricted net assets of approximately \$17.3 million and \$11.9 million at December 31, 2013 and 2012, respectively, are restricted to investments to be held in perpetuity with the income expendable to support the Corporation's mission.

**12. Related Party Transactions**

The Corporation's Health Centers incurred clinical laboratory charges from the Laboratories of approximately \$64.6 million and \$60.5 million for the years ended December 31, 2013 and 2012, respectively, which is included in purchased services in the consolidated statements of operations and changes in net assets. The Corporation provides information technology services, central procurement and disbursement services, and rents the core lab facilities to the Laboratories for which the Corporation has recorded approximately \$2.6 million and \$2.3 million for the years ended December 31, 2013 and 2012, respectively, as other operating revenue on the consolidated statements of operations and changes in net assets.

**13. Functional Expenses**

The Corporation provides general health care services to residents within its geographical location. Expenses related to providing these services for the years ended December 31, 2013 and 2012 are as follows:

	<b>2013</b>	<b>2012</b>
	(in thousands)	
Health care services	\$ 2,046,228	\$ 2,042,280
General, administrative, and other nonhealth care services	<u>525,634</u>	<u>474,800</u>
Total operating expenses before asset impairment	<u>\$ 2,571,862</u>	<u>\$ 2,517,080</u>

**14. Subsequent Events**

Management has evaluated events and transactions through April 30, 2014, the date the consolidated financial statements were issued, noting the following subsequent event requiring recording or disclosure.

The Corporation has received and signed a nonbinding nonexclusive letter of intent to sell two of its Health Centers in Illinois. Should a transaction occur, the proceeds received may not equal the carrying value of the Health Centers. The Corporation may also have to defease a portion of its long-term debt through the use of proceeds received and use of board designated investments.