



CONSOLIDATED FINANCIAL STATEMENTS
AND OTHER FINANCIAL INFORMATION

Memorial Health System, Inc. and Affiliated Corporations
Years Ended December 31, 2011 and 2010
With Report of Independent Auditors

Ernst & Young LLP

 **ERNST & YOUNG**

Memorial Health System, Inc. and Affiliated Corporations

Consolidated Financial Statements
and Other Financial Information

Years Ended December 31, 2011 and 2010

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Report of Independent Auditors

The Board of Directors
Memorial Health System, Inc. and Affiliated Corporations

We have audited the accompanying consolidated balance sheets of Memorial Health System, Inc. and Affiliated Corporations (the Corporation) as of December 31, 2011 and 2010, and the related consolidated statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Corporation's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Memorial Health System, Inc. and Affiliated Corporations at December 31, 2011 and 2010, and the consolidated results of their operations and changes in net assets and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2011, the Corporation adopted authoritative guidance issued by the Financial Accounting Standards Board related to presentation and disclosure of patient service revenue, provisions for bad debts, and the allowance for doubtful accounts.



March 8, 2012

Memorial Health System, Inc. and Affiliated Corporations

Consolidated Balance Sheets

| | December 31 | |
|----------------------------------------------------------------------------------------------------------|-----------------------|-------------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 59,571 | \$ 54,700 |
| Short-term investments | 6,982 | 6,787 |
| Patient accounts receivable, less allowances for doubtful accounts (2011 – \$16,206; 2010 – \$15,459) | 74,479 | 70,801 |
| Due from third-party payors | 4,825 | 850 |
| Other receivables | 1,929 | 1,638 |
| Inventories | 14,191 | 15,085 |
| Prepaid expenses | 6,925 | 6,482 |
| Total current assets | 168,902 | 156,343 |
| Assets limited as to use: | | |
| Internally designated investments | 227,116 | 220,666 |
| Externally designated investments under debt agreements | – | 53 |
| Externally designated investments – insurance trust | 2,564 | 2,515 |
| Board-designated endowment | 17,525 | 18,031 |
| | 247,205 | 241,265 |
| Property and equipment: | | |
| Land | 37,424 | 35,784 |
| Buildings and improvements | 397,958 | 368,379 |
| Furniture and equipment | 264,189 | 247,877 |
| Construction in progress | 9,604 | 11,402 |
| | 709,175 | 663,442 |
| Less allowances for depreciation and amortization | 344,289 | 317,671 |
| | 364,886 | 345,771 |
| Unamortized bond issuance costs, net | 1,394 | 1,470 |
| Deferred charges and other assets | 18,332 | 13,917 |
| Interest rate and basis swaps | 123 | – |
| | \$ 800,842 | \$ 758,766 |

| | December 31 | |
|-------------------------------------------------------------|-----------------------|-------------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Liabilities and net assets | | |
| Current liabilities: | | |
| Accounts payable | \$ 25,540 | \$ 22,213 |
| Accrued expenses | 31,668 | 24,806 |
| Due to third-party payors | 2,245 | 946 |
| Current maturities of long-term debt | 4,621 | 4,552 |
| Total current liabilities | <u>64,074</u> | <u>52,517</u> |
| Noncurrent liabilities: | | |
| Long-term debt, less current maturities | 133,041 | 137,745 |
| Pension, asset retirement obligations and other liabilities | 53,505 | 44,653 |
| Interest rate and basis swaps | 42,184 | 36,316 |
| | <u>228,730</u> | <u>218,714</u> |
| Total liabilities | <u>292,804</u> | <u>271,231</u> |
| Net assets: | | |
| Unrestricted: | | |
| Undesignated | 485,839 | 465,766 |
| Board-designated endowment | 17,525 | 18,031 |
| Total unrestricted | <u>503,364</u> | <u>483,797</u> |
| Temporarily restricted | 4,483 | 3,738 |
| Permanently restricted | 191 | - |
| Total net assets | <u>508,038</u> | <u>487,535</u> |
| | <u>\$ 800,842</u> | <u>\$ 758,766</u> |

See accompanying notes.

Memorial Health System, Inc. and Affiliated Corporations

Consolidated Statements of Operations
and Changes in Net Assets

| | Year Ended December 31 | |
|-----------------------------------------------------------|-------------------------------|-------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Unrestricted revenue, gains, and other support | | |
| Net patient service revenue | \$ 479,485 | \$ 441,177 |
| Provision for bad debts | (45,020) | (39,787) |
| Net patient service revenue less provision for bad debt | 434,465 | 401,390 |
| Other revenue | 20,461 | 17,706 |
| Net assets released from restrictions used for operations | 891 | 2,126 |
| | 455,817 | 421,222 |
| Expenses | | |
| Salaries and wages | 191,321 | 176,053 |
| Employee benefits | 48,561 | 48,123 |
| Supplies and other | 106,590 | 109,609 |
| Professional fees and purchased services | 56,313 | 51,822 |
| Depreciation and amortization | 28,708 | 30,746 |
| Interest | 4,038 | 2,694 |
| | 435,531 | 419,047 |
| Income from operations | 20,286 | 2,175 |
| Nonoperating | | |
| Investment income, net | 891 | 20,880 |
| Unrealized losses on swap transactions | (5,745) | (27,672) |
| Gain on asset acquisition | 16,410 | – |
| Realized gain on swap termination | – | 5,271 |
| Revenue and gains in excess of expenses | 31,842 | 654 |

Memorial Health System, Inc. and Affiliated Corporations

Consolidated Statements of Operations
and Changes in Net Assets (continued)

| | Year Ended December 31 | |
|-------------------------------------------------------------------------------|-------------------------------|-------------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Unrestricted net assets | | |
| Revenue and gains in excess of expenses | \$ 31,842 | \$ 654 |
| Net assets released from restrictions used for capital purposes | 290 | 1,956 |
| Net assets released from restrictions to an outside organization | 8 | 39 |
| Other | – | 112 |
| Postretirement benefit adjustments other than periodic costs | <u>(12,573)</u> | 1,499 |
| Increase in unrestricted net assets | 19,567 | 4,260 |
| Temporarily restricted net assets | | |
| Contributions temporarily restricted for use | 1,965 | 1,295 |
| Investment (loss) income | (39) | 65 |
| Net assets released from restrictions used for operating and capital purposes | <u>(1,181)</u> | (4,121) |
| Increase (decrease) in temporarily restricted net assets | 745 | (2,761) |
| Permanently restricted net assets | | |
| Contributions permanently restricted for use | <u>191</u> | – |
| Increase in permanently restricted net assets | 191 | – |
| Increase in net assets | 20,503 | 1,499 |
| Net assets at beginning of year | <u>487,535</u> | 486,036 |
| Net assets at end of year | \$ 508,038 | \$ 487,535 |

See accompanying notes.

Memorial Health System, Inc. and Affiliated Corporations

Consolidated Statements of Cash Flows

| | Year Ended December 31 | |
|---------------------------------------------------------------------------------------------|-------------------------------|------------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Operating activities | | |
| Change in net assets | \$ 20,503 | \$ 1,499 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities: | | |
| Depreciation and amortization | 28,708 | 30,746 |
| Provision for bad debts | 45,020 | 39,787 |
| Unrealized losses on swap transactions | 5,745 | 27,672 |
| Realized gain on swap termination | - | (5,271) |
| Loss on disposal of assets | 86 | - |
| Gain on asset acquisition | (16,410) | - |
| Postretirement benefit adjustments other than periodic costs | 12,573 | (1,499) |
| Net unrealized losses (gains) on investments | 5,912 | (15,643) |
| Restricted contributions and investment income | (1,926) | (1,360) |
| Changes in operating assets and liabilities: | | |
| Patient accounts receivable | (48,698) | (31,385) |
| Other receivables, inventories, and prepaid expenses | 160 | 540 |
| Other assets | (4,444) | (1,252) |
| Investments | (12,047) | (34,814) |
| Accounts payable and accrued expenses | 10,189 | (5,261) |
| Due to third-party payors | (2,676) | (1,966) |
| Other long-term liabilities | (3,904) | 3,029 |
| Net cash provided by operating activities | <u>38,791</u> | <u>4,822</u> |
| Investing activities | | |
| Net gain on termination of swap transactions | - | 5,395 |
| Acquisition of net assets | (19,418) | (4,804) |
| Net additions to property and equipment | (11,656) | (31,658) |
| Cash used in investing activities | <u>(31,074)</u> | <u>(31,067)</u> |
| Financing activities | | |
| Principal payments on long-term debt and other debt obligations | (5,169) | (4,797) |
| Net proceeds from issuance of long-term debt and other debt obligations | 397 | 2,869 |
| Restricted contributions and investment income | 1,926 | 1,360 |
| Net cash used in financing activities | <u>(2,846)</u> | <u>(568)</u> |
| Increase (decrease) in cash and cash equivalents | 4,871 | (26,813) |
| Cash and cash equivalents at beginning of year | 54,700 | 81,513 |
| Cash and cash equivalents at end of year | <u>\$ 59,571</u> | <u>\$ 54,700</u> |
| Supplemental disclosure on cash flow information | | |
| Interest paid | <u>\$ 4,156</u> | <u>\$ 3,117</u> |

See accompanying notes.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements

December 31, 2011

1. Organization and Basis of Consolidation

The accompanying consolidated financial statements represent the accounts of Memorial Health System, Inc. (the Corporation) and its various affiliated corporations under the control of the Corporation. The Corporation is an Indiana not-for-profit corporation exempt from federal income tax under Internal Revenue Code (the Code) Section 501(a) as an organization described in Section 501(c)(3) and a public charity as described in Section 509(a)(2). Included among the affiliated corporations are Memorial Hospital of South Bend, Inc. (the Hospital), Memorial Health Foundation, Inc. (MHF), Memorial Health System, Inc. (MHS), and Memorial Home Care, Inc. (Home Care). The Hospital and MHF are also exempt from federal income tax under Section 501(a) as organizations described in Section 501(c)(3) and as public charities described in Sections of 509(a)(1) and 509(a)(2), respectively. Home Care is an Indiana for-profit corporation. All significant intercompany accounts and transactions have been eliminated in the consolidation.

In March 2011, MHS and Elkhart General Hospital Inc. (EGH) completed a Memorandum of Understanding to form an affiliation. Effective December 1, 2011, a newly formed corporation, Elkhart Memorial Topco Inc. (Topco), became the sole corporate member for both MHS and EGH.

The Corporation also owns a 50% interest in Community Health Alliance LLC, an Indiana physician hospital organization; a 33.33% interest in Partners Health Plan, an inactive provider-owned health plan; a 40% interest in Skyway Limited Partnership, a professional medical building venture; a 50% interest in Memorial Spine and Neuroscience Center, LLC, an outpatient surgery center specializing in neurologic, spine, and pain control procedures; a 49% interest in LaPorte Medical Group Surgery Center, LLP, an outpatient surgery center; and a 35% interest in Physicians Hospital LLC, a long-term acute care facility.

In May 2010, the Corporation obtained a 50% interest in Michiana Linen Service, LLC, an institutional laundry provider. Prior to June 2010, MHS owned a 50% interest in Memorial Lighthouse Medical Imaging, LLC (MLMI), an outpatient diagnostic imaging center. In June 2010, the Hospital acquired 100% of the assets of MLMI.

The Hospital is a 526-bed acute care facility. The Hospital provides inpatient, outpatient, and 20 emergency care services for residents of South Bend, Indiana, and the surrounding communities. MHF is organized primarily to promote and encourage philanthropic activities for the support of the Corporation and its affiliates. Home Care manages the taxable operations of the Corporation.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Although estimates are considered to be fairly stated at the time the estimates are made, actual results could differ from those estimates.

Cash Equivalents

All investments that are not limited as to use with a maturity of three months or less at the time of acquisition are reflected as cash equivalents. Cash equivalents include checking accounts, money market accounts, corporate credit card accounts, petty cash, and prepaid vendor accounts. The carrying value of cash equivalents approximates fair value.

Short-Term Investments

Short-term investments include cash reinvested on a daily basis, accrued interest on investments, and money expected to be used in less than a year as part of the Corporation's community benefit. Also included in short-term investments are restricted and unrestricted investment donations that are in the process of being liquidated.

Accounts Receivable

The Corporation evaluates the collectability of its accounts receivable based on the length of time the receivable is outstanding, payor class, and the anticipated future uncollectible amounts based on historical experience. Accounts receivable are charged to the allowance for doubtful accounts when they are deemed uncollectible.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Assets Limited as to Use

Assets limited as to use include assets set aside by the Board of Directors (the Board) for future capital improvements and community health enhancement initiatives which the Board, at its discretion, may subsequently use for other purposes. In Addition, assets limited as to use also include assets held by trustees under debt and self-funded insurance agreements.

Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value based on quoted market prices for those or similar investments. Dividend and interest income, realized gains and losses, and changes to fair values of investments are reported as nonoperating investment income in the consolidated statements of operations and changes in net assets.

Investments in alternative investments, primarily hedge fund of funds, that invest in marketable securities and derivative products, are reported using the equity method. The estimated fair values are provided by the respective fund managers and are based on historical costs, appraisals, and other estimates that require varying degrees of judgment. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and may differ from the value that would have been used had a ready market for such investments existed. Resulting differences could be material. The financial statements of the hedge funds are audited annually. Equity earnings related to these alternative investments are included in nonoperating investment income. The Corporation's holding reflects net contributions to the hedge fund and an allocated share of realized and unrealized investment income and expense.

Inventories

Inventories are stated at the lower of cost (average cost method) or market.

Unamortized Bond Issuance Costs

Costs incurred in connection with the issuance of long-term debt are deferred and amortized over the term of the related financing, which approximates the effective interest method.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment

Property and equipment are carried at cost, except donated assets, which are recorded at fair value at the date of donation. Allowances for depreciation and amortization are computed primarily utilizing the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years.

Asset Impairment

The Corporation considers whether indicators of impairment are present and performs the necessary tests to determine if the carrying value of an asset is appropriate. Impairment write-downs are recognized in operating expenses at the time the impairment is identified. There was no impairment of long-lived assets in 2011 and 2010.

Deferred Charges and Other Assets

Included in deferred charges and other assets are intangible assets and investments in unconsolidated affiliates.

The acquisition of a business entity can result in the recording of intangible assets. Acquired intangible assets (excluding goodwill) are amortized over the useful life of the assets. Goodwill is carried at acquisition value, less any impairment reductions.

The Corporation accounts for its investments in less than majority owned and controlled affiliates using either the cost basis or the equity method of accounting. These investments are included in other long-term assets. Income from these investments is reflected in other income in the statement of operations and changes in net assets.

Endowment Investments

Income is received directly by MHF from MHF board-designated endowment investments. These endowment investments have perpetual existence.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Contributions

Unconditional pledges to give cash and other assets are reported at fair value at the date the pledge is received to the extent estimated to be collectible by MHF or the Hospital. Pledges received with donor restrictions that limit the use of the donated assets are reported as either temporarily or permanently restricted support. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statements of operations and changes in net assets as net assets released from restrictions.

As of December 31, pledges expected to be received, which are included in other receivables, were as follows (in thousands):

| | <u>2011</u> | <u>2010</u> |
|-------------------|---------------|--------------|
| One to five years | \$ 100 | \$ 50 |
| Total pledges | <u>\$ 100</u> | <u>\$ 50</u> |

Temporarily Restricted Net Assets

Temporarily restricted net assets are used to differentiate resources, the use of which is restricted by donors or grantors to a specific time period or purpose, from resources on which no restrictions have been placed or that arise from the general operations of the Corporation. Temporarily restricted gifts and bequests are recorded as an addition to temporarily restricted net assets in the period received. Assets released from restrictions that are used for the purchase of property and equipment or capital purposes are reported in the consolidated statements of operations and changes in net assets as additions to unrestricted net assets. Resources restricted by donors for specific operating purposes are reported in unrestricted revenue, gains, and other support to the extent expended within the period.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Net Patient Service Revenue

The Corporation has agreements with various third-party payors that provide for payments to the Corporation at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. Net patient service revenue is reported at the estimated net realizable amounts received or due from patients, third-party payors, and others for services rendered. These amounts include estimated adjustments under certain reimbursement agreements with third-party payors, which are subject to audit by the applicable administering agency. These adjustments are accrued on an estimated basis and are adjusted in future periods as final settlements are determined (see Note 3).

Community Commitment

The Hospital provides care to all patients regardless of their ability to pay. Charity care provided by the Hospital is excluded from net patient service revenue (see Note 4).

Revenue and Gains in Excess of Expenses

The consolidated statements of operations and changes in net assets include revenue and gains in excess of expenses. Changes in unrestricted net assets, which are excluded from revenue and gains in excess of expenses, consistent with industry practice, include contributions of long-lived assets, including assets acquired using contributions, which by donor restrictions, were to be used for the purpose of acquiring such assets, and pension-related changes other than net periodic costs.

Allocation of Costs

The Corporation's ability to exercise control over consolidated entities could result in the entities having a financial position or operating results that are significantly different from those that would have been obtained if the entities were autonomous. The manner of allocating certain shared and centralized costs, such as accounts payable processing, information technology support, and other Corporation-managed administration costs, is determined by the Corporation utilizing Internal Revenue Service transfer pricing guidance. Alternate methods of accounting for these cost allocations may produce significantly different operating results for each of the consolidated entities.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Interest Rate and Basis Swaps

All interest rate and basis swaps are measured at fair value based on quoted market interest rates. None of the swaps are designated as hedging instruments; therefore, the unrealized gains or losses on the fair value of the swaps are included in revenue and gains in excess of expenses in the consolidated statements of operations and changes in net assets.

Asset Retirement Obligations

The Corporation accounts for the fair value of legal obligations associated with long-lived asset retirements by recognizing an expense and accreting a liability over the life of the asset to cover potential legal obligations at the end of the asset's useful life. The asset retirement obligation primarily relates to future asbestos remediation related to buildings on the Hospital's campus, as well as ground/soil remediation associated with the removal of underground fuel tanks. The carrying value of the obligation amounted to approximately \$4,321,000 and \$4,138,000 at December 31, 2011 and 2010, respectively.

Recent Accounting Pronouncements

In August 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-23, *Measuring Charity Care for Disclosure*. The provisions of ASU 2010-23 are intended to reduce the diversity in how charity care is calculated for disclosures across health care entities that provide it. Charity care is required to be measured at cost, defined as the direct and indirect costs of providing the charity care. This new guidance is effective for fiscal years beginning after December 15, 2010, with early application permitted. The Corporation adopted the required components of this guidance in 2011.

In July 2011, the FASB issued ASU 2011-07, *Presentation and Disclosure for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. The guidance requires certain health care entities to reclassify in the statement of operations the provision for bad debts associated with patient service revenue from an operating expense to a deduction from patient service revenues (net of contractual allowances and discounts). In addition, the guidance requires enhanced disclosures about policies for recognizing revenue, assessing bad debts and qualitative and quantitative information about the changes in the allowance for uncollectible accounts. The guidance is effective for the Corporation for the reporting period beginning January 1, 2012, with early adoption permitted. The Corporation adopted this guidance in 2011.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

ASU 2010-24, *Presentation of Insurance Claims and Related Insurance Recoveries*, addresses the diversity in the accounting for medical malpractice and similar liabilities and their related anticipated insurance recoveries by health care entities that mostly have netted insurance recoveries against the accrued liability, although some have presented the anticipated insurance recovery and the liability on a gross basis. The amendments to Accounting Standards Codification (ASC) Topic 954 clarify that a health care entity should not net insurance recoveries against a related claim liability; the amount of the claim liability should be determined without consideration of insurance recoveries. The Corporation adopted ASU 2010-24 for the year ended December 31, 2011. The adoption of ASU 2010-24 impacts the balance sheet and footnote presentation for the Corporation to reflect the gross estimated receivable and gross noncurrent liabilities compared to the netted accrued liability presentation (see Note 12).

Reclassifications

Certain amounts in the 2010 financial statements have been reclassified to conform to the 2011 presentation. These reclassifications did not impact revenues and gains in excess of expenses or net assets previously reported.

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts

The Medicare and Medicaid programs reimburse for inpatient and outpatient services at predetermined rates based on treatment diagnosis. Changes in the Medicare and Medicaid programs or reduction of funding levels for the programs could have an adverse effect on future amounts recognized as net patient service revenue.

The laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Managed care reimbursement agreements provide for payment of patient services at a fixed percentage of covered charges. The Corporation has also entered into contractual arrangements with various health maintenance and preferred provider organizations, the terms of which call for covered services to be paid at predetermined rates, including percent of charges, per diem, and case rate.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

**3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts
(continued)**

Net patient service revenue is recorded in the period in which services are rendered, based upon estimated amounts due from patients and third-party payors. Third parties include Medicare, Medicaid, managed health care plans, and other commercial plans. Estimated amounts due are calculated from contractually obligated terms of payment for each payor, as well as uninsured discounts applied for patients with no insurance coverage. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources, is as follows (in thousands):

| Payor | Net Revenue | |
|-----------------------------------------|--------------------|-------------------|
| | 2011 | 2010 |
| Anthem | \$ 117,745 | \$ 109,210 |
| Commercial | 158,385 | 144,711 |
| Medicare | 132,968 | 117,616 |
| Medicaid | 23,231 | 26,899 |
| Self-pay | 47,156 | 42,741 |
| Revenues before provision for bad debts | 479,485 | 441,177 |
| Provision for bad debts | (45,020) | (39,787) |
| Net patient service revenue | <u>\$ 434,465</u> | <u>\$ 401,390</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts (continued)

Revenues received under the Medicare program account for 28% and 27% of net patient service revenue for the years ended December 31, 2011 and 2010, respectively. Revenues received under the Anthem Payor Contract account for 25% and 25% of net patient service revenue the years ended December 31, 2011 and 2010, respectively.

Credit is granted without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Major components of net patient accounts receivable include 24% from Medicare and 19% from Anthem at December 31, 2011, and 23% from Medicare and 26% from Anthem at December 31, 2010.

The provision for bad debts is based upon management's assessment of historical and expected net collections taking into consideration the trends in health care coverage, historical economic trends and other collection indicators. Management assesses the adequacy of the allowances periodically throughout the year based upon historical write-off experience by major payor category. The results of the review are then utilized to make modifications, as necessary, to the provision for bad debts to provide for an appropriate allowance for uncollectible accounts. A significant portion of the Corporation's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Corporation records a significant provision for bad debts related to uninsured patients in the period the services are provided. The allowance for uncollectible accounts recognized at December 31 by major payor source is as follows (in thousands):

| Payor | Allowance for Doubtful Accounts | |
|-----------------|--------------------------------------------|------------------|
| | 2011 | 2010 |
| Third-party | \$ 8,005 | \$ 4,054 |
| Self-pay | 8,201 | 11,405 |
| Total allowance | <u>\$ 16,206</u> | <u>\$ 15,459</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

3. Contractual Arrangements With Third-Party Payors and Uncollectible Accounts (continued)

The Corporation's allowance for uncollectable accounts for self-pay patients decreased from 74% of self-pay accounts receivable at December 31, 2010, to 51% of self-pay accounts receivable at December 31, 2011. The decrease in allowance rates is attributable to the discounting at time of billing of self-pay accounts in the Hospital per federal regulation. As a result, self-pay write-offs decreased \$6,570,000 from \$29,350,000 in 2010 to \$22,780,000 in 2011. The Corporation has increased the allowance for uncollectable accounts for third-party payors from 26% of third-party accounts receivable at December 31, 2010, to 49% of third-party accounts receivable at December 31, 2011, to account for the increase of co-pay and deductible amounts not paid by patients. This increase was attributed to more patients enrolled in high deductible health plans thereby increasing the population of the underinsured which resulted in an increased risk of bad debt write offs.

Estimates for cost report settlements and contractual allowances can differ from actual reimbursement based on the results of subsequent reviews and cost report audits. For the years ended December 31, 2011 and 2010, net patient service revenue has been decreased by approximately \$1,252,000 and increased by \$2,219,000, respectively, for third-party settlements.

4. Community Commitment

The Corporation adopted ASU 2010-23 for the fiscal period beginning January 1, 2011. This change requires that charity care be reported at estimated direct and indirect costs. The Corporation utilized a cost-to-charge ratio methodology for the cost analysis.

Community commitment represents charity care and/or unreimbursed costs for services rendered at a reduced fee, or no fee, due to the inability of the patient to pay for services. The amount of the community commitment provided was approximately \$6,860,000 and \$9,656,000 for the years ended December 31, 2011 and 2010, respectively, at estimated cost. The decrease was partially caused by the uninsured discount to gross charges, as some of those discounts would previously have been captured as charity write-offs. Additionally, as noted above, the Corporation used a cost to charge ratio methodology to estimate the cost of charity care, and this ratio has changed significantly over the prior year. The only reimbursement for charity care received by the Corporation is determined through a settlement process in the Hospital's annual Medicare cost report filing. Charity care reimbursement was approximately \$149,000 and \$372,000 for the years ended December 31, 2011 and 2010, respectively.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

4. Community Commitment (continued)

In addition, the Corporation reinvests funds into the community to improve the health status of community members, in particular underserved populations. Each year, the Corporation tithes based on the Corporation's income from operations plus certain investment earnings in a separate unrestricted current asset account. The estimated amount of tithing funds expended was approximately \$1,884,000 and \$2,536,000 for the years ended December, 2011 and 2010, respectively.

5. Pension Plan

The Corporation maintains a defined-contribution employee retirement and savings plan. All employees who have attained 21 years of age and have completed 12 months of continuous service are eligible to participate. In 2010, the Corporation's contribution was based on 100% of the employee's contributions, up to 5% of an employee's salary if the employee had been employed less than 10 years, and up to 6% of the employee's salary if the employee had been employed 10 years or more. In 2011, the Corporation's contribution was based on 100% of the employee's contributions, up to 4% of the employee's salary. Contributions were approximately \$5,072,000 and \$6,371,000 for the years ended December 31, 2011 and 2010, respectively.

The Corporation also has a noncontributory, defined-benefit pension plan (the Plan), which includes a final average pay plan and a cash balance plan. The cash balance plan was frozen as of December 31, 2007, and the much smaller grandfathered final average pay plan, with fewer participants, remains frozen and was not altered. The assets in the cash balance plan will continue to earn interest, but service credits are frozen.

The Corporation's pension plan expenses for the years ended December 31, 2011 and 2010, was approximately \$1,804,000 and \$2,031,000, respectively. The Corporation anticipates \$2,518,000 in pension expense for the year ended December 31, 2012.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

The measurement date of December 31 is utilized. The summary of the changes in the benefit obligation and plan assets and the resulting funded status of the Plan is as follows (in thousands):

| | December 31 | |
|--------------------------------------------------------------------------------------------------------------------|--------------------|--------------------|
| | 2011 | 2010 |
| Accumulated benefit obligation | <u>\$ 127,895</u> | <u>\$ 123,007</u> |
| Change in projected benefit obligation: | | |
| Projected benefit obligation at beginning of year | \$ 127,016 | \$ 122,533 |
| Service cost | 1,167 | 1,019 |
| Interest cost | 6,503 | 6,876 |
| Actuarial loss | 4,924 | 2,394 |
| Benefits paid | (8,197) | (5,806) |
| Projected benefit obligation at end of year | <u>\$ 131,413</u> | <u>\$ 127,016</u> |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | \$ 97,396 | \$ 92,788 |
| Actual (loss) gain on plan assets | (1,781) | 9,756 |
| Employer contributions | 3,163 | 658 |
| Benefits and administration fees paid | (8,197) | (5,806) |
| Fair value of plan assets at end of year | <u>\$ 90,581</u> | <u>\$ 97,396</u> |
| Funded status: | | |
| Funded status of the Plan and amounts recognized as other long-term liabilities in the consolidated balance sheets | <u>\$ (40,832)</u> | <u>\$ (29,620)</u> |

Included in unrestricted net assets are the following amounts that have not been recognized in net periodic pension cost at December 31 (in thousands):

| | 2011 | 2010 |
|---------------------------------|-----------------|-----------------|
| Unrecognized prior service cost | \$ (6) | \$ (6) |
| Unrecognized actuarial net loss | 2,447 | 1,314 |
| | <u>\$ 2,441</u> | <u>\$ 1,308</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

Changes in the Plan's assets and benefit obligations recognized in unrestricted net assets during 2011 and 2010 include the following (in thousands):

| | <u>2011</u> | <u>2010</u> |
|----------------------------------------------|------------------|-------------------|
| Current year actuarial loss (gain) | \$ 12,567 | \$ (1,505) |
| Current year amortization prior service cost | 6 | 6 |
| | <u>\$ 12,573</u> | <u>\$ (1,499)</u> |

The components of net periodic benefit cost for the defined-benefit pension plan are as follows (in thousands):

| | <u>Year Ended December 31</u> | |
|-----------------------------------|-------------------------------|-----------------|
| | <u>2011</u> | <u>2010</u> |
| Service cost | \$ 1,167 | \$ 1,019 |
| Interest cost | 6,503 | 6,876 |
| Expected return on plan assets | (7,174) | (7,213) |
| Prior service credit recognized | (6) | (6) |
| Amortization of recognized losses | 1,314 | 1,355 |
| Benefit cost | <u>\$ 1,804</u> | <u>\$ 2,031</u> |

Assumptions used to determine benefit obligations at the measurement date are as follows:

| | <u>December 31</u> | |
|--------------------------------|--------------------|-------------|
| | <u>2011</u> | <u>2010</u> |
| Discount rates | 4.25% | 5.25% |
| Expected return on plan assets | 7.50 | 7.50 |
| Rate of compensation increase | 3.00 | 3.50 |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

Assumptions used to determine net pension expense for the fiscal years are as follows:

| | December 31 | |
|--------------------------------|--------------------|-------------|
| | 2011 | 2010 |
| Discount rates | 5.25% | 5.75% |
| Expected return on plan assets | 7.50 | 8.00 |
| Rate of compensation increase | 3.50 | 4.28 |

The following is a summary of the pension plan asset target and actual allocations at December 31:

| Asset Category | Strategic Target | Actual Asset Allocation at | |
|-----------------------|-------------------------|-----------------------------------|-------------|
| | | December 31 | |
| | | 2011 | 2010 |
| Equity securities | 40% | 27% | 44% |
| Debt securities | 15 | 12 | 20 |
| Other | 45 | 61 | 36 |
| Total | 100% | 100% | 100% |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

The following table sets forth by level, within the fair value hierarchy (see Note 9), the Plan's assets carried at fair value as of December 31, 2011 (in thousands):

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Fair Value</u> |
|------------------------------------------------|------------------|------------------|----------------|-------------------|
| Short-term investment funds ^a | \$ 3,320 | \$ — | \$ — | \$ 3,320 |
| Mutual funds: ^a | | | | |
| Large cap | 8,303 | — | — | 8,303 |
| International | 7,230 | — | — | 7,230 |
| Other | 12,122 | — | — | 12,122 |
| Corporate bonds | 10,882 | — | — | 10,882 |
| Common stocks ^a | 3,632 | — | — | 3,632 |
| Common collective trust funds ^b | — | 1,825 | — | 1,825 |
| Long/short funds: ^{b,c} | | | | |
| Long/short | — | 15,437 | — | 15,437 |
| Leveraged capital | — | 5,687 | — | 5,687 |
| Hedge funds: ^c | | | | |
| Multi-strategy | — | 5,994 | — | 5,994 |
| Long/short | — | 2,147 | — | 2,147 |
| Fixed and convertible arbitrage hedge funds | — | 3,319 | — | 3,319 |
| Long commodities | — | 5,943 | — | 5,943 |
| Other hedge funds | — | 1,712 | — | 1,712 |
| Other funds ^c | — | 3,028 | — | 3,028 |
| | <u>\$ 45,489</u> | <u>\$ 45,092</u> | <u>\$ —</u> | <u>\$ 90,581</u> |

- (a) Pricing for common stocks, mutual funds, and short-term investments are based on the open market and are valued on a daily basis.
- (b) Pricing is based on the market value of the securities and is valued on a monthly basis. In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue to appropriately value the holding.
- (c) Investment in other funds, long/short funds, and hedge funds are valued using the net asset value (NAV) provided by the administrator of the fund. These investments are not otherwise traded on a securities exchange. The NAV is based on the underlying assets owned by the fund, minus its liabilities, and then divided by the number of shares outstanding.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

In addition to understanding fair value methodologies, the long/short, hedge, and other funds may be subject to redemption and/or liquidity restrictions. Restrictions of such funds by category are as follows:

| Type of Fund | Fair Value | Redemption Restrictions | Liquidity Time Frame |
|------------------------------------------------|------------|-------------------------|----------------------|
| Long/short funds | | | |
| Long/short | \$ 7,801 | None | Under 95 days |
| Long/short | 7,635 | None | Annual |
| Long/short leveraged capital | 5,687 | None | Under 95 days |
| Hedge funds | | | |
| Multi-strategy hedge funds | 5,994 | None | Under 95 days |
| Long/short hedge funds | 2,147 | None | Under 95 days |
| Fixed and convertible arbitrage hedge funds | 3,319 | None | Under 95 days |
| Long commodities | 5,943 | None | Under 95 days |
| Other hedge funds | 1,712 | None | Under 95 days |
| Other funds | 3,028 | None | Illiquid |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

The following table sets forth by level, within the fair value hierarchy, the Plan's assets carried at fair value as of December 31, 2010:

| | Level 1 | Level 2 | Level 3 | Fair Value |
|------------------------------------------------|------------------|------------------|----------------|-------------------|
| Short-term investment funds ^a | \$ 1,252 | \$ — | \$ — | \$ 1,252 |
| Mutual funds: ^a | | | | |
| Large cap | 8,181 | — | — | 8,181 |
| International | 8,778 | — | — | 8,778 |
| Other | 4,470 | — | — | 4,470 |
| Corporate bonds | 19,143 | — | — | 19,143 |
| Common stocks ^a | 3,763 | — | — | 3,763 |
| Common collective trust funds ^b | — | 1,318 | — | 1,318 |
| Long/short funds: ^{b,c} | — | | | |
| Long/short | — | 15,582 | — | 15,582 |
| Leveraged capital | — | 5,549 | — | 5,549 |
| Hedge funds: ^c | | | | |
| Multi-strategy | — | 9,574 | — | 9,574 |
| Long/short | — | 6,962 | — | 6,962 |
| Fixed and convertible arbitrage hedge funds | — | 2,880 | — | 2,880 |
| Other hedge funds | — | 6,796 | — | 6,796 |
| Other funds ^c | — | 3,148 | — | 3,148 |
| | <u>\$ 45,587</u> | <u>\$ 51,809</u> | <u>\$ —</u> | <u>\$ 97,396</u> |

- (a) Pricing for common stocks, mutual funds, and short-term investments are based on the open market and are valued on a daily basis.
- (b) Pricing is based on the market value of the securities and is valued on a monthly basis. In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue to appropriately value the holding.
- (c) Investment in other funds, long/short funds, and hedge funds are valued using the net asset value (NAV) provided by the administrator of the fund. These investments are not otherwise traded on a securities exchange. The NAV is based on the underlying assets owned by the fund, minus its liabilities, and then divided by the number of shares outstanding.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

5. Pension Plan (continued)

The Corporation employs a total return investment approach, whereby a mix of equities and fixed-income investments are used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through careful consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio contains a diversified blend of equity, fixed-income, and alternative investments. Equity investments are diversified across U.S. and non-U.S. corporate stocks, as well as growth, value, and small and large capitalizations.

Other assets such as real estate, private equity, and hedge funds are used to enhance long-term returns while improving portfolio diversification. The Corporation's external investment managers may use derivatives to gain market exposure in an efficient and timely manner. Investment risk is measured and monitored on an ongoing basis through quarterly investment portfolio reviews, annual liability measurements, and periodic asset/liability studies.

The following pension benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years ended December 31 (in thousands):

| | | |
|-------------|----|--------|
| 2012 | \$ | 6,685 |
| 2013 | | 7,145 |
| 2014 | | 7,357 |
| 2015 | | 7,423 |
| 2016 | | 7,864 |
| 2017 – 2020 | | 44,034 |

The Corporation contributed \$3,164,000 to plan assets during 2011 from employer assets. The Corporation contributed \$515,000 to plan assets from employer assets in January 2012 for the 2011 pension year. The Corporation anticipates contributing \$4,353,000 to the plan assets from employer assets in 2012.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

6. Lease Obligations

The Corporation leases certain office space and equipment under noncancelable operating leases. At December 31, 2011, the minimum future rental payments under these leases are as follows (in thousands):

| | | |
|------------|----|---------------|
| 2012 | \$ | 3,800 |
| 2013 | | 1,958 |
| 2014 | | 1,836 |
| 2015 | | 1,803 |
| 2016 | | 1,013 |
| Thereafter | | 4,804 |
| | \$ | <u>15,214</u> |

Rental expense for the years ended December 31, 2011 and 2010, was approximately \$4,672,000 and \$4,401,000, respectively.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt

Long-term debt consists of the following at December 31 (in thousands):

| | <u>2011</u> | <u>2010</u> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Tax-exempt bonds issued on behalf of the Hospital by the Hospital Authority of St. Joseph County: | | |
| Health System Revenue Bonds, Series 2008A, bearing interest at variable rates retaining the hedge from the Series 2006 with a floating to fixed interest rate swap at 3.5% at December 31, 2011 and 2010, due in varying annual installments on August 15 of each year through 2033 | \$ 38,405 | \$ 38,580 |
| Health System Revenue Bonds, Series 2008B, bearing interest at variable rates of 0.09% and 0.31% at December 31, 2011 and 2010, respectively, due in varying annual installments on August 15 of each year through 2034 | 37,265 | 38,105 |
| Health System Revenue Bonds, Series 2007, bearing interest at variable rates of 1.26% and 0.27% at December 31, 2011 and 2010, respectively, due in varying annual installments on August 15 of each year through 2046 | 1,000 | 1,000 |
| Health System Revenue Bonds, Series 1998A, interest ranging from 4.60% to 5.50%, due in varying annual installments on August 15 of each year through 2028 | 60,780 | 63,430 |
| Mortgage for Memorial Lighthouse Imaging bearing interest of 2.56% at December 31, 2011 and 2010, at variable rates of LIBOR plus 2.25%, due in varying annual installments on the last day of every month through 2015 | 1,593 | 1,781 |
| Capital leases | 806 | 1,724 |
| | <u>139,849</u> | 144,620 |
| Less unamortized discount | 2,187 | 2,323 |
| | <u>137,662</u> | 142,297 |
| Less current portion | 4,621 | 4,552 |
| | <u>\$ 133,041</u> | <u>\$ 137,745</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt (continued)

The Hospital purchased \$27,000,000 par value of the Series 2007 Bonds for \$13,230,000 in March 2009. In October 2008, the Hospital purchased \$52,000,000 par value of the Series 2007 Bonds for \$29,640,000. The par value of the Series 2007 Bonds remains outstanding with the Hospital as owner of record. The consolidated balance sheet reflects these purchases as a reduction of long-term debt for the Series 2007 Bonds of \$79,000,000 at par value. These Bonds are available for reissuance.

The Hospital has a \$2,000,000 revolving line of credit with 1st Source Bank. The line of credit was renewed and extended through May 31, 2012. Of the \$2,000,000 revolving line of credit, \$300,000 and \$200,000 for the years ended December 31, 2011 and 2010, respectively, were segregated for the beneficiary of a self insurance trust. Conversely, \$1,700,000 and \$1,800,000 were available to be drawn on at December 31, 2011 and 2010, respectively. No draws were taken by the Hospital in either 2011 or 2010. The interest rate on the line of credit is prime rate minus one half percent. No amounts were outstanding on the line of credit as of December 31, 2011 and 2010.

In August 2008, the Hospital Authority of St. Joseph County, on behalf of the Hospital, issued revenue refunding bonds in the principal amount of \$78,495,000 to refund Series 2003 and Series 2006 Bonds. The interest rate for the Series 2008A and 2008B Bonds is a weekly interest rate determined by the remarketing agent. The 2008 bond issue was secured by two separate irrevocable direct-pay letters of credit issued by Fifth Third Bank. In October 2009, there was a substitution on the letters of credit from Fifth Third Bank to JPMorgan Chase Bank. In October 2010, the JPMorgan Chase letters of credit expiration date was extended to October 12, 2015. As long as no default has occurred, draws on the direct-pay letters of credit made for failed remarketing will be required to be repaid in 12 equal quarterly installments commencing 12 months after the date of draw.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

7. Long-Term Debt (continued)

The Series 2008A Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 commencing with the year 2011 to, and including the year, 2033 in amounts sufficient to redeem the principal amounts. The Series 2008B Bonds are subject to mandatory redemption through the operation of a sinking fund on each August 15 that commenced with the year 2009 to, and including the year, 2034 in amounts sufficient to redeem the principal amounts.

As of the date of the issuance of the Series 2007 Bonds, under the terms of a Master Trust Indenture, the Corporation and the Hospital formed the Obligated Group. MHF and Home Care constitute designated affiliates under the terms of the Master Trust Indenture.

The Series 2008A, 2008B, 2007, 2000, and 1998A Bonds were issued pursuant to the Master Trust Indentures, which are secured by pledged revenues of the Obligated Group and contain various covenants, including achievement of specified financial ratios and limitations on additional debt.

Interest capitalized during the years ended December 31, 2011 and 2010, was approximately \$0 and \$23,000, respectively.

Maturities of long-term debt and capital lease obligations for each of the next five years are as follows (in thousands):

| | | |
|------|----|-------|
| 2012 | \$ | 4,621 |
| 2013 | | 4,604 |
| 2014 | | 4,450 |
| 2015 | | 4,387 |
| 2016 | | 5,415 |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

8. Interest Rate and Basis Swaps

The Hospital has various derivative instruments to manage the exposure on interest rates and the Hospital's interest expense. Through the use of derivative financial instruments, the Hospital is exposed to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contracts. When the fair value of the derivative contract is positive, the counterparty owes the Hospital, which creates credit risk to the Hospital. When the fair value of the derivative contract is negative, the Hospital owes the counterparty, and there is no credit risk to the Hospital at that point in time. The Hospital minimizes the credit risk in derivative instruments by entering into transactions that require the counterparty to post collateral for the benefit of the fair value of the derivative contract. Market risk is the adverse effect on the value of the financial instrument that results from a change in interest rates. The management of market risk associated with interest rate changes is defined in the Hospital's Swap Management Policy. The policy includes continuous monitoring of market conditions, emergent opportunities, and risks. Swap management is meant to be long term in nature, and any modifications to the program are reviewed for the long-term costs and benefits. Management also mitigates risk through periodic reviews of its derivative position in the context of its total blended cost of capital. In October 2010, the Hospital terminated two yield curve swaps in order to maximize the benefit from these swaps. The termination of the yield curve swaps resulted in a realized gain of \$5,271,000, which is included in nonoperating in the consolidated statement of operations and changes in net assets for the year ended December 31, 2010.

In December 2011, novations of the Citigroup Inc. swaps were completed which formed new counterparty relationships with PNC Bank and Wells Fargo. As of December 31, 2011, the mark to market valuation on the swap portfolio was below the required collateral posting threshold of \$30,000,000 with PNC Bank and \$25,000,000 with Morgan Stanley, \$25,000,000 with Wells Fargo and \$25,000,000 with Deutsche Bank. Two swaps with the notional amounts of \$77,390,000 and \$9,050,000 as of December 31, 2011, have notional adjustments on specified dates as further described in their swap agreements.

As of December 31, 2010, the mark to market valuation on the swap portfolio was below the required collateral posting threshold of \$30,000,000 with Citigroup, Inc., \$25,000,000 with Morgan Stanley, and \$25,000,000 with Deutsche Bank.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

8. Interest Rate and Basis Swaps (continued)

The following is a summary of the outstanding fixed payer rate swaps as of December 31, 2011:

| Origination Date | Notional Amounts | Hospital Receives | Hospital Pays | Maturity Date |
|-------------------------|-------------------------|---------------------------|----------------------|----------------------|
| March 2006 | \$ 38,405,000 | 61.9% 1M LIBOR + 0.31% | 3.516% | August 2033 |
| March 2003 | 9,050,000 | 65.0% 1M LIBOR + 0.45% | 3.800% | July 2034 |

The following is a summary of the outstanding basis rate swaps as of December 31, 2011:

| Origination Date | Notional Amounts | Hospital Receives | Hospital Pays | Maturity Date |
|-------------------------|-------------------------|----------------------------|----------------------|----------------------|
| January 2007 | \$ 42,000,000 | 74.6% 1M LIBOR | SIFMA + 0.0715% | January 2041 |
| August 2007 | 54,000,000 | 61.7% 1M LIBOR + 0.76% | SIFMA + 0.0715% | September 2041 |
| March 2001 | 140,000,000 | 75.125% 3M LIBOR | SIFMA | March 2031 |
| July 2002 | 56,000,000 | 75.125% 3M LIBOR | SIFMA | July 2022 |
| February 2003 | 30,000,000 | 81.125% 1M LIBOR | SIFMA | February 2033 |
| February 2003 | 30,000,000 | 80.625% 1M LIBOR | SIFMA | February 2023 |
| June 2004 | 77,390,000 | 62.6% 1M LIBOR + 0.785% | SIFMA | August 2033 |
| July 2009 | 63,000,000 | 74.6% 1M LIBOR | SIFMA + 0.17% | January 2041 |
| August 2009 | 81,000,000 | 61.7% 1M LIBOR + 0.76% | SIFMA + 0.17% | August 2041 |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

8. Interest Rate and Basis Swaps (continued)

In October 2010, the Corporation terminated two yield curve swaps. The termination of the yield curve swaps resulted in a realized gain of \$5,271,000 and the receipt of accrued interest of \$245,000. The following is a summary of the terminated yield curve swaps as of October 29, 2010:

| Origination Date | Notional Amounts | Hospital Receives | Hospital Pays | Maturity Date |
|-------------------------|-------------------------|---------------------------|----------------------|----------------------|
| August 2008 | \$ 60,000,000 | 10-year USD-SIFMA – 0.65% | SIFMA | August 2027 |
| September 2008 | 60,000,000 | 10-year USD-SIFMA – 0.65% | SIFMA | September 2027 |

The following is a summary of the outstanding swaps as of December 31, 2010:

| Origination Date | Notional Amounts | Hospital Receives | Hospital Pays | Maturity Date |
|-------------------------|-------------------------|--------------------------|----------------------|----------------------|
| January 2007 | \$ 42,000,000 | 74.6% 1M LIBOR | SIFMA + 0.0715% | January 2041 |
| August 2007 | 54,000,000 | 61.7% 1M LIBOR + 0.76% | SIFMA + 0.0715% | September 2041 |
| March 2001 | 140,000,000 | 75.125% 3M LIBOR | SIFMA | March 2031 |
| July 2002 | 56,000,000 | 75.125% 3M LIBOR | SIFMA | July 2022 |
| February 2003 | 30,000,000 | 81.125% 1M LIBOR | SIFMA | February 2033 |
| February 2003 | 30,000,000 | 80.625% 1M LIBOR | SIFMA | February 2023 |
| June 2004 | 77,630,000 | 62.6% 1M LIBOR + 0.785% | SIFMA | August 2033 |
| July 2009 | 63,000,000 | 74.6% 1M LIBOR | SIFMA + 0.17% | January 2041 |
| August 2009 | 81,000,000 | 61.7% 1M LIBOR + 0.76% | SIFMA + 0.17% | August 2041 |
| March 2006 | 38,580,000 | 61.9% 1M LIBOR + 0.31% | 3.516% | August 2033 |
| March 2003 | 9,250,000 | 65.0% 1M LIBOR + 0.45% | 3.800% | July 2034 |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

8. Interest Rate and Basis Swaps (continued)

Net interest paid or received under the above swap agreements is included in interest expense. The net differential for the Corporation as a result of the swap agreements amounted to receipts of \$8,000 and \$1,575,000 for the years ended December 31, 2011 and 2010, respectively, and is reflected as a decrease to interest expense. The swap agreements do not qualify for hedge accounting; therefore, the change in the fair value of the swap agreements is recorded as an unrealized nonoperating loss of \$5,745,000 and \$27,672,000 for the years ended December 31, 2011 and 2010, respectively.

The fair value of derivative instruments at December 31 is as follows (in thousands):

| | | Asset Derivatives | | |
|----------------------------------------------------|-------------------------------|------------------------------|------------------|------------------|
| | | Balance Sheet | | |
| | | Location | 2011 | 2010 |
| Derivatives not designated as hedging instruments: | | | | |
| Interest rate contracts | Interest rate and basis swaps | | \$ 123 | \$ — |
| | | | <u>\$ 123</u> | <u>\$ —</u> |
| | | Liability Derivatives | | |
| | | Balance Sheet | | |
| | | Location | 2011 | 2010 |
| Derivatives not designated as hedging instruments: | | | | |
| Interest rate contracts | Interest rate and basis swaps | | \$ 42,184 | \$ 36,316 |
| | | | <u>\$ 42,184</u> | <u>\$ 36,316</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments

The fair value of the Corporation's long-term debt, excluding capital leases and the mortgage on MLMI, is approximately \$137,057,000 and \$138,825,000 at December 31, 2011 and 2010, respectively.

Total investment return for the years ended December 31 is summarized as follows (in thousands):

| | <u>2011</u> | <u>2010</u> |
|---------------------------------------------------|---------------|------------------|
| Investment return: | | |
| Net unrealized (losses) gains on investments, net | \$ (6,585) | \$ 10,029 |
| Net realized gains on investments, net | 6,802 | 5,266 |
| Net equity earnings on alternative investments | 674 | 5,585 |
| | <u>\$ 891</u> | <u>\$ 20,880</u> |
| Reported as: | | |
| Investment income, net | \$ 891 | \$ 20,880 |
| | <u>\$ 891</u> | <u>\$ 20,880</u> |

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable and accrued expenses are reasonable estimates of their fair value due to the short-term nature of these financial instruments.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

ASC Topic 820-10-50-2 establishes a three-level valuation hierarchy. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 – Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instruments.
- Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables present the financial instruments carried as of December 31, 2011 and 2010, by caption, on the consolidated balance sheets by the valuation hierarchy defined above for those instruments carried at fair value, as well as the alternative investments that are reported on the equity method. Deferred compensation investments are included in other assets on the consolidated balance sheets (in thousands).

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

| December 31, 2011 | Level 1 | Level 2 | Level 3 | Fair Value | Equity Method | Carrying Value |
|-------------------------------------------------------|------------|---------|-------------|-------------|---------------|----------------|
| Assets | | | | | | |
| Short-term investments ^a | \$ 6,982 | \$ — | \$ — | \$ 6,982 | \$ — | \$ 6,982 |
| Internally designated investments: | | | | | | |
| Mutual funds: ^a | | | | | | |
| Large cap equity | 13,132 | — | — | 13,132 | — | 13,132 |
| International equity | 19,787 | — | — | 19,787 | — | 19,787 |
| Small cap equity | 3,913 | — | — | 3,913 | — | 3,913 |
| Long/short equity | 4,964 | — | — | 4,964 | — | 4,964 |
| Total return fund | 57,886 | — | — | 57,886 | — | 57,886 |
| Blended fund | 18,126 | — | — | 18,126 | — | 18,126 |
| Total mutual funds | 117,808 | — | — | 117,808 | — | 117,808 |
| Common stock ^a | 5,403 | — | — | 5,403 | — | 5,403 |
| Alternatives: | | | | | | |
| Fixed income | — | — | — | — | 7,585 | 7,585 |
| Fund of hedge funds | — | — | — | — | 47,154 | 47,154 |
| Long/short credit | — | — | — | — | 5,721 | 5,721 |
| Long/short equity | — | — | — | — | 37,668 | 37,668 |
| Real estate | — | — | — | — | 5,777 | 5,777 |
| Total alternatives | — | — | — | — | 103,905 | 103,905 |
| | 123,211 | — | — | 123,211 | 103,905 | 227,116 |
| Ext. designated invest.– insurance trust ^a | 2,564 | — | — | 2,564 | — | 2,564 |
| Board-designated endowment: | | | | | | |
| Mutual funds: ^a | | | | | | |
| Equities | 7,005 | — | — | 7,005 | — | 7,005 |
| Fixed income | 5,458 | 328 | — | 5,786 | — | 5,786 |
| Long/short equity | 1,514 | — | — | 1,514 | — | 1,514 |
| Equities ^a | 790 | — | — | 790 | — | 790 |
| Alternatives | — | — | — | — | 2,430 | 2,430 |
| Total Board-designated endowment | 14,767 | 328 | — | 15,095 | 2,430 | 17,525 |
| Swaps ^c | — | — | 123 | 123 | — | 123 |
| | 147,524 | 328 | 123 | 147,975 | 106,335 | 254,310 |
| Other long-term assets ^a | 3,960 | — | — | 3,960 | — | 3,960 |
| Total | \$ 151,484 | \$ 328 | \$ 123 | \$ 151,935 | \$ 106,335 | \$ 258,270 |
| Liabilities | | | | | | |
| Swaps ^c | \$ — | \$ — | \$ (42,184) | \$ (42,184) | \$ — | \$ (42,184) |
| Total | \$ — | \$ — | \$ (42,184) | \$ (42,184) | \$ — | \$ (42,184) |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

- (a) Pricing for mutual funds, short-term investments, equities, and government obligations are based on the open market and are valued on a daily basis.
- (b) Pricing is based on the fair value of the securities and is valued on a monthly basis. Information used to value this account is provided by International Data Corp. (IDC). In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue from the IDC data to appropriately value the holding.
- (c) Pricing is based on discounted cash flows to reflect a credit spread adjustment to the LIBOR discount curve in order to reflect “nonperformance” risk. The credit spread adjustment is derived from how other comparable entities’ bonds price and trade in the market. As the credit spread adjustment is a significant component of the swap valuation and is an unobservable input, the swaps have been classified as Level 3.

In addition to understanding fair value methodologies, the alternative funds may have redemption and/or liquidity restrictions. Restrictions of such funds by category are as follows as of December 31, 2011:

| <u>Type of Fund</u> | <u>Carrying Value</u> | <u>Redemption Restrictions</u> | <u>Liquidity Time Frame</u> |
|---------------------|-----------------------|---------------------------------------------------|-----------------------------|
| | <i>(In Thousands)</i> | | |
| Fixed income | \$ 3,420 | None | Illiquid |
| Fixed income | 4,165 | 2.5-year lock | Illiquid |
| Fund of hedge funds | 1,661 | None | Illiquid |
| Fund of hedge funds | 10,963 | Semiannual redemptions | Illiquid |
| Fund of hedge funds | 15,258 | None | Under 95 days |
| Fund of hedge funds | 11,801 | 15% redemption gate | Under 95 days |
| Fund of hedge funds | 5,353 | Quarterly redemptions | Under 95 days |
| Fund of hedge funds | 2,439 | 3-year lock | Illiquid |
| Long/short credit | 5,721 | 2-soft lock (5% fee 1st year and 3% fee 2nd year) | Under 95 days |
| Long/short equity | 21,450 | None | Annual |
| Long/short equity | 18,326 | None | Under 95 days |
| Real estate | 5,777 | None | Annual |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

| December 31, 2010 | Level 1 | Level 2 | Level 3 | Fair Value | Equity Method | Carrying Value |
|----------------------------------------------------------------|------------|-----------|-------------|-------------|---------------|----------------|
| Assets | | | | | | |
| Short-term investments ^a | \$ 6,787 | \$ – | \$ – | \$ 6,787 | \$ – | \$ 6,787 |
| Internally designated investments: | | | | | | |
| Mutual funds: ^a | | | | | | |
| Large cap equity | 12,863 | – | – | 12,863 | – | 12,863 |
| International equity | 22,919 | – | – | 22,919 | – | 22,919 |
| Small cap equity | 4,377 | – | – | 4,377 | – | 4,377 |
| Total return fund | 48,428 | – | – | 48,428 | – | 48,428 |
| Blended fund | 8,626 | – | – | 8,626 | – | 8,626 |
| Total mutual funds | 97,213 | – | – | 97,213 | – | 97,213 |
| Common stock ^a | 5,534 | – | – | 5,534 | – | 5,534 |
| Bonds ^b | 2,584 | 15,686 | 184 | 18,454 | – | 18,454 |
| Alternatives: | | | | | | |
| Fixed income | – | – | – | – | 3,571 | 3,571 |
| Fund of hedge funds | – | – | – | – | 45,650 | 45,650 |
| Long/short credit | – | – | – | – | 5,549 | 5,549 |
| Long/short equity | – | – | – | – | 38,515 | 38,515 |
| Real estate | – | – | – | – | 6,180 | 6,180 |
| Total alternatives | – | – | – | – | 99,465 | 99,465 |
| | 105,331 | 15,686 | 184 | 121,201 | 99,465 | 220,666 |
| Ext. designated investments under debt agreements ^a | 53 | – | – | 53 | – | 53 |
| Ext. designated invest.– insurance trust ^a | 2,515 | – | – | 2,515 | – | 2,515 |
| Board-designated endowment: | | | | | | |
| Mutual funds: ^a | | | | | | |
| Equities | 7,663 | – | – | 7,663 | – | 7,663 |
| Fixed income | 3,849 | 368 | – | 4,217 | – | 4,217 |
| Equities ^a | 831 | – | – | 831 | – | 831 |
| Alternatives | – | – | – | – | 5,320 | 5,320 |
| Total Board-designated endowment | 12,343 | 368 | – | 12,711 | 5,320 | 18,031 |
| | 127,029 | 16,054 | 184 | 143,267 | 104,785 | 248,052 |
| Other long-term assets ^a | 3,852 | – | – | 3,852 | – | 3,852 |
| Total | \$ 130,881 | \$ 16,054 | \$ 184 | \$ 147,119 | \$ 104,785 | \$ 251,904 |
| Liabilities | | | | | | |
| Swaps ^c | \$ – | \$ – | \$ (36,316) | \$ (36,316) | \$ – | \$ (36,316) |
| Total | \$ – | \$ – | \$ (36,316) | \$ (36,316) | \$ – | \$ (36,316) |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

- (a) Pricing for mutual funds, short-term investments, equities, and government obligations are based on the open market and are valued on a daily basis.
- (b) Pricing is based on the fair value of the securities and is valued on a monthly basis. Information used to value this account is provided by International Data Corp. (IDC). In the event that a security is not actively traded in the open market, the characteristics are matched to a comparable issue from the IDC data to appropriately value the holding.
- (c) Pricing is based on discounted cash flows to reflect a credit spread adjustment to the LIBOR discount curve in order to reflect “nonperformance” risk. The credit spread adjustment is derived from how other comparable entities’ bonds price and trade in the market. As the credit spread adjustment is a significant component of the swap valuation and is an unobservable input, the swaps have been classified as Level 3.

The table below sets forth a summary of changes in the fair value of the Plan’s Level 3 swaps for the year ended December 31, 2011 (in thousands):

| | |
|--------------------------------|--------------------|
| Balance, beginning of the year | \$ (36,316) |
| Unrealized gains/loss, net | <u>(5,745)</u> |
| Balance, end of the year | <u>\$ (42,061)</u> |

For the years ended December 31, 2011 and 2010, the Corporation recorded approximately \$5,745,000 and \$27,672,000, respectively, in nonoperating losses, which relates to losses of \$7,726,000 and \$30,077,000, respectively, due to the change in the swap’s value, and credit of \$1,981,000 and \$2,405,000, respectively, to reflect the fair value of the uncollateralized portion of the swap balance.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

9. Fair Value of Financial Instruments (continued)

The Corporation's investments are exposed to various kinds and levels of risk. Equity mutual funds expose the Corporation to market risk, performance risk, and liquidity risk. Market risk is the risk associated with major movements of the equity markets. Performance risk is the risk associated with a company's operating performance. Fixed-income securities expose the Corporation to interest rate risk, credit risk, and liquidity risk. As interest rates change, the value of many fixed-income securities is affected, including those with fixed interest rates. Credit risk is the risk that the obligor of the security will not fulfill its obligations. Liquidity risk is affected by the willingness of market participants to buy and sell given securities. Liquidity risk tends to be higher for equities related to small capitalization companies. Due to the volatility of the capital markets, there is a reasonable possibility of changes in fair value, resulting in additional gains and losses in the near term.

10. Functional Expenses

The Corporation provides general health care services to residents within its geographic location. Expenses related to this and general and administrative functions for each of the years ended December 31 are as follows (in thousands):

| | <u>2011</u> | <u>2010</u> |
|----------------------------|-------------------|-------------------|
| Health care services | \$ 255,394 | \$ 254,092 |
| Affiliated health services | 79,694 | 70,282 |
| General and administrative | 100,443 | 94,673 |
| | <u>\$ 435,531</u> | <u>\$ 419,047</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

11. Commitments

At December 31, 2011, the Hospital was contractually obligated for approximately \$804,000, which primarily relates to wound care and vascular lab expenditures and the conversion to private rooms as approved by the Corporation's Board of Trustees.

The Corporation was a co-guarantor with an unaffiliated business for the debt of an unconsolidated joint venture, MLMI, in which the Corporation recorded an equity interest. The portion of the debt guaranteed by the Corporation through June 30, 2010, was \$2,473,000. In June 2010, the Hospital purchased the assets of MLMI and assumed the debt. The debt of \$1,593,000 and \$1,781,000 is reflected as a long-term liability, less the current portion, at December 31, 2011 and 2010.

During 2009, the Corporation committed to investing up to \$7,500,000 in other privately held investment funds. As of December 31, 2011 and 2010, the Corporation had made investments of \$7,500,000 and \$6,008,000, respectively. As of December 31, 2011 and 2010, the Corporation had unfunded commitments of \$0 and \$1,492,000, respectively.

During 2011, the Corporation committed to investing \$20,000,000 in certain hedge funds and a distressed asset fund. As of December 31, 2011, the Corporation had contributed \$6,648,000 to the funds. The Corporation had an unfunded commitment of \$13,352,000 at December 31, 2011.

12. Professional Liability Insurance

The Corporation is a defendant in certain litigation arising in the ordinary course of business. Professional liability insurance coverage is provided under a claims-made policy. The Corporation terminated self-funding of its professional and general liability coverage on November 30, 2009, and obtained claims-made insurance policies for coverage. The Indiana Medical Malpractice Act has provided recovery up to \$1,250,000 per occurrence, with the first \$250,000 covered by the Corporation. The Corporation maintains a trust fund for its self-insurance program, which it will continue to maintain until all claims have been settled. The fair value of the trust funds at December 31, 2011 and 2010, was approximately \$2,564,000 and \$2,515,000, respectively. The amount of malpractice and general liability claims, including a component for incurred but not reported claims, was approximately \$4,067,000, gross of insurance recoverable, and \$2,501,000, net of insurance recoverable, at December 31, 2011 and 2010, respectively. The interest rate used to discount these claims was 4.5% at December 31, 2011 and 2010. In addition, at December 31, 2011, the Corporation recognized net recoverable insurance assets of approximately \$2,017,000, in accordance with ASU 2010-24.

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

13. Income Taxes

The Corporation and its related affiliates, except for Home Care, have been determined to qualify as exempt from federal income tax under 501(a) as organizations described in Section 501(c)(3) of the Code.

Most of the income received by the Corporation and its related affiliates, except for Home Care, is exempt from taxation, as income related to the mission of the organization. Accordingly, there is no material provision for income tax for these entities. However, some of the income received by exempt entities is subject to taxation as unrelated business income. The Corporation and its subsidiaries file federal and various state income tax returns in the United States.

14. Restricted Net Assets

Temporarily restricted net assets are available for the following purposes or periods at December 31 (in thousands):

| | 2011 | 2010 |
|-------------------------------------|-----------------|-------------|
| Net assets currently available for: | | |
| General | \$ 1,339 | \$ 1,231 |
| Capital | 1,595 | 742 |
| Programs | 351 | 424 |
| Education | 267 | 357 |
| Other | 931 | 984 |
| | \$ 4,483 | \$ 3,738 |

Permanently restricted net assets generate investment income, which is used to benefit the following purposes at December 31 (in thousands):

| | 2011 | 2010 |
|-----------------------------------------------------------------------------|---------------|-------------|
| Endowment investments providing income for health care educational purposes | \$ 191 | \$ — |
| | \$ 191 | \$ — |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

15. Board-Designated Endowment

MHF has a Board-designated endowment. The Board provides direction to use the income, profits for support, betterment, improvement, upkeep, expansion, and replacement of MHS and its corporate affiliates.

MHF follows its Statement of Investment Objectives and Policy, which established formal yet flexible investment guidelines incorporating prudent risk parameters, appropriate asset guidelines, and realistic return goals. Per the policy, the primary objective is to meet commitments to employees at a reasonable cost to the company. Therefore, MHF will actively invest to achieve real growth of capital over inflation through appreciation of securities held and through the accumulation and reinvestment of dividends and interest income. MHF utilizes an investment consulting firm to assist in development of asset allocation targets, review investment performance to benchmarks, review investment strategies, and communicate this information to the MHF Investment Committee and management.

Endowment Net Asset Composition by Type of Fund

| | Unrestricted December 31 | |
|----------------------------------|-------------------------------------|------------------|
| | 2011 | 2010 |
| | <i>(In Thousands)</i> | |
| Board-designated endowment funds | \$ 17,525 | \$ 18,031 |
| Total funds | <u>\$ 17,525</u> | <u>\$ 18,031</u> |

Memorial Health System, Inc. and Affiliated Corporations

Notes to Consolidated Financial Statements (continued)

15. Board-Designated Endowment (continued)

Changes in Endowment Net Assets

| | <u>Unrestricted</u> |
|-------------------------------------------------------|-------------------------|
| Board-designated endowment funds at January 1, 2010 | \$ 16,167 |
| Investment return: | |
| Investment income | (10) |
| Net unrealized gains on investments | 1,613 |
| Net equity gains on investments | 261 |
| Total investment return | <u>1,864</u> |
| Board-designated endowment funds at December 31, 2010 | <u>\$ 18,031</u> |
| | |
| Board-designated endowment funds at January 1, 2011 | \$ 18,031 |
| Investment return: | |
| Investment income | 9 |
| Net unrealized losses on investments | (516) |
| Net equity gains on investments | 1 |
| Total investment return | <u>(506)</u> |
| Board-designated endowment funds at December 31, 2011 | <u>\$ 17,525</u> |

16. Acquisition

In April 2011 the Corporation purchased buildings, land and equipment for \$3,000,000 during the bankruptcy proceedings for a former mental health provider. The appraised value exceeded the purchase price which resulted in a gain of \$16,410,000 which was recognized as a non-operating gain in the statement of operations and changes in net assets. On April 7, 2011 the Hospital began inpatient mental health services within the properties obtained in the proceedings.

17. Subsequent Events

The Corporation evaluated events and transactions occurring subsequent to December 31, 2011, through March 8, 2012, the date of issuance of the consolidated financial statements. During this period, there were no subsequent events requiring recognition or disclosure in the consolidated financial statements, other than those previously disclosed.

Other Financial Information

Report of Independent Auditors on Other Financial Information

The Board of Directors
Memorial Health System, Inc. and Affiliated Corporations

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The following financial information is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audits of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

Ernst & Young LLP

March 8, 2012

Memorial Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet

December 31, 2011

| | Consolidated | Eliminations | Memorial Hospital of South Bend, Inc. | Memorial Health System, Inc. | Memorial Health Foundation, Inc. | Memorial Home Care, Inc. |
|-----------------------------------------------------|-----------------------|---------------------|------------------------------------------------------|---------------------------------------------|-------------------------------------------------|-----------------------------------------|
| | <i>(In Thousands)</i> | | | | | |
| Assets | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents | \$ 59,571 | \$ – | \$ 47,200 | \$ 6,633 | \$ 3,579 | \$ 2,159 |
| Short-term investments | 6,982 | – | 6,095 | – | 887 | – |
| Patient accounts receivable, net | 74,479 | – | 63,302 | 8,079 | – | 3,098 |
| Due from third-party payors | 4,825 | – | 4,825 | – | – | – |
| Other receivables | 1,929 | – | 1,200 | 827 | 25 | (123) |
| Inventories | 14,191 | – | 12,855 | – | – | 1,336 |
| Prepaid expenses | 6,925 | – | 972 | 5,878 | – | 75 |
| Due from affiliates | – | (712) | – | – | – | 712 |
| Total current assets | 168,902 | (712) | 136,449 | 21,417 | 4,491 | 7,257 |
| Assets limited as to use: | | | | | | |
| Internally designated investments | 227,116 | – | 227,116 | – | – | – |
| Externally designated investments – insurance trust | 2,564 | – | 2,533 | 20 | – | 11 |
| Board-designated endowment | 17,525 | – | – | – | 17,525 | – |
| | 247,205 | – | 229,649 | 20 | 17,525 | 11 |
| Property and equipment: | | | | | | |
| Land | 37,424 | – | 20,605 | 16,819 | – | – |
| Buildings and improvements | 397,958 | – | 338,103 | 52,048 | – | 7,807 |
| Furniture and equipment | 264,189 | – | 216,375 | 42,180 | 417 | 5,217 |
| Construction in progress | 9,604 | – | 7,601 | 1,906 | – | 97 |
| | 709,175 | – | 582,684 | 112,953 | 417 | 13,121 |
| Less allowances for depreciation and amortization | 344,289 | – | 282,537 | 51,836 | 297 | 9,619 |
| | 364,886 | – | 300,147 | 61,117 | 120 | 3,502 |
| Unamortized bond issuance costs, net | 1,394 | – | 1,394 | – | – | – |
| Deferred charges and other assets | 18,332 | (12,367) | 3,808 | 23,844 | 75 | 2,972 |
| Interest rate and basis swaps | 123 | – | 123 | – | – | – |
| Interest in net assets of recipient organization | – | (4,483) | 4,483 | – | – | – |
| | <u>\$ 800,842</u> | <u>\$ (17,562)</u> | <u>\$ 676,053</u> | <u>\$ 106,398</u> | <u>\$ 22,211</u> | <u>\$ 13,742</u> |

Memorial Health System, Inc. and Affiliated Corporations

Details of Consolidated Balance Sheet (continued)

December 31, 2011

| | Consolidated | Eliminations | Memorial Hospital of South Bend, Inc. | Memorial Health System, Inc. | Memorial Health Foundation, Inc. | Memorial Home Care, Inc. |
|-------------------------------------------------------------|-----------------------|---------------------|------------------------------------------------------|---------------------------------------------|-------------------------------------------------|-----------------------------------------|
| | <i>(In Thousands)</i> | | | | | |
| Liabilities and net assets | | | | | | |
| Current liabilities: | | | | | | |
| Accounts payable | \$ 25,540 | \$ – | \$ 17,089 | \$ 7,590 | \$ – | \$ 861 |
| Accrued expenses | 31,668 | – | 20,655 | 8,680 | 124 | 2,209 |
| Due to third-party payors | 2,245 | – | 2,245 | – | – | – |
| Due to affiliates | – | (712) | 529 | 183 | – | – |
| Current maturities of long-term debt | 4,621 | – | 4,621 | – | – | – |
| Total current liabilities | <u>64,074</u> | <u>(712)</u> | <u>45,139</u> | <u>16,453</u> | <u>124</u> | <u>3,070</u> |
| Noncurrent liabilities: | | | | | | |
| Long-term debt, less current maturities | 133,041 | – | 133,041 | – | – | – |
| Pension, asset retirement obligations and other liabilities | 53,505 | – | 8,338 | 45,118 | – | 49 |
| Interest rate and basis swaps | 42,184 | – | 42,184 | – | – | – |
| | <u>228,730</u> | <u>–</u> | <u>183,563</u> | <u>45,118</u> | <u>–</u> | <u>49</u> |
| Total liabilities | <u>292,804</u> | <u>(712)</u> | <u>228,702</u> | <u>61,571</u> | <u>124</u> | <u>3,119</u> |
| Net assets: | | | | | | |
| Unrestricted: | | | | | | |
| Undesignated | 485,839 | (12,367) | 442,868 | 44,827 | (112) | 10,623 |
| Board-designated endowment | 17,525 | – | – | – | 17,525 | – |
| Total unrestricted | <u>503,364</u> | <u>(12,367)</u> | <u>442,868</u> | <u>44,827</u> | <u>17,413</u> | <u>10,623</u> |
| Temporarily restricted | 4,483 | (4,483) | 4,483 | – | 4,483 | – |
| Permanently restricted | 191 | – | – | – | 191 | – |
| Total net assets | <u>508,038</u> | <u>(16,850)</u> | <u>447,351</u> | <u>44,827</u> | <u>22,087</u> | <u>10,623</u> |
| | <u>\$ 800,842</u> | <u>\$ (17,562)</u> | <u>\$ 676,053</u> | <u>\$ 106,398</u> | <u>\$ 22,211</u> | <u>\$ 13,742</u> |

Memorial Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets

Year Ended December 31, 2011

| | Consolidated | Eliminations | Memorial Hospital of South Bend, Inc. | Memorial Health System, Inc. | Memorial Health Foundation, Inc. | Memorial Home Care, Inc. |
|-----------------------------------------------------------|-----------------------|--------------|---------------------------------------------|------------------------------------|----------------------------------------|--------------------------------|
| | <i>(In Thousands)</i> | | | | | |
| Unrestricted revenue, gains, and other support | | | | | | |
| Net patient service revenue | \$ 479,485 | \$ (1,076) | \$ 401,863 | \$ 54,521 | \$ – | \$ 24,177 |
| Provision for bad debts | (45,020) | – | (41,704) | (2,944) | – | (372) |
| Net patient service revenue less provision for bad debts | 434,465 | (1,076) | 360,159 | 51,577 | – | 23,805 |
| Other revenue | 20,461 | (1,733) | 13,633 | 7,268 | 56 | 1,237 |
| Net assets released from restrictions used for operations | 891 | – | 470 | 402 | 19 | – |
| | 455,817 | (2,809) | 374,262 | 59,247 | 75 | 25,042 |
| Expenses | | | | | | |
| Salaries and wages | 191,321 | (167) | 117,969 | 60,110 | – | 13,409 |
| Employee benefits | 48,561 | (5) | 31,553 | 13,772 | 38 | 3,203 |
| Supplies and other | 106,590 | (2,625) | 89,333 | 14,005 | 252 | 5,625 |
| Management fees | – | – | 21,289 | (22,844) | 437 | 1,118 |
| Professional fees and purchased services | 56,313 | (12) | 44,195 | 10,770 | 547 | 813 |
| Depreciation and amortization | 28,708 | – | 22,963 | 4,999 | 49 | 697 |
| Interest | 4,038 | – | 4,009 | – | 29 | – |
| | 435,531 | (2,809) | 331,311 | 80,812 | 1,352 | 24,865 |
| Income (loss) from operations | 20,286 | – | 42,951 | (21,565) | (1,277) | 177 |
| Nonoperating | | | | | | |
| Investment income, net | 891 | – | 1,075 | 115 | (305) | 6 |
| Unrealized losses on swap transactions | (5,745) | – | (5,745) | – | – | – |
| Gain on asset acquisition | 16,410 | – | 16,410 | – | – | – |
| Revenue and gains in excess of (less than) expenses | 31,842 | – | 54,691 | (21,450) | (1,582) | 183 |

Memorial Health System, Inc. and Affiliated Corporations

Details of Consolidated Statement of Operations and Changes in Net Assets (continued)

Year Ended December 31, 2011

| | <u>Consolidated</u> | <u>Eliminations</u> | <u>Memorial Hospital of South Bend, Inc.</u> | <u>Memorial Health System, Inc.</u> | <u>Memorial Health Foundation, Inc.</u> | <u>Memorial Home Care, Inc.</u> |
|----------------------------------------------------------------------------------|-----------------------|---------------------|------------------------------------------------------|---------------------------------------------|-------------------------------------------------|-----------------------------------------|
| | <i>(In Thousands)</i> | | | | | |
| Unrestricted net assets | | | | | | |
| Revenue and gains in excess of (less than) expenses | \$ 31,842 | \$ — | \$ 54,691 | \$ (21,450) | \$ (1,582) | \$ 183 |
| Net assets released from restrictions used for capital purposes | 290 | — | 177 | 113 | — | — |
| Net assets released from restrictions to an outside organization | 8 | — | — | — | 8 | — |
| Other | — | — | (26,392) | 25,392 | 1,000 | — |
| Postretirement benefit adjustments, other than periodic costs | (12,573) | — | — | (12,573) | — | — |
| Increase (decrease) in unrestricted net assets | <u>19,567</u> | <u>—</u> | <u>28,476</u> | <u>(8,518)</u> | <u>(574)</u> | <u>183</u> |
| Temporarily restricted net assets | | | | | | |
| Contributions temporarily restricted for use | 1,965 | — | — | — | 1,965 | — |
| Investment loss | (39) | — | — | — | (39) | — |
| Net assets released from restrictions used for operating and capital purposes | (1,181) | — | — | — | (1,181) | — |
| Change in interest in recipient organization | — | (744) | 744 | — | — | — |
| Increase in temporarily restricted net assets | <u>745</u> | <u>(744)</u> | <u>744</u> | <u>—</u> | <u>745</u> | <u>—</u> |
| Permanently restricted net assets | | | | | | |
| Contributions permanently restricted for use | 191 | — | — | — | 191 | — |
| Increase in permanently restricted net assets | <u>191</u> | <u>—</u> | <u>—</u> | <u>—</u> | <u>191</u> | <u>—</u> |
| Increase (decrease) in net assets | 20,503 | (744) | 29,220 | (8,518) | 362 | 183 |
| Net assets at beginning of year | 487,535 | (16,106) | 418,131 | 53,345 | 21,725 | 10,440 |
| Net assets at end of year | <u>\$ 508,038</u> | <u>\$ (16,850)</u> | <u>\$ 447,351</u> | <u>\$ 44,827</u> | <u>\$ 22,087</u> | <u>\$ 10,623</u> |

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