



Fayette Regional Health System

FINANCIAL STATEMENTS

SEPTEMBER 30, 2012 AND 2011

CPAs / ADVISORS



FAYETTE REGIONAL HEALTH SYSTEM

TABLE OF CONTENTS SEPTEMBER 30, 2012 AND 2011

	Page
Report of Independent Auditors	1
Financial Statements	
Statements of Financial Position.....	2
Statements of Operations	4
Statements of Changes in Net Assets	5
Statements of Cash Flows	6
Notes to Financial Statements	7



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REPORT OF INDEPENDENT AUDITORS

Board of Trustees
Fayette Regional Health System
Connersville, Indiana

We have audited the accompanying statements of financial position of Fayette Regional Health System (the System) as of September 30, 2012 and 2011, and the related statements of operations, changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the System'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 of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 financial position of the System as of September 30, 2012 and 2011 and its results of operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Blue & Co., LLC

Indianapolis, IN
May 20, 2013

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
ASSETS		
Current assets		
Cash and cash equivalents	\$ 1,480,670	814,772
Accounts receivable		
Patient services, net	9,363,132	9,579,883
Other	393,013	605,401
Inventories	866,863	846,247
Prepaid expenses and other current assets	602,056	715,804
Estimated third-party settlements	-0-	1,070,134
Total current assets	<u>12,705,734</u>	<u>13,632,241</u>
Investments	15,890,722	13,934,860
Property and equipment		
Land	1,244,594	1,244,594
Land improvements	541,226	535,471
Buildings and building equipment	51,742,331	51,711,417
Major movable equipment	22,631,041	22,102,522
Construction in progress	193,951	35,713
Total property and equipment	<u>76,353,143</u>	<u>75,629,717</u>
Less accumulated depreciation and amortization	<u>(50,258,708)</u>	<u>(47,933,884)</u>
Net property and equipment	26,094,435	27,695,833
Interest in net assets of foundation	1,278,899	724,328
Other assets	<u>590,607</u>	<u>626,921</u>
 Total assets	 <u><u>\$ 56,560,397</u></u>	 <u><u>\$ 56,614,183</u></u>

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2012 AND 2011

LIABILITIES AND NET ASSETS

	<u>2012</u>	<u>2011</u>
Current liabilities		
Line-of-credit	\$ 760,273	\$ 4,164,021
Current maturities of long-term debt	986,501	945,291
Current maturities of capital leases	404,115	230,888
Accounts payable	847,362	917,508
Accrued salaries, wages, and payroll taxes	1,330,528	1,051,897
Other accrued liabilities	520,904	531,026
Estimated third-party settlements	236,658	-0-
Total current liabilities	<u>5,086,341</u>	<u>7,840,631</u>
Derivative liabilities	4,062,214	3,921,757
Long-term debt, less current maturities	19,038,590	20,025,092
Long-term capital leases, less current maturities	<u>707,464</u>	<u>391,992</u>
Total liabilities	<u>28,894,609</u>	<u>32,179,472</u>
Net assets		
Unrestricted	26,386,889	23,710,383
Temporarily restricted - interest in foundation's net assets	<u>1,278,899</u>	<u>724,328</u>
Total net assets	<u>27,665,788</u>	<u>24,434,711</u>
Total liabilities and net assets	<u><u>\$ 56,560,397</u></u>	<u><u>\$ 56,614,183</u></u>

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF OPERATIONS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
Net revenues		
Net patient service revenue	\$ 55,778,339	\$ 54,741,645
Other revenue including investment income	3,299,335	2,174,643
Total revenue	<u>59,077,674</u>	<u>56,916,288</u>
Expenses		
Salaries and wages	24,259,554	25,094,568
Fringe benefits	5,324,287	6,039,899
Supplies and drugs	5,057,152	5,515,186
Purchased services	8,641,629	8,308,224
Professional fees	603,283	494,564
Utilities	1,277,288	1,400,585
Bad debts	5,649,125	5,367,048
Depreciation and amortization	2,927,020	3,237,935
Interest	1,341,405	1,336,563
Hospital assessment fee	1,813,440	-0-
Other	1,127,622	1,438,598
Total expenses	<u>58,021,805</u>	<u>58,233,170</u>
Operating income (loss)	1,055,869	(1,316,882)
Nonoperating revenues (expenses)		
Unrealized loss on derivatives	<u>(140,457)</u>	<u>(338,807)</u>
Excess revenues over (under) expenses	915,412	(1,655,689)
Other changes in unrestricted net assets		
Contributions of property and equipment	14,547	289,318
Net unrealized gain (loss) on investments	<u>1,746,547</u>	<u>(1,077,703)</u>
Change in unrestricted net assets	<u>\$ 2,676,506</u>	<u>\$ (2,444,074)</u>

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	<u>2012</u>	<u>2011</u>
Unrestricted net assets		
Excess revenues over (under) expenses	\$ 915,412	\$ (1,655,689)
Contributions of property and equipment	14,547	289,318
Net unrealized gain (loss) on investments	<u>1,746,547</u>	<u>(1,077,703)</u>
Change in unrestricted net assets	2,676,506	(2,444,074)
Temporarily restricted net assets		
Change in interest in net assets of foundation	<u>554,571</u>	<u>(281,209)</u>
Change in net assets	3,231,077	(2,725,283)
Net assets		
Beginning of year	<u>24,434,711</u>	<u>27,159,994</u>
End of year	<u><u>\$ 27,665,788</u></u>	<u><u>\$ 24,434,711</u></u>

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
Operating activities		
Change in net assets	\$ 3,231,077	\$ (2,725,283)
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Change in interest in net assets of the Foundation	(554,571)	281,209
Unrealized loss on derivatives	140,457	338,807
Depreciation and amortization	2,927,020	3,237,935
Bad debts	5,649,125	5,367,048
Net realized and unrealized loss (gain) on investments	(2,165,804)	579,819
Loss on disposal of property and equipment	11,638	193,209
Contributions of property and equipment	(14,547)	(289,318)
Changes in operating assets and liabilities:		
Accounts receivable	(5,219,986)	(5,076,774)
Inventories, prepaid expenses and other current	93,132	560,909
Accounts payable and other current liabilities	198,363	(712,841)
Estimated third-party settlements	1,306,792	1,937,856
Net cash flows from operating activities	5,602,696	3,692,576
Investing activities		
Purchases of property and equipment	(391,743)	(862,047)
Proceeds from disposal of property and equipment	3,131	27,479
Purchase of investments	(8,307,501)	(8,025,454)
Proceeds from sale of investments	8,517,443	7,130,758
Change in other assets, net	(2,970)	(3,960)
Net cash flows from investing activities	(181,640)	(1,733,224)
Financing activities		
Contributions of property and equipment	14,547	289,318
Change in cash overdraft	-0-	(65,679)
Payments on long-term debt	(945,292)	(909,407)
Payments on capital leases	(420,665)	(240,565)
Change in line-of-credit	(3,403,748)	(218,247)
Net cash flows from financing activities	(4,755,158)	(1,144,580)
Net change in cash and cash equivalents	665,898	814,772
Cash and cash equivalents		
Beginning of year	814,772	-0-
End of year	\$ 1,480,670	\$ 814,772
Supplemental disclosures of cash flow information		
Cash paid for interest	\$ 1,341,405	\$ 1,336,563
Non-cash investing activities		
Property acquired through capital leases	\$ 909,054	\$ 103,884

See accompanying notes to financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

1. SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES

Organization

Fayette Memorial Hospital Association, Inc. d/b/a Fayette Regional Health System (the System) is located in Connorsville, Indiana, and includes a not-for-profit acute care hospital. The System provides inpatient, outpatient, emergency and other ancillary services for residents of east central Indiana.

Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits and investments in highly liquid debt instruments with maturities of three months or less from the date of purchase. The System maintains its cash in bank deposit accounts, which, at times, may exceed the federally insured limits. The System has not experienced any losses in such accounts. The System believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Allowance for Patient Services Accounts Receivable

The System evaluates the collectability of its accounts receivable based on certain factors, such as payer type, historical collection trends and aging categories. The allowance that is applied to the receivable balances is based on the historical experience and time limits, if any, for each particular payer source, such as private, insurance, Medicare and Medicaid. Actual results could differ from the estimated allowances.

Investments

Investments consist primarily of U.S. government securities, corporate bonds, mutual funds and various equity securities. Investments are carried at fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenue over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses as the investments are not considered trading securities and the System demonstrates the ability and intent to hold the securities until they recover.

Inventories

Inventories consist mainly of medical supplies and are valued at the lower of cost (first-in, first-out method) or market value.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Net Assets

Under the applicable Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) Topics, the System is required to report information regarding its financial position and activities according to three classes of net assets (unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets) based upon the existence or absence of donor imposed restrictions.

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received and are included in other revenue if the promise to give is unrestricted. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. The System holds a beneficial interest in the net assets of Fayette Regional Health System Foundation that is adjusted to reflect that activity of the Foundation. Donor-restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the accompanying financial statements.

Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset and is computed using the straight-line method. Useful lives are 3 to 40 years for property and equipment.

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

Operating Indicator

The statements of operations include an operating indicator, operating income (loss). Operating income (loss) includes transactions that are pursuant to and used in the operations of the System which includes investment income (interest, dividends, and realized gain (losses)).

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Performance Indicator

The statements of operations include a performance indicator, excess revenues over (under) expenses. Changes in unrestricted net assets, which are excluded from excess revenues over (under) expenses, consistent with industry practice, include unrealized gains and losses on investments that are considered to be other than trading securities and contributions of long-lived assets.

Other Assets

Deferred financing costs are recorded at cost. The costs are amortized over the life of the bonds. Amortization expense for 2012 and 2011 is \$39,284. Amortization expense for the next five years is \$39,284 per year.

Net Patient Service Revenue

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

Indiana Hospital Assessment Fee Program

During 2012, the Indiana Hospital Assessment Fee (HAF) Program for the period July 1, 2011 through June 30, 2013 was approved by the Centers for Medicare & Medicaid Services retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals. Previously, the State share was funded by governmental entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. Under the HAF Program, the enhanced Medicaid payments follow the patients and are realized through increased Medicaid rates.

During 2012 and 2011, the Hospital recognized HAF assessment fee expense of approximately \$1,800,000 and \$-0-, respectively, which is recorded within the statements of operations. The HAF program resulted in Medicaid rate increases of approximately \$7,115,000 and \$-0-, respectively.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Charity Care and Community Benefit

The System provides charity care on a case-by-case basis for those patients who meet certain criteria of financial need. This care is provided without charge or at amounts less than established rates. Because the System does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The System maintains records to identify and monitor the level of charity care it provides. These records include the amount of charges forgone for services and supplies furnished under its charity care policy.

Of the System's total expenses reported (approximately \$58,022,000 and \$58,233,000 during 2012 and 2011, respectively), an estimated \$824,000 and \$1,034,000 arose from providing services to charity patients during 2012 and 2011, respectively. The estimated costs of providing charity services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the System's total expenses (less bad debt expense) divided by gross patient service revenue.

Pension Plans

The System maintains a defined contribution pension plan (the Plan) covering substantially all employees. The System contributed 0% and 2%, respectively in 2012 and 2011 and matches 100% of employee deferral contributions up to 3% of the employees' salary, subject to certain eligibility requirements.

The System also maintains a 457(b) deferred compensation plan that provides for non-elective employer deferrals covering a select group of management or highly compensated individuals.

It is the System's policy to fund pension costs as accrued. Pension expense was \$439,757 and \$764,887 in 2012 and 2011, respectively.

Advertising Costs

The System's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were \$254,818 and \$251,633 in 2012 and 2011, respectively.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including the allowance for estimated uncollectable accounts and estimated third-party payor settlements, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

Medical Malpractice Claims

The System participates in the Indiana Medical Malpractice Act, which limits the maximum recovery to \$1,250,000 per occurrence, the first \$250,000 of which would be the responsibility of the System, with the balance paid by the State of Indiana Patient Compensation Fund. The System carries an occurrence basis insurance policy covering the System's \$250,000 of exposure per claim. Accordingly, the System has not recorded any provision for self-insured medical malpractice claims.

Risk and Uncertainties

The Systems' investments (Note 3 and 4) are exposed to various risks such as interest rate, market and credit. Due to the level of risk associated with these securities and the level of uncertainty related to changes in the value, it is at least reasonably possible that changes in the various risk factors will occur in the near term that could materially affect the amounts reported in the accompanying financial statements.

Federal and State Income Taxes

The System is a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the System and recognize a tax liability if the System has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the System, and has concluded that as of September 30, 2012 and 2011, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

As such, the System is generally exempt from income taxes. However, the System is required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only. The System is subject to routine audits by taxing jurisdictions; however, as of the date the financial statements were issued, there were not audits for any tax periods in progress.

Reclassification

Certain 2011 balances were reclassified to agree with the current year presentation.

Subsequent Events

The System has evaluated events or transactions occurring subsequent to the statement of financial position date for recognition and disclosure in the accompanying financial statements through the date the financial statements are issued which is May 20, 2013.

2. NET PATIENT SERVICES ACCOUNTS RECEIVABLE

Net patient services accounts receivable consists of the following as of September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Gross patient accounts receivable	\$ 17,071,292	\$ 18,492,090
Allowance for estimated contractual adjustments	(5,769,930)	(6,443,242)
Allowance for uncollectible accounts	<u>(1,938,230)</u>	<u>(2,468,965)</u>
Net patient services accounts receivable	<u>\$ 9,363,132</u>	<u>\$ 9,579,883</u>

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

3. INVESTMENTS

The composition of investments at September 30, 2012 and 2011 follows:

	<u>2012</u>	<u>2011</u>
Common stocks	\$ 9,509,872	\$ 8,145,647
Corporate bonds and notes	140,708	108,767
Convertible securities	837,623	1,012,332
Preferred securities	131,902	71,069
Mutual Funds	2,874,675	2,281,889
U.S. government securities	770,595	1,133,403
Mortgage backed securities	<u>1,625,347</u>	<u>1,181,753</u>
	<u>\$ 15,890,722</u>	<u>\$ 13,934,860</u>

Investment return for 2012 and 2011 is as follows:

	<u>2012</u>	<u>2011</u>
Investment income		
Interest and dividend income	\$ 423,585	\$ 480,694
Realized gain, net	<u>419,257</u>	<u>497,884</u>
	842,842	978,578
Net unrealized gain (loss) on investments	<u>1,746,547</u>	<u>(1,077,703)</u>
Investment return, net	<u>\$ 2,589,389</u>	<u>\$ (99,125)</u>

Investment fees for the 2012 and 2011 were \$268,124 and \$211,913, respectively. The fees are offset against investment income included in the other revenue on the statements of operation.

The following schedule summarizes the fair value of securities included in investments that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of September 30, 2012 and 2011. The schedule further segregates the securities that have been in a gross unrealized position as of September 30, 2012 and 2011, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in near term. The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of September 30, 2012 and 2011.

Description of securities	September 30, 2012					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stock	\$ 898,651	\$ (86,823)	\$ 1,337,469	\$ (339,594)	\$ 2,236,120	\$ (426,417)
Convertible securities	213,537	(7,906)	164,852	(20,032)	378,388	(27,938)
Preferred securities	-0-	-0-	24,395	(1,534)	24,395	(1,534)
Mutual Funds	-0-	-0-	35,521	(1,364)	35,521	(1,364)
Total temporarily impaired securities	<u>\$ 1,112,188</u>	<u>\$ (94,729)</u>	<u>\$ 1,562,236</u>	<u>\$ (362,524)</u>	<u>\$ 2,674,424</u>	<u>\$ (457,253)</u>

Description of securities	September 30, 2011					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Common stock	\$ 2,518,095.00	\$ (524,435)	\$ 1,215,612	\$ (458,040)	\$ 3,733,707	\$ (982,475)
Convertible securities	398,693	(33,650)	117,384	(8,813)	516,077	(42,463)
Preferred securities	71,069	(6,317)	-0-	-0-	71,069	(6,317)
Government Obligations	196,358	(6,135)	-0-	-0-	196,358	(6,135)
Mortgage backed securities	130,790	(249)				
Mutual Funds	213,723	(23,836)	-0-	-0-	213,723	(23,836)
Total temporarily impaired securities	<u>\$ 3,528,728</u>	<u>\$ (594,622)</u>	<u>\$ 1,332,996</u>	<u>\$ (466,853)</u>	<u>\$ 4,730,934</u>	<u>\$ (1,061,226)</u>

4. FAIR VALUE OF FINANCIAL INSTRUMENTS

Major classes of assets and liabilities that are measured at fair value are categorized according to a fair value hierarchy that prioritizes the inputs to value techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Level 1 inputs are readily determinable using unadjusted quoted prices for identical assets or liabilities in active markets. Level 2 inputs are derived from quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (other than those included in Level 1) which are observable for the asset or liability, either directly or indirectly. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. If the inputs used fall within different levels of the hierarchy, the categorization is based upon the lowest level input that is significant to the fair value measurement.

Based upon the levels as defined above the System's investments and liabilities as of September 30, 2012 and 2011 are classified as follows:

	September 30, 2012			
	Total	Level 1	Level 2	Level 3
Investments				
Common stocks				
Consumer	\$ 2,055,391	\$ 2,055,391	\$ -0-	\$ -0-
Energy	1,237,300	1,237,300	-0-	-0-
Financial	1,075,613	1,075,613	-0-	-0-
Healthcare	1,416,865	1,416,865	-0-	-0-
Industrials	915,695	915,695	-0-	-0-
Materials	393,805	393,805	-0-	-0-
Information technology	2,124,797	2,124,797	-0-	-0-
Telecommunications	231,343	231,343	-0-	-0-
Services	49,443	49,443	-0-	-0-
International	9,620	9,620	-0-	-0-
Corporate bonds and notes	140,708	-0-	140,708	-0-
Convertible securities				
Consumer	34,223	-0-	34,223	-0-
Energy	30,348	-0-	30,348	-0-
Financial	27,747	-0-	27,747	-0-
Healthcare	201,836	-0-	201,836	-0-
Industrials	68,211	-0-	68,211	-0-
Materials	87,038	-0-	87,038	-0-
Information technology	315,044	-0-	315,044	-0-
Services	73,175	-0-	73,175	-0-
Preferred securities	131,902	131,902	-0-	-0-
Mutual funds				
Fixed Income funds	2,593,394	2,593,394	-0-	-0-
Mid Cap funds	39,942	39,942	-0-	-0-
Industry funds	28,025	28,025	-0-	-0-
International funds	204,151	204,151	-0-	-0-
Index funds	9,163	9,163	-0-	-0-
Mortgage backed securities	1,625,347	-0-	1,625,347	-0-
US government securities	770,595	-0-	770,595	-0-
	<u>\$ 15,890,722</u>	<u>\$ 12,516,449</u>	<u>\$ 3,374,273</u>	<u>\$ -0-</u>
Long-term liabilities				
Derivative liability	\$ 4,062,214	\$ -0-	\$ 4,062,214	\$ -0-

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

	September 30, 2011			
	Total	Level 1	Level 2	Level 3
Investments				
Common stocks				
Consumer	\$ 1,546,502	\$ 1,546,502	\$ -0-	\$ -0-
Energy	1,223,722	1,223,722	-0-	-0-
Financial	922,650	922,650	-0-	-0-
Healthcare	1,163,466	1,163,466	-0-	-0-
Industrials	763,006	763,006	-0-	-0-
Materials	303,351	303,351	-0-	-0-
Information technology	1,821,626	1,821,626	-0-	-0-
Telecommunications	363,198	363,198	-0-	-0-
Services	8,498	8,498	-0-	-0-
International	29,628	29,628	-0-	-0-
Corporate bonds and notes	108,767	-0-	108,767	-0-
Convertible securities				
Consumer	92,008	-0-	92,008	-0-
Energy	77,666	-0-	77,666	-0-
Financial	6,322	-0-	6,322	-0-
Healthcare	152,077	-0-	152,077	-0-
Industrials	37,521	-0-	37,521	-0-
Materials	70,331	-0-	70,331	-0-
Information technology	287,906	-0-	287,906	-0-
Services	107,612	-0-	107,612	-0-
International	180,889	-0-	180,889	-0-
Preferred securities	71,069	71,069	-0-	-0-
Mutual funds				
Fixed Income funds	2,089,759	2,089,759	-0-	-0-
Mid Cap funds	30,132	30,132	-0-	-0-
Industry funds	21,845	21,845	-0-	-0-
International funds	132,707	132,707	-0-	-0-
Index funds	7,446	7,446	-0-	-0-
Mortgage backed securities	1,181,753	-0-	1,181,753	-0-
US government securities	1,133,403	-0-	1,133,403	-0-
	<u>\$ 13,934,860</u>	<u>\$ 10,498,605</u>	<u>\$ 3,436,255</u>	<u>\$ -0-</u>
Long-term liabilities				
Derivative liability	<u>\$ 3,921,757</u>	<u>\$ -0-</u>	<u>\$ 3,921,757</u>	<u>\$ -0-</u>

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

- Cash and cash equivalents, accounts payable, accrued expenses and estimated third-party settlements: The carrying amount reported in the statements of financial position for cash and cash equivalents, accounts payable, accrued expenses and estimated third-party settlements approximate fair value based upon short term maturities.
- Interest rate swap derivative: The fair value of the System's derivative liability is based on discounted cash flows and interest rate yields curves.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

- Long-term debt: The carrying amount of the System's long-term debt approximates fair value based upon the variable nature of the primary debt.

5. RELATED PARTIES

The Fayette Memorial Hospital Foundation, Inc., d/b/a Fayette Regional Health System Foundation (the Foundation), which is a financially interrelated organization with Fayette Regional Health System was established to solicit contributions from the general public and to support the System activities. Funds are distributed to the System as determined by the Foundation's Board of Trustees and therefore all net assets are classified as temporarily restricted within the System's statement of financial position.

A summary of the Foundation assets, liabilities, net assets, results of operations and changes in net assets for September 30, 2012 and 2011, follows.

	2012	2011
Financial position		
Assets, principally cash, investments and property	\$ 1,285,890	\$ 733,280
Liabilities	\$ 6,991	\$ 8,952
Net assets	1,278,899	724,328
Total liabilities and net assets	\$ 1,285,890	\$ 733,280
	2012	2011
Statement of activities		
Support, revenue and income	\$ 279,098	\$ 414,972
Expenses		
Contributions to Fayette Regional Health System	29,930	269,676
Other	245,719	252,022
Total expenses	275,649	521,698
Excess revenue over (under) expenses	3,449	(106,726)
Net unrealized gains (loss) on investments	101,660	(60,918)
Unrestricted net assets, beginning of year	567,512	735,156
Unrestricted net assets, end of year	672,621	567,512
Temporarily restricted net assets	606,278	156,816
Net assets, end of year	\$ 1,278,899	\$ 724,328
Change in temporarily restricted net assets	\$ 449,462	\$ (113,565)
Change in interest in Foundation	\$ 554,571	\$ (281,209)

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The System provided accounting and financial management services to the Foundation of approximately \$141,000 during 2012 and 2011, respectively.

The System purchased services from organizations that employ board members related primarily to credit bureau services for 2012 and 2011 in the amount of \$286,777 and \$295,903, respectively.

6. DERIVATIVE LIABILITIES

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

At September 30, 2012, the System had outstanding two interest rate swap agreements with a commercial bank, having a total principal amount of \$19,770,000. Those agreements effectively change the System's interest rate exposure on its \$11,775,000 variable rate revenue bonds, series 2002A, due 2032 to a fixed 3.47% and its \$7,995,000 variable rate revenue bonds, series 2002B, due 2022 to a fixed 4.13%. The interest rate swap agreements mature at the time the related notes mature. The System is exposed to credit loss in the event of nonperformance by the other parties to the interest rate swap agreements. However, the System does not anticipate nonperformance by the counterparties.

These derivatives are not designated as hedging instruments, and are marked-to-market on the statement of financial position at fair value at the end of each period. The related gains and loss are included in excess of revenues over expenses, the performance indicator, for the reporting period. Cash flows from interest rate swap contracts are classified as an operating activity on the statement of cash flows.

The derivatives are reported as derivative liabilities. At September 30, 2012 and 2011, the fair values of derivatives recorded in the statement of financial position are as follows:

	2012	2011
Interest rate swap agreements	<u>\$ 4,062,214</u>	<u>\$ 3,921,757</u>

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

During 2012 and 2011, the amounts of gain or loss recognized in the statement of operations are as follows:

2012		
Financial instrument	Gain (Loss)	Location
Interest rate swap agreements	\$ (140,457)	Unrealized loss on derivatives

2011		
Financial instrument	Gain (Loss)	Location
Interest rate swap agreements	\$ (338,807)	Unrealized loss on derivatives

Additional information regarding fair value measurements of the interest rate swap agreements is disclosed in Note 4.

7. LONG-TERM DEBT AND LINE-OF-CREDIT

A summary of long-term debt at September 30, 2012 and 2011 follows:

	2012	2011
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 1998, Adjustable interest rate every 5 years, 2.87% at September 30, 2012 with monthly principal amounts, due in 2018.	\$ 255,091	\$ 295,383
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002A, variable interest rate 0.14% at September 30, 2012, principal maturing in varying annual amounts due in 2032.	11,775,000	12,130,000
Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002B, variable interest rate 0.14% at September 30, 2012, principal maturing in varying annual amounts due in 2022.	7,995,000	8,545,000
	20,025,091	20,970,383
Less current maturities	986,501	945,291
	\$ 19,038,590	\$ 20,025,092

On May 18, 1999, the System issued \$1,400,000 of Revenue bonds, Series 1998 through the Indiana Health Facility Financing Authority for the purchase of computer equipment and the construction of a new facility.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

On February 1, 2002, the System issued \$13,980,000 of revenue bonds, Series 2002A through the Indiana Health Facility Financing Authority for the purchase of a computer system and the construction of an addition to the System facilities.

On July 1, 2002, the System issued \$12,185,000 of revenue bonds, Series 2002B through the Indiana Health Facility Financing Authority to refinance the Series 1992 bonds and a 1997 lease.

The System has entered into an interest rate swap agreement related to the 2002 Series A and B bonds (Note 6).

Principal repayments on long-term debt are as follows:

Year ending <u>September 30,</u>	
2013	986,501
2014	1,032,946
2015	1,074,195
2016	1,120,480
2017	1,166,803
Thereafter	<u>14,644,166</u>
	<u><u>\$ 20,025,091</u></u>

The System has a letter-of-credit for the 2002A Bonds in the amount of \$11,775,000 that was due to expire in July 2013. Subsequent to September 30, 2012, the 2002A letter of credit was extended through October 3, 2014. The System has a letter-of-credit for the 2002B Bonds in the amount of \$7,995,000 that was due to expire in July 2013. Subsequent to September 30, 2012, the 2002B letter of credit was extended through October 3, 2014. The System has pledged certain assets and is subject to covenants related to the debt instruments.

In the event of a liquidity advance for a failed remarketing for either the 2002A and/or 2002B Bonds, interest will be charged at the bank's prime rate for the first 60 days. Subsequently, interest will be charged at the bank's prime rate plus 50 basis points. The System shall pay the principal amount of each liquidity advance by monthly payments, due on the first day of each calendar month, commencing with the first of such dates to occur more than sixty days following the date of such liquidity advance. Each principal payment of one fifty-eighth of the original amount of the liquidity advance will require final payment on the date which is the later of (i) the then existing stated expiration date, or (ii) that which would otherwise be the due date of the tenth monthly principal payment following the date of such Liquidity Advance.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The debt instruments are secured by substantially all assets and require the System to comply with certain restrictive financial covenants. As of September 30, 2012, the System believes it was in compliance with the financial covenants.

As of September 30, 2012 and 2011, the System has borrowings of \$760,273 and \$4,164,021 on its \$7,200,000 revolving line of credit, which bears interest at 1.25% above the 30 day LIBOR standard lending rate (1.0% at September 30, 2012 and 2011). The line of credit is secured by the System's investments with no stated expiration date as long as collateral is maintained.

8. LEASE OBLIGATIONS

Operating Leases

The System leases equipment under non-cancelable operating leases expiring in various years through 2014. Total rental expense amounted to \$1,327,579 and \$1,714,860 for 2012 and 2011, respectively. Future minimum payments under the operating leases with initial terms in excess of one year are as follows:

Year ending <u>September 30,</u>	
2013	\$ 823,944
2014	18,665
	<u>\$ 842,609</u>

Capital Leases

The System has various capital lease arrangements for medical equipment expiring through 2017. Interest rates range from approximately 5.5% to 8.0% with monthly payments ranging from approximately \$450 to \$11,600. The leases are secured by property and equipment.

The following is the cost and accumulated depreciation on capital lease assets as of September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Equipment	\$ 2,001,294	\$ 1,442,219
Accumulated depreciation	835,993	857,142
	<u>\$ 1,165,301</u>	<u>\$ 585,077</u>

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Future payments under all capital lease obligations are as follows:

<u>Year Ending September 30,</u>	
2013	\$ 459,180
2014	332,063
2015	218,683
2016	201,723
2017	<u>18,750</u>
	1,230,399
Less interest	<u>118,820</u>
	<u><u>\$ 1,111,579</u></u>

9. NET PATIENT SERVICE REVENUE

The System has agreements with third-party payors that provide for reimbursement to the System at amounts different from its established rates. Estimated contractual adjustments under third-party reimbursement programs represent the difference between the System's billings at standard rates and amounts reimbursed by third-party payors. They also include any differences between estimated third-party reimbursement settlements for prior years and subsequent final settlements. A summary of the reimbursement arrangements with major third-party payors is as follows:

Medicare and Medicaid

Medicare inpatient services are reimbursed based on a predetermined amount for each case based on the diagnosis associated with the patient (Prospective Payment System). These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. The prospectively determined rates are not subject to retroactive adjustment. The System's classification of patients under the Prospective Payment System and the appropriateness of patient admissions are subject to validation reviews by the Medicare peer review organization, which is under contract with the System to perform such reviews. Medicare outpatient services are primarily reimbursed on predetermined rates based on the services provided. Medicare cost reports have been settled through 2009.

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The System is reimbursed for Medicaid inpatient services under a prospectively determined rate-per-discharge and is not subject to retroactive adjustment. The differences between standard charges and reimbursement from these programs are recorded as contractual adjustments. Reimbursement for Medicaid outpatient services is based on predetermined rates, and is not subject to retroactive cost based settlements.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The System believes that it is in compliance with all applicable laws and regulations and has provided for settlement of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs

Other Payors

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

A summary of net patient service revenue, contractual adjustments and charity care for the years ended September 30, 2012 and 2011 follows:

	<u>2012</u>	<u>2011</u>
Patient service revenue		
Inpatient		
Routine services	\$ 12,249,355	\$ 13,983,405
Ancillary services	17,276,679	20,346,689
Outpatient		
Ancillary services	65,998,279	63,909,288
Physician services	18,336,377	18,042,230
Charity care	<u>(1,617,256)</u>	<u>(2,065,011)</u>
Patient service revenue	112,243,434	114,216,601
Contractual adjustments	<u>(56,465,095)</u>	<u>(59,474,956)</u>
Net patient service revenue	<u>\$ 55,778,339</u>	<u>\$ 54,741,645</u>

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

10. ELECTRONIC HEALTH RECORDS (EHR) INCENTIVE PAYMENTS

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

The System recognizes EHR incentive payments as grant income when there is reasonable assurance that the System will comply with the conditions of the meaningful use objectives and any other specific grant requirements. In addition, the financial statement effects of the grants must be both recognizable and measurable. During 2012 and 2011, the System recognized approximately \$1,392,000 and \$-0-, respectively, in EHR incentive payments as grant income using the cliff recognition method. Under the cliff recognition method, the System records income at the end of EHR reporting period in which compliance is achieved.

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

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

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

11. CONCENTRATIONS OF CREDIT RISK

The System grants credit without collateral to its patients, most of who are local residents and are generally insured under third-party payor agreements. Accounts receivable as of September 30, 2012 and 2011 and gross patient service revenue from patients and third-party payors for 2012 and 2011 is as follows:

	Receivable		Revenue	
	2012	2011	2012	2011
Medicare	34%	35%	50%	50%
Commercial insurance	9%	9%	13%	13%
Patients	34%	36%	2%	2%
Medicaid	17%	15%	24%	22%
Blue Cross	6%	5%	11%	13%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

12. AFFILIATION AGREEMENTS

The System has an affiliation agreement with a health system located in central Indiana to identify areas of collaboration in providing clinical services. No change in control of the System occurred as a result of the agreement. However, neither of the parties is allowed to enter into another affiliation agreement without prior approval of the other party.

13. FUNCTIONAL EXPENSES

The System is an acute care facility providing inpatient, outpatient, emergency and other ancillary services to residents within its geographical location. Expenses related to providing these services approximate the following:

	2012	2011
Health care services	\$ 51,304,199	\$ 53,152,710
Administrative and general	6,717,606	5,080,460
	<u>\$ 58,021,805</u>	<u>\$ 58,233,170</u>

FAYETTE REGIONAL HEALTH SYSTEM

NOTES TO FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

14. COMMITMENTS AND CONTINGENCIES

Self-Funded Health Plan

The System is committed to pay for employees' health care costs. A third-party administrator has been retained to process and present all benefit claims to the System for payment. The System has purchased excess loss insurance from Zurich American Insurance Company. The System is responsible for the funding of all claims and related administrative costs up to \$150,000 per individual per policy year and up to \$282,497 per month on the group as a whole as of September 30, 2012. Group health insurance expense for the years ended September 30, 2012 and 2011 totaled \$3,148,309 and \$3,540,233, respectively.

Commitments

Subsequent to year end, the System has begun planning construction for a Geropsychiatric unit that is expected to cost approximately \$2,500,000.

Litigation

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