



# Fayette Regional Health System

**FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2013 AND 2012**



# FAYETTE REGIONAL HEALTH SYSTEM

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Blue & Co., LLC / One American Square, Suite 2200 / Box 82062 / Indianapolis, IN 46282  
main 317.633.4705 fax 317.633.4889 email blue@blueandco.com

## REPORT OF INDEPENDENT AUDITORS

Board of Trustees  
Fayette Regional Health System  
Connersville, Indiana

### **REPORT ON THE FINANCIAL STATEMENTS**

We have audited the accompanying financial statements of Fayette Regional Health System (the System), which comprise the statements of financial position as of September 30, 2013 and 2012, and the related statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the financial statements.

### **MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS**

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

### **AUDITOR'S RESPONSIBILITY**

Our responsibility is to express an opinion on these 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.

Board of Trustees  
Fayette Regional Health System  
Connersville, Indiana

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

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

## **OPINION**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the System as of September 30, 2013 and 2012 and its results of operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Blue & Co., LLC*

Indianapolis, Indiana  
February 25, 2014

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2013 AND 2012

|  | <b>ASSETS</b> | <u>2013</u>                 | <u>2012</u>                 |
|--|---------------|-----------------------------|-----------------------------|
| <b>Current assets</b>                          |               |                             |                             |
| Cash and cash equivalents                      |               | \$ 1,922,212                | \$ 1,480,670                |
| Accounts receivable                            |               |                             |                             |
| Patient services, net                          |               | 10,368,492                  | 9,363,132                   |
| Other  |               | 1,052,160                   | 393,013                     |
| Inventories                                    |               | 908,280                     | 866,863                     |
| Prepaid expenses and other current assets      |               | 565,618                     | 602,056                     |
| Trustee held assets                            |               | <u>727,516</u>              | <u>-0-</u>                  |
| <br>   |               |                             |                             |
| Total current assets                           |               | 15,544,278                  | 12,705,734                  |
| <br>   |               |                             |                             |
| <b>Investments</b>                             |               | 17,367,012                  | 15,890,722                  |
| <br>   |               |                             |                             |
| <b>Property and equipment</b>                  |               |                             |                             |
| Land   |               | 1,244,594                   | 1,244,594                   |
| Land improvements                              |               | 553,626                     | 541,226                     |
| Buildings and building equipment               |               | 53,070,241                  | 52,556,229                  |
| Major movable equipment                        |               | 24,225,509                  | 21,817,143                  |
| Construction in progress                       |               | <u>1,594,823</u>            | <u>193,951</u>              |
| Total property and equipment                   |               | 80,688,793                  | 76,353,143                  |
| Less accumulated depreciation and amortization |               | <u>(52,029,079)</u>         | <u>(50,258,708)</u>         |
| Net property and equipment                     |               | 28,659,714                  | 26,094,435                  |
| <br>   |               |                             |                             |
| <b>Interest in net assets of foundation</b>    |               | 970,245                     | 1,278,899                   |
| <b>Other assets</b>                            |               | <u>345,396</u>              | <u>590,607</u>              |
| <br>   |               |                             |                             |
| Total assets                                   |               | <u><u>\$ 62,886,645</u></u> | <u><u>\$ 56,560,397</u></u> |

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

## STATEMENTS OF FINANCIAL POSITION SEPTEMBER 30, 2013 AND 2012

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### LIABILITIES AND NET ASSETS

|  | <u>2013</u>                 | <u>2012</u>                 |
|--|-----------------------------|-----------------------------|
| <b>Current liabilities</b>                                   |                             |                             |
| Line-of-credit   | \$ 1,051,181                | \$ 760,273                  |
| Current maturities of long-term debt                         | 705,725                     | 986,501                     |
| Current maturities of capital leases                         | 825,849                     | 404,115                     |
| Accounts payable   | 1,739,699                   | 847,362                     |
| Accrued salaries, wages, and payroll taxes                   | 1,327,165                   | 1,330,528                   |
| Other accrued liabilities                                    | 451,497                     | 520,904                     |
| Estimated third-party settlements                            | 1,174,195                   | 236,658                     |
| Total current liabilities                                    | <u>7,275,311</u>            | <u>5,086,341</u>            |
| <b>Derivative liabilities</b>                                | 2,641,669                   | 4,062,214                   |
| <b>Long-term debt, less current maturities</b>               | 20,613,865                  | 19,038,590                  |
| <b>Long-term capital leases, less current maturities</b>     | <u>2,508,922</u>            | <u>707,464</u>              |
| Total liabilities  | <u>33,039,767</u>           | <u>28,894,609</u>           |
| <b>Net assets</b>  |                             |                             |
| Unrestricted   | 28,876,633                  | 26,386,889                  |
| Temporarily restricted - interest in foundation's net assets | <u>970,245</u>              | <u>1,278,899</u>            |
| Total net assets   | <u>29,846,878</u>           | <u>27,665,788</u>           |
| Total liabilities and net assets                             | <u><u>\$ 62,886,645</u></u> | <u><u>\$ 56,560,397</u></u> |

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See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

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

|  | 2013          | 2012          |
|--|---------------|---------------|
| <b>Net revenues</b>                                      |               |               |
| Net patient service revenue                              | \$ 58,462,594 | \$ 55,778,339 |
| Provision for bad debts                                  | (5,797,561)   | (5,649,125)   |
| Net patient service revenue less provision for bad debts | 52,665,033    | 50,129,214    |
| Other revenue including investment income                | 4,328,072     | 3,299,335     |
| Total revenue  | 56,993,105    | 53,428,549    |
| <b>Expenses</b>  |               |               |
| Salaries and wages                                       | 25,843,918    | 24,259,554    |
| Fringe benefits  | 5,570,690     | 5,324,287     |
| Supplies and drugs                                       | 5,679,840     | 5,057,152     |
| Purchased services                                       | 9,978,687     | 8,641,629     |
| Professional fees  | 575,562       | 603,283       |
| Utilities  | 1,312,634     | 1,277,288     |
| Depreciation and amortization                            | 2,943,943     | 2,927,020     |
| Interest   | 1,474,457     | 1,341,405     |
| Hospital assessment fee                                  | 1,085,850     | 1,813,440     |
| Other  | 1,124,517     | 1,127,622     |
| Total expenses   | 55,590,098    | 52,372,680    |
| Operating income   | 1,403,007     | 1,055,869     |
| <b>Nonoperating revenues (expenses)</b>                  |               |               |
| Unrealized gain (loss) on derivatives                    | 1,420,545     | (140,457)     |
| Loss on extinguishment of debt                           | (493,369)     | -0-           |
| Total nonoperating gain (loss), net                      | 927,176       | (140,457)     |
| Excess revenues over expenses                            | 2,330,183     | 915,412       |
| <b>Other changes in unrestricted net assets</b>          |               |               |
| Contributions of property and equipment                  | 355,891       | 14,547        |
| Net unrealized gain (loss) on investments                | (196,330)     | 1,746,547     |
| <b>Change in unrestricted net assets</b>                 | \$ 2,489,744  | \$ 2,676,506  |

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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|  | <u>2013</u>                 | <u>2012</u>                 |
|--|-----------------------------|-----------------------------|
| <b>Unrestricted net assets</b>                 |                             |                             |
| Excess revenues over expenses                  | \$ 2,330,183                | \$ 915,412                  |
| Contributions of property and equipment        | 355,891                     | 14,547                      |
| Net unrealized gain (loss) on investments      | <u>(196,330)</u>            | <u>1,746,547</u>            |
| Change in unrestricted net assets              | 2,489,744                   | 2,676,506                   |
| <b>Temporarily restricted net assets</b>       |                             |                             |
| Change in interest in net assets of foundation | <u>(308,654)</u>            | <u>554,571</u>              |
| <b>Change in net assets</b>                    | 2,181,090                   | 3,231,077                   |
| <b>Net assets</b>                              |                             |                             |
| Beginning of year                              | <u>27,665,788</u>           | <u>24,434,711</u>           |
| End of year                                    | <u><u>\$ 29,846,878</u></u> | <u><u>\$ 27,665,788</u></u> |

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See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

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

|   | 2013         | 2012         |
|---|--------------|--------------|
| <b>Operating activities</b>   |              |              |
| Change in net assets  | \$ 2,181,090 | \$ 3,231,077 |
| Adjustments to reconcile change in net assets to net cash flows from operating activities |              |              |
| Change in interest in net assets of the Foundation  | 308,654      | (554,571)    |
| Unrealized (gain) loss on derivatives   | (1,420,545)  | 140,457      |
| Depreciation and amortization   | 2,943,943    | 2,927,020    |
| Bad debts   | 5,797,561    | 5,649,125    |
| Net realized and unrealized loss (gain) on investments                                    | (1,602,003)  | (2,165,804)  |
| Loss on disposal of property and equipment  | 13,033       | 11,638       |
| Contributions of property and equipment   | (355,891)    | (14,547)     |
| Changes in operating assets and liabilities:  |              |              |
| Accounts receivable   | (7,462,068)  | (5,219,986)  |
| Inventories, prepaid expenses and other current   | (4,979)      | 93,132       |
| Accounts payable and other current liabilities  | 819,567      | 198,363      |
| Estimated third-party settlements   | 937,537      | 1,306,792    |
| Net cash flows from operating activities  | 2,155,899    | 5,602,696    |
| <b>Investing activities</b>   |              |              |
| Purchases of property and equipment   | (2,439,708)  | (391,743)    |
| Proceeds from disposal of property and equipment  | 9,567        | 3,131        |
| Purchase of trustee held assets   | (727,516)    | -0-          |
| Purchase of investments   | (13,272,464) | (8,307,501)  |
| Proceeds from sale of investments   | 13,398,177   | 8,517,443    |
| Change in other assets, net   | 205,927      | (2,970)      |
| Net cash flows from investing activities  | (2,826,017)  | (181,640)    |
| <b>Financing activities</b>   |              |              |
| Contributions of property and equipment   | 355,891      | 14,547       |
| Proceeds from long-term debt  | 21,106,000   | -0-          |
| Payments on long-term debt  | (19,811,501) | (945,292)    |
| Payments on capital leases  | (829,638)    | (420,665)    |
| Change in line-of-credit  | 290,908      | (3,403,748)  |
| Net cash flows from financing activities  | 1,111,660    | (4,755,158)  |
| Net change in cash and cash equivalents   | 441,542      | 665,898      |
| <b>Cash and cash equivalents</b>  |              |              |
| Beginning of year   | 1,480,670    | 814,772      |
| End of year   | \$ 1,922,212 | \$ 1,480,670 |
| <b>Supplemental disclosures of cash flow information</b>                                  |              |              |
| Cash paid for interest  | \$ 1,474,457 | \$ 1,341,405 |
| <b>Non-cash investing activities</b>  |              |              |
| Property acquired through capital leases  | \$ 3,052,830 | \$ 909,054   |
| <b>Non-cash financing activities</b>  |              |              |
| Bond issuance costs   | \$ 280,198   | \$ -0-       |

See accompanying notes to financial statements.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 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.

#### 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.

#### New Accounting Pronouncement

During 2013, the System adopted Accounting Standards Update 2011-07, Healthcare Entities (Topic 954), "Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Healthcare Entities," which requires certain healthcare entities to present the provision for bad debts relating to patient service revenue as a deduction from patient service revenue in the statement of operations rather than as an operating expense. Accordingly, these accounting changes have been retrospectively applied to prior periods as if the policies have always been used. The System's adoption of this standard had no net impact on financial position, results of operations, or cash flows.

ASU 2011-07 also requires healthcare entities to provide enhanced disclosure about their policies for recognizing revenue and assessing bad debts, as well as qualitative and quantitative information about changes in the allowance for doubtful accounts. See the "Patient Accounts Receivable and Net Patient Service Revenue" and "Allowance for Doubtful Accounts" sections of this note.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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Additionally in 2013, the System adopted the provisions of Accounting Standard Update 2011-04 "Fair Value Measurements (Topic 820), Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRS. Accordingly, the accounting change has been retrospectively applied to prior periods presented as if the policy had always been used.

### 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.

### Patient Accounts Receivable and Net Patient Service Revenue

Patient accounts receivable and net patient service revenue are reported at the estimated net realizable amounts due from patients, third-party payors, and others for services rendered. Net patient service revenue includes estimated retroactive adjustments under reimbursement agreements with certain third-party payors (principally for the Medicare program). Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered, adjusted in future periods as final settlements are determined, and are included with estimated receivables from third-party payors.

### Allowance for Doubtful Accounts

Accounts receivable are reduced by an allowance for doubtful accounts. In evaluating the collectability of accounts receivable, the System analyzes its past history and identifies trends for each of its major payor sources of revenue to estimate the appropriate allowance for doubtful accounts and provision for bad debts. Management regularly reviews data about these major payor sources of revenue in evaluating the sufficiency of the allowance for doubtful accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments on accounts for which the third-party payor has not yet paid, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely).

# FAYETTE REGIONAL HEALTH SYSTEM

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

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For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

During 2013, the System's allowance for uncollectible accounts for patient and physician services increased approximately \$190,000 from approximately \$1,938,000 to approximately \$2,128,000. This increase is due to payor mix changes in accounts receivable from 2012 to 2013. As of September 30, 2013, the allowance for uncollectible accounts of \$2,128,000 was comprised of approximately \$1,767,000 reserved for self-pay balances and approximately \$361,000 reserved for third-party payor balances. As of September 30, 2012, the allowance for uncollectible accounts of \$1,938,000 was comprised of approximately \$1,697,000 reserved for self-pay balances and approximately \$241,000 reserved for third-party payor balances.

The System grants credit to patients, substantially all of whom are local residents of the communities served. The System does not generally require credit or other collateral or other security in extending credit to patients; however, it routinely obtains assignment of (or is otherwise entitled to receive) patients' benefits payable under their health insurance programs, plans, or policies (e.g., Medicare, Medicaid, HMOs, and commercial insurance policies). The System has not changed its charity care or uninsured discount policies during 2013 or 2012.

### Accounts Receivable Other

Other receivables consist primarily of amounts due under a pharmacy benefit management service agreement and other miscellaneous receivables.

### 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, 2013 AND 2012

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### Trustee Held Assets

Trustee held assets include assets held by trustee under an indenture agreement for future capital improvements. Amounts required to meet current liabilities of the System have been classified as current assets. These are included within the statement of financial position and consist of cash and cash equivalents.

### Investments

Investments consist primarily of U.S. government securities, corporate bonds, mutual funds, various equity securities and hedge funds. 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.

### 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.

### Other Assets

Deferred financing costs are recorded at cost. The costs are amortized over the life of the bonds. Amortization expense for 2013 and 2012 is approximately \$37,000. Amortization expense for the next five years is approximately \$39,000 per year.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 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.

### 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 (CMS) retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals. 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 2013 and 2012, the System recognized HAF assessment fee expense of approximately \$1,086,000 and \$1,813,000, respectively, which resulted in increased Medicaid reimbursement.

The State legislature has extended the HAF Program through June 30, 2017 and is pending CMS final approval of the program.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 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 \$55,926,000 and \$52,373,000 during 2013 and 2012, respectively), an estimated \$679,000 and \$744,000 arose from providing services to charity patients during 2013 and 2012, 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 made no discretionary profit sharing contributions during 2013 and 2012. The System 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 approximately \$442,000 and \$440,000 in 2013 and 2012, respectively.

### Advertising Costs

The System's policy is to expense advertising costs when the advertising first takes place. Advertising expenses were approximately \$326,000 and \$255,000 in 2013 and 2012, respectively.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### Operating Indicator

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

### Performance Indicator

The statements of operations include a performance indicator, excess revenues over expenses. Changes in unrestricted net assets, which are excluded from excess revenues over 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.

### 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.

### 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, 2013 and 2012, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements.

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 has filed its federal and state income tax returns for September 30, 2012.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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The System is subject to routine audits by taxing jurisdictions; however, as of the date the financial statements were issued, there were no audits for any tax periods in progress.

### Reclassification

Certain 2012 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 February 25, 2014.

## 2. INVESTMENTS

The composition of investments at September 30, 2013 and 2012 follows:

|                            | <u>2013</u>          | <u>2012</u>          |
|----------------------------|----------------------|----------------------|
| Common stocks              | \$ 9,246,815         | \$ 9,509,872         |
| Corporate bonds and notes  | -0-                  | 140,708              |
| Convertible securities     | 784,007              | 837,623              |
| Preferred securities       | 156,068              | 131,902              |
| Mutual funds               | 1,960,820            | 2,874,675            |
| U.S. government securities | 1,271,246            | 770,595              |
| Mortgage backed securities | 919,696              | 1,625,347            |
| Hedge funds                | 3,028,360            | -0-                  |
|                            | <u>\$ 17,367,012</u> | <u>\$ 15,890,722</u> |

Investment return for 2013 and 2012 is as follows:

|   | <u>2013</u>         | <u>2012</u>         |
|---|---------------------|---------------------|
| Investment income                         |                     |                     |
| Interest and dividend income              | \$ 476,256          | \$ 423,585          |
| Realized gain, net                        | 1,798,333           | 419,257             |
|   | 2,274,589           | 842,842             |
| Net unrealized gain (loss) on investments | <u>(196,330)</u>    | <u>1,746,547</u>    |
| Investment return, net                    | <u>\$ 2,078,259</u> | <u>\$ 2,589,389</u> |

Investment fees for 2013 and 2012 were approximately \$208,000 and \$268,000, respectively. The fees are offset against investment income included in the other revenue on the statements of operations.

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# FAYETTE REGIONAL HEALTH SYSTEM

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

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, 2013 and 2012. The schedule further segregates the securities that have been in a gross unrealized position as of September 30, 2013 and 2012, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary.

The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in 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, 2013 and 2012.

| Description of securities             | September 30, 2013  |                     |                     |                     |                     |                     |
|---------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
|                                       | Less than 12 Months |                     | 12 Months or Longer |                     | Total               |                     |
|                                       | Fair Value          | Unrealized Losses   | Fair Value          | Unrealized Losses   | Fair Value          | Unrealized Losses   |
| Common stock                          | \$ 458,548          | \$ (45,463)         | \$ 1,020,970        | \$ (102,682)        | \$ 1,479,518        | \$ (148,145)        |
| Convertible securities                | 154,992             | (10,000)            | 68,856              | (4,257)             | 223,848             | (14,257)            |
| Government obligations                | 1,955,305           | (109,393)           | -0-                 | -0-                 | 1,955,305           | (109,393)           |
| Total temporarily impaired securities | <u>\$ 2,568,845</u> | <u>\$ (164,856)</u> | <u>\$ 1,089,826</u> | <u>\$ (106,939)</u> | <u>\$ 3,658,671</u> | <u>\$ (271,795)</u> |

  

| 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> |

### 3. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the System has the ability to access.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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

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

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

- *Common stocks:* Valued at the closing price reported on the active market on which the individual securities are traded.
- *Corporate bonds and notes:* Valued using pricing models maximizing the use of observable inputs for similar securities. This includes basing value on yields currently available on comparable securities of issuers with similar credit ratings.
- *Convertible securities:* Valued using pricing models based on a compilation of primarily observable inputs and imputed utilizing a conversion ratio.
- *Preferred securities:* Valued at the closing price reported on the active market on which the individual securities are traded.
- *Mutual funds:* Valued at the daily closing price as reported by the fund. Mutual funds held by the System are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the System are deemed to be actively traded.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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- *Mortgage-backed securities and U.S government securities:* Valued using pricing models maximizing the use of observable inputs for similar securities.
- *Hedge funds:* Valued at the net asset value (NAV) of units of the fund. The NAV, as provided by the investment manager, is used as a practical expedient to estimate fair value. The hedge funds consist of investments in a variety of domestic and foreign equity and debt securities, managed accounts and other investment vehicles that employ diversified styles and strategies. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. Due to the nature of the investments held by the fund, changes in market conditions and the economic environment may significantly impact the net asset value of the fund and, consequently, the fair value of the System's interests in the funds. Although a secondary market exists for these investments, it is not active and individual transactions are typically not observable. When transactions do occur in this limited secondary market, they may occur at discounts to the reported net asset value. It is therefore reasonably possible that if the System were to sell these investments in the secondary market, a buyer may require a discount to the reported net asset value, and the discount could be significant.
- *Derivative liability:* The derivative liability is an interest rate swap agreement that is valued using pricing models that are derived principally from observable market data based on discounted cash flows and interest rate yield curves at quoted intervals for the full term of the swap.

# FAYETTE REGIONAL HEALTH SYSTEM

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

The following tables set forth by level, within the hierarchy, the System's assets and liabilities measured at fair value on a recurring basis as of September 30, 2013:

|                            | September 30, 2013   |                      |                     |                     |
|----------------------------|----------------------|----------------------|---------------------|---------------------|
|                            | Total                | Level 1              | Level 2             | Level 3             |
| Investments                |                      |                      |                     |                     |
| Common stocks              |                      |                      |                     |                     |
| Consumer                   | \$ 1,965,396         | \$ 1,965,396         | \$ -0-              | \$ -0-              |
| Energy                     | 1,435,546            | 1,435,546            | -0-                 | -0-                 |
| Financial                  | 1,219,884            | 1,219,884            | -0-                 | -0-                 |
| Healthcare                 | 1,254,017            | 1,254,017            | -0-                 | -0-                 |
| Industrials                | 980,668              | 980,668              | -0-                 | -0-                 |
| Materials                  | 242,389              | 242,389              | -0-                 | -0-                 |
| Information technology     | 1,620,215            | 1,620,215            | -0-                 | -0-                 |
| Telecommunications         | 528,700              | 528,700              | -0-                 | -0-                 |
| Convertible securities     |                      |                      |                     |                     |
| Consumer                   | 20,921               | -0-                  | 20,921              | -0-                 |
| Energy                     | 12,578               | -0-                  | 12,578              | -0-                 |
| Financial                  | 19,822               | -0-                  | 19,822              | -0-                 |
| Healthcare                 | 167,569              | -0-                  | 167,569             | -0-                 |
| Materials                  | 151,601              | -0-                  | 151,601             | -0-                 |
| Information technology     | 307,414              | -0-                  | 307,414             | -0-                 |
| Services                   | 104,102              | -0-                  | 104,102             | -0-                 |
| Preferred securities       | 156,068              | 156,068              | -0-                 | -0-                 |
| Fixed income mutual funds  | 1,960,820            | 1,960,820            | -0-                 | -0-                 |
| Mortgage backed securities | 919,696              | -0-                  | 919,696             | -0-                 |
| US government securities   | 1,271,246            | -0-                  | 1,271,246           | -0-                 |
| Hedge funds                |                      |                      |                     |                     |
| Multi-strategy             | 602,225              | -0-                  | -0-                 | 602,225             |
| Diversified fund of funds  | 1,494,923            | -0-                  | -0-                 | 1,494,923           |
| Managed futures            | 289,509              | -0-                  | -0-                 | 289,509             |
| Equity long/short          | 641,703              | -0-                  | -0-                 | 641,703             |
|                            | <u>\$ 17,367,012</u> | <u>\$ 11,363,703</u> | <u>\$ 2,974,949</u> | <u>\$ 3,028,360</u> |
| Long-term liabilities      |                      |                      |                     |                     |
| Derivative liability       | <u>\$ 2,641,669</u>  | <u>\$ -0-</u>        | <u>\$ 2,641,669</u> | <u>\$ -0-</u>       |

# FAYETTE REGIONAL HEALTH SYSTEM

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

The following tables set forth by level, within the hierarchy, the System's assets and liabilities measured at fair value on a recurring basis as of September 30, 2012:

|                            | 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       | <u>\$ 4,062,214</u>  | <u>\$ -0-</u>        | <u>\$ 4,062,214</u> | <u>\$ -0-</u> |

# FAYETTE REGIONAL HEALTH SYSTEM

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

The following is a reconciliation of activity for 2013 and 2012 for assets measured at fair value based upon significant unobservable (Level 3) inputs:

|  | Hedge Funds  |        |
|--|--------------|--------|
|  | 2013         | 2012   |
| Balance, beginning of year                   | \$ -0-       | \$ -0- |
| Interest and dividends credited              | 36           | -0-    |
| Purchases                                    | 5,016,774    | -0-    |
| Sales  | (1,986,807)  | -0-    |
| Total realized and unrealized gains (losses) | (1,643)      | -0-    |
| Balance, end of year                         | \$ 3,028,360 | \$ -0- |

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

Realized gains and losses are reported in the statements of operations and changes in net assets as a component of investment income.

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

### Fair Value of Investments in Entities that Use Net Asset Value

The following table summarizes investments measured at fair value based on net asset value per share as of September 30, 2013 and 2012, respectively.

| September 30, 2013                      |              |                        |                         |                                |
|---|--------------|------------------------|-------------------------|--------------------------------|
| Investment                              | Fair Value   | Unfunded<br>Commitment | Redemption<br>Frequency | Redemption<br>Notice<br>Period |
| Hedge funds - multi-strategy            | \$ 602,225   | N/A                    | Quarterly               | 30 days                        |
| Hedge funds - diversified fund of funds | 1,494,923    | N/A                    | Quarterly               | 30 days                        |
| Hedge funds - managed futures           | 289,509      | N/A                    | Monthly                 | 15 days                        |
| Hedge funds - equity long/short         | 641,703      | N/A                    | Quarterly               | 15 days                        |
|   | \$ 3,028,360 |                        |                         |                                |

The hedge funds are subject to a one year lock-up period.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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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 yield curves.
- 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.

#### 4. 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, and net assets for September 30, 2013 and 2012, follows.

|  | 2013       | 2012         |
|--|------------|--------------|
| Financial position                                 |            |              |
| Assets, principally cash, investments and property | \$ 991,029 | \$ 1,285,890 |
| Liabilities  | \$ 20,784  | \$ 6,991     |
| Net assets   | 970,245    | 1,278,899    |
| Total liabilities and net assets                   | \$ 991,029 | \$ 1,285,890 |

# FAYETTE REGIONAL HEALTH SYSTEM

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

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A summary of the Foundation results of operations and changes in net assets for September 30, 2013 and 2012, follows.

|   | <u>2013</u>       | <u>2012</u>         |
|---|-------------------|---------------------|
| Statement of activities                         |                   |                     |
| Support, revenue and income                     | \$ 624,664        | \$ 279,098          |
| Expenses  |                   |                     |
| Contributions to Fayette Regional Health System | 359,572           | 29,930              |
| Other   | <u>327,954</u>    | <u>245,719</u>      |
| Total expenses                                  | <u>687,526</u>    | <u>275,649</u>      |
| Excess revenue over (under) expenses            | (62,862)          | 3,449               |
| Net unrealized gains on investments             | 40,223            | 101,660             |
| Unrestricted net assets, beginning of year      | <u>672,621</u>    | <u>567,512</u>      |
| Unrestricted net assets, end of year            | 649,982           | 672,621             |
| Temporarily restricted net assets               | <u>320,263</u>    | <u>606,278</u>      |
| Net assets, end of year                         | <u>\$ 970,245</u> | <u>\$ 1,278,899</u> |
| <br>  |                   |                     |
| Change in temporarily restricted net assets     | \$ (286,015)      | \$ 449,462          |
| <br>  |                   |                     |
| Change in interest in Foundation                | \$ (308,654)      | \$ 554,571          |

The System provided accounting and financial management services to the Foundation of approximately \$141,000 during 2013 and 2012, respectively.

The System purchased services from organizations that employ board members related primarily to credit bureau services for 2013 and 2012 in the amount of approximately \$295,000 and \$287,000, respectively.

### 5. 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.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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At September 30, 2013, the System had outstanding two interest rate swap agreements with a commercial bank, having a total principal amount of \$18,825,000. Those agreements effectively change the System's interest rate exposure on its variable rate revenue bonds, series 2002A, due 2032 to a fixed 3.47% and its variable rate revenue bonds, series 2002B, due 2022 to a fixed 4.13%. The related bonds had been retired as of September 30, 2013, but the interest rate swap agreements remained in place. Subsequent to September 30, 2013, a novation transaction served to replace the interest rate swap agreement on the series 2002B with a new agreement at a different commercial bank. The terms of the new agreement remained substantially unchanged from the old agreement. The interest rate swap on the series 2002A remained with the existing commercial bank.

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, 2013 and 2012, the fair values of derivatives recorded in the statement of financial position are as follows:

|                               |                     |                     |
|-------------------------------|---------------------|---------------------|
|                               | <u>2013</u>         | <u>2012</u>         |
| Interest rate swap agreements | <u>\$ 2,641,669</u> | <u>\$ 4,062,214</u> |

During 2013 and 2012, the amounts of gain or loss recognized in the statement of operations are as follows:

|                               | <u>2013</u>  |                                |
|-------------------------------|--------------|--------------------------------|
| Financial instrument          | Gain (Loss)  | Location                       |
| Interest rate swap agreements | \$ 1,420,545 | Unrealized gain on derivatives |

  

|                               | <u>2012</u>  |                                |
|-------------------------------|--------------|--------------------------------|
| Financial instrument          | Gain (Loss)  | Location                       |
| Interest rate swap agreements | \$ (140,457) | Unrealized loss on derivatives |

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

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# FAYETTE REGIONAL HEALTH SYSTEM

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

### 6. LONG-TERM DEBT AND LINE-OF-CREDIT

A summary of long-term debt at September 30, 2013 and 2012 follows:

|   | 2013          | 2012          |
|---|---------------|---------------|
| Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 1998, Adjustable interest rate every 5 years, based on the then current 5 year treasury rate, 0.66% at September 30, 2013 with monthly principal amounts, due in 2018. | \$ 213,590    | \$ 255,091    |
| Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002A, variable interest rate, based on the LIBOR rate, principal maturing in varying annual amounts through 2032, refinanced in 2013.                                 | -0-           | 11,775,000    |
| Indiana Health Facility Financing Authority Hospital Revenue Bonds, Series 2002B, variable interest rate, based on the LIBOR rate, principal maturing in varying annual amounts through 2022, refinanced in 2013.                                 | -0-           | 7,995,000     |
| Indiana Finance Authority Health Facility Revenue and Refunding Bonds, Series 2013, variable interest rate, based on the LIBOR rate, 2.13% at September 30, 2013 with principal maturing in varying annual amounts through 2021                   | 21,106,000    | -0-           |
|   | 21,319,590    | 20,025,091    |
| Less current maturities   | 705,725       | 986,501       |
|   | \$ 20,613,865 | \$ 19,038,590 |

On August 21, 2013, the System issued \$21,106,000 of Revenue and Refunding Bonds, Series 2013 through the Indiana Finance Authority Health Facility to refinance the 2002 Series A and B bonds and fund the construction of an addition to the System facilities. The bonds were a private placement and are not actively traded on the market.

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.

As of September 30, 2013, the System continued to have the interest rate swap agreement related to the 2002 Series A and B bonds (Note 5).

# FAYETTE REGIONAL HEALTH SYSTEM

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

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Principal repayments on long-term debt are as follows:

| Year ending<br>September 30, |                      |
|------------------------------|----------------------|
| 2014                         | \$ 705,725           |
| 2015                         | 743,195              |
| 2016                         | 782,480              |
| 2017                         | 822,803              |
| 2018                         | 852,166              |
| Thereafter                   | 17,413,221           |
|                              | <u>\$ 21,319,590</u> |

The System had a letter-of-credit for the 2002A Bonds in the amount of \$11,775,000 and for the 2002B Bonds in the amount of \$7,995,000 that was due to expire on October 3, 2014. As of August 21, 2013, the letter-of-credits were returned to the bank in correlation with the refinancing of indebtedness associated with the issuance of the 2013 Bonds.

The debt instruments are secured by substantially all assets and require the System to comply with certain restrictive financial covenants. As of September 30, 2013, the System believes it was in compliance with the financial covenants.

As of September 30, 2013 and 2012, the System has borrowings of approximately \$1,051,000 and \$760,000 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, 2013 and 2012). The line of credit is secured by the System's investments with no stated expiration date as long as collateral is maintained.

## 7. LEASE OBLIGATIONS

### Operating Leases

The System leases equipment under non-cancelable operating leases expiring in various years through 2019. Total rental expense amounted to approximately \$1,017,000 and \$1,328,000 for 2013 and 2012, respectively.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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Future minimum payments under the operating leases with initial terms in excess of one year are as follows:

| Year ending<br>September 30, |            |
|------------------------------|------------|
| 2014                         | \$ 225,584 |
| 2015                         | 225,280    |
| 2016                         | 225,280    |
| 2017                         | 225,280    |
| 2018                         | 67,681     |
| Thereafter                   | 913        |
|                              | \$ 970,018 |

### Capital Leases

The System has various capital lease arrangements for medical equipment expiring through 2018. Interest rates range from approximately 1% to 7% with monthly payments ranging from approximately \$350 to \$23,500. The leases are secured by property and equipment.

The following is the cost and accumulated depreciation on capital lease assets as of September 30, 2013 and 2012:

|                          | 2013         | 2012         |
|--------------------------|--------------|--------------|
| Equipment                | \$ 5,054,123 | \$ 2,001,294 |
| Accumulated depreciation | 1,575,293    | 835,993      |
|                          | \$ 3,478,830 | \$ 1,165,301 |

Future payments under all capital lease obligations are as follows:

| Year Ending<br>September 30, |              |
|------------------------------|--------------|
| 2014                         | \$ 1,032,236 |
| 2015                         | 923,915      |
| 2016                         | 885,999      |
| 2017                         | 712,997      |
| 2018                         | 139,216      |
|                              | 3,694,363    |
| Less interest                | 359,592      |
|                              | \$ 3,334,771 |

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 8. 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.

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.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 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, 2013 and 2012 follows:

|                             | <u>2013</u>          | <u>2012</u>          |
|-----------------------------|----------------------|----------------------|
| Patient service revenue     |                      |                      |
| Inpatient                   |                      |                      |
| Routine services            | \$ 13,033,037        | \$ 12,249,355        |
| Ancillary services          | 16,181,175           | 17,276,679           |
| Outpatient                  |                      |                      |
| Ancillary services          | 70,973,652           | 65,998,279           |
| Physician services          | 17,468,419           | 18,336,377           |
| Patient service revenue     | <u>117,656,283</u>   | <u>113,860,690</u>   |
| Deductions                  |                      |                      |
| Charity care                | (1,427,881)          | (1,617,256)          |
| Contractual adjustments     | (57,765,808)         | (56,465,095)         |
| Provisions for bad debts    | (5,797,561)          | (5,649,125)          |
| Deductions                  | <u>(64,991,250)</u>  | <u>(63,731,476)</u>  |
| Net patient service revenue | <u>\$ 52,665,033</u> | <u>\$ 50,129,214</u> |

## 9. 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 30<sup>th</sup>). 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.

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# FAYETTE REGIONAL HEALTH SYSTEM

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

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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 2013 and 2012, the System recognized approximately \$913,000 and \$1,392,000, 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.

### 10. 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, 2013 and 2012 and gross patient service revenue from patients and third-party payors for 2013 and 2012 is as follows:

|                      | Receivable  |             | Revenue     |             |
|----------------------|-------------|-------------|-------------|-------------|
|                      | 2013        | 2012        | 2013        | 2012        |
| Medicare             | 31%         | 34%         | 47%         | 50%         |
| Medicaid             | 17%         | 17%         | 26%         | 24%         |
| Blue Cross           | 6%          | 6%          | 10%         | 11%         |
| Commercial insurance | 11%         | 9%          | 15%         | 13%         |
| Patients             | 35%         | 34%         | 2%          | 2%          |
|                      | <u>100%</u> | <u>100%</u> | <u>100%</u> | <u>100%</u> |

### 11. 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.

# FAYETTE REGIONAL HEALTH SYSTEM

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

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### 12. 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:

|                            | <u>2013</u>          | <u>2012</u>          |
|----------------------------|----------------------|----------------------|
| Health care services       | \$ 49,092,213        | \$ 45,655,074        |
| Administrative and general | 6,497,885            | 6,717,606            |
|                            | <u>\$ 55,590,098</u> | <u>\$ 52,372,680</u> |

### 13. 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 \$284,534 per month on the group as a whole as of September 30, 2013. Group health insurance expense for 2013 and 2012 totaled approximately \$2,924,000 and \$3,148,000, respectively.

#### Commitments

As of September 30, 2013, the System had construction commitments outstanding of approximately \$728,000 for the Geropsychiatric unit.

#### Litigation

The System is involved in litigation and regulatory investigations arising in the normal course of business. After consultation with legal counsel, the effect if any on the Systems future position, results from operations, and cash flows for certain regulatory investigations is not determinable at this time.