



SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Financial Statements and
Consolidating Information

September 30, 2015 and 2014

(With Independent Auditors' Report Thereon)

SAINT MARY’S HEALTH SYSTEM, INC.

Consolidated Financial Statements and
Consolidating Information

Table of Contents

	Page(s)
Independent Auditors’ Report	1–2
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Changes in Net Assets	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7
Exhibits	
1 Consolidating Balance Sheet as of September 30, 2015	33–34
2 Consolidating Statement of Operations for the year ended September 30, 2015	35



KPMG LLP
One Financial Plaza
755 Main Street
Hartford, CT 06103

Independent Auditors' Report

The Board of Directors
Saint Mary's Health System, Inc.:

We have audited the accompanying consolidated financial statements of Saint Mary's Health System, Inc. (the System), as of September 30, 2015 and 2014, which comprise the consolidated balance sheets as of September 30, 2015 and 2014, and the related consolidated statements of operations, changes in net assets, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the 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 consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Saint Mary's Health System, Inc. as of September 30, 2015 and 2014, and the results of its operations and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Other Matter

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The supplementary information included in Exhibits 1 and 2 is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

KPMG LLP

February 24, 2016

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Balance Sheets

September 30, 2015 and 2014

(In thousands)

Assets		
	2015	2014
Current assets:		
Cash and cash equivalents	\$ 14,091	26,866
Restricted cash	1,000	-
Short-term investments	17	17
Current portion of assets whose use is limited	3,418	5,948
Accounts receivable, net of estimated uncollectible amounts of \$6,042 in 2015 and \$8,978 in 2014	32,905	30,238
Other current assets	11,619	7,123
Total current assets	<u>63,050</u>	<u>70,192</u>
Marketable securities	<u>4,244</u>	<u>24,966</u>
Assets whose use is limited:		
By donor and held in trust by others	14,764	15,696
For estimated self-insurance liability	26,309	41,038
By bond indenture	-	4,321
Pledged collateral	20,160	-
Other	6	6
Total assets whose use is limited	<u>61,239</u>	<u>61,061</u>
Less current portion of assets whose use is limited	<u>3,418</u>	<u>5,948</u>
Noncurrent assets whose use is limited	<u>57,821</u>	<u>55,113</u>
Property and equipment, net	<u>70,291</u>	<u>63,374</u>
Other assets:		
Investments in joint venture arrangements	9,574	10,024
Deferred financing costs, net	-	103
Other noncurrent assets	1,880	241
Total other assets	<u>11,454</u>	<u>10,368</u>
Total assets	<u>\$ 206,860</u>	<u>224,013</u>
Liabilities and Net Assets		
Current liabilities:		
Current portion of long-term obligations	\$ 3,409	2,509
Accounts payable	22,665	17,369
Salaries, wages, and payroll withholdings	6,002	5,643
Due to third-party payors, net	727	783
Accrued expenses and other current liabilities	12,980	14,308
Total current liabilities	<u>45,783</u>	<u>40,612</u>
Long-term liabilities:		
Long-term obligations, net of current portion	11,018	17,891
Estimated self-insurance liability	17,751	31,814
Pension and deferred compensation	74,894	72,182
Other long-term liabilities	6,311	9,523
Total long-term liabilities	<u>109,974</u>	<u>131,410</u>
Net assets:		
Unrestricted	32,395	32,525
Noncontrolling interest in subsidiaries	955	370
Total unrestricted	<u>33,350</u>	<u>32,895</u>
Temporarily restricted	1,922	2,415
Permanently restricted	15,831	16,681
Total net assets	<u>51,103</u>	<u>51,991</u>
Total liabilities and net assets	<u>\$ 206,860</u>	<u>224,013</u>

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Statements of Operations

Years ended September 30, 2015 and 2014

(In thousands)

	<u>2015</u>	<u>2014</u>
Revenues:		
Revenue from patient services, net of contractual allowance	\$ 295,064	279,161
Provision for uncollectible accounts, net of recoveries	<u>(9,675)</u>	<u>(11,074)</u>
Net revenue from patient services	285,389	268,087
Other operating revenues	<u>10,072</u>	<u>11,525</u>
Total revenues	<u>295,461</u>	<u>279,612</u>
Expenses:		
Salaries and wages	123,197	113,553
Employee benefits	32,298	28,631
Supplies and other expenses	125,177	115,557
Provision for uncollectible accounts, net of recoveries	12	7
Depreciation and amortization	11,636	10,529
Interest	<u>980</u>	<u>1,438</u>
Total expenses	<u>293,300</u>	<u>269,715</u>
Operating income	<u>2,161</u>	<u>9,897</u>
Nonoperating gains (losses):		
Investment income, net	1,565	3,073
Equity in earnings of joint ventures	914	189
Net gain (loss) on disposal of assets	97	(46)
Other	<u>(48)</u>	<u>(283)</u>
Total nonoperating gains, net	<u>2,528</u>	<u>2,933</u>
Excess of revenue over expenses	<u>4,689</u>	<u>12,830</u>
Net assets released from restriction for capital expenditures	351	(48)
Capital transactions with affiliates	191	(387)
Reduction in unrealized gains on marketable securities and other assets whose use is limited	(2,003)	(527)
Change in accumulated pension charges to unrestricted net assets	<u>(2,773)</u>	<u>(13,377)</u>
Increase (decrease) in unrestricted net assets	<u>\$ 455</u>	<u>(1,509)</u>

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.
Consolidated Statements of Changes in Net Assets
Years ended September 30, 2015 and 2014
(In thousands)

	<u>2015</u>	<u>2014</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 4,689	12,830
Net assets released from restriction for capital expenditures	351	(48)
Capital transactions with affiliates	191	(387)
Reduction in unrealized gains on marketable securities and other assets whose use is limited	(2,003)	(527)
Change in accumulated pension charges to unrestricted net assets	<u>(2,773)</u>	<u>(13,377)</u>
Increase (decrease) in unrestricted net assets	<u>455</u>	<u>(1,509)</u>
Temporarily restricted net assets:		
Net assets released from restriction	(589)	(121)
Restricted contributions	<u>96</u>	<u>267</u>
(Decrease) increase in temporarily restricted net assets	<u>(493)</u>	<u>146</u>
Permanently restricted net assets:		
Net earnings on assets held in trust by others	(248)	1,177
Contributions	83	-
Appropriation for expenditure	<u>(685)</u>	<u>(751)</u>
(Decrease) increase in permanently restricted net assets	<u>(850)</u>	<u>426</u>
Decrease in net assets	(888)	(937)
Net assets - beginning of year	<u>51,991</u>	<u>52,928</u>
Net assets - end of year	<u>\$ 51,103</u>	<u>51,991</u>

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidated Statements of Cash Flows
Years ended September 30, 2015 and 2014
(In thousands)

	2015	2014
Cash flows from operating activities:		
Decrease in net assets	\$ (888)	(937)
Adjustments to decrease in net assets to net cash (used in) provided by operating activities:		
Depreciation and amortization	11,636	10,529
Net (gain) loss on disposal of assets	(97)	46
Reduction in unrealized gains on investments	2,003	527
Change in accumulated pension charges to unrestricted net assets	2,773	13,377
Change in permanently restricted net assets	850	(426)
Investment income, net	(1,565)	(3,824)
Equity in earnings of joint ventures and partnerships	(914)	(189)
(Increase) decrease in operating assets:		
Accounts receivable, net	(2,667)	530
Other current assets	(4,393)	(2,264)
Other non current assets	(713)	-
Increase (decrease) in operating liabilities:		
Due to third-party payors, net	(56)	(5,252)
Accounts payable and other current liabilities	2,924	(6,671)
Estimated self-insurance liability	(14,063)	9,906
Pension, accrued compensation, and other long term liabilities	(3,273)	(667)
Net cash (used in) provided by operating activities	(8,443)	14,685
Cash flows from investing activities:		
Purchases of property and equipment	(17,053)	(7,211)
Distributions from joint ventures and partnerships	-	546
Purchase of additional interest in business	(700)	-
Investments in joint venture arrangements	1,138	316
Change in other assets whose use is limited	17,226	(6,258)
Change in assets held in trust by others	(933)	426
Transfer of cash to restricted	(1,000)	-
Net increase in investments	(1,441)	(3,116)
Net cash used in investing activities	(2,763)	(15,297)
Cash flows from financing activities:		
Decrease in assets whose use is limited by bond indentures	4,321	3
Proceeds from permanently restricted contributions	83	-
Borrowings under long-term obligations	15,000	-
Payments on long-term obligations	(20,973)	(2,464)
Net cash used in financing activities	(1,569)	(2,461)
Net decrease in cash and cash equivalents	(12,775)	(3,073)
Cash and cash equivalents - beginning of year	26,866	29,939
Cash and cash equivalents - end of year	\$ 14,091	26,866
Restricted cash	\$ 1,000	-
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,368	1,402
Assets acquired under capital lease	\$ 690	-

See accompanying notes to consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(1) Organization

Saint Mary's Health System, Inc. (SMHS or the System) is a not-for-profit, nonstock Connecticut holding company. It is the sole member of Saint Mary's Hospital, Inc. (the Hospital) and Saint Mary's Hospital Foundation, Inc. (the Foundation).

The Hospital is an acute care hospital located in Waterbury, Connecticut. The Hospital was founded in 1907 and is licensed for 347 beds and 32 newborn bassinets. The Hospital currently staffs 168 beds and 20 newborn bassinets. The Hospital provides a broad range of inpatient and outpatient services including a number of medical and surgical specialties, obstetrics, pediatrics, mental health, alcohol and substance abuse rehabilitation (outpatient) and off-site ambulatory services.

The Hospital has five consolidated subsidiaries: Franklin Medical Group, P.C. (Franklin), a for-profit Connecticut corporation; Saint Mary's Indemnity Company, LLC (the Indemnity Company) a Vermont limited liability company; Diagnostic Imaging of Southbury, LLC (the Diagnostic Center), a for-profit Connecticut corporation, Naugatuck Valley MRI, LLC (NVMRI) a Connecticut limited liability company and Saint Mary's Physician Partners, LLC (Physician Partners) a Connecticut limited liability company.

The Indemnity Company was formed during June 2009 to provide professional and general liability insurance to the Hospital, Franklin, Scovill, Partners, and community physicians.

The Hospital has a 60% equity interest in the Diagnostic Center, which provides diagnostic imaging services. The remaining interest is accounted for as noncontrolling interest in the accompanying consolidated financial statements.

Physician Partners was formed during July 2014 as a Medicare Shared Savings Plan (MSSP) Accountable Care Organization (ACO). The company had no activity in fiscal year 2015 and; therefore is not included in the consolidating schedules.

The Hospital acquired an additional 30.3% of Naugatuck Valley MRI on January 1, 2015 for \$700,000. The Hospital previously held a 48% equity interest in the company. The remaining interest is accounted for as noncontrolling interest in the accompanying consolidated financial statements.

The Foundation was organized to raise funds to support the Hospital.

The assets, liabilities and operations of the Hospital's Auxiliary have not been reflected in the accompanying consolidated financial statements. Such amounts are not considered significant to the Hospital's consolidated financial position or results of its operations.

In September 2015, the Hospital and Trinity Health signed a definitive agreement for a member substitution. The definitive agreement with Trinity Health, along with Saint Francis Care, will form a regional health ministry in New England. A Certificate of Need application was filed with the Office of Health Care Access in November 2015. The agreement is subject to review and approval from the appropriate regulatory bodies.

(2) Community Benefit (Unaudited)

The Hospital is a community teaching hospital that serves the healthcare needs of the Central Naugatuck Valley area. Like other healthcare providers across the nation, the Hospital is faced with the challenge of

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

serving those in need with fewer resources. Although the Hospital cannot meet community needs alone, it is committed to seek out unmet community needs and to be a catalyst in efforts to ensure an adequate community-wide response from government and public organizations in fulfilling community needs.

(a) *Charity and Uncompensated Care*

As part of fulfilling its mission, the Hospital provides care to all patients in need, regardless of their ability to pay. The Hospital has a formalized charity care policy that identifies which patients are deemed "charity care". During 2015 and 2014, the costs associated with the charges foregone, measured using a ratio of cost to charge, related to charity care were approximately \$1,072,000 and \$328,000, respectively.

In addition, the Hospital provides care to patients covered by governmental healthcare programs. During 2015 and 2014, the Hospital estimates that the cost of providing this care exceeded compensation by \$18,935,000 and \$11,082,000, respectively.

(b) *Education, Research and Training*

As a community teaching hospital affiliated with Yale School of Medicine, the Hospital has residency programs for general surgery, internal medicine and dental. These programs educate in excess of 50 residents and medical students per year. In addition to its residency programs, the Hospital furthers its educational mission by offering allied health programs affiliated with area educational facilities.

(c) *Wellness and Health Promotional Activities*

The Hospital provides many activities to promote the concept of healthy lifestyles, including the publishing and free distribution of Thrive, which reaches more than 30,000 community households, health risk screenings, health fairs, support groups, a web-based physician search tool, and a health content library available via the Hospital's website (www.stmh.org).

(d) *Leadership, Advocacy and Voluntarism*

The Hospital's employees are responsive to the community in the areas of planning, governance and service by annually providing thousands of hours of volunteer services, participating on boards of directors and advisory councils, testifying before public policy bodies and working with other healthcare organizations to develop healthcare policies for all persons. The Hospital also provides volunteer opportunities for community residents. The Hospital recognizes donated goods and services at their appraised or estimated value if they create or enhance nonfinancial assets or require specialized skills and would typically be purchased if not provided by donation. The volunteer services the Hospital received do not meet this criteria for recognition in the accompanying consolidated financial statements, but the volunteers donate a significant amount of time to the Hospital. In fiscal years 2015 and 2014, approximately 173 and 171 volunteers spent more than 13,700 and 21,100 hours, respectively, of service in Hospital departments.

(e) *Dollar, Time and In-kind Donations*

The Hospital also provides services to neighborhood schools and organizations at no cost. Contributions are made to programs, organizations and foundations for efforts on behalf of the poor, the disadvantaged and the general population. The Hospital also provides a variety of in-kind services

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

including education on parenting and child abuse prevention and use of Hospital space for community meetings.

(f) *Other Support Services*

The Hospital provides outreach and social support services to patients. Programs such as the Sleep Disorders Support Group and the Chronic Lung Disorders/Pulmonary Support Group are integral to the healing of patients, and represent the Hospital's overall commitment to the continuum of care.

(3) Summary of Significant Accounting Policies

(a) *Basis of Presentation*

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with U.S. generally accepted accounting principles. All intercompany transactions have been eliminated in consolidation.

(b) *Patient Service Revenue*

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, and per diem payments. 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.

(c) *Charity Care and Provision for Uncollectible Accounts*

The Hospital provides care to patients who meet certain criteria under its financial assistance policy without charge or at amounts less than its established rates. Because the Hospital does not anticipate collection of amounts determined to qualify as charity care, they are not reported as revenue.

The Hospital grants credit without collateral to patients, most of whom are local residents and are insured under third-party arrangements. Additions to the allowance for uncollectible accounts are made by means of the provision for uncollectible accounts. Accounts written off as uncollectible are deducted from the allowance and subsequent recoveries are added. The amount of the provision for uncollectible accounts is based upon management's assessment of historical and expected net collections, business and economic conditions, trends in federal and state governmental health care coverage and other collection indicators.

(d) *Cash and Cash Equivalents*

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less.

The System invests its surplus operating funds in overnight repurchase agreement investments. These investments are collateralized with securities issued by the United States Government or its agencies and are not covered by FDIC insurance.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(e) *Assets Whose Use is Limited*

Assets whose use is limited primarily include assets held by others pursuant to donor restrictions, pledged as collateral under debt agreements, and by the Hospital's wholly owned captive insurance company for professional and general liability insurance.

(f) *Marketable Securities*

Investments in equity securities, mutual funds and all investments in debt securities are reported at fair value based on readily determinable fair market values or estimated fair value in the accompanying consolidated balance sheets. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess (deficiency) of revenues 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 unless the investments are trading securities or are considered to be other than temporarily impaired.

The System has followed a policy of reviewing all investments that have been below cost by at least 25% for three quarters. Unless specific evidence exists to the contrary, the adjustments of these investments to fair value (i.e. new cost basis) is reflected as an other than temporary impairment. The System recorded \$1,424,000 and \$53,000 of other than temporary impairments on investments in 2015 and 2014, respectively, which is included in investment income, net in the accompanying consolidated statements of operations.

Investment securities, in general, are exposed to various risks. Recent market conditions have resulted in an unusually high degree of volatility and increased the risks and short term liquidity of certain investments held by the System which could impact the value of investments after the date of these consolidated financial statements.

(g) *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. Equipment under capital lease obligations is amortized on the straight-line method over the shorter period of the lease term or the estimated useful life of the equipment. Costs for repairs and maintenance are expensed as incurred.

Gifts of long-lived assets 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 restriction that specify how the 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.

The System reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset exceeds its fair value and may not be recoverable.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(h) *Investments In Joint Venture Arrangements*

Investments in joint venture arrangements, generally in the form of partnership interests, are accounted for using the equity method of accounting.

(i) *Fair Value of Financial Instruments*

FASB ASC 820 establishes a framework for measuring fair value which 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 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described below:

- *Level 1* – Inputs into the valuation methodology are the unadjusted quoted prices for identical assets or liabilities in active markets that the System has the ability to access.
- *Level 2* – Inputs into the valuation methodology include quoted prices for similar assets or liabilities in active and inactive markets, other than quoted prices that are observable for specific assets or liabilities, and values 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 value must be observable for substantially the full term of the asset or liability.
- *Level 3* – Inputs into the valuation methodology are unobservable and significant to the fair value measurement.

The asset's 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 used need to maximize the use of observable inputs and minimize the use of unobservable inputs.

Assets held in trust by others represents a donor established perpetual trust held and administered by an outside trustee. The Hospital owns an interest in the trust rather than in the securities underlying the trust, and therefore it is generally required to consider such investments as Level 3 for the purposes of applying ASC 820. Such classification is based on the inability to redeem the investment, even though the underlying securities may not be difficult to value or may be readily marketable. Accordingly, the inputs or methodology used for valuing or classifying investments for financial reporting purposes are not necessarily an indication of the risk associated with investing in those investments.

The methods described above may produce a fair value that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the System believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The carrying amount of patient accounts receivable, accounts payable, and accrued expenses approximate fair value because of the short maturity of these accounts.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(j) Net Asset Categories

To ensure observance of limitations and restrictions placed on the use of resources available to the System, the accounts of the System are maintained in the following net asset categories:

Unrestricted – Unrestricted net assets represent available resources other than donor restricted contributions. Included in unrestricted net assets are assets designated by the board of directors for future capital improvements or for other purposes, as deemed appropriate.

Temporarily Restricted – Temporarily restricted net assets represent contributions that are restricted by the donor either as to purpose or as to time of expenditure.

Permanently Restricted – Permanently restricted net assets represent contributions received with the donor restriction that the principal be invested in perpetuity and that only the income earned that the trustee does not reinvest be available for operations. The net appreciation of the value of investments held in trust by others remains in permanently restricted net assets until cash is transferred to the System.

(k) Excess of Revenues over Expenses

Excess of revenues over expenses included in the consolidated statements of operations reflects the System's performance measure. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include unrealized gains and losses on investments, except for losses that are deemed to be other than temporary, contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purposes of acquiring such assets). Nonoperating gains and losses, and equity in earnings of joint ventures are considered in the performance measure.

(l) Income Taxes

The System, Hospital, and Foundation are tax-exempt organizations as described in Section 501(c)(3) of the Internal Revenue Code and are generally exempt from income taxes. The accompanying consolidated financial statements have been prepared on the basis that this tax-exempt status will be maintained.

Franklin is a for-profit organization subject to income taxes. Franklin has net operating loss carryforwards. A valuation allowance has been recorded as management believes realization of such carryforwards is doubtful.

The Diagnostic Center and NVMRI are pass-through entities. The Indemnity Company and Physician Partners are disregarded entities. The tax consequences of their operating results are assessed at the member level.

The System recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount of benefit that is greater than fifty percent likely to be realized upon settlement. Changes in measurement are reflected in the period in which the change in judgment occurs. The System did not recognize the effect of any income tax positions in either 2015 or 2014.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(m) Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Financial statement areas where management applies the use of assumptions and estimates consist primarily of the allowance for uncollectible accounts, contractual allowances and related third-party accounts, the pension liability, and the estimated self-insurance liability.

(n) Professional and General Liability

The liability for unpaid losses and loss adjustment expenses includes estimates for reported losses, plus supplemental amounts calculated based upon loss projections utilizing the Indemnity Company's and insureds' historical data. In establishing this reserve, the Indemnity Company utilizes the findings of an independent consulting actuary. Management believes that its aggregate liability for unpaid losses and loss adjustment expenses at year-end represents its best estimate, based upon available data, of the amount necessary to cover the ultimate cost of losses.

The ultimate liability and receivable could be significantly in excess of or less than the amount indicated in the consolidated financial statements. As adjustments to these estimates become necessary, such adjustments will be reflected in current operations.

(o) Goodwill

The Hospital held a 48% interest in NVMRI. On January 1, 2015, the Hospital acquired an additional 30.3% interest in NVMRI from limited partners for \$700,000 and obtained control of NVMRI. The transaction generated goodwill of \$1,929,971 and is recorded as other noncurrent assets. The goodwill is amortized over 10 years on a straight line basis. The fair value of the non-controlling interest in NVMRI, a private company, was estimated by applying the market approach. The Hospital recognized a gain of \$926,385 as a result of measuring at fair value its 48% equity interest in NVMRI held before the transaction. The gain is included in equity in earnings of joint ventures.

(p) Recently Issued Accounting Pronouncements

In May 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2015-07, Fair Value Measurement (Topic 820) – *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)*, which removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. ASU 2015-07 also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient. Reporting entities will be required to disclose the amount of investments measured at net asset value (or its equivalent) using the practical expedient to reconcile total investments in the fair value hierarchy to total investments measured at fair value. ASU 2015-07 is effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The effective date for all other entities is fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted. Management is currently evaluating the effect of this guidance on its consolidated financial statements.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(q) Prior Year Reclassifications

Certain prior year balances have been reclassified in order to be consistent with the current year presentation.

(4) Net Revenue from Patient Services

A substantial portion of net revenue from patient services is derived from funds provided on behalf of patients under federal and state medical assistance programs. Revenue from some of these sources is determined by the application of reimbursement principles and is subject to audit by the applicable agencies. In the opinion of management, such principles have been properly applied in the determination of net patient service revenue. Settlement notices have been received from the Medicare program through 2012 and tentative settlements from the Medicaid program through 2014. 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 or as years are no longer subject to audits, reviews and investigations. Adjustments related to prior year estimates increased the Hospital's net revenues by approximately \$4,631,000 and \$5,977,000, respectively.

Net patient service revenues consist of inpatient revenues, principally from routine patient care and ancillary services and outpatient revenues from ancillary services, after considering allowances under agreements with various third-party payors and provisions for uncollectible accounts. A reconciliation of gross revenues to net revenues from patient services after allowance for the years ended September 30, 2015 and 2014, is as follows (in thousands):

	<u>Hospital</u>	<u>Other Entities</u>	<u>2015 Total</u>
Gross revenue from patient services	\$ 746,752	85,465	832,217
Contractual and other allowances	(485,579)	(50,502)	(536,081)
Charity care	(1,072)	—	(1,072)
Provision for uncollectible accounts, net of recoveries	(8,180)	(1,495)	(9,675)
Net revenue from patient services	<u>\$ 251,921</u>	<u>33,468</u>	<u>285,389</u>
	<u>Hospital</u>	<u>Other Entities</u>	<u>2014 Total</u>
Gross revenue from patient services	\$ 663,968	69,951	733,919
Contractual and other allowances	(414,833)	(39,597)	(454,430)
Charity care	(328)	—	(328)
Provision for uncollectible accounts, net of recoveries	(10,078)	(996)	(11,074)
Net revenue from patient services	<u>\$ 238,729</u>	<u>29,358</u>	<u>268,087</u>

The Hospital recognizes patient service revenue associated with services provided to patients who have third-party payor coverage on the basis of contractual rates for the services rendered. For uninsured patients that do not qualify for charity care, the Hospital recognizes revenue on the basis of discounted rates based on the self-pay discount policy. On the basis of historical experience, a significant portion of the Hospital's

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Hospital records a significant provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts), recognized in the period from these major payor sources, is as follows:

	Governmental and other third-party payors	Self-pay	Total all payors
Revenue from patient services, net of contractual allowances, as of September 30, 2015	\$ 289,376	5,688	295,064
Revenue from patient services, net of contractual allowances, as of September 30, 2014	\$ 271,936	7,225	279,161

The Hospital grants credit without collateral to its patients, most of who are local residents and are insured under third-party payor agreements. The mix of gross receivables from private pay patients and third-party payors at September 30, 2015 and 2014 was as follows:

	2015	2014
Medicare (including Medicare managed care)	31.4%	31.6%
Medicaid	16.1	12.3
Other third-party payors	35.4	32.5
Private pay patients	17.1	23.6
	<u>100.0%</u>	<u>100.0%</u>

The Hospital's exposure to risk of nonpayment from private pay patients is more significant than other payors. However, the Hospital has recorded an estimate for uncollectible accounts, which, in management's opinion, is sufficient to provide for such risk. This estimate is based on a variety of factors including historical experience, the current economic environment and recent payment patterns.

(5) Regulatory and Legislative Matters

(a) State of Connecticut Regulatory Environment

Connecticut's acute care hospital regulatory system is currently administered by the State of Connecticut Office of Health Care Access (OHCA). The Hospital is subject to a regulatory system that includes the administration of a pool resulting in distribution of monies by the State to the Hospital.

The Hospital is subject to legislation enacted in 2011 imposing a tax on certain net patient service revenues of hospitals and changes to the disproportionate share hospital payments (DSH) pursuant to 2011 Conn. Pub. Acts 6 (145-149), as amended by 2011 Conn. Pub. Acts 44 (102-103) and Conn. Pub. Acts 61 (79). The tax is paid on a quarterly basis. The Hospital recorded a tax of \$9,765,668 which

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

has been offset with \$5,027,709 of DSH payments and is recorded in supplies and other expenses for the year ended September 30, 2015. The Hospital recorded a tax of \$8,789,076 which has been offset with \$7,559,854 of DSH payments and is recorded in supplies and other expenses for the year ended September 30, 2014.

(b) Federal Regulatory Environment

The healthcare industry is subject to numerous laws and regulations of federal, state and local governments. These laws and regulations include, but are not necessarily limited to, matters such as licensure, accreditation, government healthcare program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse and security and privacy of health information. Government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by healthcare providers. Violations of these laws and regulations could result in expulsion from government healthcare programs together with the imposition of significant fines and penalties, as well as significant repayments for patient services previously billed. Management believes that the Hospital is in compliance with fraud and abuse regulations as well as other applicable government laws and regulations. While no material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at this time.

(6) Marketable Securities and Assets Whose Use is Limited

A comparison of cost and fair values of short-term investments, marketable securities, and assets whose use is limited, including the fair value of investments with unrealized losses that are not deemed other-than-temporarily impaired and the length of time the individual securities have been in a continuous unrealized loss position, at September 30, 2015 and 2014, is as follows (in thousands):

	2015					
	Total		Less than 12 months		12 months or more	
	Fair value	Cost	Fair value	Unrealized losses	Fair value	Unrealized losses
Cash and cash equivalents	\$ 5,909	5,909	—	—	—	—
Corporate bonds	14,879	14,963	4,670	(89)	4,309	(149)
U.S. government and agency obligations	11,552	11,473	1,484	(6)	1,185	(10)
Mutual funds	29,096	27,114	3,531	(497)	—	—
Equities	1,308	1,620	394	(272)	—	—
	<u>\$ 62,744</u>	<u>61,079</u>	<u>10,079</u>	<u>(864)</u>	<u>5,494</u>	<u>(159)</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

	2014					
	Total		Less than 12 months		12 months or more	
	Fair value	Cost	Fair value	Unrealized losses	Fair value	Unrealized losses
Cash and cash equivalents	\$ 19,021	19,021	—	—	—	—
Corporate bonds	12,451	12,428	1,088	(19)	4,653	(163)
U.S. government and agency obligations	14,177	14,141	2,926	(16)	1,686	(34)
Mutual funds	28,344	23,521	605	(62)	—	—
Equities	1,145	1,173	608	(9)	—	—
	<u>\$ 75,138</u>	<u>70,284</u>	<u>5,227</u>	<u>(106)</u>	<u>6,339</u>	<u>(197)</u>

The above tables include permanently restricted assets held by others whose fair value exceeded cost by \$27,000 at September 30, 2015 and \$1,209,000 at September 30, 2014.

Assets whose use is limited for estimated self-insurance includes approximately \$2,750,000 and \$10,900,000 of other assets, substantially receivables, as of September 30, 2015 and 2014, respectively.

The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2015 (in thousands):

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 5,010	—	—	5,010
Domestic corporate bonds	—	13,425	—	13,425
U.S. government and agency obligations	—	9,692	—	9,692
Equity mutual funds	18,873	—	—	18,873
Fixed income mutual funds	522	—	—	522
Equity funds	458	—	—	458
Total	<u>24,863</u>	<u>23,117</u>	<u>—</u>	<u>47,980</u>
Assets held in trust by others:				
Perpetual trust	<u>—</u>	<u>—</u>	14,764	<u>14,764</u>
Total	<u>\$ 24,863</u>	<u>23,117</u>	<u>14,764</u>	<u>62,744</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The following table sets forth by level, within the fair value hierarchy, the System's financial instruments at fair value as of September 30, 2014 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Cash and cash equivalents	\$ 18,229	—	—	18,229
Domestic corporate bonds	—	10,469	—	10,469
U.S. government and agency obligations	—	12,501	—	12,501
Equity mutual funds	17,635	—	—	17,635
Fixed income mutual funds	277	—	—	277
Equity funds	331	—	—	331
Total	36,472	22,970	—	59,442
Assets held in trust by others:				
Perpetual trust	—	—	15,696	15,696
Total	\$ 36,472	22,970	15,696	75,138

Mutual funds and equities are traded actively on exchanges and price quotes for these shares are readily available.

For domestic and foreign bonds and U.S. government obligations multiple prices and price types are obtained from pricing vendors whenever possible, which enables cross-provider validations. A primary price source is identified based on asset type, class or issue for each security. The fair values of fixed-income securities are based on evaluated prices that reflect observable market information, such as actual trade information of similar securities, adjusted for observable differences.

The redemption period for the System's financial instruments ranges from daily to monthly and require notification of one to five days.

The following table presents additional information about investments measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended September 30 (in thousands):

<u>Perpetual trust</u>	<u>2015</u>	<u>2014</u>
Fair value at beginning of the year	\$ 15,696	15,258
Net realized and change in unrealized gains and losses	(199)	1,177
Appropriation of endowment assets for expenditure	(733)	(739)
Fair value at end of the year	\$ <u>14,764</u>	<u>15,696</u>

Assets held in trust by others represents a donor established perpetual trust held and administered by an outside trustee. The Hospital receives a specific portion of the return on the underlying assets of the perpetual trust. The investment income is recorded as unrestricted investment income in nonoperating gains (losses).

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(7) Property and Equipment

A summary of property and equipment at September 30, 2015 and 2014 is as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Land and land improvements (5–25 yrs)	\$ 8,316	7,926
Buildings and building improvements (10–40 yrs)	71,478	69,714
Equipment (3–25 yrs)	137,853	122,712
Projects in process	2,316	394
	<u>219,963</u>	<u>200,746</u>
Less accumulated depreciation and amortization	<u>(149,672)</u>	<u>(137,372)</u>
Property and equipment, net	<u>\$ 70,291</u>	<u>63,374</u>

Property under capital leases had a net book value of \$611,000 and \$955,000 at September 30, 2015 and 2014, respectively.

(8) Long-Term Obligations

In May 1997 the Hospital issued \$36,150,000 of State of Connecticut Health and Educational Facilities Authority (CHEFA) Bonds, Series E, dated May 1, 1997, 5.00% – 6.00% Serial and Term Bonds (Bonds) payable annually in amounts ranging from \$985,000 to \$3,000,000 through July 1, 2022.

In March 2015, the Hospital obtained a \$15.0 million bank loan using the proceeds and amounts held in trust under the Bond indenture to pay off \$19.9 million of Bonds outstanding. The Bonds were called in April 2015 and extinguished. The bank loan has a five year term with \$250,000 principal due each month and corresponding interest at the current LIBOR rate plus 110 basis points (1.3% at September 30, 2015). The loan matures in February 2020. The bank loan is collateralized by securities pledged for such purposes. The Hospital is required to comply with certain financial covenants for the loan, including a debt service coverage ratio requirement of at least 1.25.

Other long-term obligations consist of capital equipment financing notes and capital leases.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

Long-term obligations at September 30, 2015 and 2014 are as follows (in thousands):

	2015	2014
CHEFA Series E Bonds, principal payable annually and interest payable in semi-annual installments	\$ —	19,625
Bank loan	13,500	
Capital leases	927	891
	14,427	20,516
Less unamortized portion of bond discount	—	(116)
Less current portion	(3,409)	(2,509)
	\$ 11,018	17,891

Principal payments on the Hospital's long-term obligations and capital lease payments are as follows (in thousands):

	Long-term obligations	Capital leases
Year ending September 30:		
2016	\$ 3,000	409
2017	3,000	260
2018	3,000	112
2019	3,000	83
2020	1,500	63
Thereafter	—	—
	\$ 13,500	927
Interest payments		80
		\$ 1,007

(9) Line of Credit

The Hospital maintains a financing agreement with a bank for a \$1,000,000 line of credit which has an August 13, 2016 maturity date. Interest on the line of credit is at the Hospital's choice of either the lending institution's prime rate or at the LIBOR rate plus 110 basis points. At September 30, 2015 and 2014, there was no outstanding balance under this line of credit agreement.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(10) Unrestricted, Temporarily and Permanently Restricted Net Assets

The changes in consolidated unrestricted net assets attributable to the System and noncontrolling interest for the year ended September 30, 2015 were as follows (in thousands):

	<u>Total</u>	<u>Controlling interest</u>	<u>Noncontrolling interest</u>
Unrestricted net assets, beginning of year	\$ 32,895	32,525	370
Excess of revenues over expenses	4,689	4,295	394
Net assets released from restriction for capital expenditures	351	351	—
Transfers to affiliates	191	—	191
Reduction in unrealized gains on marketable securities and other assets whose use is limited	(2,003)	(2,003)	—
Change in accumulated pension charges to unrestricted net assets	(2,773)	(2,773)	—
Unrestricted net assets, end of year	<u>\$ 33,350</u>	<u>32,395</u>	<u>955</u>

The changes in consolidated unrestricted net assets attributable to the System and noncontrolling interest for the year ended September 30, 2014 were as follows (in thousands):

	<u>Total</u>	<u>Controlling interest</u>	<u>Noncontrolling interest</u>
Unrestricted net assets, beginning of year	\$ 34,404	34,102	302
Excess of revenues over expenses	12,830	12,398	432
Net assets released from restriction for capital expenditures	(48)	(48)	—
Transfers to affiliates	(387)	(23)	(364)
Reduction in unrealized gains on marketable securities and other assets whose use is limited	(527)	(527)	—
Change in accumulated pension charges to unrestricted net assets	(13,377)	(13,377)	—
Unrestricted net assets, end of year	<u>\$ 32,895</u>	<u>32,525</u>	<u>370</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

Temporarily restricted net assets are available for the following purposes at September 30, 2015 and 2014 (in thousands):

	2015	2014
Cancer	\$ 241	212
Building and equipment	236	421
Community services	421	511
Education	215	186
Other	809	1,085
	\$ 1,922	2,415

Permanently restricted net assets at September 30, 2015 and 2014 are restricted to (in thousands):

	2015	2014
Investments held by trustee in perpetuity, the income from which is expendable to support Hospital operations	\$ 14,781	15,713
Investments held by Hospital Foundation in perpetuity, the income from which is expendable to support:		
Hospital operations	900	818
Medical education	150	150
	\$ 15,831	16,681

(11) Endowment

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) adopted by the State of Connecticut (Act) provides standards to guide investing in a prudent manner and eliminated the restriction that endowment funds could not be spent below historical dollar value.

The System's endowment consists of funds established for a variety of purposes including donor-restricted endowment funds. Net assets associated with endowment funds are classified and reported based on the existence or absence of donor-imposed restrictions. At September 30, 2015 and 2014, the System has no funds designated by the Board of Directors as endowment.

The System has interpreted UPMIFA as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. The System classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the System in a manner consistent with the standard of prudence prescribed by the Act.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The System considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds; the duration and preservation of the fund, the purposes of the System and the donor-restricted endowment funds, general economic conditions, the possible effect of inflation and deflation, the expected total return from income and the appreciation of investments, other resources of the System, and the investment policies of the System.

Endowment funds consist of the following at September 30, 2015 and 2014 (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Donor-restricted endowment funds at September 30, 2015	\$ 409	15,831	16,240
Donor-restricted endowment funds at September 30, 2014	\$ 457	16,681	17,138

Changes in endowment funds for the year ended September 30, 2015 are as follows (in thousands):

	<u>Temporarily restricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, September 30, 2014	\$ 457	16,681	17,138
Investment return:			
Investment income	—	1,054	1,054
Net depreciation	—	(1,302)	(1,302)
Total investment return	—	(248)	(248)
Contributions	—	83	83
Appropriation of endowment assets for expenditure	(48)	(685)	(733)
Endowment net assets, September 30, 2015	<u>\$ 409</u>	<u>15,831</u>	<u>16,240</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

Changes in endowment funds for the year ended September 30, 2014 are as follows (in thousands):

	Temporarily restricted	Permanently restricted	Total
Endowment net assets, September 30, 2013	\$ 375	16,255	16,630
Investment return:			
Investment income	110	913	1,023
Net appreciation (depreciation)	(23)	264	241
Total investment return	87	1,177	1,264
Appropriation of endowment assets for expenditure	(5)	(751)	(756)
Endowment net assets, September 30, 2014	\$ 457	16,681	17,138

The System has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that the System must hold in perpetuity or for a donor-specified period. Funds held in trust by others represents a donor established perpetual trust held and administered by an outside trustee and are not within the System's control as to spending and investment policies.

To satisfy its long term rate-of-return objectives, the System relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). The System targets a diversified asset allocation that places emphasis on investments in equities and fixed income investments to achieve its long-term return objectives with prudent risk constraints.

The System follows a policy of spending an amount that approximates the investment income earned, in addition to specific purchases of capital equipment. Accordingly, the System expects its spending policy will allow its endowment funds to be maintained in perpetuity by growing at a rate at least equal to the planned payouts. Additional real endowment growth will be provided through new gifts and any excess investment return.

(12) Professional and General Liability

Prior to July 1, 2009, the Hospital purchased limits of professional and general liability from Partners Interinsurance Exchange (PIE) to cover risks up to specified limits. Within PIE the Hospital maintained retentions net to its own account by type of coverage. A claims made reinsurance contract was purchased each fiscal year that provided coverage above these retentions. Beginning January 1, 2002, the professional liability coverage provided for total limits, with respect to professional liability, of \$18 million per claim and \$27 million in the aggregate, with a retention inside that limit of \$3,000,000 per incident applying as net to the Hospital's account within PIE. The general liability coverage provided limits of \$16 million per claim

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

and \$19 million in the aggregate with a retention of \$1,000,000 per incident and \$4,000,000 in the annual aggregate retained as net to the Hospital's account within PIE. The Hospital paid an actuarially determined premium to PIE for the purpose of setting aside assets to cover the reasonable value of ultimate expected loss retained as net within PIE.

During June 2009, the Hospital established the Indemnity Company as a successor to the Hospital's financial interest in PIE. On July 1, 2009 the Hospital's account in PIE was transferred to the Indemnity Company. The Hospital and certain affiliates continue to purchase limits of professional and general liability from the Indemnity Company at levels previously purchased from PIE.

Professional liability claims have been asserted against the Hospital by various claimants. The claims are in various stages of assessment and resolution. There are also known and unknown incidents that have occurred through September 30, 2015 that may result in the assertion of additional claims. Actuarially determined premiums are paid in order to set aside assets to cover the reasonable value of ultimate expected losses. Hospital management, along with its consulting actuaries, accrued its best estimate of professional and general liabilities. The resolution of these claims, including those unasserted, involves extended evaluation of the facts, including the involvement of independent specialists. As a result, the estimates made are reassessed periodically and subject to change. Hospital management believes that the ultimate settlement of these claims will not have a material impact on the Hospital's consolidated financial position or results of their operations, as adequate self-insurance reserves, Indemnity Company assets and reinsurance are in place.

The Indemnity Company entered into a loss portfolio transfer (LPT) on July 1, 2009 with PIE. The losses associated with this transaction did not transfer insurance risk to the Indemnity Company. As such, this LPT is accounted for using deposit accounting, which requires offsetting assets and liabilities.

Activity in the reserves for premiums held on deposit included in self-insurance liability is summarized as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Reserves for premiums held on deposit at beginning of year	\$ 15,115	10,544
Current period payments from loss escrow	(8,150)	4,600
Change in reserve for premiums held on deposit for loss portfolio transfer	35	374
Current period payments from reserves for premiums held on deposit	<u>(6,959)</u>	<u>(403)</u>
Reserves for premium held on deposit at end of year	<u>\$ 41</u>	<u>15,115</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

Activity in the self-insurance liability for unpaid losses and loss adjustment expenses for prospective losses is summarized as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Balance at beginning of period	\$ 18,224	14,993
Less reinsurance recoverable	<u>(2,750)</u>	<u>(2,650)</u>
Net balance at beginning of period	<u>15,474</u>	<u>12,343</u>
Incurred related to:		
Current year	4,583	4,547
Prior years	<u>(1,604)</u>	<u>(993)</u>
Total incurred	<u>2,979</u>	<u>3,554</u>
Paid related to:		
Current year	55	73
Prior years	<u>3,061</u>	<u>350</u>
Total paid	<u>3,116</u>	<u>423</u>
Net balance at end of period	15,337	15,474
Add reinsurance recoverable	<u>2,750</u>	<u>2,750</u>
Balance at end of period	\$ <u><u>18,087</u></u>	<u><u>18,224</u></u>

The provision for incurred losses related to prior years (relating to loss incurred subsequent to the loss portfolio transfer from Partner Interinsurance Exchange at July 1, 2009) totaled (\$1,604,000) and (\$993,000) for 2015 and 2014, respectively, the result of development on outstanding claims.

(13) Retirement Plans

(a) Defined Benefit Plan

The Hospital has a noncontributory, defined benefit pension plan (the Plan) for most employees, which is funded with available cash flow. The Plan is qualified as a "Church Plan" and is therefore exempt from a majority of ERISA regulations. Plan benefits are not guaranteed by the Pension Benefit Guaranty Corporation. The Plan was frozen to new entrants in 1997. In 2004, the Plan's benefits were curtailed to eliminate participants' earnings of additional benefits for future services.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The following table sets forth the Plan's funded status at September 30, 2015 and 2014, the Plan measurement date, (in thousands):

	2015	2014
Change in benefit obligation:		
Benefit obligation, beginning of year	\$ 140,928	124,196
Interest cost	6,224	6,064
Actuarial loss (gain)	920	17,454
Benefits paid	(7,041)	(6,786)
Benefit obligation, end of year	141,031	140,928
Change in plan assets:		
Fair value of plan assets, beginning of year	69,641	66,215
Actual return on plan assets	(986)	6,091
Contributions	5,399	4,121
Benefits paid	(7,041)	(6,786)
Fair value of plan assets, end of year	67,013	69,641
Funded status at year end	\$ (74,018)	(71,287)
Amounts recognized in consolidated balance sheets consist of:		
Noncurrent liabilities	\$ (74,018)	(71,287)
Accumulated charges to unrestricted net assets, consisting of net actuarial losses	59,111	56,338
Net amount recognized	\$ (14,907)	(14,949)

The net actuarial loss that will be amortized from accumulated charges to unrestricted net assets into net periodic benefit cost over the next fiscal year is \$4,407,000.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The accumulated benefit obligation for the pension plan was \$141,031,000 and \$140,928,000 at September 30, 2015 and 2014, respectively. Net periodic benefit cost recognized in 2015 and 2014 was (in thousands):

	<u>2015</u>	<u>2014</u>
Components of net periodic benefit cost:		
Interest cost	\$ 6,224	6,064
Expected return on plan assets	(5,227)	(5,064)
Net amortization and deferral	<u>4,359</u>	<u>3,050</u>
Net periodic benefit cost	<u>5,356</u>	<u>4,050</u>
Other changes in plan assets and benefit obligation recognized as (charges) credits to unrestricted net assets in 2015 and 2014 are as follows (in thousands):		
Net (loss) gain	1,586	(10,327)
Net amortization and deferral	<u>(4,359)</u>	<u>(3,050)</u>
Decrease increase recognized in changes to unrestricted net assets	<u>(2,773)</u>	<u>(13,377)</u>
Decrease increase to unrestricted net assets associated with recognized net periodic benefit costs and (charge) credit to accumulated pension charge	\$ <u>(8,129)</u>	<u>(17,427)</u>

Weighted average assumptions used to determine benefit obligations and net periodic benefit cost as of and for the years end September 30, 2015 and 2014 were as follows:

	<u>2015</u>	<u>2014</u>
Weighted average assumptions at September 30:		
Discount rate for benefit obligations	4.60%	4.55%
Discount rate for net periodic benefit cost	4.55	5.02
Expected return on plan assets	8.00	8.00

The discount rate is based on high-grade bond yield curve under which benefits were projected and discounted at spot rates along the curve. The discount rate was then determined as a single rate yielding the same present values.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The following table sets forth by level, within the fair value hierarchy, the pension plan's financial instruments at fair value as of September 30, 2015 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Money market funds	\$ 8,078	—	—	8,078
U.S. government and agency obligations	—	41	—	41
Equity mutual funds	39,130	—	—	39,130
Fixed income mutual funds	19,764	—	—	19,764
Total	\$ 66,972	41	—	67,013

The following table sets forth by level, within the fair value hierarchy, the pension plan's financial instruments at fair value as of September 30, 2014 (in thousands):

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Money market funds	\$ 2,241	—	—	2,241
Domestic corporate bonds	—	12,827	—	12,827
U.S. government and agency obligations	—	261	—	261
Equity mutual funds	47,991	—	—	47,991
Fixed income mutual funds	6,321	—	—	6,321
Total	\$ 56,553	13,088	—	69,641

The redemption period for the Plan's financial instruments ranges from daily to monthly and require notification of one to five days.

The expected long-term rate of return for the plan's total assets is based on the expected return of each of the above categories, weighted based on the target allocation of each class. Equity securities are expected to return 9% to 10% over the long-term, while debt securities are expected to return between 4% and 7%. Money market funds are held to pursue market opportunities.

The investment policy, as established by the Investment Committee, is to earn a total return in any five-year period that will have exceeded the interest assumption in the actuarial plan valuation for that five-year period. For performance evaluation purposes, all rates of return will be examined on a net-of-fee basis. The pension assets are to be broadly diversified so as to limit the impact of large losses in individual investments on the total portfolio. The asset allocation is reviewed on a quarterly basis.

In the aggregate, contributions to the pension plan are expected to be \$5,300,000 in 2016.

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

The following benefit payments are expected to be paid (in thousands):

2016	\$	7,751
2017		7,980
2018		8,313
2019		8,572
2020		8,796
2021 through 2025		<u>46,473</u>
	\$	<u><u>87,885</u></u>

(b) Defined Contribution Plan

The Hospital established a defined contribution plan when it reduced the benefits of the Plan via amendment in 1997. The defined contribution plan provides for a Hospital match up to a certain percentage of employee contributions. Expenses related to the defined contribution plan amounted to \$3,964,000 and \$3,885,000 in 2015 and 2014, respectively, and are included in employee benefits in the accompanying consolidated statements of operations.

(c) Supplemental Pension Plan

In addition, the Hospital has an unfunded supplemental pension plan for a small group of long term employees, who are now retired. The Hospital's recorded liability was \$957,000 and \$975,000 at September 30, 2015 and 2014, respectively.

(14) Leases and Rental Expenses

Rental expense aggregated approximately \$6,582,000 and \$6,147,000 for the years ended September 30, 2015 and 2014, respectively. Minimum future rental commitments on all noncancelable operating leases with initial or remaining terms of more than one year are as follows (in thousands):

Fiscal year:		
2016	\$	3,578
2017		2,406
2018		2,012
2019		1,838
2020		1,400
2021 and thereafter		<u>6,475</u>
	\$	<u><u>17,709</u></u>

(15) Cancer Center

During 1997, the Hospital entered into an agreement with Waterbury Hospital to develop a joint Cancer Care Center, known as the Harold Leever Regional Cancer Center (HLRCC) that provides treatment services to cancer patients in the greater Waterbury area. The Hospital is entitled to distributions at the discretion of HLRCC's Board of Directors, which is selected by Waterbury Hospital and the Hospital on a 50/50 basis. The Hospital's investment in HLRCC is carried on the equity basis, and the carrying value is approximately

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

\$9,356,000 and \$9,562,000 at September 30, 2015 and 2014, respectively. Equity in earnings (losses) was approximately (\$81,000) and (\$424,000) in 2015 and 2014, respectively.

(16) Heart Center of Greater Waterbury

The Hospital and Waterbury Hospital operate an advanced cardiac care program known as the Heart Center of Greater Waterbury, Inc. (HCGW). Patients at the Hospital and Waterbury Hospital are provided access to services such as angioplasty and open heart surgery. Procedures are performed at both hospitals, each recording related revenues and expenses. The HCGW, a MSO that provides administrative support and management functions to the program, has a Board of Directors selected by Waterbury Hospital and the Hospital on a 50/50 basis. HCGW incurs costs, which are funded by the hospitals, to market the program and derives no net assets from its activities. The Hospital expensed \$113,000 and \$118,000 of funding, in 2015 and 2014, respectively.

(17) Investments in Joint Venture Arrangements

Naugatuck Valley MRI Limited Partnership

The Hospital was a 1% general partner and a 47% limited partner in the Naugatuck Valley MRI Limited Partnership, which provides diagnostic imaging services in Waterbury. The Hospital acquired an additional 30.3% of the limited partner shares on January 1, 2015. The company was then converted from an LP to an LLC and the Hospital retained 78.3% of the LLC.

In 2014, the investment was carried on the equity basis, and the carrying value is approximately \$199,000 at September 30, 2014. Equity in earnings (losses) was approximately (\$55,000) in 2014.

(18) Other Operating Revenues

Components of other operating revenues for the years ended September 30, 2015 and 2014 are as follows (in thousands):

	2015	2014
Investment income related to short-term investments and investments for self-insurance	\$ 485	671
Net assets released from restriction	897	797
Contributions	724	561
Cafeteria	1,221	1,170
Outside services	334	545
State grants	631	656
Parking fees	228	232
Day care	771	718
Rentals	1,411	1,242
Meaningful Use	2,118	2,962
Other	1,252	1,971
Total	\$ 10,072	11,525

SAINT MARY'S HEALTH SYSTEM, INC.

Notes to Consolidated Financial Statements

September 30, 2015 and 2014

(19) Functional Expenses

The System provides general health care services to residents within its geographic location. Expenses related to providing these services for the years ended September 30, 2015 and 2014 are as follows (in thousands):

	<u>2015</u>	<u>2014</u>
Health care services	\$ 240,043	225,237
General and administrative	52,601	43,785
Fundraising	656	693
	<u>\$ 293,300</u>	<u>269,715</u>

(20) Subsequent Events

The System has evaluated events through February 24, 2016, which represents the date the consolidated financial statements were available to be issued and noted no subsequent events that would have impacted the System's consolidated financial statements except as disclosed below.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Balance Sheet

September 30, 2015

(In thousands)

	<u>Saint Mary's Hospital, Inc. Consolidated</u>	<u>Saint Mary's Hospital Foundation Inc.</u>	<u>Saint Mary's Health System Inc.</u>	<u>Eliminations</u>	<u>Saint Mary's Health System, Inc. Consolidated</u>
Current assets:					
Cash and cash equivalents	\$ 13,258	768	65	-	14,091
Restricted cash	1,000	-	-	-	1,000
Short-term investments	17	-	-	-	17
Current portion of assets whose use is limited	3,418	-	-	-	3,418
Accounts receivable, net	32,861	44	-	-	32,905
Other current assets	11,171	17	453	(22)	11,619
Total current assets	<u>61,725</u>	<u>829</u>	<u>518</u>	<u>(22)</u>	<u>63,050</u>
Marketable securities	124	4,120	-	-	4,244
Assets whose use is limited:					
By donor and held in trust by others	14,764	-	-	-	14,764
For estimated self-insurance liability	26,309	-	-	-	26,309
Pledged Collateral	20,160	-	-	-	20,160
Net interest in Foundation	4,908	-	-	(4,908)	-
Other	6	-	-	-	6
Total assets whose use is limited	<u>66,147</u>	<u>-</u>	<u>-</u>	<u>(4,908)</u>	<u>61,239</u>
Less current portion of assets whose use is limited	3,418	-	-	-	3,418
Noncurrent assets whose use is limited	<u>62,729</u>	<u>-</u>	<u>-</u>	<u>(4,908)</u>	<u>57,821</u>
Property and equipment, net	69,285	4	1,002	-	70,291
Other assets:					
Investments in joint venture arrangements	9,574	-	-	-	9,574
Other noncurrent assets	1,785	-	95	-	1,880
Total other assets	<u>11,359</u>	<u>-</u>	<u>95</u>	<u>-</u>	<u>11,454</u>
Total assets	<u>\$ 205,222</u>	<u>4,953</u>	<u>1,615</u>	<u>(4,930)</u>	<u>206,860</u>

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Balance Sheet

September 30, 2015

(In thousands)

	Saint Mary's Hospital, Inc. Consolidated	Saint Mary's Hospital Foundation, Inc.	Saint Mary's Health System Inc.	Eliminations	Saint Mary's Health System, Inc. Consolidated
Current liabilities:					
Current portion of long-term obligations	\$ 3,409	-	-	-	3,409
Accounts payable	22,642	23	-	-	22,665
Salaries, wages, and payroll withholdings	6,002	-	-	-	6,002
Due to third-party payors, net	727	-	-	-	727
Accrued expenses and other current liabilities	12,950	22	30	(22)	12,980
Total current liabilities	<u>45,730</u>	<u>45</u>	<u>30</u>	<u>(22)</u>	<u>45,783</u>
Long-term liabilities:					
Long-term obligations, net of current portion	11,018	-	-	-	11,018
Estimated self-insurance liability	17,751	-	-	-	17,751
Pension and deferred compensation	74,894	-	-	-	74,894
Other long-term liabilities	6,311	-	-	-	6,311
Total long-term liabilities	<u>109,974</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>109,974</u>
Net assets (deficit):					
Unrestricted	30,810	2,060	1,585	(2,060)	32,395
Noncontrolling interest in subsidiaries	955	-	-	-	955
Total unrestricted	<u>31,765</u>	<u>2,060</u>	<u>1,585</u>	<u>(2,060)</u>	<u>33,350</u>
Temporarily restricted	1,922	1,798	-	(1,798)	1,922
Permanently restricted	15,831	1,050	-	(1,050)	15,831
Total net assets	<u>49,518</u>	<u>4,908</u>	<u>1,585</u>	<u>(4,908)</u>	<u>51,103</u>
Total liabilities and net assets	<u>\$ 205,222</u>	<u>4,953</u>	<u>1,615</u>	<u>(4,930)</u>	<u>206,860</u>

See accompanying independent auditors' report.

SAINT MARY'S HEALTH SYSTEM, INC.

Consolidating Statement of Operations

Year ended September 30, 2015

(In thousands)

	<u>Saint Mary's Hospital, Inc. Consolidated</u>	<u>Saint Mary's Hospital Foundation, Inc.</u>	<u>Saint Mary's Health System Inc.</u>	<u>Eliminations</u>	<u>Saint Mary's Health System, Inc. Consolidated</u>
Revenues:					
Revenue from patient services, net of contractual allowance	\$ 295,064	-	-	-	295,064
Provision for uncollectible accounts, net of recoveries	(9,675)	-	-	-	(9,675)
Net revenue from patient services	<u>285,389</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>285,389</u>
Other operating revenues	8,981	1,091	156	(156)	10,072
Total revenues	<u>294,370</u>	<u>1,091</u>	<u>156</u>	<u>(156)</u>	<u>295,461</u>
Expenses:					
Salaries and wages	123,001	158	38	-	123,197
Employee benefits	32,244	43	11	-	32,298
Supplies and other expenses	124,788	442	103	(156)	125,177
Provision for uncollectible accounts	-	12	-	-	12
Depreciation and amortization	11,486	1	149	-	11,636
Interest	980	-	-	-	980
Total expenses	<u>292,499</u>	<u>656</u>	<u>301</u>	<u>(156)</u>	<u>293,300</u>
Operating income (loss)	<u>1,871</u>	<u>435</u>	<u>(145)</u>	<u>-</u>	<u>2,161</u>
Nonoperating gains (losses):					
Investment income, net	1,565	-	-	-	1,565
Equity in earnings of joint ventures	914	-	-	-	914
Change in net assets of Foundation	435	-	-	(435)	-
Net gain on disposal of assets	97	-	-	-	97
Other	(48)	-	-	-	(48)
Total nonoperating gains, net	<u>2,963</u>	<u>-</u>	<u>-</u>	<u>(435)</u>	<u>2,528</u>
Excess (deficiency) of revenues over (under) expenses	<u>4,834</u>	<u>435</u>	<u>(145)</u>	<u>(435)</u>	<u>4,689</u>
Net assets released from restriction for capital expenditures	351	-	-	-	351
Capital transactions with affiliates	191	-	-	-	191
Reduction in unrealized gains on marketable securities and other assets whose use is limited	(2,003)	(298)	-	298	(2,003)
Change in accumulated pension charges to unrestricted net assets	(2,773)	-	-	-	(2,773)
Increase (decrease) in net assets	<u>600</u>	<u>137</u>	<u>(145)</u>	<u>(137)</u>	<u>455</u>

See accompanying independent auditors' report.