

CONSOLIDATED FINANCIAL STATEMENTS

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE
CATHOLIC HEALTH SYSTEM, INC.)**

DECEMBER 31, 2015

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

CONTENTS

	<u>Page</u>
Independent Auditor's Report	1
Consolidated Financial Statements:	
Consolidated Balance Sheets	2
Consolidated Statements of Operations and Changes in Net Assets	3 - 4
Consolidated Statements of Cash Flows	5
Notes to the Consolidated Financial Statements	6 - 30
Independent Auditor's Report on Accompanying Supplementary Information	31
Supplemental Schedule:	
Schedule of Net Cost of Providing Care of Persons Living in Poverty and Community Benefit Programs (Schedule of Social Accountability – Unaudited)	32
Consolidating Information	33 - 35



INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Catholic Health System, Inc.
Buffalo, New York

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Kenmore Mercy Hospital and its subsidiaries (collectively, the Hospital), which comprise the consolidated balance sheet as of December 31, 2015 and 2014, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended and the related notes to the consolidated financial statements (collectively, consolidated financial statements).

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on 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 auditor's 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 Hospital'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 Hospital'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 Kenmore Mercy Hospital and its subsidiaries as of December 31, 2015 and 2014, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 15, the Hospital had significant transactions with related parties. Our opinion is not modified with respect to this matter.

Freed Maxick CPAs, P.C.

Buffalo, New York
April 26, 2016

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATED BALANCE SHEETS
December 31,

ASSETS	2015	2014
Current assets:		
Cash and cash equivalents	\$ 50,682,842	\$ 43,402,951
Patient/resident accounts receivable, net of allowance for doubtful accounts of \$4,711,000 (2014 - \$4,579,000)	24,036,661	21,401,117
Other receivables	3,551,089	1,451,114
Inventories	2,948,899	2,514,895
Prepaid expenses and other current assets	382,180	298,082
Due from affiliates	60,315	22,456
Total current assets	81,661,986	69,090,615
Assets limited as to use	4,968,958	6,398,910
Investments	2,227,825	2,950,758
Due from affiliates	1,456,493	1,456,493
Property and equipment, net	63,147,326	61,556,735
Other assets	17,666,871	16,089,179
Total assets	\$ 171,129,459	\$ 157,542,690
LIABILITIES AND NET ASSETS		
Current liabilities:		
Current portion of long-term obligations	\$ 2,151,609	\$ 6,503,335
Accounts payable	10,728,007	8,831,175
Accrued expenses	6,649,334	6,521,884
Due to third-party payors	6,635,756	6,041,453
Due to affiliates	21,288,765	11,103,145
Total current liabilities	47,453,471	39,000,992
Long-term obligations, net	26,783,466	29,117,212
Long-term portion of insurance liabilities	23,856,039	21,238,113
Pension obligation	31,793,978	32,475,636
Asset retirement obligation	180,785	184,567
Other long term liabilities	-	138,336
Total liabilities	130,067,739	122,154,856
Net assets:		
Unrestricted	40,854,951	34,922,401
Temporarily restricted	206,769	465,433
Total net assets	41,061,720	35,387,834
Total liabilities and net assets	\$ 171,129,459	\$ 157,542,690

See accompanying notes.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Years Ended December 31,

	2015	2014
Unrestricted revenue and other support:		
Net patient/resident service revenue	\$ 173,115,228	\$ 160,933,817
Provision for bad debts	<u>(3,892,461)</u>	<u>(2,495,784)</u>
Net patient/resident service revenue, less provision for bad debts	169,222,767	158,438,033
Other revenue	<u>5,055,317</u>	<u>2,256,198</u>
Total unrestricted revenue and other support	<u>174,278,084</u>	<u>160,694,231</u>
Expenses:		
Salaries and wages	70,170,119	67,440,820
Employee benefits	21,628,647	19,712,006
Medical and professional fees	5,508,864	4,398,491
Purchased services	15,275,930	13,889,890
Supplies	37,415,538	33,580,379
Depreciation and amortization	8,012,004	7,447,322
Interest	2,274,822	1,916,716
Insurance	2,795,589	1,174,743
Other expenses	<u>4,814,027</u>	<u>5,217,770</u>
Total expenses	<u>167,895,540</u>	<u>154,778,137</u>
Income from operations	6,382,544	5,916,094
Nonoperating revenues and losses:		
Investment income	55,561	301,320
Other, net	<u>77,729</u>	<u>46,274</u>
Total nonoperating revenues and losses	<u>133,290</u>	<u>347,594</u>
Excess of revenues over expenses	<u><u>\$ 6,515,834</u></u>	<u><u>\$ 6,263,688</u></u>

See accompanying notes.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS (CONTINUED)
For the Years Ended December 31,

	<u>2015</u>	<u>2014</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 6,515,834	\$ 6,263,688
Change in pension obligation, other than net periodic cost	2,365,302	(7,758,083)
Distributions and transfers (to) from parents and affiliates	(3,443,137)	911,771
Change in unrealized gain on interest rate swap	-	32,046
Net assets released from restrictions used for capital	259,570	270,500
Other	234,981	118,889
Increase in unrestricted net assets	<u>5,932,550</u>	<u>(161,189)</u>
Temporarily restricted net assets:		
Contributions	243	10,307
Temporarily restricted net assets released from restrictions	(259,570)	(270,500)
Other	663	737
Decrease in temporarily restricted net assets	<u>(258,664)</u>	<u>(259,456)</u>
Increase (decrease) in net assets	<u>5,673,886</u>	<u>(420,645)</u>
Net assets - beginning of year	<u>35,387,834</u>	<u>35,808,479</u>
Net assets - end of year	<u><u>\$ 41,061,720</u></u>	<u><u>\$ 35,387,834</u></u>

See accompanying notes.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31,

	2015	2014
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 5,673,886	\$ (420,645)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities:		
Depreciation and amortization	8,012,004	7,447,322
Provision for bad debts	3,892,461	2,495,784
Distribution and transfer to (from) parent and affiliates	3,443,137	(911,771)
Change in pension obligation, other than net periodic cost	(2,365,302)	7,758,083
Discount on issuance	402,456	19,743
Premium on issuance	(23,699)	(15,611)
Gain on termination of interest rate swap	-	(28,798)
Change in realized and unrealized (gain) losses on investments	82,710	(63,327)
Loss on sale of property and equipment	-	(4,594)
(Increase) decrease in assets		
Patient accounts receivables	(6,528,005)	(5,932,479)
Other receivables	(2,099,975)	373,369
Inventories	(434,004)	(334,223)
Prepaid expenses	(84,098)	157,546
Other assets	2,183	261,820
Due from affiliates	(37,859)	(2,171)
Increase (decrease) in liabilities		
Accounts payable	(449,940)	847,757
Accrued expenses	127,450	(904,023)
Due to affiliates	9,009,246	2,721,329
Due to third-party payors	594,303	178,111
Other liabilities	2,310,488	1,007,020
Net cash and cash equivalents provided by operating activities	21,527,442	14,650,242
Cash flows from investing activities:		
Purchase of property and equipment	(4,965,448)	(10,158,568)
Purchase of assets whose use is limited	(3,897,746)	35,807
Proceeds from sale of property and equipment	-	3,913,144
Sale of assets whose use is limited	5,303,689	-
Purchase of investments	(192,246)	(1,150,050)
Sale of investments	832,469	1,937,789
Other	24,009	(1,979)
Net cash and cash equivalents used in investing activities	(2,895,273)	(5,423,857)
Cash flows (to) from financing activities:		
Distribution and transfer from parent and affiliates	(3,443,137)	911,771
Termination of interest rate swap	-	(1,139,000)
Proceeds from issuance of long-term obligations	3,515,000	3,990,000
Repayments of long-term obligations	(11,424,141)	(2,629,619)
Net cash and cash equivalents (used in) provided by financing activities	(11,352,278)	1,133,152
Increase in cash and cash equivalents	7,279,891	10,359,537
Cash and cash equivalent, beginning of year	43,402,951	33,043,414
Cash and cash equivalent, end of year	<u>\$ 50,682,842</u>	<u>\$ 43,402,951</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 2,044,288	\$ 1,892,381
Noncash investing and financing activities:		
Assets acquired under capital lease obligations	\$ 844,912	\$ 1,284,946
Increase in construction-related payables	\$ 2,346,772	\$ -

See accompanying notes.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

Kenmore Mercy Hospital is a not-for-profit acute care hospital and KMH Homes, Inc., whose sole member is Kenmore Mercy Hospital, is a not-for-profit corporation established to hold the property and related debt utilized by The McAuley Residence (TMR). TMR is a separate department of Kenmore Mercy Hospital operating as a not-for-profit nursing home. All operations are located in Erie County, New York and serve the community of Western New York. The Hospital provides inpatient, outpatient, and emergency services for the residents primarily in and around its surrounding area. Admitting physicians are primarily practitioners in the local area.

Kenmore Mercy Hospital is the sole corporate member of Kenmore Mercy Foundation, Inc. (the Foundation). The Foundation is a non-profit organization incorporated under the New York State Corporation Laws. The Foundation's sole purpose is to receive and administer gifts and bequests made on behalf of Kenmore Mercy Hospital, which are generally used to support the capital needs of Kenmore Mercy Hospital.

Kenmore Mercy Hospital, KMH Homes, Inc, TMR and the Foundation (collectively referred to as the Hospital) are part of the Catholic Health System, Inc. and Subsidiaries (CHS or the System) and its organizational structure is discussed below.

System: Catholic Health System, Inc. and Subsidiaries is an integrated healthcare delivery system in Western New York jointly sponsored by the Diocese of Buffalo, New York, Ascension Health Ministries and Catholic Health Ministries. Ascension Health, Trinity Health, and the Diocese of Buffalo, New York are the corporate members of CHS, with equal ownership interest. CHS is the sole corporate member of the following subsidiaries:

Acute Care Subsidiaries: The Acute Care Subsidiaries (also collectively referred to as the Hospitals) include Mercy Hospital of Buffalo (MHB), Kenmore Mercy Hospital including The McAuley Residence (KMH), Sisters of Charity Hospital (SCH) and Mount St. Mary's Hospital and Health Center (MSM).

Long-Term Care Subsidiaries: The Long-term Care Subsidiaries include St. Francis Geriatric and Healthcare Services, Inc. (closed December 2009), St. Francis Home of Williamsville (SFHW), Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), Nazareth Home of the Franciscan Sisters of the Immaculate Conception (closed 2007) and St. Elizabeth's Home (SHE) and St. Vincent's Home for the Aged (SVH).

Home Care Subsidiaries and Other: The Home Care and Other Subsidiaries include Mercy Home Care of Western New York, Inc. (MHC), McAuley Seton Home Care (MSHC), Our Lady of Victory Renaissance Corporation (OLV Renaissance), Catholic Health Infusion Pharmacy, Continuing Care Foundation and Catholic Health System Program of All Inclusive Care for the Elderly, Inc. (LIFE) and Trinity Medical WNY, PC.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies applied in preparing the accompanying consolidated financial statements are summarized below:

Principles of Consolidation: The consolidated financial statements of the Hospital include the accounts of Kenmore Mercy Hospital and KMH Homes, Inc, and Kenmore Mercy Foundation. All significant intercompany balances and transactions have been eliminated to reflect the consolidated amounts.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Use of Estimates: The preparation of consolidated 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 and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made by the Hospital include, but are not limited to, the reserves for asset retirement obligations, reserve for bad debts, reserve for third-party payor contractual adjustments and allowances, the provision for estimated receivables and payables for final settlements with those payors, the insurance reserves for workers' compensation, professional and general liability, and actuarial assumptions used in determining pension expense.

Risks and Uncertainties: Investment securities are exposed to various risks, such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the fair value of investment securities, it is at least possible that changes in risks in the near term could materially affect the net assets of the Hospital.

Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates related to third-party payment matters will change by a material amount in the near term.

Cash and Cash Equivalents: The Hospital considers all highly liquid investments, generally with original maturities of three months or less when purchased, and short term investments (certificates of deposit), excluding amounts limited as to use, to be cash equivalents. The Hospital maintains funds on deposit in excess of amounts insured by the Federal Depository Insurance limits.

Other Receivables: Other receivables consist primarily of managed care risk sharing receivables, physician loans, and other receivables. There is no allowance for doubtful accounts established against these receivables.

Inventory Valuation: Inventory consists primarily of drugs, medical supplies and food. These inventories are generally stated at the lower of cost (first-in, first-out) or market.

Assets Limited as to Use: Assets limited as to use include assets set aside for debt service as required by trustee or indenture agreements, assets set aside by the Board of Directors for specific future purposes and unexpended bond proceeds. The Board retains control of these funds and may at its discretion subsequently use these funds for other purposes.

Investments: Investments in marketable securities with readily determinable fair values and all investments in debt securities are reported at their fair values in the consolidated balance sheets.

Investment income and gains restricted by a donor are reported as increases in unrestricted net assets if the restrictions are met (either by passage of time or by use) in the reporting period in which the income and gains are recognized. Investment income or loss (including realized gains or losses on investments, interest, and dividends) is included in the excess of revenues over expenses, unless their use is restricted by donor stipulations or law. Unrealized gains and losses on investments are included in the operating measure as the investments are trading securities.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Prepaid Expenses and Other Assets: Prepaid expense and other assets consist of prepaid general expenses, deferred financing costs, insurance recoveries and other miscellaneous deferred charges. Amortization of the financing costs is provided on the effective interest method over the maturity of the bond issues.

Property and Equipment: Property and equipment are stated at cost if purchased, or if contributed, at the fair value on the date contributed. Depreciation is computed using the straight-line method over useful lives ranging from three to forty years. Equipment under capital lease is amortized on the straight-line method over the lease term or the estimated useful life of the equipment. Such amortization is included in depreciation and amortization in the consolidated financial statements.

Gifts of long-lived assets such as land, building, or equipment are reported as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions 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 these long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

Impairment of Long-Lived Assets: The Hospital evaluates its long-lived assets for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

The Hospital evaluates the recoverability of long-lived assets not held for sale by measuring the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. If such evaluations indicate that the future undiscounted cash flows of certain long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their fair values. Based on these evaluations, there were no adjustments to the carrying value of long-lived assets in 2015 and 2014.

Asset Retirement Obligations: The Hospital accrues for asset retirement obligations in the period in which they are incurred if sufficient information is available to reasonably estimate the fair value of the obligation. Over time, the liability is accreted to its settlement value. Upon settlement of the liability, the Hospital will recognize a gain or loss for any difference between the settlement amount and liability recorded. Accretion expense for the years ended December 31, 2015 and 2014 was \$15,774 and \$14,988, respectively.

Net Patient/Resident Service Revenue: Net patient service revenue is reported at the estimated net realizable amounts from third-party payors, patients, and others for services rendered. These estimated amounts include estimated adjustments under various reimbursement agreements with third-party payors and government regulations. The Hospital has agreements that provide for payments to the Hospital at amounts different from its established charges. Payment arrangements include prospectively determined rates per discharge, discounted charges, reimbursed costs, per diem payments and risk share arrangements. Third-party payors retain the right to review and propose adjustments to amounts recorded by the Hospital after initial payment of the claim. Such adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as necessary. CHS's Healthcare Assistance Program (HAP) provides discounts to uninsured patients and self pay balances. In addition, the Hospital will also assist patients with the application process for free or low-cost insurance. Those uninsured patients who do not qualify for the HAP or low-cost insurance and live in New York State, a state contiguous to New York State, or the state of Ohio, are provided an uninsured discount based on a service specific uninsured rate. This uninsured rate is similar in calculation method and amount to third party payor methods and rates.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Under the New York Health Care Reform Act (NYHCRA), hospitals are authorized to negotiate reimbursement rates with certain non-Medicare payors except for Medicaid, Workers' Compensation and No-fault, which are regulated by New York State. These negotiated rates may take the form of rates per discharge, reimbursed costs, discounted charges or as per diem payments. Reimbursement rates for non-Medicare payors regulated by New York State are determined on a prospective basis. These rates also vary according to a patient classification system defined by the Health Care Reform Act (HCRA) that is based on clinical, diagnostic and other factors.

A summary of the payment arrangements with major governmental third-party payors follows:

- **Medicare.** Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. The Hospital is reimbursed at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare Administrative Contractor. Cost reports have been audited and finalized by the Medicare Administrative Contractor through December 31, 2009. Disproportionate Share (DSH), Indirect Medical Education (IME), Graduate Medical Education (GME), Paramedical Education and Meaningful Use (MU) are all reconciled through settlement processes. During 2012, the system began participation with Catholic Medical Partners (CMP) as an Accountable Care Organization (ACO). The ACO places a global budget on all traditional Medicare claims (excluding e.g. DSH, IME, DME, MU) for patients associated with CMP Primary Care physicians. Claims are processed through fee for service billing and reconciled to the global budget along with quality measurement at the end of the period.
- **Non-Medicare.** The New York Health Care Reform Act of 1996, as updated, governs payments to hospitals in New York State. Under this system, hospitals and all non-Medicare payors, except Medicaid, Workers' Compensation and No-Fault insurance programs, negotiate hospital's payment rates. If negotiated rates are not established, payors are billed at hospitals established charges. Medicaid, Workers' Compensation and No-Fault payors pay hospital rates promulgated by the New York State Department of Health (DOH) on a prospective basis. Adjustments to current and prior years' rates for these payors will continue to be made in the future. Effective December 1, 2009, NYS implemented inpatient reimbursement reform. The reform updated the data utilized to calculate the NYS DRG rates and service intensity weights (SIWS) in order to utilize refined data and more current information in DOH promulgated rates. Similar type outpatient reforms were implemented effective December 1, 2008.

Amounts recognized in 2015 and 2014 related to prior years, including adjustments to prior year estimates and audit settlements, increased revenues \$187,251 and \$1,219,227, respectively. These changes in estimates related to estimates for prior years cost report reopening, appeals, and tentative final cost reports, some of which are still subject to audit, additional reopening, and/or appeals.

Approximately 51% and 50% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2015 and 2014, respectively. Approximately 37% and 37% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2015 and 2014, respectively.

There are various proposals at the federal and state level that could, among other things reduce payment rates. The outcome of these proposals, regulatory changes and other market conditions cannot presently be determined.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Provision for Bad Debts: The provision for bad debt is based upon management's assessment of expected net collections considering economic experience, trends in health care coverage, and other collection indicators. Periodically throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon historical write-off experience by payor category, including those amounts not covered by insurance and history of cash collections. The results of this review are then used to make any modifications to the provision for bad debt expense to establish an appropriate allowance for uncollectible accounts. After satisfaction of amounts due from insurance and reasonable efforts to collect from the patient have been exhausted, the Hospital follows established guidelines for placing certain past-due patient balances with the collection agencies, subject to terms of certain restrictions on collection efforts as determined by the Hospital. Accounts receivable are written off after collection efforts have been followed in accordance with the Hospital's policies.

Patient and resident 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 for the years ended December 31, 2015 and 2014:

	<u>2015</u>	<u>2014</u>
Patient/resident service revenue (net of Contractual allowances and discounts):		
Medicare	\$ 68,630,727	\$ 65,212,579
Medicaid	18,916,436	15,373,707
Blue Cross	20,347,602	18,742,793
Other third party payors	62,033,645	57,000,331
Patients/residents	<u>3,186,818</u>	<u>4,604,407</u>
Total net patient/resident service revenue	173,115,228	160,933,817
Provision for bad debts	<u>(3,892,461)</u>	<u>(2,495,784)</u>
Net patient/resident service revenue less provision for bad debts	<u>\$ 169,222,767</u>	<u>\$ 158,438,033</u>

Charity Care: The System provides services to all patients regardless of ability to pay. A patient is classified as a charity patient based on income eligibility criteria as established by the HAP which is determined by presentation for care without insurance, while using an estimator, Payment Assistance Rank Ordering score (PARO), of each guarantor's ability to pay. Free care is determined at 110% of Federal Poverty Guidelines (FPG), whereas discounted care is also provided at 500% FPG.

Of the Hospital's total expenses, an estimated \$931,897 and \$1,209,669 arose from providing services to charity care patients in 2015 and 2014, respectively. Costing is a full step down methodology of cost from non-revenue producing departments to revenue producing departments, with assignment of cost to individual charge items based on relative value units. Additional costs for the Hospitals include required payments for a gross receipts assessment to New York State which is used to fund the New York State Medicaid program and HCRA. Revenues that offset the costs of Charity Care include payments from the New York State Uncompensated Care Pools.

The Hospital provides care to patients at no charge or at a discounted rate who meet eligibility requirements under its HAP (charity care). In addition to charity care, the Hospital provides services to patients covered by Medicaid. The payments received for services provided to patients covered by Medicaid may be at or below costs in addition to the cost of care for patients without insurance. The Hospitals are also required to pay a gross receipts assessment to New York State which is used to fund the New York State Medicaid program and HCRA.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Collective Bargaining Agreements: The Hospital has approximately 50% of its employees working under four different collective bargaining agreements. The agreements are set to expire beginning January 31, 2017 through July 21, 2019.

Operating and Nonoperating Revenue and Losses: The Hospital's primary mission is dedicated to meeting the health care needs in the regions in which it operates. The Hospital is committed to providing a broad range of general and specialized health care services including inpatient, primary care, long-term care, outpatient services, and other health care related services. Only those activities directly associated with the furtherance of this mission are considered to be operating activities. Such activities include operation of cafeterias, parking lots, rental real estate and other ancillary activities. Other activities that result in gains or losses unrelated to the Hospital's primary mission are considered to be nonoperating.

Electronic Health Record Incentive Payments: The American Recovery and Reinvestment Act of 2009 provides for Medicare and Medicaid incentive payments beginning in 2011 for eligible hospitals and professionals that adopt and meaningfully use certified electronic health record (EHR) technology. The Hospital recognizes income related to Medicare and Medicaid incentive payments using a gain contingency model that is based upon when the Hospital has demonstrated meaningful use of certified EHR technology for the applicable period and the cost report information for the full cost report year that will determine the final calculation of the incentive payment is available.

Medicaid EHR incentive calculations and related payment amounts are based upon prior period cost report information available at the time the Hospital adopts, implements or demonstrates meaningful use of certified EHR technology for the applicable period, and are not subject to revision for cost report data filed for a subsequent period. Thus, incentive income recognition occurs at the point the Hospital adopts, implements or demonstrates meaningful use of certified EHR technology for the applicable period, as the cost report information for the full cost report year that will determine the final calculation of the incentive payment is known at that time. Medicare EHR incentive calculations and related initial payment amounts are based upon the most current filed cost report information available at the time the Hospital demonstrates meaningful use of certified EHR technology for the applicable period. However, unlike Medicaid, this initial payment amount will be adjusted based upon an updated calculation using the annual cost report information for the cost report period that began during the applicable payment year. Thus, incentive income recognition occurs at the point the Hospital demonstrates meaningful use of certified EHR technology for the applicable period and the cost report information for the full cost report year that will determine the final calculation of the incentive payment is available.

The Hospital recognized approximately \$513,000 and \$532,000 of electronic health record incentive income related to Medicare and Medicaid incentive programs during the years ended December 31, 2015 and 2014, respectively, which is recorded in other revenue.

Other Revenue: The composition of other revenue for the years ended December 31, is set forth in the following table:

	<u>2015</u>	<u>2014</u>
Shared services	\$ 694,128	\$ 261,739
Cafeteria revenue	326,422	304,837
Rental income	505,938	408,153
Contributions to Foundation	2,623,338	243,049
Foundation special events revenue	272,693	360,046
Medicare and Medicaid meaningful use	513,006	531,903
Other	<u>119,792</u>	<u>146,471</u>
Total other revenue	<u>\$ 5,055,317</u>	<u>\$ 2,256,198</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Other Expenses: The composition of other expenses for the years ended December 31, is set forth in the following table:

	<u>2015</u>	<u>2014</u>
System dues (a)	\$ 1,224,847	\$ 1,210,198
Rents and operating leases	1,334,202	1,519,891
NYS Health Facilities Cash Receipts Assessment Program	685,501	498,637
Catholic Health System other expense	866,659	1,005,995
Professional fees	365,433	288,646
Other	<u>337,385</u>	<u>694,403</u>
Total other expenses	<u>\$ 4,814,027</u>	<u>\$ 5,217,770</u>

(a) System dues are comprised of the following expenses in 2015 and 2014:

	<u>2015</u>	<u>2014</u>
Salaries, wages and employee benefits	\$ 203,669	\$ 161,042
Professional fees and purchase services	176,166	217,300
Dues to Trinity Health	698,188	697,557
Other	<u>146,824</u>	<u>134,299</u>
Total system dues	<u>\$ 1,224,847</u>	<u>\$ 1,210,198</u>

Contributions: Contributions received are recorded as unrestricted, temporary restricted or permanently restricted net assets depending on the existence and nature of any donor restrictions.

Contributions and pledges that are restricted by the donor are reported as an increase in unrestricted net assets if the restrictions expire, that is, when a stipulated time restriction ends or purpose restriction is accomplished in the reporting period in which the contribution is recognized. All other donor-restricted support is reported as increases in temporarily or permanently restricted net assets, depending on the nature of the restrictions. When a restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statements of activities and changes in net assets released from restrictions.

Excess of Revenues Over Expenses: The statement of operations and changes in net assets includes excess of revenues over expenses, commonly referred to as the performance indicator. Changes in unrestricted net assets which are excluded from the performance indicator, consistent with industry practice, include permanent transfers of assets to and from affiliates for other than goods and services, 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), and the effective portion of cash flow hedging derivatives, and pension liability adjustments.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Net Assets: Unrestricted net assets are available for the general operating purposes of the Hospital and are not subject to any donor limitations.

Temporarily restricted net assets are those whose use is limited by donors to a specific period or purpose and include the Hospital's interest in the net assets of the Kenmore Mercy Hospital Foundation, Inc. (the Foundation). Temporarily restricted net assets are released to unrestricted net assets as restrictions are met, which can occur in the same period. Gifts whose restrictions are met in the same period in which they are received are recorded as an increase in unrestricted net assets. Such restrictions include purpose restrictions where donors have specified the purpose for which the net assets are to be spent, or time restrictions imposed by donors or implied by the nature of the gift, pledges to be paid in future periods and life income funds. Investment return is included in unrestricted net assets unless the return is restricted by donor or law.

Income Taxes: The financial statements do not include a provision for income taxes, since the Hospital is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code. The tax-exempt organizations are subject to federal taxes on unrelated business income under section 511 of the Internal Revenue Code which are reported as other expenses in these financial statements. The Hospital's federal Exempt Organization Business Income Tax Returns for 2012, 2013, and 2014 remain subject to examination by the Internal Revenue Service.

Transactions among Subsidiaries: Common costs incurred by CHS are allocated to the subsidiaries on a pro-rata cost basis formula. The allocation of these costs is recorded as other revenue by CHS and are recorded by the subsidiaries as a component of the natural account classification. The related income and expense is eliminated in the consolidated financial statements. The respective assets and liabilities are eliminated in the consolidated financial statements.

Capitalized Software Costs: The Hospital capitalizes certain costs that are incurred to purchase or to create and implement internal-use computer software, which includes software coding, installation, testing and certain data conversion from both internal and external providers in accordance with the accounting standards. These capitalized costs are amortized on a straight-line basis over ten years and reviewed for impairment on an annual basis. The Hospital capitalized software, computer equipment, and other external costs of \$1,125,116 and \$655,833 during 2015 and 2014, respectively. Capitalized internal project labor costs amounted to \$0 and \$2,988 during 2015 and 2014, respectively.

Reclassifications: Certain prior year amounts were reclassified to conform to the 2015 consolidated financial statement presentation including KMH becoming the sole corporate member of the Kenmore Mercy Hospital Foundation, Inc. in 2015.

Subsequent Events: The Hospital evaluated subsequent events through April 26, 2016 which was the date the financial statements were available to be issued.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. ASSETS LIMITED AS TO USE

The composition of assets limited as to use, including unspent bond proceeds, is as follows at December 31:

	<u>2015</u>	<u>2014</u>
Held by Trustee for funded depreciation:		
Cash and cash equivalents	\$ 3,322,738	\$ 3,315,234
Held by Trustee under indenture agreements:		
Cash and cash equivalents	1,581,693	979,781
Held by Trustee for renewal and replacement:		
Cash and cash equivalents	<u>64,527</u>	<u>2,103,895</u>
Assets limited as to use	<u>\$ 4,968,958</u>	<u>\$ 6,398,910</u>

NOTE 4. INVESTMENTS

Investments consist of the following at December 31:

	<u>2015</u>		<u>2014</u>	
	<u>Cost</u>	<u>Fair Value</u>	<u>Cost</u>	<u>Fair Value</u>
Cash and marketable equity securities	\$ 1,542,204	\$ 1,634,935	\$ 1,942,042	\$ 2,148,361
Governmental and corporate obligations	<u>536,959</u>	<u>592,890</u>	<u>738,456</u>	<u>802,397</u>
	<u>\$ 2,079,163</u>	<u>\$ 2,227,825</u>	<u>\$ 2,680,498</u>	<u>\$ 2,950,758</u>

Investment income and losses is summarized as follows for the years ended December 31:

	<u>2015</u>	<u>2014</u>
Interest and dividend income	\$ 138,271	\$ 364,647
Net realized and unrealized gains and losses	<u>(82,710)</u>	<u>63,327</u>
Total investment income	<u>\$ 55,561</u>	<u>\$ 301,320</u>

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. PROPERTY AND EQUIPMENT

Property and equipment, recorded at cost, consists of the following at December 31:

	<u>2015</u>	<u>2014</u>
Land and land improvements	\$ 1,377,428	\$ 1,377,428
Buildings	74,625,122	71,721,534
Leasehold improvements	10,173,965	12,403,089
Equipment	33,720,503	31,301,732
Automobiles	20,978	20,978
Equipment under capital leases	<u>7,541,806</u>	<u>6,891,500</u>
	127,459,802	123,716,261
Less: Accumulated depreciation	(65,201,063)	(59,254,335)
Accumulated amortization under capital leases	<u>(3,741,862)</u>	<u>(3,122,047)</u>
	58,516,877	61,339,879
 Construction in progress	 <u>4,630,449</u>	 <u>216,856</u>
 Property and equipment, net	 <u>\$ 63,147,326</u>	 <u>\$ 61,556,735</u>

Depreciation expense in 2015 and 2014 amounted to approximately \$7,398,968 and \$6,534,148 respectively. Amortization expense on equipment under capital leases amounted to \$343,947 and \$785,678 in 2015 and 2014, respectively.

NOTE 6. OTHER ASSETS AND OTHER RECEIVABLES

The composition of prepaid expenses, other assets and other receivables is as follows at December 31:

	<u>2015</u>	<u>2014</u>
Current prepaid expenses and other current assets:		
Prepaid general expenses	\$ 179,067	\$ 284,310
Other assets	<u>203,113</u>	<u>13,772</u>
 Prepaid expenses and other current assets	 <u>\$ 382,180</u>	 <u>\$ 298,082</u>
Current other receivables:		
Physician loans	\$ 600,673	\$ 692,192
Managed care risk receivables	206,064	47,530
Foundation pledges receivable, net	2,535,625	249,278
Other	<u>208,727</u>	<u>462,114</u>
 Other receivables	 <u>\$ 3,551,089</u>	 <u>\$ 1,451,114</u>
Non-current:		
Insurance recoveries	\$ 16,468,923	\$ 14,635,733
Debt issuance costs, net accumulated amortization	1,190,339	1,331,467
Other	<u>7,609</u>	<u>121,979</u>
 Other assets	 <u>\$ 17,666,871</u>	 <u>\$ 16,089,179</u>

Amortization expense on debt issuance costs amounted to \$255,433 and \$97,088 for the years ended December 31, 2015 and December 31, 2014, respectively. Accumulated amortization related to the debt issuance costs amounted to \$1,097,194 and \$841,761 at December 31, 2015 and December 31, 2014, respectively, respectively. Amortization expense is expected to be approximately \$81,000 for the years ended December 31, 2016 to 2020.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. ACCRUED EXPENSES

Accrued expenses consist of the following at December 31:

	<u>2015</u>	<u>2014</u>
Workers' compensation, current portion	\$ 1,664,787	\$ 1,446,773
Payroll and benefits	3,969,371	3,794,647
Other	<u>1,015,176</u>	<u>1,280,464</u>
Accrued expenses	<u>\$ 6,649,334</u>	<u>\$ 6,521,884</u>

NOTE 8. LONG-TERM OBLIGATIONS

Long-Term Debt: Long-term debt obligations are comprised of the following at December 31:

	<u>2015</u>	<u>2014</u>
2006 Series C Bonds payable, Kenmore Mercy Hospital (a)	\$ 8,465,386	\$ 9,511,599
2012 Series A Bonds payable, Kenmore Mercy Hospital (b)	13,377,594	13,726,006
2015 Series Bonds payable, Kenmore Mercy Hospital (c)	3,888,383	-
Bridge loan financing (d)	-	3,990,000
Mortgage payable, The McAuley Residence (e)	-	5,339,379
Capital lease obligations and other, at various rates of interest ranging from 2.9% to 4.0%, collateralized by equipment	3,177,264	3,018,086
Note payable to an individual, payable in monthly installments of \$988 including interest at 9%, until May 2018	<u>26,448</u>	<u>35,477</u>
Total long-term obligations	28,935,075	35,620,547
Less: Current portion	<u>(2,151,609)</u>	<u>(6,503,335)</u>
Long-term obligations, net	<u>\$ 26,783,466</u>	<u>\$ 29,117,212</u>

- (a) In 2006, the System formed the Acute Care Obligated Group (the Obligated Group), consisting of its three primary hospitals (MHB, SCH and KMH) and the parent. No affiliates of CHS other than the Members of the Obligated Group were included in this offering. Collectively, the Obligated Group refinanced all outstanding indebtedness of the Obligated Group. On November 29, 2006, \$68,820,000 of Dormitory Authority of the State of New York (DASNY) Catholic Health System Obligated Group Revenue Bonds, Series 2006 were issued. The bonds consisted of four series. Series 2006 C Bonds for \$16,730,000 was loaned to the Hospital for the purpose of retiring the NYS Medical Care Facilities Finance Agency FHA - Insured Mortgage Project Revenue Bonds 1995 Series B, which were applied to finance the construction of a three floor patient tower, certain renovations to the the Hospital facility and to refinance outstanding indebtedness. The discount on the bonds of \$136,928 will be accreted over the life of the bonds.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

In connection with the issuance of the Series 2006 Bonds, the Obligated Group entered into a Loan Agreement (the Loan Agreement) whereby the Obligated Group is required to pay funds sufficient in timing and amount to pay the principal and redemption price of the Series 2006 Bonds and related interest and administrative expenses as they come due. The Series 2006 Bonds pay interest at a variable remarketed rate and are collateralized by a letter of credit with HSBC Bank which expires on November 29, 2019. In the event the letter of credit is not renewed at expiration, and no event of default exists then, the outstanding Bonds, at the option of the members of the Obligated Group, would be subject to a mandatory tender and will then convert to a five year (initial) Term Loan. Repayment of the principal of Initial Term Loan shall be identical to the scheduled principal payments on the Bonds with the remaining amount due at the end of the five year term.

The interest borne by the Series 2006 Bonds will be determined by the Remarketing Agent to be the lowest rate that, in the judgment of the Remarketing Agent, under prevailing financial market conditions, enables such Series 2006 Bonds to be sold at a price of par. The variable interest rate was 0.01% and 0.04% at December 31, 2015 and 2014, respectively.

The Loan Agreement specifies that the Hospital shall continuously pledge, as a security for the payment of all liabilities and the performance of all obligations of the Hospital pursuant to the loan agreement, a security interest in and assignment of the gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts. Further, the Hospital delivered a mortgage to secure all obligations and liabilities of the Hospital under the Loan Agreement. As further security to the Loan Agreement, the Hospital granted DASNY a security interest in such fixtures, furnishings and equipment as owned by the Hospital. In addition, a letter of credit in the amount of the bonds was entered into with HSBC Bank USA to provide security on the Series 2006 Bonds.

Certain financial covenants must be maintained by the Obligated Group. Failure to comply with these covenants requires a formal consultant's report and quarterly progress reports demonstrating how the facility is progressing towards compliance. The Loan Agreement requires the Obligated Group to comply with certain financial covenants, including maintenance of (i) a minimum number of days cash on hand; (ii) long-term debt service coverage; (iii) a maximum leverage ratio. The Obligated Group was in compliance with these covenants at December 31, 2015 and 2014.

Prior to 2013, the letter of credit reimbursement agreement contained an acceleration clause that relied upon subjective evaluation criteria, which necessitated a current classification for the related obligations. The letter of credit reimbursement agreement has since been modified to replace the previously subjective criteria with objective and measureable criteria. Accordingly, the obligations are classified as non-current liabilities at December 31, 2015 and 2014.

- (b) On July 12, 2012, \$17,315,000 of Dormitory Authority of the State of New York (DASNY) Catholic Health System Obligated Group Revenue Bonds, Series 2012 were issued. Series 2012A Bonds for \$14,235,000 were loaned to the Hospital for the purpose of financing the cost of a new two-story addition, which includes approximately 19,000 square feet on the first floor for a new emergency department, an approximately 14,794 square feet shell space on the second floor, and an approximately 16,000 square feet basement, as well as the cost of renovating existing space, expanding the existing parking lot and related demolition, and other mechanical and infrastructure improvements. Proceeds of the Series 2012A Bonds were also applied to pay certain costs of issuing the Bonds. The discount and premium on the bonds of \$156,812 and \$159,265, respectively, are attributable to the difference between the stated interest rate on these bonds and will be amortized over the life of the Bonds.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

The Series 2012 Bonds were issued under the Master Trust Indenture that was created in 2006 during the formation of the Obligated Group. In connection with the issuance of the Series 2012 Bonds, the Hospital entered into a Loan Agreement whereby the Hospital is required to make monthly payments sufficient to pay, among other things, the principal and Sinking Fund Installments of and interest on the Series 2012 Bonds as they become due. The Series 2012 Bonds bear interest at a fixed rate. The interest rates, maturities, and aggregate principal amounts outstanding at December 31, 2015 are as follows:

3.00% Serial Bonds due July 1, 2016	\$ 350,000
3.00% Serial Bonds due July 1, 2017	360,000
4.00% Serial Bonds due July 1, 2018	370,000
3.50% Term Bonds due July 1, 2022	1,610,000
4.00% Term Bonds due July 1, 2027	2,385,000
5.00% Term Bonds due July 1, 2032 (i)	2,960,000
4.75% Term Bonds due July 1, 2039	<u>5,530,000</u>
Total Series 2012A bonds	<u>\$ 13,565,000</u>

(i) Optional redemption on July 1, 2022 at a redemption price of 100% of the principal amount of such Series 2012 Bonds or portions thereof to be redeemed, plus accrued interest to the redemption date.

The Loan Agreement specifies that the Hospital shall continuously pledge, as a security for the payment of all liabilities and the performance of all obligations of the Hospital pursuant to the Loan Agreement, a security interest in and assignment of the gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts. Further, the Hospital delivered a mortgage to secure all obligations and liabilities of the Hospital under the Loan Agreement. As further security to the Loan Agreement, the Hospital granted DASNY a security interest in such fixtures, furnishings and equipment as owned by the Hospital.

The financial covenants required under the Loan Agreement are consistent with those of the Series 2006 Bonds.

- (c) On April 29, 2015, \$93,800,000 of Buffalo and Erie County Industrial Land Development Corporation Catholic Health System Obligated Group Revenue Bonds, Series 2015 were issued. A portion of the Series 2015 was loaned to the Hospital for the purpose of financing the cost of improvements to the Operating Room Expansion. Proceeds of the Series 2015 Bonds were also applied to pay certain costs of issuing the Bonds. The premium on the bonds of \$383,000 is attributable to the difference between the stated interest rate on these bonds and will be amortized over the life of the bonds.

The Series 2015 Bonds were issued under the Master Trust Indenture that was created in 2006 pursuant to the formation of the Obligated Group. In connection with the issuance of the Series 2015 Bonds, the Hospital entered into a Loan Agreement whereby the Hospital is required to make monthly payments sufficient to pay, among other things, the principal and Sinking Fund Installments of and interest on the Series 2015 Bonds as they become due. The Series 2015 Bonds bear interest at a fixed rate. The interest rates, maturities, and aggregate principal amounts outstanding at December 31, 2015 are as follows:

5.00% Serial Bonds Due July 1, 2018	\$ 75,000
5.00% Serial Bonds Due July 1, 2019	75,000
5.00% Serial Bonds Due July 1, 2020	80,000
5.00% Serial Bonds Due July 1, 2021	85,000
5.00% Term Bonds Due July 1, 2022	90,000

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

5.00% Term Bonds Due July 1, 2023	95,000
5.00% Term Bonds Due July 1, 2024	100,000
5.00% Term Bonds Due July 1, 2025	105,000
5.00% Term Bonds Due July 1, 2026	110,000
5.00% Term Bonds Due July 1, 2027	115,000
5.00% Term Bonds Due July 1, 2028	120,000
5.00% Term Bonds Due July 1, 2029	125,000
5.00% Term Bonds Due July 1, 2030	130,000
5.25% Term Bonds Due July 1, 2035	770,000
5.00% Term Bonds Due July 1, 2040	980,000
4.00% Term Bonds Due July 1, 2045	<u>460,000</u>

Total Series 2015 Bonds \$ 3,515,000

- (d) In 2014, the Hospital entered into a loan agreement with a commercial bank to borrow \$3,990,000 at an adjusted LIBOR rate. The proceeds from the 2015 bond issuance were used to repay all outstanding amounts under this loan agreement.
- (e) Mortgage payable to Century Health Capital. The mortgage is an FHA - Insured Mortgage revenue bonds to Century Health Capital. The mortgage is payable in monthly installments of \$65,176 including interest of 5.51%. Monthly payments commenced on July 1, 1994. The mortgage is collateralized by the building and equipment. The mortgage was paid off in 2015.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2015 are as follows:

	<u>Long-Term Debt</u>	<u>Capital Leases</u>	<u>Total</u>
2016	\$ 1,462,374	\$ 780,927	\$ 2,243,301
2017	1,552,050	730,371	6,139,554
2018	1,643,274	602,801	2,171,075
2019	1,699,583	437,652	2,060,152
2020	1,769,583	315,895	2,003,395
Thereafter	17,630,947	603,700	14,611,680
	<u>25,757,811</u>	<u>3,471,346</u>	<u>29,229,157</u>
Less: Amount representing interest	<u>-</u>	<u>(294,082)</u>	<u>(294,082)</u>
Long-term obligations	<u>\$ 25,757,811</u>	<u>\$ 3,177,264</u>	<u>\$ 28,935,075</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

Operating Leases

Minimum annual rental commitments at December 31, 2015 under noncancelable operating leases are as follows:

2016	\$ 1,185,728
2017	1,185,728
2018	1,080,646
2019	552,836
2020	<u>552,836</u>
	<u>\$ 4,557,774</u>

Total expense for rents and operating type leases for equipment and property was approximately \$1,334,202 and \$1,519,891 in 2015 and 2014, respectively.

NOTE 9. DERIVATIVE FINANCIAL INSTRUMENTS

In connection with the issuance of the Series 2006 Bonds and execution of the Loan Agreement, the Obligated Group entered into an interest rate swap agreement (a derivative agreement) with JP Morgan Chase. The Hospital entered into a derivative agreement for purposes of mitigating risk posed by the Bonds accruing interest at a variable rate. The interest rate swap agreement was settled in 2014. The swap termination costs, in the amount of \$1,139,000, will be amortized over the remaining life of the bonds. The net amount of termination costs were recorded in financing activities as realized losses on interest rate swap agreements in 2014. Amortization expense related to the termination cost was \$234,523 and \$19,720 for 2015 and 2014, respectively.

NOTE 10. EMPLOYEE BENEFIT PLANS

Pension Arrangements: Prior to December 31, 2001, the Hospital had a noncontributory defined benefit pension plan covering substantially all employees. Effective January 1, 2001, the System began maintaining a qualified defined benefit pension plan covering substantially all of its employees. As of that date, the Kenmore Mercy Hospital Pension Plan was merged into the Retirement Plan of the Catholic Health System (the Plan).

Effective January 1, 2001, all nonunion employees who had met the age and service requirements under their previous plan were given the option of choosing to participate in the cash balance feature of the plan. Those who did not choose to participate in the cash balance feature accrue benefits under the same formula under the previous plan. All nonunion employees who become participants after that date automatically participate under the cash balance formula.

The Plan bases benefits upon both years of service and earnings. Participants under the Hospital formula earn benefits based on a career average formula. The cash balance formula is a hypothetical account balance formula. A participant's benefit obligation is assigned to the location at which the person works. As participants transfer around the System to other CHS subsidiaries, the obligations and a proportional amount of the plan's assets transfer.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Funded Status: The following tables summarize changes in the projected benefit obligation, the plan assets and the funded status of our pension plan as well as the components of net periodic benefit costs, including key assumptions. The disclosures below have been actuarially determined based on an allocation of the System's obligations specific to Kenmore Mercy Hospital. The measurement dates for plan assets and obligations were December 31, 2015 and 2014.

	<u>2015</u>	<u>2014</u>
Projected Benefit Obligations		
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 56,935,757	\$ 47,660,970
Service cost	2,169,411	1,792,070
Interest cost	2,333,659	2,342,520
Plan Amendments	1,416	0
Actuarial (gains) losses	(4,006,594)	7,975,167
Transfers (to) from CHS subsidiaries	1,873,518	(901,485)
Benefits paid	(2,339,956)	(1,893,862)
Expenses	<u>(51,312)</u>	<u>(39,623)</u>
Projected Benefit obligation at end of year	\$ <u>56,915,899</u>	\$ <u>56,935,757</u>
Accumulated benefit obligations, end of year	<u>\$ 51,473,663</u>	<u>\$ 51,553,092</u>
Plan Assets		
Change in plan assets:		
Fair value of assets at beginning of year	\$ 24,460,121	\$ 23,839,342
Actual return on plan assets	(183,878)	700,550
Transfers (to) from CHS subsidiaries	826,946	(387,286)
Benefits paid	(2,339,956)	(1,893,862)
Hospital contributions	2,410,000	2,241,000
Expenses	<u>(51,312)</u>	<u>(39,623)</u>
Fair value of plan assets at end of year	\$ <u>25,121,921</u>	\$ <u>24,460,121</u>
Funded status at end of year	<u>\$ 31,793,978</u>	<u>\$ 32,475,636</u>
Amounts recognized in the consolidated balance sheets:		
Non-current liabilities	\$ <u>(31,793,978)</u>	\$ <u>(32,475,636)</u>
Net amounts recognized	\$ <u>(31,793,978)</u>	\$ <u>(32,475,636)</u>
Amounts recognized in unrestricted net assets consists of:		
	<u>2015</u>	<u>2014</u>
Actuarial net loss	\$ (14,904,372)	\$ (18,393,737)
Prior service cost	<u>(180,473)</u>	<u>(166,095)</u>
Total amount recognized	\$ <u>(15,084,845)</u>	\$ <u>(18,559,832)</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Components of net periodic benefit cost:

	<u>2015</u>	<u>2014</u>
Service cost	\$ 2,169,411	\$ 1,792,070
Interest cost	2,333,659	2,342,520
Expected return on plan assets	(1,815,347)	(1,762,155)
Amortization of prior service cost or (credit)	44,764	44,764
Recognized actuarial loss	<u>1,361,157</u>	<u>719,726</u>
Net periodic pension cost	<u>\$ 4,093,644</u>	<u>\$ 3,136,925</u>

Since the Hospital is a participant in the System's Plan, the following disclosures are made for the entire Plan in the aggregate, and do not represent the Hospital on a stand-alone basis.

The estimated prior service cost, and net loss that will be amortized from unrestricted net assets into net periodic pension cost over the next fiscal year for the System are \$59,415 and \$11,242,373, respectively.

The Plan's investment policies and strategies were used to develop the expected long-term rate of return on risk-free investment (primarily government bonds), the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return of each asset class was then weighted based on the target asset allocation to develop the expected long-term rate of return on assets assumption.

The Plan's target asset allocation and the actual asset allocation percentages for 2015 and 2014 are as follows at the respective measurement dates:

<u>Asset Category</u>	<u>Target</u>	<u>Actual</u>	
		<u>2015</u>	<u>2014</u>
Equities	70%	65%	65%
Fixed income	25	25	25
Other	<u>5</u>	<u>10</u>	<u>10</u>
	<u>100%</u>	<u>100%</u>	<u>100%</u>

The portfolio is diversified among a mix of assets including large and small cap, domestic and foreign equities, fixed income, alternatives (a fund of hedge funds), and cash. Asset mix is targeted to a specific allocation that is established by evaluating expected return, standard deviation, and correlation of various assets against the plan's long-term objectives. Asset performance is monitored quarterly and rebalanced if asset classes exceed explicit ranges. The Statement of Policy and Investment Objectives governs permitted types of investments, and outlines specific benchmarks and performance percentiles. The Catholic Health Benefit Plan Committee oversees the pension investment program and monitors investment performance. Risk is closely monitored through the evaluation of portfolio holdings and tracking the beta and standard deviation of the portfolio performance. The use of derivative financial instruments as an investment vehicle is specifically limited.

The assets or liability's fair value measurement level with 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.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

The following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2015 and 2014:

Cash and Cash Equivalents – Include certain instruments in highly liquid debt instruments with original maturities of three months or less at date of purchase.

Equity Securities – Equity securities are valued at the closing price reported on the applicable exchange on which the security is traded, or are estimated using quoted market prices for similar securities.

Debt Securities – Debt securities are valued using quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices, discounted cash flow models and other pricing models. These models are primarily industry-standard models that consider various assumptions, including time value and yield curve as well as other relevant economic measures.

Mutual Funds – Mutual funds are valued using the net asset value based on the value of the underlying assets owned by the fund, minus liabilities, divided by the number of shares outstanding, and multiplied by the number of shares owned.

Commingled Funds – Commingled funds are developed for investment by institutional investors only and therefore do not require registration with the Securities and Exchange Commission. Commingled funds are recorded at fair value based on either the underlying investments that have a readily determinable market value or based on net asset value, which is calculated using the most recent fund financial statements. Commingled funds are categorized as Level 2 unless they have a redemption restriction greater than 90 days, in which case they are categorized as Level 3.

Hedge Funds – Hedge funds utilize either a direct or a “fund-of-funds” approach resulting in diversified multi-strategy, multi-manager investments. Underlying investments in these funds may include equities, fixed income securities, commodities, currencies and derivatives. These funds are valued at net asset value, which is calculated using the most recent fund financial statements. Hedge funds are categorized as Level 2 unless they have a redemption restriction greater than 90 days, in which case they are categorized as Level 3.

The preceding methods described may produce a fair value calculation that may not be indicative of the net realizable value or reflective of future fair values. Furthermore, although the Plan 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.

Asset Backed Securities: Asset backed securities are valued based on quotes received from independent pricing services or from dealers who make markets in such securities.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

The following table presents the Plan's financial instruments as of December 31, 2015, measured at fair value on a recurring basis using the fair value hierarchy defined in Note 14.

At December 31, 2015	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Pension Plans:				
Cash and cash equivalents	\$ 15,184,947	\$ -	\$ -	\$ 15,184,947
Equity securities	25,498,783	-	-	25,498,783
Debt securities:				
Government and government agency obligations	-	15,326,315	-	15,326,315
Corporate bonds	-	51,145,161	-	51,145,161
Asset backed securities	-	6,281,194	-	6,281,194
Mutual funds:				
Equity mutual funds	31,963,175	-	-	31,963,175
Fixed mutual funds	<u>22,140,350</u>	<u>-</u>	<u>-</u>	<u>22,140,350</u>
Subtotal	<u>94,787,255</u>	<u>72,752,670</u>	<u>-</u>	<u>167,539,925</u>
Investment measured at net asset value:				
Commingled funds:				
Equity commingled funds				119,230,530
Fixed income commingled funds				558,017
Hedge funds				<u>10,777,490</u>
Total				<u>\$ 298,105,962</u>
At December 31, 2014	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Pension Plans:				
Cash and cash equivalents	\$ 14,057,138	\$ -	\$ -	\$ 14,057,138
Equity securities	31,992,392	-	-	31,992,392
Debt securities:				
Government and government agency obligations	-	7,934,717	-	7,934,717
Corporate bonds	-	49,708,426	-	49,708,426
Asset backed securities	-	4,940,479	-	4,940,479
Mutual funds:				
Equity mutual funds	57,106,772	-	-	57,106,772
Fixed mutual funds	21,476,993	-	-	21,476,993
Other	<u>702,325</u>	<u>-</u>	<u>-</u>	<u>702,325</u>
Subtotal	<u>125,335,620</u>	<u>62,583,622</u>	<u>-</u>	<u>187,919,242</u>
Investment measured at net asset value:				
Commingled funds:				
Equity commingled funds				75,406,436
Fixed income commingled funds				805,560
Hedge funds				<u>30,783,014</u>
Total				<u>\$ 294,914,252</u>

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Contributions: Contributions to the Plan are made to make benefit payments to plan participants. The funding policy is to contribute amounts to the trusts sufficient to meet minimum funding requirements plus such additional amounts as may be determined to be appropriate. Contributions are made to benefit plans for the sole benefit of plan participants.

The System is expected to contribute an aggregate amount of approximately \$23,349,000 to the pension plan trust in 2016 to be allocated amongst participating entities.

Benefit Payments: The following table summarizes the System's estimated future benefit payments. Actual benefit payments may differ from expected benefit payments.

2016	\$ 20,508,000
2017	\$ 22,803,000
2018	\$ 24,669,000
2019	\$ 27,270,000
2020	\$ 29,706,000
2021 – 2025	\$ 186,638,000

	<u>2015</u>	<u>2014</u>
Weighted average assumptions used to determine end of the year benefit obligations:		
Discount rate	4.65%	4.20%
Rate of compensation increase	3.50%	3.50%
Weighted average assumptions used to determine net periodic pension cost:		
Discount rate	4.20%	5.05%
Expected long-term rate of return on plan assets	7.50%	7.75%
Measurement date	12/31/2015	12/31/2014

NOTE 11. INSURANCE ARRANGEMENTS

Professional and General Liability Arrangements

The System participates in the Trinity Health insurance program which provides coverage for healthcare professional (medical malpractice) and general liability exposures. The primary limits were \$20,000,000 per occurrence for healthcare professional liability and general liability for the years ending December 31 2015 and 2014. Professional and general liabilities are insured by Venzke Insurance Company, Ltd. (Venzke), a Cayman-domiciled insurer wholly-owned by Trinity Health. Excess coverage was also provided to the System, and this excess coverage is fully reinsured with nonaffiliated commercial insurance companies.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. INSURANCE ARRANGEMENTS (CONTINUED)

The coverage provided is on a claims-made basis. The System, on the Hospital's behalf therefore retains the liability for unasserted claims resulting from incidents that occurred on services provided prior to the financial statement date. The System has independent actuaries estimate the ultimate costs of such unasserted claims, which were discounted at 3% in 2015 and 2014. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2015 and 2014 is \$0 and \$50,332, respectively, and is included in accrued expenses. The Hospital's portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2015 and 2014 is \$11,838,951 and \$10,693,694, respectively recorded in long-term portion of insurance liabilities. The charges to expenses for professional and general liability for 2015 and 2014 approximated \$2,602,390 and \$984,784, respectively, which has been included in insurance expenses. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for professional and general liabilities. The required claims liability and any anticipated insurance recoveries are to be reported on a gross basis versus the previous practice of netting the recoveries against claims liability. Amounts recognized as insurance receivables related to the claims approximate \$10,701,232 and \$9,737,373 at December 31, 2015 and 2014, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

Workers' Compensation Arrangements

The System's insurance program for workers' compensation, in which the Hospital participates, has a deductible of \$750,000 per occurrence in 2015 and 2014. Claims in excess of self-insurance levels are fully insured. Losses from asserted claims and from unasserted claims identified by the System's incident reporting for the Hospital were accrued on a discounted basis based on actuarial estimates of the settlement of such claims. The discount rate applied is 3% in 2015 and 2014. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2015 and 2014 is \$1,698,578 and \$1,411,515, respectively, and is included in accrued expenses. The Hospital's portion of the System's long term portion of liabilities for unpaid and incurred but not reported claims at December 31, 2015 and 2014 is \$12,017,088 and \$10,544,491, respectively, and is included in long-term portion of insurance liabilities.

The charges to expenses for workers' compensation costs approximated \$2,272,581 and \$2,392,744 in 2015 and 2014, respectively which has been included in employee benefits expenses. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for workers' compensation. The required claims liability and any anticipated insurance recoveries are to be reported on a gross basis versus the previous practice of netting the recoveries against claims liability. Amounts recognized as insurance receivables related to the claims approximate \$5,767,691 and \$4,898,360 at December 31, 2015 and 2014, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

Employee Health Arrangements

The System's insurance for employee health costs, in which the Hospital participates, is self-insured up to \$350,000 per claim. Claims in excess of self-insurance levels are fully insured. Claims are accrued based upon the System's estimates of the aggregate liability for claims incurred using certain actuarial assumptions used in the insurance industry and based on the System's experience. Charges were billed monthly by the System and are included in employee benefit costs.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12. LEGAL MATTERS

The Hospital is involved in litigation and regulatory investigations arising in the course of business. The health care industry is subject to numerous laws and regulations of federal, state and local governments. Compliance with these laws and regulations can be subject to future government review and interpretation as well as regulatory actions unknown or unasserted at the time. Recently, government activity has increased with respect to investigations and allegations concerning possible violations by health care providers of fraud and abuse statutes and regulations, which could result in the imposition of significant fines and penalties as well as significant repayments for patient services previously billed under Medicare and Medicaid programs in the current and preceding years. Management believes it is in compliance with such laws and regulations and no unknown or unasserted claims were known at this time, which could have a material adverse affect on the Hospital's future financial position, results from operations or cash flows.

NOTE 13. CONCENTRATIONS OF CREDIT RISK

The Hospital grants credit without collateral to its patients, most of whom are residents of Western New York and are insured under third-party agreements. The mix of receivables from patients and third-party payors at December 31 are:

	<u>2015</u>	<u>2014</u>
Medicare	27%	34%
Medicaid	17	12
Blue Cross	7	6
Other third-party payors	35	34
Patients/residents	<u>14</u>	<u>14</u>
	<u>100%</u>	<u>100%</u>

The Hospital maintains funds in excess of amounts insured by the Federal Depository Insurance limits. The Hospital has diversified its deposit amounts in a variety of institutions to reduce the level of concentrated credit risk.

NOTE 14. FAIR VALUE MEASUREMENTS

The following methods and assumptions were used by the Hospital in estimating fair value disclosures for financial statements:

The Hospital's consolidated financial statements reflect certain assets and liabilities recorded at fair value. Assets and liabilities measured at fair value on a recurring basis on the Hospital's consolidated balance sheets include cash and cash equivalents, equity securities, exchange traded funds, debt securities, mutual funds, and commingled funds. Liabilities measured at fair value on a recurring basis for disclosure only include debt.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value should be based on assumptions that market participants would use, including a consideration of non-performance risk.

**KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

To determine fair value, the Hospital uses various valuation methodologies based on market inputs. For many instruments, pricing inputs are readily observable in the market; the valuation methodology is widely accepted by market participants and involves little to no judgment. For other instruments, pricing inputs are less observable in the marketplace. These inputs can be subjective in nature and involve uncertainties and matters of considerable judgment. The use of different assumptions, judgments and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The Hospital assesses the inputs used to measure fair value using a three level hierarchy based on the extent to which inputs used in measuring fair value are observable in the market. The fair value hierarchy is as follows:

Level 1 – Quoted (unadjusted) prices for identical instruments in active markets.

Level 2 – Other observable inputs, either directly or indirectly, including:

- Quoted prices for similar instruments in active markets;
- Quoted prices for identical or similar instruments in non-active markets (few transactions, limited information, non-current prices, high variability over time, etc.);
- Inputs other than quoted prices that are observable for the instrument (interest rates, yield curves, volatilities, default rates, etc.); and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 – Unobservable inputs that cannot be corroborated by observable market data.

Valuation Methodologies - Exchange-traded securities whose fair value is derived using quoted prices in active markets are classified as Level 1. In instances where quoted market prices are not readily available, fair value is estimated using quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices, discounted cash flow models and other pricing models. These models are primarily industry-standard models that consider various assumptions, including time value and yield curve as well as other relevant economic measures. The inputs to these models depends on the type of security being priced but are typically benchmark yields, credit spreads, prepayment speeds, reported trades and broker-dealer quotes, all with reasonable levels of transparency. Generally, significant changes in any of those inputs in isolation would result in a significantly different fair value measurement, respectively. The Hospital classifies these securities as Level 2 within the fair value hierarchy.

The Hospital's Level 3 securities are primarily investments in hedge funds. Based on the information available, we believe that the fair values provided by the third-party pricing services and investment fund managers are representative of prices that would be received to sell the assets at December 31, 2015.

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Hospital's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

Following is a description of the valuation methodologies the Hospital used for instruments recorded at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Cash and cash equivalents: The carrying amounts reported in the consolidated balance sheets approximate their fair value. Certain cash and cash equivalents are included in investments and assets limited or restricted as to use in the consolidated balance sheets.

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

Equity Securities: Equity securities are valued at the closing price reported on the applicable exchange on which the security is traded, or are estimated using quoted market prices for similar securities.

Exchange-traded securities: Exchange traded funds are valued at the NAV of shares held by the Hospital at year end.

Debt Securities: Debt securities are valued using quoted market prices and/or other market data for the same or comparable instruments and transactions in establishing the prices, discounted cash flow models and other pricing models. These models are primarily industry-standard models that consider various assumptions, including time value and yield curve as well as other relevant economic measures.

Mutual Funds: Mutual funds are valued using the net asset value based on the value of the underlying assets owned by the fund, minus liabilities, divided by the number of shares outstanding, and multiplied by the number of shares owned.

Commingled Funds: Commingled funds are developed for investment by institutional investors only and therefore do not require registration with the Securities and Exchange Commission. Commingled funds are recorded at fair value based on either the underlying investments that have a readily determinable market value or based on net asset value, which is calculated using the most recent fund financial statements. Commingled funds are categorized as Level 2 unless they have a redemption restriction greater than 90 days, in which case they are categorized as Level 3.

Hedge Funds: Hedge funds utilize either a direct or a "fund-of-funds" approach resulting in diversified multi-strategy, multi-manager investments. Underlying investments in these funds may include equities, fixed income securities, commodities, currencies and derivatives. These funds are valued at net asset value, which is calculated using the most recent fund financial statements. Hedge funds are categorized as Level 2 unless they have a redemption restriction greater than 90 days, in which case they are categorized as Level 3.

Long-Term Debt: The fair value of the based on current rates offered for similar issues with similar security terms and maturities, or estimated using a discount rate that a market participant would demand. The carrying value of the long-term debt approximates fair value as of December 31, 2015 and 2014. Long-term debt would be classified as Level 2 in the fair value hierarchy.

The following tables summarize the fair values, by input hierarchy, of financial instruments measured at fair value on a recurring basis at December 31, 2015:

At December 31, 2015	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ 4,014,760	\$ 954,198	\$ -	\$ 4,968,958
	<u>\$ 4,014,760</u>	<u>\$ 954,198</u>	<u>\$ -</u>	<u>\$ 4,968,958</u>
Investments:				
Debt securities:				
Government and government agency obligations	\$ 213,586	\$ -	\$ -	\$ 213,586
Corporate bonds	-	379,304	-	379,304
Mutual Funds	209,054	-	-	209,054
Exchange traded funds	<u>1,425,881</u>	<u>-</u>	<u>-</u>	<u>1,425,881</u>
Subtotal	<u>1,848,521</u>	<u>379,304</u>	<u>-</u>	<u>2,227,825</u>

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

At December 31, 2014	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ <u>60,460</u>	\$ <u>6,338,450</u>	\$ <u>-</u>	\$ <u>6,398,910</u>
	\$ <u>60,460</u>	\$ <u>6,338,450</u>	\$ <u>-</u>	\$ <u>6,398,910</u>
Investments:				
Debt securities:				
Government and government agency obligations	\$ 369,548	\$ -	\$ -	\$ 369,548
Corporate bonds	-	432,849	-	432,849
Mutual Funds	278,335	-	-	278,335
Exchange traded funds	<u>1,870,026</u>	<u>-</u>	<u>-</u>	<u>1,870,026</u>
Subtotal	<u>2,517,908</u>	<u>432,849</u>	<u>-</u>	<u>2,950,758</u>

NOTE 15. RELATED PARTY TRANSACTIONS

The Hospital is one of a group of health care providers who are affiliated as a result of their association with the System.

During 2015 and 2014, the Hospital incurred expenses from affiliates for administration services, rent and other services. These expenses approximated \$30,156,385 in 2015 and \$25,014,730 in 2014. During 2015 and 2014, the Hospital provided cost sharing services to and received reimbursement from affiliates for laboratory, computer, and other services. Revenues from these services approximated \$694,128 and \$261,739 in 2015 and 2014, respectively.

During 2015 and 2014, distributions were made to/from the parent and affiliates of \$3,443,137 and \$911,771, respectively. During 2015 and 2014, the Hospital received cash payments from affiliates and made cash payments to affiliates in the normal course of operations.

Amounts due to affiliates at December 31, 2015 and 2014 were \$21,427,729 and \$11,103,145, respectively. Amounts due from affiliates at December 31, 2015 and 2014 were \$1,456,493 and \$1,456,493 respectively. The amounts due to affiliates are non-interest bearing and have no maturity date.

NOTE 16. FUNCTIONAL EXPENSES

The Hospital provides general health care services to residents within its geographic location. Expenses relating to providing these services included in the statement of operations are as follows:

	<u>2015</u>	<u>2014</u>
Healthcare services	\$ 141,246,875	\$ 130,211,488
General and administrative	<u>26,648,665</u>	<u>24,566,649</u>
	<u>\$ 167,895,540</u>	<u>\$ 154,778,137</u>

INDEPENDENT AUDITOR'S REPORT ON ACCOMPANYING SUPPLEMENTARY INFORMATION

To the Board of Directors
Catholic Health System, Inc.
Buffalo, New York

We have audited the consolidated financial statements of Kenmore Mercy Hospital and Subsidiaries (a subsidiary of Catholic Health System, Inc.) as of and for the years ended December 31, 2015 and 2014 and our report thereon appears on page 1 of this document. Our audits were performed for the purpose of forming an opinion on the consolidated financial statements as a whole. The Schedule of Net Cost of Providing Care of Persons Living in Poverty and Community Benefit Programs (Schedule of Social Accountability) is the responsibility of management and is provided for purposes of additional analysis of the consolidated financial statements. Such information is unaudited and therefore, we do not express an opinion on the Schedule of Net Cost of Providing Care of Persons Living in Poverty and Community Benefit Programs (Schedule of Social Accountability).

The accompanying consolidating supplementary information 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 audits 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 to the consolidated financial statements as a whole.

Freed Maxick CPAs, P.C.

Buffalo, New York
April 26, 2016

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

**SCHEDULE OF NET COST OF PROVIDING CARE OF PERSONS LIVING IN POVERTY AND
COMMUNITY BENEFIT PROGRAMS (SCHEDULE OF SOCIAL ACCOUNTABILITY - UNAUDITED)**
Years Ended December 31, 2015 and 2014

The total costs related to the care of the poor and benefits for the broader community as of December 31 are set forth in the following table:

	<u>2015</u>	<u>2014</u>
Charity care	\$ 931,897	\$ 1,209,669
Cost of community benefit programs	4,045,982	3,524,415
Unpaid cost of Medicaid programs	<u>7,404,304</u>	<u>7,078,738</u>
Social accountability costs	\$ <u>12,382,183</u>	\$ <u>11,812,822</u>

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING BALANCE SHEETS
December 31, 2015

ASSETS	Kenmore Mercy Hospital	The Kenmore Mercy Foundation	Eliminations	Consolidated
Current assets:				
Cash and cash equivalents	\$ 50,087,712	\$ 281,562	\$ 313,568	\$ 50,682,842
Patient/resident accounts receivable, net of allowance for doubtful accounts of \$4,711,000	24,036,661	-	-	24,036,661
Other receivables	1,015,464	2,535,625	-	3,551,089
Inventories	2,948,899	-	-	2,948,899
Prepaid expenses and other current assets	382,180	-	-	382,180
Due from affiliates	1,085,056	-	(1,024,741)	60,315
Total current assets	<u>79,555,972</u>	<u>2,817,187</u>	<u>(711,173)</u>	<u>81,661,986</u>
Interest in net assets of affiliated Foundations	4,330,105	-	(4,330,105)	-
Assets limited as to use	4,968,958	-	-	4,968,958
Investments	-	2,227,825	-	2,227,825
Due from affiliates	1,456,493	-	-	1,456,493
Property and equipment, net	63,147,326	-	-	63,147,326
Other assets	17,666,871	-	-	17,666,871
Total assets	<u>\$ 171,125,725</u>	<u>\$ 5,045,012</u>	<u>\$ (5,041,278)</u>	<u>\$ 171,129,459</u>
LIABILITIES AND NET ASSETS				
Current liabilities:				
Current portion of long-term obligations	\$ 2,151,609	\$ -	\$ -	\$ 2,151,609
Accounts payable	10,728,007	-	-	10,728,007
Accrued expenses	6,645,600	714,907	(711,173)	6,649,334
Due to third-party payors	6,635,756	-	-	6,635,756
Due to affiliates	21,288,765	-	-	21,288,765
Total current liabilities	<u>47,449,737</u>	<u>714,907</u>	<u>(711,173)</u>	<u>47,453,471</u>
Long-term obligations, net	26,783,466	-	-	26,783,466
Long-term portion of insurance liabilities	23,856,039	-	-	23,856,039
Pension obligation	31,793,978	-	-	31,793,978
Asset retirement obligation	180,785	-	-	180,785
Total liabilities	<u>130,064,005</u>	<u>714,907</u>	<u>(711,173)</u>	<u>130,067,739</u>
Net assets:				
Unrestricted	40,854,951	4,130,946	(4,130,946)	40,854,951
Temporarily restricted	206,769	199,159	(199,159)	206,769
Total net assets	<u>41,061,720</u>	<u>4,330,105</u>	<u>(4,330,105)</u>	<u>41,061,720</u>
Total liabilities and net assets	<u>\$ 171,125,725</u>	<u>\$ 5,045,012</u>	<u>\$ (5,041,278)</u>	<u>\$ 171,129,459</u>

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Year Ended December 31, 2015

	Kenmore Mercy Hospital	The Kenmore Mercy Foundation	Eliminations	Consolidated
Unrestricted revenue and other support:				
Net patient/resident service revenue	\$ 173,115,228	\$ -	\$ -	\$ 173,115,228
Provision for bad debts	(3,877,411)	(15,050)	-	(3,892,461)
Net patient/resident service revenue, less provision for bad debts	169,237,817	(15,050)	-	169,222,767
Other revenue	2,159,287	2,896,030	-	5,055,317
Total unrestricted revenue and other support	171,397,104	2,880,980	-	174,278,084
Expenses:				
Salaries and wages	69,998,712	171,407	-	70,170,119
Employee benefits	21,594,951	33,696	-	21,628,647
Medical and professional fees	5,498,415	10,449	-	5,508,864
Purchased services	15,598,675	1,124,129	(1,446,874)	15,275,930
Supplies	37,399,909	15,629	-	37,415,538
Depreciation and amortization	8,010,051	1,953	-	8,012,004
Interest	2,274,822	-	-	2,274,822
Insurance	2,795,589	-	-	2,795,589
Other expenses	4,782,204	31,823	-	4,814,027
Total expenses	167,953,328	1,389,086	(1,446,874)	167,895,540
Income from operations	3,443,776	1,491,894	1,446,874	6,382,544
Nonoperating revenues (losses):				
Investment income	69,429	(13,868)	-	55,561
Other, net	77,729	-	-	77,729
Total nonoperating revenues (losses)	147,158	(13,868)	-	133,290
Excess of revenues over expenses	<u>\$ 3,590,934</u>	<u>\$ 1,478,026</u>	<u>\$ 1,446,874</u>	<u>\$ 6,515,834</u>

KENMORE MERCY HOSPITAL AND SUBSIDIARIES
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS (CONTINUED)
For the Year Ended December 31, 2015

	Kenmore Mercy Hospital	The Kenmore Mercy Foundation	Eliminations	Consolidated
Unrestricted net assets:				
Excess of revenues over expenses	\$ 3,590,934	\$ 1,478,026	\$ 1,446,874	\$ 6,515,834
Change in pension obligation, other than net periodic cost	2,365,302	-	-	2,365,302
Change in unrestricted interest in KMH Foundation, Inc.	1,737,596	-	(1,737,596)	-
Distributions and transfers to parents and affiliates	(3,443,137)	-	-	(3,443,137)
Net assets released from restriction for capital	-	259,570	-	259,570
Distributions from Foundation	1,446,874	-	(1,446,874)	-
Other	234,981	-	-	234,981
Increase in unrestricted net assets	<u>5,932,550</u>	<u>1,737,596</u>	<u>(1,737,596)</u>	<u>5,932,550</u>
Temporarily restricted net assets:				
Contributions	-	243	-	243
Temporarily restricted net asset released from restrictions	-	(259,570)	-	(259,570)
Change in interest in Kenmore Mercy Foundation, Inc.	(259,327)	-	259,327	-
Other	663	-	-	663
Decrease in temporarily restricted net assets	<u>(258,664)</u>	<u>(259,327)</u>	<u>259,327</u>	<u>(258,664)</u>
Increase in net assets	<u>5,673,886</u>	<u>1,478,269</u>	<u>(1,478,269)</u>	<u>5,673,886</u>
Net assets - beginning of year	<u>35,387,834</u>	<u>2,851,836</u>	<u>(2,851,836)</u>	<u>35,387,834</u>
Net assets - end of year	<u><u>\$ 41,061,720</u></u>	<u><u>\$ 4,330,105</u></u>	<u><u>\$ (4,330,105)</u></u>	<u><u>\$ 41,061,720</u></u>