



**Mercy Hospital of Buffalo
(a subsidiary of the
Catholic Health System, Inc.)**

**Consolidated Financial Statements
December 31, 2012 and 2011**

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
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December 31, 2012 and 2011

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Independent Auditor's Report

To the Board of Directors of the Catholic Health System, Inc.

We have audited the accompanying consolidated financial statements of Mercy Hospital of Buffalo and its subsidiary (collectively, the "Hospital"), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations and changes in net assets (deficits) and of cash flows for the years then ended.

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 the 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 our 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, we consider 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 Mercy Hospital of Buffalo and its subsidiary as of December 31, 2012 and 2011, and the results of their operations and changes in net assets (deficits) and their 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 13, the Hospital had significant transactions with related parties.

As discussed in Note 2 to the consolidated financial statements, the Hospital has restated its 2011 consolidated balance sheet to correct for an error. Our opinion is not modified with respect to this matter.

PricewaterhouseCoopers LLP

April 25, 2013

Mercy Hospital of Buffalo
(a subsidiary of the Catholic Health System, Inc.)
Consolidated Balance Sheets
December 31, 2012 and 2011

	2012	2011 (restated)
Assets		
Current assets		
Cash and cash equivalents	\$ 59,315,430	\$ 42,531,854
Patient/resident accounts receivable, net of estimated uncollectibles of \$8,997,000 and \$6,794,000	47,457,305	43,388,626
Other receivables	2,771,158	3,165,180
Inventories	6,685,016	5,611,519
Prepaid expenses and other current assets	792,109	725,447
Total current assets	117,021,018	95,422,626
Assets limited as to use	5,740,639	3,090,855
Investments	1,322,371	1,205,180
Due from affiliates	88,858	69,944
Property and equipment, net	96,748,840	86,471,669
Other assets	24,683,008	21,752,039
Total assets	<u>\$ 245,604,734</u>	<u>\$ 208,012,313</u>
Liabilities and Net Assets (Deficit)		
Current liabilities		
Current portion of long-term obligations	\$ 5,114,199	\$ 4,224,773
Long-term obligations subject to short-term remarketing arrangements	31,581,853	32,849,286
Accounts payable	16,592,558	14,322,929
Accrued expenses	14,941,232	12,641,877
Due to third-party payors	16,698,439	13,396,307
Due to affiliates	11,711,064	8,276,174
Total current liabilities	96,639,345	85,711,346
Long-term obligations, net	18,021,925	8,593,499
Long-term portion of insurance liabilities	36,135,613	32,185,219
Pension obligation	134,601,242	114,152,595
Asset retirement obligation	5,481,582	5,396,627
Interest rate swap	6,710,446	6,384,753
Deferred compensation plan	169,585	163,913
Other long term liabilities	321,678	-
Total liabilities	298,081,416	252,587,952
Net deficit		
Unrestricted	(54,269,577)	(46,346,867)
Temporarily restricted	1,670,372	1,648,705
Permanently restricted	122,523	122,523
Total net deficit	(52,476,682)	(44,575,639)
Total liabilities and net deficit	<u>\$ 245,604,734</u>	<u>\$ 208,012,313</u>

The accompanying notes are an integral part of these consolidated financial statements.

Mercy Hospital of Buffalo

(a subsidiary of the Catholic Health System, Inc.)

Consolidated Statements of Operations and Changes in Net Assets (Deficits) Years Ended December 31, 2012 and 2011

	2012	2011
Unrestricted revenues, gains and other support		
Net patient/resident service revenue	\$ 349,335,710	\$ 318,165,661
Provision for bad debts	<u>(9,782,589)</u>	<u>(8,186,096)</u>
Net patient/resident service revenue, less provision for bad debt	339,553,121	309,979,565
Other revenue	8,512,935	7,672,643
Net assets released from restrictions	<u>37,000</u>	<u>73,000</u>
Total unrestricted revenues, gains and other support	<u>348,103,056</u>	<u>317,725,208</u>
Expenses		
Salaries and wages	138,399,547	129,217,106
Employee benefits	52,142,374	45,094,621
Medical and professional fees	12,131,001	10,012,998
Purchased services	28,609,429	26,344,862
Supplies	70,456,696	64,277,917
Depreciation and amortization	12,868,635	12,281,102
Interest	2,357,546	2,371,498
Insurance	2,945,970	2,617,870
Other expenses	<u>15,241,162</u>	<u>13,661,640</u>
Total expenses	<u>335,152,360</u>	<u>305,879,614</u>
Income from operations	12,950,696	11,845,594
Nonoperating revenues and losses		
Investment income	441,205	579,703
Other	<u>269,447</u>	<u>(85,048)</u>
Total nonoperating revenues	<u>710,652</u>	<u>494,655</u>
Excess of revenues over expenses	<u>\$ 13,661,348</u>	<u>\$ 12,340,249</u>

The accompanying notes are an integral part of these consolidated financial statements.

Mercy Hospital of Buffalo

(a subsidiary of the Catholic Health System, Inc.)

Consolidated Statements of Operations and Changes in Net Assets (Deficits) Years Ended December 31, 2012 and 2011

	2012	2011
Unrestricted net assets		
Excess of revenues over expenses	\$ 13,661,348	\$ 12,340,249
Change in unrealized loss on interest rate swap	(316,987)	(3,592,288)
Change in minimum pension obligation	(11,328,460)	(27,941,026)
Impact of pension transfers to/ from CHS Subsidiaries	(1,904,352)	2,170,782
Net assets released from restriction	99,131	297,769
Distributions to parent	(8,133,390)	(12,408,821)
Grant revenue for capital expenditures	-	1,632,876
Decrease in unrestricted net assets	<u>(7,922,710)</u>	<u>(27,500,459)</u>
Temporarily restricted net assets		
Contributions	54,128	92,776
Special events	87,303	104,011
Investment income	16,367	-
Temporarily restricted net assets released from restrictions	<u>(136,131)</u>	<u>(370,769)</u>
Increase (decrease) in temporarily restricted net assets	<u>21,667</u>	<u>(173,982)</u>
Decrease in net assets	<u>(7,901,043)</u>	<u>(27,674,441)</u>
Net assets (deficit), beginning of year	<u>(44,575,639)</u>	<u>(16,901,198)</u>
Net assets (deficit), end of year	<u>\$ (52,476,682)</u>	<u>\$ (44,575,639)</u>

The accompanying notes are an integral part of these consolidated financial statements.

Mercy Hospital of Buffalo
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Notes to Consolidated Financial Statements
December 31, 2012 and 2011

	2012	2011
Cash flows from operating activities		
Decrease in net assets	\$ (7,901,043)	\$ (27,674,441)
Adjustments to reconcile decrease in net assets to net cash provided by operating activities		
Depreciation and amortization	12,868,635	12,281,102
Provision for bad debts	9,782,589	8,186,096
Loss on sale of assets	1,610	5,155
Gain on extinguishment of capital leases	(69,096)	-
Change in unrealized loss on interest rate swap	325,693	3,672,532
Distribution to parent and affiliates	8,133,390	12,408,821
Increase in pension obligation	13,232,812	25,770,244
Undistributed earnings in equity investees	22,667	(2,978)
Discount on issuance	21,870	20,067
Premium on issuance	(1,410)	-
Change in unrealized (gains) losses on investments	(99,834)	41,752
Realized (loss) gain on investment	12,613	(26,298)
Grant revenue for capital expenditures	-	(1,632,876)
Increase in cash surrender value of life insurance policies	(16,327)	(16,154)
(Increase) decrease in assets		
Patient accounts receivables	(13,851,268)	(12,972,326)
Due from affiliate	(18,914)	(63,572)
Other receivables	394,022	1,113,144
Inventories	(1,073,497)	(962,675)
Prepaid expenses and other assets	(194,549)	711,702
Increase (decrease) in liabilities		
Accounts payable	2,269,629	(1,501,829)
Accrued expenses	2,299,355	1,035,073
Due to affiliates	2,210,315	4,521,012
Due to third-party payors	3,302,132	4,507,622
Other liabilities	8,371,312	5,855,493
Net cash provided by operating activities	<u>40,022,706</u>	<u>35,276,666</u>
Cash flows from investing activities		
Purchase of property and equipment	(18,205,783)	(14,906,902)
Proceeds from sale of property and equipment	1,002	-
Purchase of assets limited as to use	(10,028,854)	-
Proceeds from sale of assets limited as to use	7,379,070	2,337,724
Change in investments, net	(13,643)	(50,137)
Net cash used in investing activities	<u>(20,868,208)</u>	<u>(12,619,315)</u>
Cash flows from financing activities		
Distribution to parent and affiliates	(8,133,390)	(12,408,821)
Proceeds from issuance of long-term debt	10,148,363	1,112,500
Discount on issuance	(31,579)	-
Premium on issuance	46,156	-
Proceeds of grant revenue for capital expenditures	-	1,632,876
Repayment of current and long-term obligations	(4,400,472)	(4,677,346)
Net cash used in financing activities	<u>(2,370,922)</u>	<u>(14,340,791)</u>
Increase in cash and cash equivalents	16,783,576	8,316,560
Cash and cash equivalents		
Beginning of year	42,531,854	34,215,294
End of year	<u>\$ 59,315,430</u>	<u>\$ 42,531,854</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for interest	\$ 2,337,086	\$ 2,351,431
Noncash investing and financing activities		
Assets acquired under capital lease obligations	\$ 4,104,923	\$ 6,174,818

Mercy Hospital of Buffalo
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Notes to Consolidated Financial Statements
December 31, 2012 and 2011

1. Organization

Mercy Hospital of Buffalo (the Hospital) is a not-for-profit acute care hospital and skilled nursing facility. 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. All operations are located in Erie County, New York and serve the community of Western New York. Mercy Hospital Foundation, Inc. (the Foundation) is a not-for-profit organization incorporated under the New York State Corporation Laws. Mercy Hospital of Buffalo is the sole corporate member of the Foundation. The Foundation's sole purpose is to receive and administer gifts and bequests made on behalf of Mercy Hospital of Buffalo (the Hospital), which are generally used to support the capital needs of Mercy Hospital of Buffalo. Mercy Hospital of Buffalo and the Foundation (collectively the Hospital) are a part of the Catholic Health System, Inc. (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 Sisters of Mercy, Daughters of Charity and the Diocese of Buffalo. Catholic Health East (CHE), Ascension Health System and the Diocese of Buffalo 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 include Mercy Hospital of Buffalo (MHB), Kenmore Mercy Hospital including The McAuley Residence (KMH) and Sisters of Charity Hospital (SCH).

Long-Term Care Subsidiaries

The Long-term Care Subsidiaries include St. Francis Home of Williamsville, Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), St. Elizabeth's Home and St. Vincent's Home for the Aged.

Home Care Subsidiaries and Other

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

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 Mercy Hospital of Buffalo and Mercy Hospital Foundation. All significant intercompany balances and transactions have been eliminated in the consolidated amounts.

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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 conditional 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 worker's 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 held as assets 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.

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.

Inventory

Inventories are generally stated at the lower of cost (first-in, first-out) or market.

Prepaid Expenses and Other Assets

Prepaid expenses and other assets consist of prepaid general expenses, deferred financing costs, investments in health care related joint ventures and partnerships, 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. The investments in health care related joint ventures and partnerships are accounted for on the equity or cost methods, as appropriate.

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Assets Limited as to Use

Assets limited as to use include assets set aside for debt service as required by trustee or indenture agreements and assets set aside by the Board of Directors for specific future purposes. The Board retains control and may at its discretion subsequently use 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 statements of financial position. Realized and unrealized gains and losses are included in changes in net assets. 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.

Cash Surrender Value of Life Insurance Policies

Cash Surrender Value of Life Insurance Policies represents the cash value of life insurance policies for which the Foundation is the named beneficiary. The premiums for these policies are paid by the insured individual. These policies had a face value of approximately \$585,000 at December 31, 2012 and 2011.

Property and Equipment

Property and equipment are stated at cost if purchased, or if contributed, at the fair market 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 shorter of 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.

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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 2012 and 2011.

Net Patient/Resident Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from third-party payers, 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 payers 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 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 Healthcare Assistance Program 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.

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, 2008. 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. The initial year of the ACO has only upside benefit which is currently unquantifiable.
- **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 payers, except Medicaid, Workers' Compensation and No-Fault insurance programs, negotiate hospital's payment rates. If negotiated rates are not established, payers 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

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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 2012 and 2011 related to prior years, including adjustments to prior year estimates and audit settlements, increased revenues by \$2,793,962 and \$6,100,000, 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 52% and 54% of net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2012 and 2011, respectively. Approximately 29% and 28% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2012 and 2011.

Bad Debt Expense

The provision for bad debt expense 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, 2012 and 2011:

	2012	2011
Patient/resident service revenue (net of contractual allowances and discounts):		
Medicare	\$ 156,814,011	\$ 145,148,744
Medicaid	26,270,278	27,418,400
Blue Cross	35,517,132	30,139,150
Other third party payors	129,611,347	114,736,885
Patients/residents	<u>1,122,942</u>	<u>722,482</u>
Total net patient/resident service revenue	349,335,710	318,165,661
Provision for bad debts	<u>(9,782,589)</u>	<u>(8,186,096)</u>
Net patient/resident service revenue less provision for bad debts	<u>\$ 339,553,121</u>	<u>\$ 309,979,565</u>

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Charity Care

The Hospital 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 Healthcare Assistance Program (HAP) which is determined by presentation for care without insurance, while using an estimator (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 \$2,302,097 and \$3,064,825 arose from providing services to charity care patients in 2012 and 2011, 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 volume and charge amount. 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 the Health Care Reform Act (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 Health Care Assistance Policy (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.

Operating and Nonoperating Revenues 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 our eligible hospitals have 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 our eligible hospitals adopt, implement or demonstrate 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

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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 \$3.1 million and \$3.3 million of electronic health record incentive income related to Medicare incentive programs during the years ended December 31, 2012 and 2011, respectively, which is recorded in other operating revenue.

Other Revenues

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

	2012	2011
Shared services (Note 13)	\$ 843,304	\$ 369,369
Cafeteria revenue	1,005,113	799,141
Parking revenue	647,115	604,196
Rental income	384,312	255,178
OLV Family Care Center - VA Contract	1,157,270	953,734
Contributions to Buffalo Mercy Foundation, Inc.	227,742	182,615
Gift shop income, net	262,623	339,731
Medicare meaningful use	3,122,680	3,342,191
Other	862,776	826,488
	<u>\$ 8,512,935</u>	<u>\$ 7,672,643</u>

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Other Expenses

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

	2012	2011
System dues (a)	\$ 3,294,464	\$ 3,439,978
Rents and operating leases	5,648,943	5,373,829
NYS Health Facilities Cash Receipts Assessment Program	1,937,691	1,593,303
Other dues	725,793	679,839
Catholic Health System other expense	1,604,598	1,112,135
Equipment rentals	966,861	802,201
Other	1,062,812	660,355
	<u>\$ 15,241,162</u>	<u>\$ 13,661,640</u>

(a) System dues are comprised of the following expenses:

	2012	2011
Dues to Catholic Health East	\$ 1,708,800	\$ 1,749,712
Salaries, wages and employee benefits	558,737	663,832
Professional fees and purchased services	725,200	626,122
Other	301,727	400,312
	<u>\$ 3,294,464</u>	<u>\$ 3,439,978</u>

Excess of Revenues Over Expenses

The statement of operations and changes in net assets (deficits) includes excess of revenues over expenses, commonly referred to as the performance indicator. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, 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.

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 are limited by donors to a specific period or purpose and include the Hospital's interest in the temporarily restricted net assets of 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.

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Permanently restricted net assets have been restricted by donors to be maintained by the Hospital in perpetuity.

Income Taxes

The consolidated financial statements do not include a provision for income taxes, since the Company 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 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 accounting guidance. 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 \$858,702 during 2012 and \$1,132,917 during 2011. Capitalized internal project labor costs amounted to \$210,633 during 2012 and \$223,354 during 2011.

Reclassifications

Certain prior year amounts were reclassified to conform to the 2012 consolidated financial statement presentation.

Restatement

As discussed in Note 9, the Hospital has restated its 2011 consolidated balance sheets to correct for a classification error of its variable rate demand bonds from a long-term to a current classification. The net impact of the restatement is to increase the long term debt subject to short term remarketing arrangements by \$32,849,286 (current liability), and to decrease long term debt, net by \$32,849,286 at December 31, 2011. There is no impact on the System's Consolidated Statements of Operations, Changes in Net Assets or Cash Flows.

The Hospital's variable rate demand bonds, while subject to long-term amortization periods, may be put to the Hospital at the option of the bondholders in connection with certain remarketing dates. To the extent that bondholders may, under the terms of the debt, put their bonds within twelve months after the reporting date (December 31), the principal amount of such bonds have been classified as a current liability in the accompanying consolidated balance sheets. The Hospital has liquidity facilities in place to fund any bonds put to the Hospital, however, the terms of the liquidity facilities include subjective acceleration clauses which prohibit the Hospital from classifying the variable demand bonds as long term obligations.

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The following table summarizes adjustments to the 2011 consolidated balance sheet.

	As Originally Reported	Adjustment	As Restated
Consolidated balance sheet as of December 31, 2011			
Current Liabilities			
Long-term debt subject to short term remarketing arrangements	\$ -	\$ 32,849,286	\$ 32,849,286
Total current liabilities	52,862,060	32,849,286	85,711,346
Non-current Liabilities			
Long-term debt, net	41,442,785	(32,849,286)	8,593,499
Total liabilities	252,587,952	-	252,587,952

Subsequent Events

The Hospital evaluated subsequent events through April 25, 2013 which was the date the financial statements were issued.

3. New Authoritative Pronouncements

In July 2011, the FASB issued ASU 2011-07, Health Care Entities (Topic 954): Presentation and Disclosure of Patient Services Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities. ASU 2011-07 includes amendments to FASB's ASC Topic 954, Health Care Entities. The objective of the update is to provide financial statement users with greater transparency about a health care entity's net patient service revenue and the related allowance for doubtful accounts. The amendments requires health care entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not immediately assess the patients' ability to pay, to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue (net of contractual allowances and discounts) on their statement of operations. The Hospital adopted this new guidance during the year ended December 31, 2012. Accordingly, the provision for bad debts of approximately \$9,782,589 and \$8,186,096 for the years ended December 31, 2012 and 2011, respectively, have been presented as a deduction from net patient service revenue in the statement of operations. In addition, certain new disclosures have been included in the financial statements relating to the Hospital's establishment of its reserve for uncollectible accounts and certain other matters.

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4. Assets Limited as to Use

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

	2012	2011
Held by Trustee under Indenture Agreement		
Cash and cash equivalents	\$ 4,360,260	\$ 2,926,941
U.S. Government Obligations	1,210,794	-
Board designated		
Deferred compensation arrangements		
Equity securities	<u>169,585</u>	<u>163,914</u>
Assets limited as to use	<u>\$ 5,740,639</u>	<u>\$ 3,090,855</u>

5. Investments

Investments consist of the following at December 31:

	2012	2011
Investment in debt and equity securities	\$ 875,049	\$ 774,185
Cash surrender value of life insurance policies and other	<u>447,322</u>	<u>430,995</u>
Total investments	<u>\$ 1,322,371</u>	<u>\$ 1,205,180</u>

Unrealized gains (losses) are summarized as follows for the years ended December 31:

	2012	2011
Investment in debt and equity securities		
Fair value	\$ 875,049	\$ 774,185
Cost	<u>749,055</u>	<u>748,025</u>
Unrealized gain	<u>\$ 125,994</u>	<u>\$ 26,160</u>

Unrestricted investment income (loss) is summarized as follows for the years ended December 31:

	2012	2011
Interest and dividend income	\$ 367,553	\$ 595,157
Net realized and unrealized gains	<u>73,652</u>	<u>(15,454)</u>
Total investment income	<u>\$ 441,205</u>	<u>\$ 579,703</u>

Interest and dividend income includes interest income on unrestricted cash and cash equivalents of \$359,634 and \$586,941 in 2012 and 2011, respectively.

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6. Property and Equipment

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

	2012	2011
Land and land improvements	\$ 1,770,973	\$ 1,684,731
Buildings	69,849,435	70,091,598
Leasehold improvements	15,323,275	15,200,604
Equipment	37,760,346	36,974,813
Equipment under capital leases	18,994,818	17,638,508
Automobiles	44,775	26,528
Foundation assets	96,966	100,048
	<u>143,840,588</u>	<u>141,716,830</u>
Less: Accumulated depreciation	(52,375,929)	(49,291,195)
Accumulated amortization on equipment under capital leases	<u>(7,381,355)</u>	<u>(6,384,362)</u>
	84,083,304	86,041,273
Construction in progress	<u>12,665,536</u>	<u>430,396</u>
Property and equipment, net	<u><u>\$ 96,748,840</u></u>	<u><u>\$ 86,471,669</u></u>

Depreciation expense amounted to \$9,509,891 and \$9,082,722 in 2012 and 2011, respectively. Amortization expense on equipment under capital leases amounted to \$2,977,271 and \$2,839,578 in 2012 and 2011, respectively. Fully depreciated assets of \$6,846,234 and \$8,467,099 were written-off for the years ended December 31, 2012 and 2011, respectively.

7. Other Assets

Other assets consist of the following at December 31:

	2012	2011
Insurance recoveries	\$ 22,839,040	\$ 19,933,255
Debt issuance costs - Series 2012	187,027	-
Debt issuance costs - Series 2008	859,368	899,338
Debt issuance costs - Series 2006	362,446	391,441
Workers compensation funding surplus	196,171	359,642
Equity investments	135,102	157,770
Other	<u>103,854</u>	<u>10,593</u>
	<u><u>\$ 24,683,008</u></u>	<u><u>\$ 21,752,039</u></u>

Amortization expense on debt issuance costs amounted to \$80,036 and \$72,402 in 2012 and 2011, respectively.

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8. Accrued Expenses

Accrued expenses consist of the following at December 31:

	2012	2011
Workers compensation	\$ 2,581,915	\$ 2,416,742
Payroll and benefits	11,319,786	10,002,152
Grants and Other	1,039,531	222,983
	<u>\$ 14,941,232</u>	<u>\$ 12,641,877</u>

9. Long-Term Obligations

Long-Term Debt

Long-term debt, inclusive of capital lease obligations, were comprised of the following at December 31:

	2012	2011
Mercy Hospital Series 2006 A (a)	\$ 9,963,055	\$ 10,568,800
Mercy Hospital Series 2008 (b)	22,906,298	23,515,486
Mercy Hospital Series 2012 B (c)	3,094,971	-
Mercy Comprehensive Care Center build-out loan held by 4628 Group, Inc., monthly payments of \$8,752, including interest at 6.25%, matures November 2015.	279,365	364,037
Mercy Hospital cafeteria renovation loan, held by Aramark Healthcare, monthly payments of \$16,159, matures February 2015	453,594	654,869
Individual subordinated to mortgage held by Lackawanna Community Development Corporation, monthly payments of \$1,239, including interest at 10%, matures December 2012.	-	14,087
Capital lease obligations and other, at interest rates ranging from 3.25% to 7.0%, collateralized by equipment.	18,020,694	10,550,279
	<u>54,717,977</u>	<u>45,667,558</u>
Less: Current portion	(5,114,199)	(4,224,773)
Less: Long Term Obligations subject to Short Term Remarketing arrangements	(31,581,853)	(32,849,286)
	<u>\$ 18,021,925</u>	<u>\$ 8,593,499</u>

The Series 2006 and 2008 variable rate demand bonds, while subject to long-term amortization periods, may be put at the option of the bondholders in which case the Bonds would be remarketed based upon the applicable LOC. In a very unlikely event of a failed remarketing, the LOC would be drawn to pay the Bonds and Catholic Health would be obligated to reimburse the applicable LOC Issuer if the Bonds are not remarketed. With respect to the 2006 and 2008 Series, absent an event of default, Catholic Health may elect to pay the obligations in installments matching the bond amortization. To the extent that bondholders may, under the terms of the debt, put their bonds to

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Catholic Health System, the principal amount of such bonds has been classified as a current liability in the accompanying consolidated Balance Sheets. Management believes the likelihood of a material amount of bonds being put to Catholic Health System to be remote. However, to address this possibility, management has taken steps to maintain sufficient unrestricted assets as a source of self-liquidity in the event the bonds are put.

- a. In 2006, the System formed the Acute Care Obligated Group (the Obligated Group), consisting of its three primary hospitals (MHB, SOC, 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. Series 2006A for \$13,360,000 was loaned to the Hospital to repurchase the outstanding Siemens Financial Services, Inc. Term Loans outstanding and to pay certain transaction related costs. The discount on the bonds of \$125,541 will be accreted over the life of the bonds.

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, 2014. In the event the letter of credit is not renewed at expiration, the outstanding Bonds, at the option of the members of the Obligated Group, will 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 0.13% and 0.11% at December 31, 2012 and 2011, 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 consultants 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, 2012 and 2011.

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- b. On November 19, 2008, \$24,700,000 of DASNY - Catholic Health System Obligated Group Revenue Bonds, Series 2008 was issued. Series 2008 was loaned to the Hospital to fund the construction of a new Emergency Department and to pay certain transaction related costs. The discount on the bonds of \$321,700 will be accreted over the life of the bonds.

The Series 2008 Bonds were issued under the Master Trust Indenture that was created in 2006 during the formation of the Obligated Group. All material components of the Series 2008 mirror the Series 2006A. Among these items are the following: 1) a variable remarketed rate (determined by the Security Industry and Financial Markets Association (SIFMA)) collateralized by a letter of credit with HSBC Bank expiring November 18, 2013 (with the option of an initial term loan), 2) a security interest in and assignment of gross receipts of the Hospital, together with the Hospital's right to receive or collect the gross receipts, 3) consistent financial covenants, and 4) execution of an interest rate swap agreement (with HSBC Bank) consistent with the terms utilized in the 2006 swap agreement. Refer to Note 10 for details.

- c. 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 2012B Bonds for \$3,080,000 were loaned to MHB for the purpose of funding the cost of improvements to MHB's existing approximately 381,000 square foot parking facility containing approximately 1,026 spaces. Proceeds of the Series 2012B Bonds were also applied to pay certain costs of issuing the Bonds. The discount on the Bonds of \$31,579 and the premium on the Bonds of \$46,156 will be accreted over the life of the Bonds.

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 are as follows:

2012

3.50% Term Bonds Due July 1, 2022	\$710,000
5.00% Term Bonds Due July 1, 2032 (i)	1,160,000
4.75% Term Bonds Due July 1, 2039	1,210,000
Total Series 2012B Bonds	<u>\$3,080,000</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.

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The financial covenants required under the Loan Agreement are consistent with those of the Series 2006 Bonds and Series 2008 Bonds.

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2012 are as follows:

	Loans	Capital Leases	Total
2013	\$ 1,585,616	\$ 4,272,534	\$ 5,858,150
2014	1,681,412	4,061,753	5,743,165
2015	1,610,715	3,152,787	4,763,502
2016	1,516,595	1,834,001	3,350,596
2017	1,584,095	1,177,103	2,761,198
Thereafter	<u>28,718,850</u>	<u>6,170,738</u>	<u>34,889,588</u>
	<u>\$ 36,697,283</u>	<u>20,668,916</u>	<u>\$ 57,366,199</u>
Less: Interest		<u>(2,648,222)</u>	
		<u>\$ 18,020,694</u>	

Operating Leases

Future minimum lease payments under noncancelable operating leases (net of sublease rental) are as follows:

2013	\$ 4,588,175
2014	4,415,689
2015	4,088,556
2016	2,726,985
2017	2,731,876
Thereafter	<u>821,217</u>
	19,372,498
Minimum sublease rental obligations	<u>(893,112)</u>
	<u>\$ 18,479,386</u>

Total expense for rents and operating type leases was approximately \$5,648,943 and \$5,373,829 in 2012 and 2011, respectively.

10. Derivative Financial Instruments

In connection with the issuance of the Series 2006 and Series 2008 Bonds and execution of the Loan Agreement, the Hospital entered into interest rate swap agreements (derivative agreements) with HSBC Bank USA, NA. (HSBC) for purposes of mitigating risk posed by the Bonds accruing interest at a variable rate. Further, the Hospital agreed not to take or omit to take any action that could reasonably be expected to result in the termination of the derivative agreement unless otherwise approved by HSBC, provided, however, that termination of the derivative agreement shall not constitute an event of default for purposes of the Loan Agreement, but upon any such termination of the derivative agreement, HSBC may require that the Hospital direct the Series 2006 or Series 2008 Bonds be converted to bonds that bear a fixed rate of interest. The terms of the

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Series 2006 swap require the Hospital to pay a fixed rate of 3.80% on the notional amount (\$10,360,000 at December 31, 2012) and in exchange, the Hospital will receive a variable rate payment based upon the Securities Industry and Financial Markets Association Index (SIFMA), calculated weekly. The notional amount of the swap is matched to the maturity schedule of the Series 2006 Bonds. The 2006 swap agreement was executed on December 13, 2006 and expires July 1, 2025. The terms of the Series 2008 swap require the Hospital to pay 3.785% on the notional amount (\$23,510,000 at December 31, 2012) and in exchange, the Hospital will receive a variable rate payment based upon the SIFMA, calculated weekly. The 2008 swap agreement was executed on November 19, 2008 and expires on July 1, 2034. These dates correlate to the issue date and due date of the Bonds. The instrument qualifies for hedge treatment and is designated a cash flow hedge of future interest payments. The effective portion of the hedge has been excluded from excess of revenues over expenses and recorded within changes to net assets.

The fair value of derivative instruments at December 31 is as follows:

		2012		2011	
		Balance Sheet		Balance Sheet	
		Location	Fair Value	Location	Fair Value
Interest rate contracts	Interest rate swap		<u>\$ 6,710,446</u>	Interest rate swap	<u>\$ 6,384,753</u>

The effects of derivative instruments on the consolidated statements of operations and changes in net assets (deficits) for 2012 and 2011 are as follows:

	Amount of Gain (Loss) Recognized in Statement of Operations		Amount of Gain (Loss) Recognized in Net Assets (Deficits)	
	2012	2011	2012	2011
Change in fair value of interest rate swaps	<u>\$ (8,706)</u>	<u>\$ (80,244)</u>	<u>\$ (316,987)</u>	<u>\$ (3,592,288)</u>

The Hospital measures its interest rate swaps at fair market value on a recurring basis. The fair market value of the interest rate swaps is determined based on financials models that consider current and future market interest rates and adjustments for nonperformance risk. The inputs utilized in the valuation process of the interest rate swaps are considered to be Level 2 within the fair value hierarchy defined in Note 15.

11. Employee Benefit Plans

Pension Arrangements

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 Mercy Hospital of Buffalo 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 as their previous plan. All nonunion employees who become participants after that date automatically participate under the cash balance formula.

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The Plan bases benefits upon both years of service and earnings. Participants under the Mercy Hospital of Buffalo 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.

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Funded Status

The following tables summarize the System's changes in the 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 Mercy Hospital of Buffalo. The measurement dates for plan assets and obligations were December 31, 2012 and 2011.

	December 31,	
	2012	2011
Benefit obligations		
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 183,536,930	\$ 151,953,845
Service cost	6,055,471	5,074,644
Interest cost	8,323,197	8,230,851
Actuarial (gains) losses	20,153,228	25,683,814
Transfers (to) from CHS Subsidiaries	1,385,735	(3,490,229)
Benefits paid	(4,277,936)	(3,828,411)
Expenses	(71,387)	(87,584)
Benefit obligation at end of year	<u>\$ 215,105,238</u>	<u>\$ 183,536,930</u>
Accumulated benefit obligation, end of year	<u>\$ 192,375,715</u>	<u>\$ 164,206,294</u>
Plan Assets		
Change in plan assets		
Fair value of plan assets at beginning of year	\$ 69,384,335	\$ 67,479,328
Actual return on plan assets	7,820,966	(10,289)
Transfers (to) from CHS Subsidiaries	518,617	(1,319,447)
Benefits paid	(4,277,936)	(3,828,411)
Hospital contributions	7,129,401	7,150,738
Expenses	(71,387)	(87,584)
Fair value of plan assets at end of year	<u>\$ 80,503,996</u>	<u>\$ 69,384,335</u>
Funded status at end of year	<u>\$ 134,601,242</u>	<u>\$ 114,152,595</u>
Amounts recognized in the consolidated balance sheets		
Noncurrent liabilities	<u>\$ (134,601,242)</u>	<u>\$ (114,152,595)</u>
Net amounts recognized	<u>\$ (134,601,242)</u>	<u>\$ (114,152,595)</u>
Amounts recognized in unrestricted net assets consists of		
Actuarial net loss	\$ (92,006,693)	\$ (78,527,559)
Prior service cost	(997,345)	(1,243,667)
Total amount recognized	<u>\$ (93,004,038)</u>	<u>\$ (79,771,226)</u>
Components of net periodic pension cost		
Service cost	\$ 6,055,471	\$ 5,074,644
Interest cost	8,323,197	8,230,851
Expected return on plan assets	(6,013,301)	(5,775,853)
Amortization of prior service cost or (credit)	246,322	246,322
Recognized actuarial loss	<u>5,733,547</u>	<u>3,282,607</u>
Net periodic pension cost	<u>\$ 14,345,236</u>	<u>\$ 11,058,571</u>

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Since the Hospital is a participant in the System's plan, the following disclosures are made for the entire plan in the aggregate.

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 \$229,260 and \$17,931,331, 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 for 2013 and the actual asset allocation percentages for 2012 and 2011 are as follows at the respective measurement dates:

	Pension target allocation	Percentage of pension plan assets	
	2013	2012	2011
Asset category			
Equities	65%	50%	50%
Fixed income	25%	35%	37%
Other	10%	15%	13%
	<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, either intermediate or long-term, 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 investment policy governs permitted types of investments, and outlines specific benchmarks and performance percentiles. The Investment Subcommittee of the Stewardship Committee of the CHE Board 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.

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The following tables present the Plan's financial instruments as of December 31, 2012 and 2011, measured at fair value on a recurring basis using the fair value hierarchy defined in Note 15.

December 31, 2012	Total	Level 1	Level 2	Level 3
Investments				
Cash and cash equivalents	\$ 14,542,176	\$ 14,491,559	\$ 50,617	\$ -
Marketable equity securities	117,518,474	55,019,557	62,498,917	-
Marketable debt securities	72,798,865	24,932,327	47,866,538	-
Managed funds	30,347,806	-	-	30,347,806
	<u>\$ 235,207,321</u>	<u>\$ 94,443,443</u>	<u>\$ 110,416,072</u>	<u>\$ 30,347,806</u>
December 31, 2011	Total	Level 1	Level 2	Level 3
Investments				
Cash and cash equivalents	\$ 11,565,458	\$ 11,543,903	\$ 21,555	\$ -
Marketable equity securities	100,534,215	92,676,777	7,857,438	-
Marketable debt securities	67,503,537	23,487,427	44,016,110	-
Managed funds	27,055,384	-	-	27,055,384
	<u>\$ 206,658,594</u>	<u>\$ 127,708,107</u>	<u>\$ 51,895,103</u>	<u>\$ 27,055,384</u>

A roll forward of pension assets classified by the defined benefit plan as Level 3 within the fair value hierarchy (defined above) is as follows:

	2012	2011
Fair value January 1	\$ 27,055,386	\$ 31,280,332
Realized and unrealized gains (losses)	944,022	(934,764)
Purchases	8,442,833	-
Sales	(10,660,843)	(1,002,631)
Transfers in/out	4,566,428	(2,287,551)
Fair value December 31	<u>\$ 30,347,826</u>	<u>\$ 27,055,386</u>

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 \$21,400,000 to the pension plan trust in 2013 to be allocated amongst participating entities.

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Benefit Payments

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

2013	\$ 15,039,000
2014	16,535,000
2015	18,215,000
2016	20,235,000
2017	22,239,000
2018 - 22	144,898,000

	2012	2011
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Weighted-average assumptions used to determine end of year benefit obligations

Discount rate	3.95%	4.60%
Rate of compensation increase	3.00%	3.00%

Weighted-average assumptions used to determine net periodic pension cost

Discount rate	4.60%	5.50%
Expected long-term rate of return on plan assets	8.00%	8.00%
Measurement date	12/31/2012	12/31/2011

12. Insurance Arrangements

The System, on the Hospital's behalf, participates in the CHE insurance program which provides coverage for healthcare professional (medical malpractice) and general liability exposures. The primary limits for healthcare professional and general liability are \$3 million per occurrence and are insured by Stella Maris Insurance Company, Ltd. (SMICL), a Cayman-domiciled insurer wholly-owned by CHE. SMICL also provides excess coverage to the System, and this excess coverage is fully reinsured with nonaffiliated commercial insurance companies. SMICL retains the full risk in the primary layer and no risk in the excess layers.

The coverage provided by SMICL 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 4% in 2012 and 2011. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2012 and 2011 is \$138,390 and \$134,750, 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, 2012 and 2011 is \$14,600,410 and \$13,807,250, respectively, and is included in long-term portion of insurance liabilities. The charges to expenses for professional and general liability for 2012 and 2011 approximated \$2,649,945 and \$2,333,256, respectively, which has been included in insurance expense. Amounts recognized as insurance receivables related to the claims approximated \$11,971,000 and \$11,247,000 at December 31, 2012 and 2011, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

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The System's insurance program for workers' compensation, in which the Hospital participates, has a deductible of \$350,000 per occurrence. 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 an undiscounted basis based on actuarial estimates of the settlement of such claims.

The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2012 and 2011 is \$2,571,915 and \$2,386,742, 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, 2012 and 2011 is \$21,535,203 and \$18,377,969, respectively, and is included in long-term portion of insurance liabilities. The charges to expenses for workers compensation costs approximated \$5,482,816 and \$5,675,523 in 2012 and 2011, respectively, which has been included in employee benefits expense. Amounts recognized as insurance receivables related to the claims approximated \$10,868,040 and \$8,686,255 at December 31, 2012 and 2011, respectively. Insurance recoveries are measured on the same basis as the liability subject to the need for a valuation allowance for uncollectible amounts.

The System's insurance for employee health costs, in which the Hospital participates, is self-insured up to \$325,000 per claim. Claims in excess of self-insurance levels are fully insured. Claims are accrued based upon the Hospital'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.

13. 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 2012 and 2011 the Hospital incurred expenses to affiliates for administration services, rent and other services. These expenses approximated \$49,694,822 for 2012 and \$44,348,412 for 2011 and are recorded in the statement of operations and changes in net assets. The Hospital also provided cost sharing services to and received reimbursement from affiliates for laboratory, computer and other services. Revenues from these services approximated \$256,021 and \$328,623 for 2012 and 2011, respectively.

During 2012 and 2011, a distribution was made to the parent of \$8,133,390 and \$12,408,821, respectively. During 2012 and 2011, 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, 2012 and 2011 were \$11,711,064 and \$8,276,174, respectively. Amounts due from affiliates at December 31, 2012 and 2011 were \$88,858 and \$69,944, respectively.

As of April 1, 2007, a lease agreement between Our Lady of Victory Corporation (landlord) and Mercy Hospital of Buffalo (tenant) was signed for the Mercy Hospital Skilled Nursing Facility (84 beds). Per the lease agreement, Mercy Hospital will pay rental expense "sufficient to reimburse Landlord for all annual payments of principal and of interest on the \$10,220,000 Erie County

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Industrial Development Agency Variable Rate Demand Civic Facility Revenue Bonds, Series 2007A.”

Marian Professional Center Associates, L.P. is a joint venture between Ciminelli Development Company, Mercy Hospital, Alsace Abbott Corporation (a wholly owned Corporation of Mercy Hospital), and 3 other joint venture partners. In 2009, Marian Professional Center Associates, L.P. refinanced its mortgage. As of December 31, 2012, there was \$5,251,670 of debt outstanding, of which MHB has guaranteed \$2,625,835. Per the guaranty agreement, MHB's obligation shall decrease on a dollar for dollar basis as the principal amount of the obligation is paid down.

East Aurora Medical Building, L.P. is a joint venture between Regent Development, Inc. and Aurora Mercy Corporation. Aurora Mercy Corporation is wholly owned by Mercy Hospital. In 1998, East Aurora Medical Building, L.P. refinanced its mortgage. As of December 31, 2012, there was \$2,449,448 of debt outstanding, of which Aurora Mercy Corporation has guaranteed the full amount.

14. 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.

15. Fair Value Measurements

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

Cash and Cash Equivalents

The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

Assets Limited to Use

The fair values for marketable equity, government, and fixed income securities are based on quoted market prices.

Investments

The fair values for marketable equity, marketable debt, government, and fixed income securities are valued at the closing price reported on the active market on which the individual securities are traded.

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Interest Rate Swap

The Hospital has entered into standard International Swaps and Derivatives Association (ISDA) interest rate swap agreements (the Swap Agreements) to manage the interest rate risk associated with its debt. The Swap Agreements effectively convert a portion of our variable rate debt to a long-term fixed rate. Under these agreements, the Hospital receives a variable rate based on the Securities Industry and Financial Markets Association Index plus a markup and pays a fixed rate. The fair value of these interest rate derivatives are based on quoted prices for similar instruments from a commercial bank, and therefore, the interest rate derivatives are considered a Level 2 item.

Assets and liabilities recorded at fair value in the balance sheet are categorized based upon the level of judgment associated with the inputs used to measure their fair value. An asset or a liability's categorization within the fair value hierarchy is based on the lowest level of judgment input to its valuation. Hierarchical levels, as defined by accounting guidance, are directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities as follows:

- Level I Valuations based on quoted prices in active markets for identical assets or liabilities that the Hospital has the ability to access. Since valuations are based on quoted prices that are readily and regularly available in active market, valuation of these products does not entail a significant degree of judgment. Level I assets include cash and cash equivalents, debt and equity securities that are traded in an active exchange markets, as well as certain U.S. Treasury and other U.S. Governments and agencies bonds that are highly liquid and are actively traded in over-the counter markets.
- Level II Valuations based on quoted prices in active markets for similar assets or liabilities quoted prices in markets that are not active or for which all significant inputs are observable, directly or indirectly. Level II assets include equity and fixed income managed funds with quoted prices that are traded less frequently than exchange-traded instruments whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.
- Level III Valuations based on inputs that are unobservable and significant to the overall fair value measurement. These are generally company generated inputs and are not market based inputs. Level III assets would include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques as well as instruments for which the determination of fair value requires significant investment management judgment or estimation.

Financial instruments measured at fair value are based on one or more of the three valuation techniques noted in fair value guidance. The three valuation techniques are as follows:

Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

Cost approach: Amount that would be required to replace the service capacity of an asset (i.e., replacement cost).

Income approach: Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques and option-pricing models).

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The following tables present information about assets and liabilities that are measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value as of December 31, 2012 and 2011.

	December 31, 2012				Valuation Technique
	Level 1	Level 2	Level 3	Total	
Assets Limited As To Use					
Cash and cash equivalents	\$ 2,804,122	\$ 1,556,138	\$ -	\$ 4,360,260	Market
Marketable equity securities	169,585	-	-	169,585	
U.S. Government & agency obligations	1,210,794	-	-	1,210,794	Market
	<u>\$ 4,184,501</u>	<u>\$ 1,556,138</u>	<u>\$ -</u>	<u>\$ 5,740,639</u>	
Investments					
Cash and cash equivalents	\$ 13,635	\$ 141	\$ -	\$ 13,776	Market
Marketable equity securities	360,275	294,162	-	654,437	Market
Marketable debt securities	31,285	50,945	-	82,230	Market
Other	-	447,322	-	447,322	Market
	<u>\$ 405,195</u>	<u>\$ 792,570</u>	<u>\$ -</u>	1,197,765	
Managed funds				124,606	
				<u>\$ 1,322,371</u>	
Interest Rate Swap	\$ -	6,710,446	\$ -	\$ 6,710,446	Market

	December 31, 2011				Valuation Technique
	Level 1	Level 2	Level 3	Total	
Assets Limited As To Use					
Cash and cash equivalents	\$ 11,141	\$ 2,915,801	\$ -	\$ 2,926,942	Market
Marketable equity securities	163,913	-	-	163,913	Market
	<u>\$ 175,054</u>	<u>\$ 2,915,801</u>	<u>\$ -</u>	<u>\$ 3,090,855</u>	
Investments					
Cash and cash equivalents	\$ 35,467	\$ 772	\$ -	\$ 36,239	Market
Marketable equity securities	553,372	49,536	-	602,908	Market
Marketable debt securities	35,198	3,569	-	38,767	Market
Other	-	430,996	-	430,996	Market
	<u>\$ 624,037</u>	<u>\$ 484,873</u>	<u>\$ -</u>	1,108,910	
Managed funds				96,270	
				<u>\$ 1,205,180</u>	
Interest Rate Swap	\$ -	\$ 6,384,753	\$ -	\$ 6,384,753	Market

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A roll forward of those marketable securities and investments whose use is limited that have been classified by the Hospital as Level 3 within the fair value hierarchy (defined above) is as follows:

	2012	2011
Fair value January 1	\$ -	\$ 9
Purchases	-	-
Realized and unrealized gains (losses)	-	-
Transfers in/out	-	(7)
Sales	-	(2)
Fair value December 31	<u>\$ -</u>	<u>\$ -</u>
Amount of unrealized gains (losses) related to Level 3 investments held at December 31, included in the statement of operations	<u>\$ -</u>	<u>\$ -</u>

The following managed fund investments are recorded under the equity method of accounting, which is similar to using the net asset value per share of the investments as of December 31, 2012:

<i>(in thousands of dollars)</i>	Recorded Value	Unfunded Commitments	Commitment Terms	Redemption Terms
Fund of Hedge Funds	\$ 101,739		n/a	Quarter-end, semiannually, or anniversary date; with 45-90 days prior written notice
Real estate	10,164	2,251	4 - 9 year; n/a for one mutual fund	Redemption not permitted
Private equity	<u>12,702</u>	6,299	5 - 13 years	Redemption not permitted
Total	<u>\$ 124,605</u>			

The objective of the hedge funds investments is to achieve equity and fixed income like returns utilizing a conservative strategy with low risk and volatility. All hedge fund investing is done in a fund of funds approach and the use of diversified funds.

The objective of the private equity and real estate portfolios is to enhance return while reducing the overall risk through investments in limited partnerships in funds with expertise in these categories. These illiquid, longer term investments seek higher returns but are held at a very low percentage of the investment portfolio.

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16. Concentrations of Credit Risk

The Hospital grants credit without collateral to its patients, most of who 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:

	2012	2011
Medicare	41 %	40 %
Medicaid	2 %	4 %
Blue Cross	7 %	8 %
Other third-party payors	38 %	35 %
Patients	12 %	13 %
	<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 risk.

17. Functional Expenses

The Hospital provides general health care services to residents within its geographic region. Expenses related to providing these services for the years ended December 31 are as follows:

	2012	2011
Health care services	\$ 250,233,345	\$ 227,158,852
General and administrative	<u>84,919,015</u>	<u>78,720,762</u>
	<u>\$ 335,152,360</u>	<u>\$ 305,879,614</u>



Report of Independent Auditors on Accompanying Other Information

To the Board of Directors of the
Catholic Health System, Inc.:

We have audited the consolidated financial statements of Mercy Hospital of Buffalo (the Hospital) as of December 31, 2012 and for the year then ended and our report thereon appears on page 1 of this document. That audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken 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 on 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).

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

April 25, 2013

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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, 2012 and 2011

(in thousands of dollars)

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:

	December 31,	
	2012	2011
Charity care	\$ 2,302,097	\$ 3,064,825
Cost of community benefit programs	5,515,264	4,054,964
Unpaid cost of Medicaid programs	<u>9,303,920</u>	<u>6,022,012</u>
Social accountability costs	<u>\$ 17,121,281</u>	<u>\$ 13,141,801</u>