

CONSOLIDATED FINANCIAL STATEMENTS

**MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE
CATHOLIC HEALTH SYSTEM, INC.)**

DECEMBER 31, 2013

**MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)**

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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 Mercy Hospital of Buffalo and its subsidiary (collectively, the "Hospital"), which comprise the consolidated balance sheet as of December 31, 2013, and the related consolidated statement of operations, changes in net assets and cash flows for the year then ended and the related notes to the 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 the consolidated financial statements based on our audit. We conducted our audit 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, 2013, and the results of its operations and its cash flows for the year 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.

Other Matters

The consolidated financial statements of the Mercy Hospital of Buffalo and its subsidiary for the year ended December 31, 2012 were audited by other auditors whose report dated April 25, 2013, expressed an unmodified opinion on those statements.

Freed Maxick CPAs, P.C.

Buffalo, New York
April 10, 2014

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATED BALANCE SHEETS
December 31,

ASSETS	2013	2012
Current assets:		
Cash and cash equivalents	\$ 64,682,656	\$ 59,315,430
Patient/resident accounts receivable, net of allowance for doubtful accounts of \$9,100,080 (2012 - \$8,996,770)	54,105,226	47,457,305
Other receivables	5,098,935	2,771,158
Inventories	11,161,194	6,685,016
Prepaid expenses and other current assets	570,735	792,109
Total current assets	135,618,746	117,021,018
Assets limited as to use	1,324,433	5,740,639
Investments	1,511,468	1,322,371
Due from affiliates	236,582	88,858
Property and equipment, net	101,129,413	96,748,840
Other assets	28,269,784	24,683,008
Total assets	\$ 268,090,426	\$ 245,604,734
LIABILITIES AND NET ASSETS		
Current liabilities:		
Current portion of long-term obligations	\$ 5,518,461	\$ 5,114,199
Long-term obligations subject to short-term remarketing arrangements	-	31,581,853
Accounts payable	17,823,615	16,592,558
Accrued expenses	15,681,679	14,941,232
Due to third-party payors	18,110,140	16,698,439
Due to affiliates	9,906,249	11,711,064
Total current liabilities	67,040,144	96,639,345
Long-term obligations, net	45,560,059	18,021,925
Long-term portion of insurance liabilities	40,427,822	36,135,613
Pension obligation	96,901,865	134,601,242
Asset retirement obligation	5,689,954	5,481,582
Interest rate swap	3,223,924	6,710,446
Deferred compensation plan	11,096	169,585
Other long term liabilities	193,704	321,678
Total liabilities	259,048,568	298,081,416
Net assets (deficit):		
Unrestricted	7,886,053	(54,269,577)
Temporarily restricted	1,033,282	1,670,372
Permanently restricted	122,523	122,523
Total net assets (deficit)	9,041,858	(52,476,682)
Total liabilities and net assets	\$ 268,090,426	\$ 245,604,734

See accompanying notes.

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

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

	2013	2012
Unrestricted revenue and other support:		
Net patient/resident service revenue	\$ 371,395,001	\$ 349,335,710
Provision for bad debts	(8,742,496)	(9,782,589)
Net patient/resident service revenue, less provision for bad debts	362,652,505	339,553,121
Other revenue	10,801,600	8,512,935
Net assets released from restrictions used in operations	256,000	37,000
Total unrestricted revenue and other support	373,710,105	348,103,056
Expenses:		
Salaries and wages	147,811,229	138,399,547
Employee benefits	55,404,094	52,142,374
Medical and professional fees	12,048,458	12,131,001
Purchased services	28,988,063	28,609,429
Supplies	75,009,179	70,456,696
Depreciation and amortization	14,275,884	12,868,635
Interest	2,370,879	2,357,546
Insurance	3,123,274	2,945,970
Other expenses	15,939,388	15,241,162
Total expenses	354,970,448	335,152,360
Income from operations	18,739,657	12,950,696
Nonoperating revenues and losses:		
Investment income	757,005	441,205
Contributions and other, net	44,545	269,447
Total nonoperating revenues and losses	801,550	710,652
Excess of revenues over expenses	\$ 19,541,207	\$ 13,661,348

See accompanying notes.

MERCY HOSPITAL OF BUFFALO
(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>2013</u>	<u>2012</u>
Unrestricted net assets (deficit):		
Excess of revenues over expenses	\$ 19,541,207	\$ 13,661,348
Change in unrealized gain (loss) on interest rate swap	3,412,516	(316,987)
Change in pension obligation, other than net periodic cost	45,520,264	(13,232,812)
Net assets released from restriction used for capital	991,475	99,131
Distributions to parent	(7,310,772)	(8,133,390)
Grant revenue for capital expenditures	940	-
Increase (decrease) in unrestricted net assets	<u>62,155,630</u>	<u>(7,922,710)</u>
Temporarily restricted net assets:		
Contributions	559,642	54,128
Special events	31,560	87,303
Investment income	19,183	16,367
Temporarily restricted net assets released from restrictions	<u>(1,247,475)</u>	<u>(136,131)</u>
(Decrease) increase in temporarily restricted net assets	<u>(637,090)</u>	<u>21,667</u>
Increase (decrease) in net assets (deficit)	<u>61,518,540</u>	<u>(7,901,043)</u>
Net assets - beginning of year	<u>(52,476,682)</u>	<u>(44,575,639)</u>
Net assets - end of year	<u><u>\$ 9,041,858</u></u>	<u><u>\$ (52,476,682)</u></u>

See accompanying notes.

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

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

	2013	2012
Cash flows from operating activities:		
Increase (decrease) in net assets	\$ 61,518,540	\$ (7,901,043)
Adjustments to reconcile increase (decrease) in net assets to net cash provided by operating activities		
Depreciation and amortization	14,275,885	12,868,635
Provision for bad debts	8,742,496	9,782,589
Loss on sale of assets	102,081	1,610
Gain on renewal of capital leases	(25,961)	(69,096)
Change in unrealized (gain) loss on interest rate swap	(3,486,522)	325,693
Distribution to parent and affiliates	7,310,772	8,133,390
Change in pension obligation, other than net periodic cost	(45,520,264)	13,232,812
Undistributed (earnings) losses in equity investees	(12,581)	22,667
Discount on issuance	23,908	21,870
Premium on issuance	(3,003)	(1,410)
Change in unrealized gains on investments	(155,311)	(99,834)
Realized loss on investments	257	12,613
Increase (decrease) in cash surrender value of life insurance policies	4,742	(16,327)
(Increase) decrease in assets:		
Patient accounts receivables	(15,390,417)	(13,851,268)
Due from affiliate	(146,228)	(18,914)
Other receivables	(2,327,777)	394,022
Inventories	(4,476,178)	(1,073,497)
Prepaid expenses and other assets	(254,205)	(194,549)
Increase (decrease) in liabilities:		
Accounts payable	31,057	2,269,629
Accrued expenses	740,447	2,299,355
Due to affiliates	(3,240,021)	2,210,315
Due to third-party payors	1,411,701	3,302,132
Other liabilities	8,533,184	8,371,312
Net cash and cash equivalents provided by operating activities	27,656,602	40,022,706
Cash flows from investing activities:		
Purchase of property and equipment	(14,258,615)	(18,205,783)
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	4,261,776	7,379,070
Change in investments, net	(38,785)	(13,643)
Other	154,430	-
Net cash and cash equivalents used in investing activities	(9,881,194)	(20,868,208)
Cash flows from financing activities:		
Distribution to parent and affiliates	(7,310,772)	(8,133,390)
Proceeds from issuance of long-term debt	-	10,148,363
Discount on issuance	-	(31,579)
Premium on issuance	-	46,156
Repayment of current and long-term obligations	(5,097,410)	(4,400,472)
Net cash and cash equivalents used in financing activities	(12,408,182)	(2,370,922)
Net increase in cash and cash equivalents	5,367,226	16,783,576
Cash and cash equivalents - beginning of year	59,315,430	42,531,854
Cash and cash equivalents - end of year	<u>\$ 64,682,656</u>	<u>\$ 59,315,430</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 2,349,973	\$ 2,337,086
Noncash investing and financing activities:		
Assets acquired under capital lease obligations	\$ 1,681,223	\$ 4,104,923
Other noncash transactions	\$ 1,200,000	\$ -

See accompanying notes.

**MERCY HOSPITAL OF BUFFALO
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

Mercy Hospital of Buffalo 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, 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. 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 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 (also collectively referred to as the "Hospitals") 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. Clare Manor (closed December 2003), St. Francis Geriatric and Healthcare Services, Inc. (closed December 2009), St. Francis Home of Williamsville, Western New York Catholic Long-Term Care, Inc. (Father Baker Manor), St. Joseph's Manor (closed August 2006), St. Luke's Manor of Batavia (closed June 2004), St. Mary's Manor (closed 2003), Nazareth Home of the Franciscan Sisters of the Immaculate Conception (closed 2007), 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), Our Lady of Victory Renaissance Corporation, 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 Mercy Hospital of Buffalo and Mercy Hospital Foundation. All significant intercompany balances and transactions have been eliminated in the consolidated amounts.

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.

**MERCY HOSPITAL OF BUFFALO
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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.

Other Receivables: Other receivables consist primarily of managed care risk sharing receivables, foundation 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 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 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.

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.

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 \$562,000 and \$585,000 at December 31, 2013 and 2012, respectively.

**MERCY HOSPITAL OF BUFFALO
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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 2013 and 2012.

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, 2013 and 2012 was \$317,263 and \$301,437, 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 final settlements are determined. CHS's Healthcare Assistance Program provides discounts to patients based on need. 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.

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 2013 and 2012 related to prior years, including adjustments to prior year estimates and audit settlements, increased revenues by \$2,969,228 and \$2,793,962, 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 55% and 52% net patient/resident service revenue was generated from services rendered to patients/residents under Medicare and Medicaid programs in 2013 and 2012, respectively. Approximately 36% and 39% of net patient/resident service revenue was generated from services rendered to patients under managed care programs in 2013 and 2012.

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.

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Patient/resident service revenue (net of Contractual allowances and discounts):		
Medicare	\$ 170,841,701	\$ 156,814,011
Medicaid	33,425,550	26,270,278
Blue Cross	37,139,500	35,517,132
Other third party payors	126,274,300	129,611,347
Patients/residents	<u>3,713,950</u>	<u>1,122,942</u>
Total net patient/resident service revenue	371,395,001	349,335,710
Provision for bad debts	<u>(8,742,496)</u>	<u>(9,782,589)</u>
Net patient/resident service revenue, less provision for bad debts	<u>\$ 362,652,505</u>	<u>\$ 339,553,121</u>

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 \$2,891,148 and \$2,302,097 arose from providing services to charity care patients in 2013 and 2012, 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 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. 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.

Collective Bargaining Agreements: The Hospital has approximately 82% of its employees working under three different collective bargaining agreements. The agreements are set to expire beginning June 3, 2016 through September 30, 2017.

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 \$2,100,000 and \$3,100,000 of electronic health record incentive income related to Medicare and Medicaid incentive programs during the years ended December 31, 2013 and 2012, respectively, which is recorded in other revenue.

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

	<u>2013</u>	<u>2012</u>
Shared services (Note 15)	\$ 745,325	\$ 843,304
Cafeteria revenue	1,154,813	1,005,113
Parking revenue	670,464	647,115
Rental income	383,877	384,312
OLV Family Care Center - VA Contract	-	1,157,270
Contributions to Mercy Hospital Foundation, Inc.	166,332	227,742
Gift shop income, net	273,773	262,623
Legal Settlement	4,000,000	-
Medicare and Medicaid meaningful use	2,118,073	3,122,680
Other	<u>1,288,943</u>	<u>862,776</u>
Total other revenues	<u>\$ 10,801,600</u>	<u>\$ 8,512,935</u>

MERCY HOSPITAL OF BUFFALO
(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>2013</u>	<u>2012</u>
System dues (a)	\$ 3,183,878	\$ 3,294,464
Rents and operating leases	5,754,785	5,648,943
NYS Health Facilities Cash Receipts Assessment Program	2,469,929	1,937,691
Other dues	673,064	725,793
Catholic Health System other expense	1,799,013	1,604,598
Equipment rentals	1,251,105	966,861
Other	<u>807,614</u>	<u>1,062,812</u>
Total other expenses	<u>\$ 15,939,388</u>	<u>\$ 15,241,162</u>

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

	<u>2013</u>	<u>2012</u>
Dues to Catholic Health East	\$ 1,794,512	\$ 1,708,800
Salaries, wages and employee benefits	671,776	558,737
Professional fees and purchase services	384,397	725,200
Other	<u>333,193</u>	<u>301,727</u>
Total system dues	<u>\$ 3,183,878</u>	<u>\$ 3,294,464</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 Revenue over Expenses: The statement of operations and changes in net assets includes excess of revenue 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, 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.

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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 includes 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.

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 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 consolidated financial statements. The Hospital's federal Exempt Organization Business Income Tax Returns for 2010, 2011, and 2012 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 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 \$2,938,910 during 2013 and \$858,702 during 2012. Capitalized internal project labor costs amounted to \$840,950 during 2013 and \$210,633 during 2012.

Reclassifications: Certain prior year amounts were reclassified to conform to the 2013 consolidated financial statement presentation.

Subsequent Events: The Hospital evaluated subsequent events through April 10, 2014 which was the date the financial statements were available to be issued.

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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>2013</u>	<u>2012</u>
Held by Trustee under indenture agreement:		
Cash and cash equivalents	\$ 855,379	\$ 4,360,260
U.S. Government obligations	457,958	1,210,794
Board designated:		
Deferred compensation arrangements:		
Equity securities	<u>11,096</u>	<u>169,585</u>
Assets limited as to use	<u>\$ 1,324,433</u>	<u>\$ 5,740,639</u>

NOTE 4. INVESTMENTS

Investments consist of the following at December 31:

	<u>2013</u>	<u>2012</u>
Investment in debt and equity securities	\$ 1,068,888	\$ 875,049
Cash surrender value of life insurance policies and other	<u>442,580</u>	<u>447,322</u>
Total investments	<u>\$ 1,511,468</u>	<u>\$ 1,322,371</u>

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

	<u>2013</u>	<u>2012</u>
Investment in debt and equity securities:		
Fair value	\$ 1,068,888	\$ 875,049
Cost	<u>913,577</u>	<u>749,055</u>
Unrealized gain	<u>\$ 155,311</u>	<u>\$ 125,994</u>

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

	<u>2013</u>	<u>2012</u>
Interest and dividend income	\$ 627,234	\$ 367,553
Net realized and unrealized gains and losses	<u>129,771</u>	<u>73,652</u>
Total investment income	<u>\$ 757,005</u>	<u>\$ 441,205</u>

MERCY HOSPITAL OF BUFFALO
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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>2013</u>	<u>2012</u>
Land and land improvements	\$ 1,768,161	\$ 1,770,973
Buildings	68,128,532	69,849,435
Leasehold improvements	31,805,143	15,323,275
Equipment	43,540,896	37,760,346
Equipment under capital leases	19,315,564	18,994,818
Automobiles	44,775	44,775
Foundation assets	<u>101,850</u>	<u>96,966</u>
	164,704,921	143,840,588
Less: Accumulated depreciation	(56,022,472)	(52,375,929)
Accumulated amortization on equipment under capital leases	<u>(8,416,640)</u>	<u>(7,381,355)</u>
	100,265,809	84,083,304
Construction in progress	<u>863,604</u>	<u>12,665,536</u>
Property and equipment, net	<u>\$ 101,129,413</u>	<u>\$ 96,748,840</u>

Depreciation expense amounted to \$10,495,133 and \$9,509,891 in 2013 and 2012, respectively. Amortization expense on equipment under capital leases amounted to \$3,377,548 and \$2,977,271 in 2013 and 2012, respectively. Fully depreciated or amortized assets of \$7,240,893 and \$6,846,234 were written-off for the years ended December 31, 2013 and 2012, 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>2013</u>	<u>2012</u>
Current prepaid expenses and other current assets:		
Prepaid general expenses	\$ 509,944	\$ 731,318
Other assets	<u>60,791</u>	<u>60,791</u>
Prepaid expenses and other current assets	<u>\$ 570,735</u>	<u>\$ 792,109</u>
Current other receivables:		
Physician loans	\$ 1,568,551	\$ 1,695,192
Managed care risk receivables	2,062,349	-
Foundation receivables	527,312	187,110
Other	<u>940,723</u>	<u>888,856</u>
Other receivables	<u>\$ 5,098,935</u>	<u>\$ 2,771,158</u>
Non-current:		
Insurance recoveries	\$ 26,023,598	\$ 22,839,040
Debt issuance costs, net – Series 2012	179,969	187,027
Debt issuance costs, net – Series 2008	819,397	859,368
Debt issuance costs, net – Series 2006	333,450	362,446
Debt issuance costs, net – Other	93,937	103,854
Workers' compensation funding surplus	671,750	196,171
Equity investments	<u>147,683</u>	<u>135,102</u>
Other assets	<u>\$ 28,269,784</u>	<u>\$ 24,683,008</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. OTHER ASSETS AND OTHER RECEIVABLES (CONTINUED)

Amortization expense on debt issuance costs amounted to \$85,942 and \$80,036 for years ended December 31, 2013 and December 31, 2012, respectively. Accumulated Amortization related to the debt issuance costs amounted to \$404,710 and \$318,768 at December 31, 2013 and December 31, 2012, respectively. Amortization expense is expected to be approximately \$86,000 for the years ended December 31, 2014 to 2018

NOTE 7. ACCRUED EXPENSES

Accrued expenses consist of the following at December 31:

	<u>2013</u>	<u>2012</u>
Workers' compensation, current portion	\$ 2,866,847	\$ 2,581,915
Payroll and benefits	12,199,749	11,319,786
Other	<u>615,083</u>	<u>1,039,531</u>
Accrued expenses	<u>\$ 15,681,679</u>	<u>\$ 14,941,232</u>

NOTE 8. LONG-TERM OBLIGATIONS

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

	<u>2013</u>	<u>2012</u>
Mercy Hospital Series 2006 A (a)	\$ 9,332,311	\$ 9,963,055
Mercy Hospital Series 2008 (b)	22,269,610	22,906,298
Mercy Hospital Series 2012 B (c)	3,060,809	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.	189,247	279,365
Mercy Hospital cafeteria renovation loan, held by Aramark Healthcare, monthly payments of \$16,971, matures March 2015	249,942	453,594
Capital lease obligations and other, at interest rates ranging from 3.1% to 6.5%, collateralized by equipment.	<u>15,976,601</u>	<u>18,020,694</u>
	51,078,520	54,717,977
Less: Current portion	(5,518,461)	(5,114,199)
Less: Long term obligations subject to short term remarketing arrangements (a)	<u>-</u>	<u>(31,581,853)</u>
Long-term obligations, net	<u>\$ 45,560,059</u>	<u>\$ 18,021,925</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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

Obligated Group Revenue Bonds, Series 2006 were issued. Series 2006A for \$13,360,000 was loaned to the Hospital to repurchase the 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, 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 0.06% and 0.13% at December 31, 2013 and 2012, 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; and (iii) a maximum leverage ratio. The Obligated Group was in compliance with these covenants at December 31, 2013 and 2012.

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, 2013.

- (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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

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, 2018 (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 9 for details. The variable interest rate was 0.06% and 0.13% at December 31, 2013 and 2012, respectively.

- (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 the Hospital for the purpose of funding the cost of improvements to the Hospital's existing 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 and premium on the bonds of \$31,579 and \$46,156, respectively, are attributable to the difference between the stated interest rate on these bonds and will be amortized 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, 2013 are as follows:

3.50% Term Bonds due July 1, 2022	\$ 675,000
5.00% Term Bonds due July 1, 2032 (i)	1,160,000
4.75% Term Bonds due July 1, 2039	<u>1,210,000</u>
Total Series 2012B bonds	<u>\$ 3,045,000</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 and Series 2008 Bonds.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. LONG-TERM OBLIGATIONS (CONTINUED)

Aggregate maturities of long-term obligations, including capital lease obligations, subsequent to December 31, 2013 are as follows:

	<u>Long-term Debt</u>	<u>Capital Leases</u>	<u>Total</u>
2014	\$ 1,691,161	\$ 4,313,149	\$ 6,004,310
2015	1,591,217	3,476,205	5,067,422
2016	1,516,595	2,202,951	3,719,546
2017	1,584,095	1,540,908	3,125,003
2018	1,651,595	892,241	2,543,836
Thereafter	<u>27,067,255</u>	<u>5,553,665</u>	<u>32,620,920</u>
	<u>\$ 35,101,918</u>	17,979,119	53,081,037
Less: Interest		<u>(2,002,517)</u>	<u>(2,002,517)</u>
Long-term obligations		<u>\$ 15,976,602</u>	<u>\$ 51,078,520</u>

Operating Leases

Future minimum lease payments under non-cancellable operating leases (net of sublease rentals) are as follows:

2014	\$ 4,658,676
2015	4,526,944
2016	4,083,328
2017	3,340,477
2018	1,808,248
Thereafter	<u>687,978</u>
	19,105,651
Minimum sublease rental obligations	<u>(792,152)</u>
	<u>\$ 18,313,499</u>

Total expense for rents and operating type leases for equipment and property was approximately \$5,754,785 and \$5,648,943 for 2013 and 2012, respectively.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. 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 Series 2006 swap require the Hospital to pay a fixed rate of 3.80% on the notional amount (\$9,735,000 at December 31, 2013) 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 (\$22,875,000 at December 31, 2013) 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:

		2013		2012	
		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts floating to fixed		Long-term liabilities	\$ <u>3,223,924</u>	Long-term liabilities	\$ <u>6,710,446</u>

The effects of derivative instruments on the consolidated statements of operations and changes in net assets for 2013 and 2012 are as follows:

	Ineffective portion in Statement of Operations		Effective portion in Net Assets	
	2013	2012	2013	2012
Change in fair value of interest rate swaps	\$ <u>74,006</u>	\$ <u>(8,706)</u>	\$ <u>3,412,516</u>	\$ <u>(316,987)</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

The Hospital measures its interest rate swaps at fair value on a recurring basis. The fair value of the interest rate swaps is determined based on financial 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 14.

NOTE 10. 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.

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.

Funded Status: The following tables summarize the System's 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 Mercy Hospital of Buffalo. The measurement dates for plan assets and obligations were December 31, 2013 and 2012.

	<u>2013</u>	<u>2012</u>
Projected Benefit Obligations		
Change in benefit obligation:		
Benefit obligation at beginning of year	\$ 215,105,238	\$ 183,536,930
Service cost	7,026,815	6,055,471
Interest cost	8,385,859	8,323,197
Actuarial (gains) losses	(29,072,447)	20,153,228
Transfers (to) from CHS Subsidiaries	(2,427,018)	1,385,735
Benefits paid	(5,074,798)	(4,277,936)
Expenses	<u>(67,866)</u>	<u>(71,387)</u>
Projected Benefit obligation at end of year	<u>\$ 193,875,783</u>	<u>\$ 215,105,238</u>
Accumulated benefit obligations, end of year	<u>\$ 175,275,089</u>	<u>\$ 192,375,715</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

	<u>2013</u>	<u>2012</u>
Plan Assets		
Change in plan assets:		
Fair value of assets at beginning of year	\$ 80,503,996	\$ 69,384,335
Actual return on plan assets	14,185,546	7,820,966
Transfers (to) from CHS subsidiaries	(1,213,960)	518,617
Benefits paid	(5,074,798)	(4,277,936)
Hospital contributions	8,641,000	7,129,401
Expenses	<u>(67,866)</u>	<u>(71,387)</u>
Fair value of plan assets at end of year	<u>\$ 96,973,918</u>	<u>\$ 80,503,996</u>
Funded status at end of year	<u>\$ 96,901,865</u>	<u>\$ 134,601,242</u>
Amounts recognized in the consolidated balance sheets:		
Non-current liabilities	\$ <u>(96,901,865)</u>	\$ <u>(134,601,242)</u>
Net amounts recognized	\$ <u>(96,901,865)</u>	\$ <u>(134,601,242)</u>
Amounts recognized in unrestricted net assets consists of:		
Actuarial net loss	\$ (46,732,751)	\$ (92,006,693)
Prior service cost	<u>(751,023)</u>	<u>(997,345)</u>
Total amount recognized	<u>\$ (47,483,774)</u>	<u>\$ (93,004,038)</u>
Components of net periodic benefit cost:		
Service cost	\$ 7,026,815	\$ 6,055,471
Interest cost	8,385,859	8,323,197
Expected return on plan assets	(6,589,050)	(6,013,301)
Amortization of prior service cost or (credit)	246,322	246,322
Recognized actuarial loss	<u>7,391,941</u>	<u>5,733,547</u>
Net periodic pension cost	<u>\$ 16,461,887</u>	<u>\$ 14,345,236</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 \$229,260 and \$8,530,663, 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

The Plan's target asset allocation and the actual asset allocation percentages for 2013 and 2012 are as follows at the respective measurement dates:

<u>Asset Category</u>	<u>Target</u>	<u>Actual</u>	
		<u>2013</u>	<u>2012</u>
Equities	65%	61%	50
Fixed income	25	30	35
Other	<u>10</u>	<u>9</u>	<u>15</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, 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.

Accounting Standards Codification Topic 820 allows for the use of a practical expedient for the estimation of fair value of investments in investment companies for which the investment does not have a readily determinable fair value. The practical expedient used by the Plan to value its investments in its Level 3 investments is the net asset value (NAV) per share, or its equivalent. For investments in non-unitized investments, the equivalent is the Plan's proportionate share of the partner's capital of the investment partnerships as reported by the general partners. Through its monitoring activities, the Plan believes that the carrying amounts of these financial instruments are reasonable estimates of fair value.

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.

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, 2013 and 2012:

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

Marketable debt securities: Valued based on yields currently available on comparable securities of issuers with similar credit rating.

Marketable equity securities: Valued at closing price reported on the active market on which the individual securities are traded.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

Partnership joint venture interests: These securities are estimated using current information obtained from the general partner or investment manager for the respective funds. Investments in venture capital/private equity partnerships are generally estimated using partner's capital balances, and the fair value of investments in hedge funds are generally estimated using NAVs. In cases where the investee has provided its investors with a NAV per share or partner capital balances that have been calculated in accordance with the AICPA Audit and Accounting Guide, *Investment Companies*, the Plan has estimated its fair value by using the NAV provided by the investee as of December 31st.

Commingled funds: Valued at the NAV of units of the commingled fund. The NAV is used as a practical expedient to estimate fair value. The NAV is based on the fair value of the underlying investments held by the fund less its liabilities. This practical expedient is not used when it is determined to be probable that the fund will sell the investment for an amount different from the reported NAV.

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.

The following tables present the Plan's financial instruments as of December 31, 2013 and 2012, measured at fair value on a recurring basis using the fair value hierarchy defined in Note 14.

At December 31, 2013	Level I	Level II	Level III	Total
Cash and cash equivalents	\$ 10,610,231	\$ 13	\$ -	\$ 10,610,244
Marketable equity securities:				
SRI large cap	36,140	-	-	36,140
Large cap flex	44,116,418	-	-	44,116,418
Small cap growth	17,695,823	-	-	17,695,823
International	11,359,573	-	-	11,359,573
Small cap value	8,722,468	-	-	8,722,468
Other	527,064	-	-	527,064
Marketable debt securities:				
US government obligations	31,735,616	-	-	31,735,616
Private placement	-	8,996,603	-	8,996,603
Banking and finance	-	9,752,736	-	9,752,736
International	-	6,203,252	-	6,203,252
Utility	-	3,897,766	-	3,897,766
Other	-	19,425,390	-	19,425,390
Alternative investments:				
Commingled funds	-	85,147,948	8,669,516	93,817,464
International hedge funds	-	-	4,825,571	4,825,571
Venture capital funds	-	-	5,179,554	5,179,554
Total	\$ 124,803,333	\$133,423,708	\$ 18,674,641	\$ 276,901,682

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

At December 31, 2012	Level I	Level II	Level III	Total
Cash and cash equivalents	\$ 14,491,559	\$ 50,617	\$ -	\$ 14,542,176
Marketable equity securities:				
SRI large cap	22,077	-	-	22,077
Large cap flex	26,642,255	-	-	26,642,255
Small cap growth	12,959,036	-	-	12,959,036
International	9,081,671	-	-	9,081,671
Small cap value	6,136,226	-	-	6,136,226
Other	178,292	-	-	178,292
Marketable debt securities:				
US government obligations	24,932,327	-	-	24,932,327
Private placement	-	9,259,692	-	9,259,692
Banking and finance	-	11,041,890	-	11,041,890
International	-	3,475,915	-	3,475,915
Utility	-	4,405,823	-	4,405,823
Other	-	19,683,218	-	19,683,218
Alternative investments:				
Commingled funds	-	62,498,917	18,617,733	81,116,650
International hedge funds	-	-	3,168,623	3,168,623
Venture capital funds	-	-	8,561,450	8,561,450
Total	\$ 94,443,443	\$110,416,072	\$ 30,347,806	\$ 235,207,321

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:

	2013	2012
Fair value January 1	\$ 30,347,806	\$ 27,055,386
Realized and unrealized gains (losses)	1,146,712	944,022
Purchases	11,545,579	13,009,261
Sales	(24,365,456)	(10,660,863)
Fair value December 31	<u>\$ 18,674,641</u>	<u>\$ 30,347,806</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 2014 to be allocated amongst participating entities.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. EMPLOYEE BENEFIT PLANS (CONTINUED)

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

2014	\$ 16,945,000
2015	\$ 18,559,000
2016	\$ 20,569,000
2017	\$ 22,658,000
2018	\$ 24,425,000
2019 – 2023	\$ 158,705,000

	<u>2013</u>	<u>2012</u>
Weighted average assumptions used to determine End of the year benefit obligations:		
Discount rate	5.05%	3.95%
Rate of compensation increase	3.00%	3.00%
Weighted average assumptions used to determine Net periodic pension cost:		
Discount rate	3.95%	4.60%
Expected long-term rate of return on plan assets	8.00%	8.00%
Measurement date	12/31/2013	12/31/2012

NOTE 11. INSURANCE ARRANGEMENTS

The System, on the Hospital's behalf, participates in the CHE Trinity Inc. insurance program which provides coverage for healthcare professional (medical malpractice) and general liability exposures. The System had two insurance programs in 2013, as the legacy CHE program merged with Trinity Health's insurance program to form the CHE Trinity Inc. program. Prior to June 1, 2013, the primary limits for healthcare professional and general liability were \$3,000,000 per occurrence and were insured by Stella Maris Insurance Company, Ltd. (SMICL), a Cayman-domiciled insurer wholly-owned by CHE. Subsequent to June 1, 2013, the primary limits were \$20,000,000 for healthcare professional liability and \$1,000,000 for general liability per occurrence. Professional and general liabilities are insured by Venzke Insurance Company, Ltd. (Venzke), a Cayman-domiciled insurer wholly-owned by CHE Trinity, Inc.. Excess coverage was also provided to the System, and this excess coverage is fully reinsured with nonaffiliated commercial insurance companies.

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% and 4% in 2013 and 2012, respectively. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$151,250 and \$138,390, 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, 2013 and 2012 is \$16,624,751 and \$14,600,410, respectively, and is included in long-term portion of insurance liabilities. The charges to expenses for professional and general liability for 2013 and 2012 approximated \$2,817,355 and \$2,649,945, respectively, which has been included in insurance expense. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for professional and general liabilities. The required liability claims and any anticipated insurance recoveries to be reported on a gross basis versus the previous practice of netting the recoveries against liability claims. Amounts recognized as insurance receivables related to the claims approximated \$13,751,000 and \$11,971,000 at December 31,

2013 and 2012, 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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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. INSURANCE ARRANGEMENTS (CONTINUED)

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 a discounted basis based on actuarial estimates of the settlement of such claims. The discount rate applied is 3% and 4% in 2013 and 2012, respectively. The Hospital's portion of the System's current portion of liabilities for unpaid and incurred but not reported claims at December 31, 2013 and 2012 is \$2,831,847 and \$2,571,915, 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, 2013 and 2012 is \$23,803,071 and \$21,535,203, respectively, and is included in long-term portion of insurance liabilities.

The charges to expenses for workers' compensation costs approximated \$5,591,742 and \$5,482,816 in 2013 and 2012, respectively, which has been included in employee benefits expense. In 2011, the Hospital adopted the principles of insurance claim and recovery accounting for workers' compensation liabilities. The required liability claims and any anticipated insurance recoveries to be reported on a gross basis versus the previous practice of netting the recoveries against liability claims. Amounts recognized as insurance receivables related to the claims approximated \$12,272,598 and \$10,868,040 at December 31, 2013 and 2012, 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 \$350,000 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.

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 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 are as follows:

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. CONCENTRATIONS OF CREDIT RISK (CONTINUED)

	<u>2013</u>	<u>2012</u>
Medicare	41%	41%
Medicaid	8	3
Blue Cross	8	7
Other third-party payors	32	37
Patients	<u>11</u>	<u>12</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 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.

Interest Rate Swap: The fair value of the interest rate swaps is determined based on financial models that consider current and future market interest rates and adjustments for nonperformance risk. 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 in the fair value hierarchy.

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, 2013 and 2012. Long-term debt would be classified as Level 2 in the fair value hierarchy.

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 Hierarchal 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

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).

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, 2013 and 2012.

At December 31, 2013	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ 855,379	\$ -	\$ -	\$ 855,379
Marketable equity securities	11,096	-	-	11,096
U.S. Government and agency obligations	<u>457,958</u>	<u>-</u>	<u>-</u>	<u>457,958</u>
	<u>\$ 1,324,433</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,324,433</u>
Investments:				
Cash and cash equivalents	\$ 17,509	\$ -	\$ -	\$ 17,509
International equity securities	125,986	-	-	125,986
Growth equity securities	272,672	-	-	272,672
Value equity securities	46,147	-	-	46,147
Social responsible securities	989	386,172	-	387,161
Fixed income	33,858	49,583	-	83,441
Managed funds	-	-	135,972	135,972
Other	<u>-</u>	<u>442,580</u>	<u>-</u>	<u>442,580</u>
	<u>\$ 497,161</u>	<u>\$ 878,335</u>	<u>\$ 135,972</u>	<u>\$ 1,511,468</u>
Interest rate swap	<u>\$ -</u>	<u>\$ 3,223,924</u>	<u>\$ -</u>	<u>\$ 3,223,924</u>

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

At December 31, 2012	<u>Level I</u>	<u>Level II</u>	<u>Level III</u>	<u>Total</u>
Assets limited as to use:				
Cash and cash equivalents	\$ 2,804,122	\$ 1,556,138	\$ -	\$ 4,360,260
Marketable equity securities	169,585	-	-	169,585
U.S. Government and agency obligations	<u>1,210,794</u>	<u>-</u>	<u>-</u>	<u>1,210,794</u>
	<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
International equity securities	107,327	-	-	107,327
Growth equity securities	218,429	-	-	218,429
Value equity securities	33,427	-	-	33,427
Social responsible securities	721	293,591	-	294,312
Fixed income	31,656	51,516	-	83,172
Managed funds	-	-	124,606	124,606
Other	<u>-</u>	<u>447,322</u>	<u>-</u>	<u>447,322</u>
	<u>\$ 405,195</u>	<u>\$ 792,570</u>	<u>\$ 124,606</u>	<u>\$ 1,322,371</u>
Interest rate swap	<u>\$ -</u>	<u>\$ 6,710,446</u>	<u>\$ -</u>	<u>\$ 6,710,446</u>

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:

	<u>2013</u>	<u>2012</u>
Fair value January 1	\$ 124,606	\$ 96,270
Realized and unrealized gains (losses)	<u>11,366</u>	<u>28,336</u>
Fair value December 31	<u>\$ 135,972</u>	<u>\$ 124,606</u>

Management reports managed funds as a component of its total investment portfolio; therefore it is included in the accompanying table of investments as of December 31, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Fund of Hedge funds (A)	\$ 113,297	\$ 101,739
Real estate (B)	9,695	10,164
Private equity (C)	<u>12,980</u>	<u>12,703</u>
Total	<u>\$ 135,972</u>	<u>\$ 124,606</u>

- (A) The hedge funds have an undetermined life and have varying redemption terms based on quarter ends, semi-annual periods or anniversary dates and require prior written notice ranging from 45 to 95 days. The hedge funds have varying redemption restrictions including 1 to 2 year lock up periods and gate provisions with expiration ranging from 1 to 3.5 years.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. FAIR VALUE MEASUREMENTS (CONTINUED)

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.

- (B) Real estate investments have an unfunded commitment totaling \$1,980 at December 31, 2013 (\$2,251 – 2012) and remaining lives ranging from 1.5 to 9 years. Redemption is not permitted for these investments.
- (C) Private equity investments have an unfunded commitment totaling \$12,980 at December 31, 2013 (\$6,299 – 2012) and remaining lives ranging from 2.5 to 14.5 years. Redemption is not permitted for these investments.

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.

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 2013 and 2012 the Hospital incurred expenses to affiliates for administration services, rent and other services. These expenses approximated \$52,488,381 for 2013 and \$49,694,822 for 2012 and are recorded in the statement of operations. The Hospital also provided cost sharing services to and received reimbursement from affiliates for laboratory, computer and other services. Revenues from these services approximated \$562,052 and \$256,021 for 2013 and 2012, respectively.

During 2013 and 2012, a distribution was made to the parent of \$7,310,772 and \$8,133,390, respectively. During 2013 and 2012, 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, 2013 and 2012 were \$9,906,249 and \$11,711,064, respectively. Amounts due from affiliates at December 31, 2013 and 2012 were \$236,582 and \$88,858, respectively. The amounts due to affiliates are non-interest bearing and have no maturity date.

As of April 1, 2007, a lease agreement between Our Lady of Victory Renaissance 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 Industrial Development Agency Variable Rate Demand Civic Facility Revenue Bonds, Series 2007A." Per the bond agreement, Our Lady of Victory Renaissance Corporation is required to comply with debt service coverage and debt to capitalization covenants. The Hospital is also required to maintain a debt service coverage covenant. The Hospital was in compliant with this covenant as of December 31, 2013 and 2012. Our Lady of Victory Renaissance Corporation failed the debt service coverage and debt to capitalization covenants for December 31, 2013 and 2012. Our Lady of Victory Renaissance obtained a waiver from HSBC Bank USA, NA.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15. RELATED PARTY TRANSACTIONS (CONTINUED)

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, 2013, there was \$5,010,596 of debt outstanding, of which the Hospital has guaranteed \$2,505,298. Per the guaranty agreement, the Hospital'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 the Hospital. In 1998, East Aurora Medical Building, L.P. refinanced its mortgage. As of December 31, 2013, there was \$2,350,161 of debt outstanding, of which Aurora Mercy Corporation has guaranteed the full amount.

NOTE 16. FUNCTIONAL EXPENSES

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

	<u>2013</u>	<u>2012</u>
Healthcare services	\$ 265,695,238	\$ 250,233,345
General and administrative	<u>89,275,210</u>	<u>84,919,015</u>
	<u>\$ 354,970,448</u>	<u>\$ 335,152,360</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 Mercy Hospital of Buffalo (the Hospital) as of December 31, 2013 and for the year then ended and our report thereon appears on page 1 of this document. The financial statements of Mercy Hospital of Buffalo for the year ended December 31, 2012 were audited by other auditors whose report was dated April 25, 2013. 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).

The consolidating information is presented for purposes of additional analysis rather than to present the financial position, results of operations and cash flows of the individual companies 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 consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the 2013 information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Freed Maxick CPAs, P.C.

Buffalo, New York
April 10, 2014

**MERCY HOSPITAL OF BUFFALO
(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, 2013 and 2012**

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>2013</u>	<u>2012</u>
Charity care	\$ 2,891,148	\$ 2,302,097
Cost of community benefit programs	8,791,219	5,515,264
Unpaid cost of Medicaid programs	<u>12,370,985</u>	<u>9,303,920</u>
Social accountability costs	\$ <u>24,053,352</u>	\$ <u>17,121,281</u>

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING BALANCE SHEETS
December 31, 2013

ASSETS	Mercy Hospital of Buffalo	Mercy Hospital Foundation, Inc.	Eliminations	Consolidated
Current assets:				
Cash and cash equivalents	\$ 63,903,853	\$ 778,803	\$ -	\$ 64,682,656
Patient/resident accounts receivable, net of allowance for doubtful accounts of \$9,100,080	54,105,226	-	-	54,105,226
Other receivables	5,345,106	527,312	(773,483)	5,098,935
Inventories	11,112,863	48,331	-	11,161,194
Prepaid expenses and other current assets	570,735	-	-	570,735
Total current assets	135,037,783	1,354,446	(773,483)	135,618,746
Interest in net assets of Mercy Hospital Foundation, Inc.	2,178,883	-	(2,178,883)	-
Assets limited as to use	1,324,433	-	-	1,324,433
Investments	-	1,511,468	-	1,511,468
Due from affiliates	119,943	116,639	-	236,582
Property and equipment, net	101,120,582	8,831	-	101,129,413
Other assets	28,269,784	-	-	28,269,784
Total assets	\$ 268,051,408	\$ 2,991,384	\$ (2,952,366)	\$ 268,090,426
LIABILITIES AND NET ASSETS				
Current liabilities:				
Current portion of long-term obligations	\$ 5,518,461	\$ -	\$ -	\$ 5,518,461
Accounts payable	17,784,597	1,826	37,192	17,823,615
Accrued expenses	15,681,679	-	-	15,681,679
Due to third-party payors	18,110,140	-	-	18,110,140
Due to affiliates	9,906,249	810,675	(810,675)	9,906,249
Total current liabilities	67,001,126	812,501	(773,483)	67,040,144
Long-term obligations, net	45,560,059	-	-	45,560,059
Long-term portion of insurance liabilities	40,427,822	-	-	40,427,822
Pension obligation	96,901,865	-	-	96,901,865
Asset retirement obligation	5,689,954	-	-	5,689,954
Interest rate swap	3,223,924	-	-	3,223,924
Deferred compensation plan	11,096	-	-	11,096
Other long term liabilities	193,704	-	-	193,704
Total liabilities	259,009,550	812,501	(773,483)	259,048,568
Net assets:				
Unrestricted	7,886,053	1,023,078	(1,023,078)	7,886,053
Temporarily restricted	1,033,282	1,033,282	(1,033,282)	1,033,282
Permanently restricted	122,523	122,523	(122,523)	122,523
Total net assets	9,041,858	2,178,883	(2,178,883)	9,041,858
Total liabilities and net assets	\$ 268,051,408	\$ 2,991,384	\$ (2,952,366)	\$ 268,090,426

See accompanying notes.

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS
For the Years Ended December 31, 2013

	Mercy Hospital of Buffalo	Mercy Hospital Foundation, Inc.	Eliminations	Consolidated
Unrestricted revenue and other support:				
Net patient/resident service revenue	\$ 371,395,001	\$ -	\$ -	\$ 371,395,001
Provision for bad debts	(8,730,516)	(11,980)	-	(8,742,496)
Net patient/resident service revenue, less provision for bad debts	362,664,485	(11,980)	-	362,652,505
Other revenue	10,142,503	659,097	-	10,801,600
Net assets released from restrictions used in operations	-	256,000	-	256,000
Total unrestricted revenue and other support	372,806,988	903,117	-	373,710,105
Expenses:				
Salaries and wages	147,687,443	123,786	-	147,811,229
Employee benefits	55,363,953	40,141	-	55,404,094
Medical and professional fees	12,030,133	18,325	-	12,048,458
Purchased services	28,817,464	1,159,010	(988,411)	28,988,063
Supplies	74,844,849	164,330	-	75,009,179
Depreciation and amortization	14,269,808	6,076	-	14,275,884
Interest	2,367,279	3,600	-	2,370,879
Insurance	3,123,236	38	-	3,123,274
Other expenses	15,928,314	11,074	-	15,939,388
Total expenses	354,432,479	1,526,380	(988,411)	354,970,448
Income (loss) from operations	18,374,509	(623,263)	988,411	18,739,657
Nonoperating revenues and losses:				
Investment income	597,709	159,296	-	757,005
Contributions and other, net	44,545	-	-	44,545
Total nonoperating revenues and losses	642,254	159,296	-	801,550
Excess (deficiency) of revenues over expenses	\$ 19,016,763	\$ (463,967)	\$ 988,411	\$ 19,541,207

See accompanying notes.

MERCY HOSPITAL OF BUFFALO
(A SUBSIDIARY OF THE CATHOLIC HEALTH SYSTEM, INC.)

CONSOLIDATING STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS (CONTINUED)
For the Years Ended December 31, 2013

	Mercy Hospital of Buffalo	Mercy Hospital Foundation, Inc.	Eliminations	Consolidated
Unrestricted net assets (deficit):				
Excess of revenues over expenses	\$ 19,016,763	\$ (463,967)	\$ 988,411	\$ 19,541,207
Change in unrealized gain on interest rate swap	3,412,516	-	-	3,412,516
Change in pension obligation, other than net periodic cost	45,520,264	-	-	45,520,264
Change in unrestricted interest in Mercy Hospital Foundation, Inc.	527,508	-	(527,508)	-
Distributions from Foundation	988,411	-	(988,411)	-
Net assets released from restriction used for capital	-	991,475	-	991,475
Distributions to Affiliates	-	-	-	-
Distributions to parent	(7,310,772)	-	-	(7,310,772)
Grant revenue for capital expenditures	940	-	-	940
Increase (decrease) in unrestricted net assets (deficit)	62,155,630	527,508	(527,508)	62,155,630
Temporarily restricted net assets:				
Contributions	-	559,642	-	559,642
Grant Income	-	-	-	-
Special events	-	31,560	-	31,560
Investment income	-	19,183	-	19,183
Temporarily restricted net assets released from restrictions	-	(1,247,475)	-	(1,247,475)
Change in temporarily restricted net assets interest in Mercy Hospital Foundation, Inc.	(637,090)	-	637,090	-
(Decrease) increase in temporarily restricted net assets	(637,090)	(637,090)	637,090	(637,090)
Increase (decrease) in net assets	61,518,540	(109,582)	109,582	61,518,540
Net assets - beginning of year	(52,476,682)	2,288,465	(2,288,465)	(52,476,682)
Net assets - end of year	<u>\$ 9,041,858</u>	<u>\$ 2,178,883</u>	<u>\$ (2,178,883)</u>	<u>\$ 9,041,858</u>

See accompanying notes.