



CONSOLIDATED FINANCIAL STATEMENTS

AND

SUPPLEMENTARY INFORMATION

SEPTEMBER 30, 2012 AND 2011

CPAs / ADVISORS



DEACONESS HEALTH SYSTEM

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

REPORT OF INDEPENDENT AUDITORS

Board of Directors
Deaconess Health System
Evansville, Indiana

We have audited the consolidated balance sheets of Deaconess Health System (System) as of September 30, 2012 and 2011 and the related consolidated statements of operations, changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the System as of September 30, 2012 and 2011, and its consolidated results of operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The supplementary information listed in the accompanying table of contents is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, changes in net assets and cash flows of the individual entities, and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Blue & Co., LLC

December 12, 2012

DEACONESS HEALTH SYSTEM

CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2012 AND 2011

ASSETS

	<u>2012</u>	<u>2011</u>
Current assets		
Cash and cash equivalents	\$ 63,419,560	\$ 59,961,722
Funds held by trustee, current portion	5,712,886	7,247,329
Patient accounts receivable, less allowance for estimated uncollectible amounts of \$45,213,000 in 2012 and \$39,210,000 in 2011	101,449,536	119,968,453
Inventories	6,362,040	5,169,428
Prepaid expenses and other current assets	11,060,431	9,076,499
Total current assets	<u>188,004,453</u>	<u>201,423,431</u>
Investments limited as to use, less current portion		
Board designated funds	254,201,470	180,166,523
Board designated funds - Foundation	5,653,343	4,879,650
Donor restricted - Foundation	5,056,888	3,473,778
Total investments limited as to use	<u>264,911,701</u>	<u>188,519,951</u>
Property and equipment		
Land and improvements	18,316,168	18,026,313
Buildings and improvements	493,491,934	450,882,855
Furniture, fixtures and equipment	254,137,426	206,315,244
	<u>765,945,528</u>	<u>675,224,412</u>
Less allowances for depreciation	422,607,617	385,295,460
	<u>343,337,911</u>	<u>289,928,952</u>
Construction in progress	9,884,463	69,534,614
Total property and equipment, net	<u>353,222,374</u>	<u>359,463,566</u>
Other assets		
Deferred financing costs	2,762,552	2,754,780
Investments in joint ventures	22,865,777	19,151,508
Goodwill	22,217,481	22,180,825
Other	11,679,179	10,158,224
Total other assets	<u>59,524,989</u>	<u>54,245,337</u>
Total assets	<u>\$ 865,663,517</u>	<u>\$ 803,652,285</u>

See accompanying notes to consolidated financial statements.

DEACONESS HEALTH SYSTEM

CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2012 AND 2011

LIABILITIES AND NET ASSETS

	<u>2012</u>	<u>2011</u>
Current liabilities		
Accounts payable and other current liabilities	\$ 33,058,097	\$ 29,225,210
Salaries, wages and related liabilities	39,843,727	33,349,330
Estimated third-party payor settlements	6,415,881	6,062,657
Accrued interest	651,549	726,894
Line of credit	-0-	1,131
Current portion of long-term debt	10,488,544	10,257,530
Total current liabilities	<u>90,457,798</u>	<u>79,622,752</u>
Long-term liabilities		
Long-term debt, less current portion	218,863,067	228,251,902
Other long-term liabilities	90,803,439	69,426,151
Total long-term liabilities	<u>309,666,506</u>	<u>297,678,053</u>
 Total liabilities	 400,124,304	 377,300,805
Net assets		
Unrestricted	451,746,047	413,424,021
Temporarily restricted	3,293,842	2,781,774
Permanently restricted	1,763,046	692,004
Net assets - controlling interest	<u>456,802,935</u>	<u>416,897,799</u>
Non-controlling interest	8,736,278	9,453,681
 Total net assets	 <u>465,539,213</u>	 <u>426,351,480</u>
 Total liabilities and net assets	 <u>\$ 865,663,517</u>	 <u>\$ 803,652,285</u>

See accompanying notes to consolidated financial statements.

DEACONESS HEALTH SYSTEM

CONSOLIDATED STATEMENTS OF OPERATIONS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
Unrestricted revenue and other support		
Net patient service revenue	\$ 675,570,391	\$ 617,237,011
Less provision for bad debts	<u>41,765,158</u>	<u>29,515,858</u>
Net patient service revenue net of provision for bad debts	633,805,233	587,721,153
Other revenue	<u>42,835,021</u>	<u>28,782,408</u>
Total unrestricted revenue and other support	676,640,254	616,503,561
Expenses		
Salaries and wages	251,853,175	238,266,534
Employee benefits	70,832,778	64,306,178
Supplies	110,192,200	110,168,811
Contract services	69,608,219	66,833,086
Repairs and maintenance	19,689,741	19,479,306
Depreciation	39,625,915	36,192,720
Interest	9,227,267	9,309,117
Utilities	13,209,277	13,176,217
Other	<u>51,909,459</u>	<u>28,576,335</u>
Total expenses	<u>636,148,031</u>	<u>586,308,304</u>
Income from operations	40,492,223	30,195,257
Nonoperating revenues (expenses)		
Investment income	8,036,317	7,165,773
Contributions, gifts, and bequests	469,250	764,292
Grants	(1,525,180)	(1,639,834)
Other nonoperating	<u>(4,574)</u>	<u>(610,183)</u>
Total nonoperating revenues (expenses)	<u>6,975,813</u>	<u>5,680,048</u>
Excess revenues over expenses	47,468,036	35,875,305
Other changes in unrestricted net assets		
Net unrealized gain (loss) on investments	20,183,539	(3,583,987)
Pension related changes other than net periodic pension cost	(20,535,930)	(3,997,956)
Net assets released from restriction	692,091	666,949
Other changes in unrestricted net assets	<u>-0-</u>	<u>200,000</u>
Change in unrestricted net assets	47,807,736	29,160,311
Temporarily restricted net assets		
Contributions, gifts and bequests	1,122,293	528,905
Net unrealized gain on investments	57,307	20,199
Investment income	24,559	31,078
Net assets released from restriction	<u>(692,091)</u>	<u>(666,949)</u>
Change in temporarily restricted net assets	512,068	(86,767)
Permanently restricted net assets		
Contributions, gifts and bequests	<u>1,071,042</u>	<u>71</u>
Consolidated change in net assets	49,390,846	29,073,615
Less amount attributable to non-controlling interest	<u>(9,485,710)</u>	<u>(7,276,318)</u>
Change in net assets attributable to controlling interest	<u>\$ 39,905,136</u>	<u>\$ 21,797,297</u>

See accompanying notes to consolidated financial statements.

DEACONESS HEALTH SYSTEM

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	Controlling Interest			Non-controlling Interest	Total
	Unrestricted	Temporarily Restricted	Permanently Restricted		
Net assets					
September 30, 2010	\$ 391,540,028	\$ 2,868,541	\$ 691,933	\$ 8,293,214	\$ 403,393,716
Change in net assets	21,883,993	(86,767)	71	7,276,318	29,073,615
Distributions	-0-	-0-	-0-	(6,115,851)	(6,115,851)
September 30, 2011	413,424,021	2,781,774	692,004	9,453,681	426,351,480
Change in net assets	38,322,026	512,068	1,071,042	9,485,710	49,390,846
Distributions	-0-	-0-	-0-	(10,203,113)	(10,203,113)
September 30, 2012	<u>\$ 451,746,047</u>	<u>\$ 3,293,842</u>	<u>\$ 1,763,046</u>	<u>\$ 8,736,278</u>	<u>\$ 465,539,213</u>

See accompanying notes to consolidated financial statements.

DEACONESS HEALTH SYSTEM

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2012 AND 2011

	2012	2011
Operating activities		
Change in net assets	\$ 49,390,846	\$ 29,073,615
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Depreciation	39,625,915	36,192,720
Provision for bad debts	41,765,158	29,515,858
Net unrealized (gain) loss on investments	(20,240,846)	3,563,788
Net realized gain on investments	(308,747)	(838,075)
(Gain) loss on disposal of assets	(85,189)	610,183
Loss on bond defeasance	95,195	-0-
Amortization of deferred financing costs and original issue discount	211,753	237,872
Pension related changes other than net periodic pension cost	20,535,930	3,997,956
Restricted activity, net	(1,583,110)	(528,976)
Changes in operating assets and liabilities		
Patient accounts receivable	(23,246,241)	(35,697,117)
Inventories	(1,192,612)	941,013
Prepaid expenses and other current assets	(1,983,935)	3,422,407
Investments in joint ventures and other assets	(5,271,880)	377,681
Accounts payable and other current liabilities	2,318,890	(11,426,297)
Salaries, wages and related liabilities	6,494,397	6,273,218
Estimated third-party payor settlements	353,224	536,660
Accrued interest	(75,345)	(295,937)
Other long-term liabilities	841,358	4,465,889
Net cash flows from operating activities	107,644,761	70,422,458
Investing activities		
Purchases of property and equipment	(31,019,808)	(43,723,530)
Proceeds from disposal of property and equipment	385,499	375,700
Net transfers to/from trustee assets for principal, interest and construction draws	1,534,443	28,537,375
Purchases of board designated funds	(147,589,783)	(113,482,502)
Proceeds from sale of board designated funds	93,197,205	78,486,654
Cash paid for goodwill	(36,656)	-0-
Other investing activities	(1,412,923)	5,285
Net cash flows from investing activities	(84,942,023)	(49,801,018)
Financing activities		
Distributions to non-controlling interest investors	(10,203,113)	(6,115,851)
Restricted activity, net	1,583,110	528,976
Payments on line of credit, net	(1,131)	(1,519,057)
Payments on long-term debt	(10,342,299)	(9,647,196)
Proceeds from long-term debt	28,340,000	-0-
Payments to refinance long-term debt	(28,340,000)	-0-
Cash paid for deferred financing costs	(281,467)	-0-
Net cash flows from financing activities	(19,244,900)	(16,753,128)
Change in cash and cash equivalents	3,457,838	3,868,312
Cash and cash equivalents		
Beginning of year	59,961,722	56,093,410
End of year	\$ 63,419,560	\$ 59,961,722

See accompanying notes to consolidated financial statements.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Deaconess Health System (System) is an integrated multi-facility health system providing comprehensive health care services to southern Indiana, southeastern Illinois and western Kentucky, employing over 5,000 within the Tri-State area.

Deaconess Health System, Inc. was formed to coordinate management and strategic planning and provide operational facilities for entities within the System, the most significant of which are Deaconess Hospital, Inc. (Hospital) and Deaconess Clinic, Inc. (Clinic), not-for-profit corporations whose mission is to provide quality health care services with a compassionate and caring spirit to persons, families and communities of the Tri-State area.

The board of Deaconess Health System, Inc. is granted the authority to provide overall direction and control of the entities through their respective bylaws. Deaconess Health System, Inc. wholly owns the Clinic and Deaconess Care Integration, LLC.

The Clinic is comprised of Deaconess employed physicians practicing primary care and multi-specialty medicine within eighteen outpatient physician offices located throughout southern Indiana, southeastern Illinois and western Kentucky and two urgent care centers located in Evansville, Indiana. The facilities provide illness and injury care, preventative care, lab and x-ray services. The Clinic also encompasses the Deaconess Clinical Research Institute which provides drug research studies for the pharmaceutical industry.

Deaconess Care Integration, LLC was formed on February 7, 2012 as an accountable care organization with the purpose of developing a care delivery model focused on quality metrics and reductions in cost for the Medicare population.

The Hospital, located in Evansville, Indiana, is comprised of two general acute care facilities, a mental health facility and two outpatient primary care facilities for seniors. The inpatient services have a combined capacity of 523 intensive care, pediatric, medical/surgical, orthopedic and neurosurgical beds.

The Hospital holds majority ownership interests in the following entities:

- The Heart Hospital at Deaconess Gateway, LLC – 51%
- Progressive Health of Indiana, LLC – 51%
- Tri-State Radiation Oncology, LLC – 51%
- Deaconess Health Plans, LLC – 94%

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The Heart Hospital at Deaconess Gateway, LLC is a 24 bed hospital providing preventative care, medical care, emergent care, diagnostic testing, cardiovascular procedures, cardiovascular surgery and cardiac rehabilitation on an outpatient and inpatient basis.

Progressive Health of Indiana, LLC provides physical, occupational and speech therapy services throughout southern Indiana.

Tri-State Radiation Oncology, LLC provides oncology and cancer services, including radiation therapy, pain management, counseling and rehabilitation.

Deaconess Health Plans, LLC is a preferred provider organization – managed care network formed to encourage collaboration in providing patient service and cost management.

Heartcare Health System, LLC facilitated collaboration on cardiac services with an emphasis on cost reduction and quality improvement. During 2012, the services and functions of Heartcare Health System, LLC were integrated into the Hospital and all remaining net assets of Heartcare Health System, LLC were distributed.

Principles of Consolidation

The consolidated financial statements include the accounts of Deaconess Health System and its wholly owned and controlled subsidiaries. All material inter-company accounts and transactions have been eliminated in consolidation.

Investments in Joint Ventures

The Hospital holds a 50% ownership in the Deaconess Women's Hospital of Southern Indiana, LLC d/b/a The Women's Hospital which is a 74-bed facility dedicated to comprehensive women's care, including obstetrics, neonatal intensive care, cancer treatment and infertility and imaging services. The Hospital recorded an investment in The Women's Hospital of approximately \$5,280,000 and \$2,612,000 as of September 30, 2012 and 2011, respectively. During 2012 and 2011, the Hospital received income distributions of approximately \$2,221,000 and \$4,012,000, respectively.

The Hospital holds a 22% ownership interest in HealthSouth/Deaconess, LLC, d/b/a HealthSouth Deaconess Rehabilitation Hospital, an 80-bed comprehensive facility dedicated to improving, maintaining or restoring physical strength, cognition and mobility through therapeutic methods and technologies for rehabilitation. The Hospital recorded an investment in the HealthSouth Deaconess Rehabilitation

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Hospital of approximately \$3,997,000 and \$4,339,000 as of September 30, 2012 and 2011, respectively. During 2012 and 2011, the Hospital received income distributions of approximately \$2,044,000 and \$1,461,000, respectively.

The Hospital holds a 50% ownership interest in Evansville Surgery Center Associates, LLC providing two locations of multispecialty outpatient surgery centers dedicated to the diagnosis and preoperative, intraoperative and postoperative care of patients. The Hospital recorded an investment in Evansville Surgery Center Associates, LLC of approximately \$10,138,000 and \$10,478,000 as of September 30, 2012 and 2011, respectively. During 2012 and 2011, the Hospital received income distributions of approximately \$9,125,000 and \$10,025,000, respectively.

The Hospital holds a 12.5% ownership interest in the Indiana Healthcare Reciprocal Risk Retention Group which was formed to provide liability insurance, reinsurance and risk management services to the members. No income distributions were received in 2012 and 2011.

On December 31, 2011, the Hospital acquired a 33.3% of the membership shares in The Healthcare Group, LLC, a preferred provider organization – managed care network, in exchange for the Hospital accepting a governance role and responsibility to share in the losses and gains and other obligations. The Healthcare Group, LLC encourages collaboration in providing patient service and cost management.

Investments in organizations where the System's ownership percentage is equal to or less than 50% are included in investments in joint ventures on the consolidated balance sheets. The System's portion of income from unconsolidated organizations is reported with other revenue and was approximately \$16,294,000 and \$15,052,000 for 2012 and 2011, respectively.

Use of Estimates

The preparation of the 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, including the allowance for estimated uncollectible accounts, estimated third-party payor settlements, defined pension plan obligations and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

New Accounting Pronouncement

As permitted, effective September 1, 2011, the System elected to early adopt Accounting Standards Update (ASU) 2011-07, Healthcare Entities (Topic 954), "Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Healthcare Entities," which requires certain healthcare entities to present the provision for bad debts relating to patient service revenue as a deduction from patient service revenue in the consolidated statement of operations rather than as an operating expense. All periods presented have been reclassified to conform to this presentation. The System's adoption of this standard had no net impact on the consolidated financial position, results of operations, or cash flows.

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

Charity Care, Community Benefit and Assistance to the Uninsured

The System provides care to patients regardless of their ability to pay. A patient is classified as a charity patient by reference to certain established policies of the System. Essentially, these policies define charity services as those services for which no payment or reduced payment based upon a graduated scale, is anticipated, up to 300% of Federal Poverty Income Guidelines, published by the Department of Health and Human Services and where incurred charges are considered significant when compared to the income of the patient. Because collection of amounts determined to qualify as charity care is not pursued, such amounts are not reported as revenue.

The System enhanced its charity care policy to more accurately reflect current economic conditions and other factors unique to the System's customer base. Charity care provided during 2012 and 2011, measured at established rates, was approximately \$86,824,000 and \$81,453,000, respectively. In addition, other programs and services for the benefit of the community are provided. The costs of these programs are included in operating expenses. The System receives reimbursements from certain governmental payors to assist in the funding of charity care.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Of the System's total expenses reported (approximately \$636,148,000 and \$586,308,000 during 2012 and 2011, respectively), an estimated \$30,587,000 and \$28,509,000 arose from providing services to charity patients during 2012 and 2011, respectively. The estimated costs of providing patient assistance services are based on a calculation which applies a ratio of costs to charges to the gross uncompensated charges associated with providing care to charity patients. The ratio of cost to charges is calculated based on the Hospital's total expenses divided by gross patient service revenue.

The System has a policy for uninsured patients with discounted rates similar to contractual payors. Uninsured self pay discounts provided to patients were approximately \$15,542,000 and \$2,949,000 in 2012 and 2011, respectively.

Statements of Cash Flows

Cash and cash equivalents are defined as investments in highly liquid debt instruments with an original maturity of three months or less, excluding amounts whose use is limited by arrangements under trust agreements, board designation or by donors. The System maintains its cash in accounts, which at times may exceed federally insured limits. The policy of the System is to collateralize deposits. The System has not experienced any losses in such accounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Additional cash flows information for 2012 and 2011 is as follows;

	<u>2012</u>	<u>2011</u>
Supplemental cash flows information:		
Cash paid for interest, net of capitalized interest	\$ 9,303,000	\$ 9,256,000
Interest expense capitalized	\$ -0-	\$ 911,000
Interest income capitalized	\$ -0-	\$ 134,000
Property and equipment in liabilities	\$ 2,585,000	\$ 1,071,000
Equipment acquired through capital leases	\$ 2,665,225	\$ 3,504,000

Patient Accounts Receivable, Estimated Third-Party Payor Settlements and Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered. Estimated retroactive adjustments under reimbursement agreements with certain third-party payors are included with estimated third-party payor settlements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Patient accounts receivable are reduced by an allowance for uncollectible accounts based on the System's evaluation of its major payor sources of revenue, the aging of the accounts, historical losses, current economic conditions, and other factors unique to its service area and the healthcare industry. Management regularly reviews data about the major payor sources of revenue in evaluating the sufficiency of the allowance for uncollectible accounts. For receivables associated with services provided to patients who have third-party coverage, the System analyzes contractually due amounts and provides an allowance for uncollectible accounts and a provision for bad debts, if necessary. For receivables associated with self-pay payments the System records a significant provision for bad debts in the period of service on the basis of its past experience, which indicates that many patients are unable or unwilling to pay the portion of their bill for which they are financially responsible. The difference between the standard rates (or the discounted rates if negotiated) and the amounts actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for uncollectible accounts.

During 2012, the System's allowance for uncollectible accounts changed from approximately \$39,210,000 to \$45,213,000. The change was the result of the System's most recent experience primarily related to self-pay patients. As of September 30, 2012, the allowance for uncollectible accounts of \$45,213,000 was comprised of \$41,881,000 reserved for self-pay balances and \$3,332,000 reserved for third-party payor balances. As of September 30, 2011, the allowance for uncollectible accounts of \$39,210,000 was comprised of \$36,087,000 reserved for self-pay balances and \$3,123,000 reserved for third-party payor balances.

Inventories

Inventories (principally pharmaceuticals and medical supplies) are stated at the lower of cost (first in, first out) or market.

Property and Equipment and Depreciation

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable assets, ranging from 3 to 40 years, using the straight-line method. Equipment under capital leases are amortized on the straight-line method over the lease term or the estimated useful life of the equipment, if shorter.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Investments Limited as to Use

Investments are stated at fair value. Dividends, interest income and realized gains and losses on sales of investments are recorded as nonoperating investment income. Unrealized gains (losses) on investments are reported as other changes in net assets in the consolidated statements of operations.

Investments consist of short-term investments (principally money market mutual funds), US Government and government agency obligations, marketable debt securities (corporate bonds and fixed income mutual funds), marketable equity securities (common and preferred corporate stock), equity mutual funds and private equity investments and mortgage and asset-backed securities. Fair values for investments are based on quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Private equity investments consist of limited partnerships investing in common stock of small and medium capitalization companies. Investments in those limited partnerships are reported at fair value as determined by the individual manager of each partnership. Although the manager uses its best judgment in estimating the fair value of the investments in the investment funds, there are inherent limitations in any estimation technique. Therefore, the values reported are not necessarily indicative of the amount that the investments funds could realize in a current transaction.

These estimated values may differ significantly from the values that would have been used had a ready market for the investments in the investment funds existed and the difference could be material. Private equity investments totaled approximately \$6,778,000 and \$5,049,000 (2.5% and 2.6% of investment portfolio) as of September 30, 2012 and 2011, respectively.

Investments limited as to use include assets held by trustees under indenture agreements, amounts set aside by the Board of Directors for future capital improvements, retirement of debt over which the Board retains control and may at its discretion subsequently designate for other purposes and amounts designated by for the Foundation and donor restrictions. Amounts required to meet current liabilities of the System have been classified as current assets.

Foundation

The Hospital also encompasses a charitable Foundation supported by donations from the community. The Foundation has a separate advisory board who carry out the mission of supporting medical, charitable and educational activities as designated by the donors.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Deferred Financing Costs

Costs incurred in connection with the issuance of debt are amortized over the term of the related debt using the bonds outstanding method. Estimated annual amortization is approximately \$200,000.

Goodwill

As of September 30, 2012 and 2011, the System recorded goodwill of approximately \$22,217,000 and \$22,181,000 respectively, related to the acquisition of majority owned entities.

Goodwill is tested for impairment on an annual basis, or whenever an event occurs or circumstances indicate the carrying value of the goodwill may be impaired. The System performed the required annual impairment test for goodwill as of September 30, 2012 using the income approach of calculating the present value of the future cash flows. The System determined no impairment of goodwill existed as of September 30, 2012 and 2011.

Medical Malpractice

Malpractice insurance coverage is provided under a claims-made policy. Should the claims-made policy be terminated, the Hospital has the option to purchase insurance for claims having occurred during its term but reported subsequently. Prior to July 1, 1999, the Indiana Medical Malpractice Act (Act) provided for a maximum recovery of \$750,000 per occurrence (\$3,000,000 annual aggregate) for professional liability, \$100,000 of which would be paid through the Hospital's malpractice insurance coverage and the balance would be paid by the State of Indiana Patient Compensation Fund (Fund). For claims on or after July 1, 1999, the Act provides for a maximum recovery of \$1,250,000 per occurrence (\$7,500,000 annual aggregate) with the first \$250,000 covered by the Hospital's insurance and the remainder by the Fund.

Effective October 1, 2003, the System became a member in a Vermont captive insurance company, Indiana Healthcare Reciprocal Risk Retention Group, to fund the Hospital's required portion of the professional, physician insurance coverage pursuant to the Act as well as its general liability insurance and excess coverage. This provides protection from liability in an amount not to exceed \$250,000 per incident and aggregate liability protection not to exceed \$7,500,000 per year. In addition, the Hospital maintains a commercial umbrella/excess liability policy with a limit of \$15,000,000 each occurrence, \$15,000,000 aggregate per member and \$30,000,000 total policy aggregate.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Performance Indicator

The consolidated statements of operations contain a performance indicator, excess revenues over expenses. Consistent with industry practice, unrealized gain and loss on other than trading investments, pension related changes other than net periodic pension cost, equity transfers, contributions restricted for long-term purposes and certain other items are excluded from the performance indicator.

Pension Plan

The System offers a defined benefit pension plan covering eligible employees. The benefits are based on years of service and each employee's compensation during the years of employment. Contributions to the plan include amortization of past service costs plus interest thereon over approximately ten years and are currently funded.

Income Taxes

Deaconess Health System, Inc., Hospital and Clinic are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code (Code) and are exempt from Federal and state income taxes on related income pursuant to Section 501(a) of the Code. However, they are required to file Federal Form 990 – Return of Organization Exempt from Income Tax which is an informational return only.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the System and recognize a tax liability if the System has taken an uncertain position that more likely than not would not be sustained upon examination by various Federal and state taxing authorities. Management has analyzed the tax positions taken by the System and has concluded that as of September 30, 2012 and 2011, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying consolidated financial statements. The System is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The remaining consolidated subsidiaries are organized as limited liability companies, whereby net taxable income is taxed directly to the members of the limited liability companies. Thus, the consolidated financial statements do not include any provision for Federal or state income taxes related to these entities.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

These entities have filed their Federal and state income tax returns for periods through their most recent fiscal year ends (primarily December 31, 2011). These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

Contribution Revenues and In-Kind Donations

Unconditional promises to give cash and other assets to the System are reported at fair value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair value at the date the gift is received. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified as unrestricted net assets and reported in the consolidated statements of operations as net assets released from restriction. Donor-restricted contributions whose restrictions are met within the same year as received are included in nonoperating revenues (expenses) in the accompanying consolidated financial statements.

In-kind donations are recorded as revenue and expense in the accompanying consolidated financial statements. These donations consist mainly of medical supplies and services which are recorded at their estimated fair values.

Temporarily Restricted Net Assets

Temporarily restricted net assets include those assets whose use by the System has been temporarily limited primarily for capital projects or a specified time period or purpose. The following is a summary of temporarily restricted net assets as of September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Patient medical care	\$ 965,132	\$ 1,044,982
Education and scholarship	556,836	464,451
Capital projects	564,374	534,485
Other System support	1,207,500	737,856
	<u>\$ 3,293,842</u>	<u>\$ 2,781,774</u>

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Permanently Restricted Net Assets

Permanently restricted net assets are contributed with donor restrictions requiring they be held in perpetuity with income used to support the System's activities. The following is a summary of permanently restricted net assets as of September 30, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Beneficial interest in trusts	\$ 1,071,042	\$ -0-
Other	<u>692,004</u>	<u>692,004</u>
	<u>\$ 1,763,046</u>	<u>\$ 692,004</u>

Electronic Health Records (EHR) Incentive Payments

The System receives EHR incentive payments under the Medicare and Medicaid programs. To qualify for the EHR incentive payments, the System must meet "meaningful use" criteria that become more stringent over time. The System periodically submits and attests to its use of certified EHR technology, satisfaction of meaningful use objectives, and various patient data. These submissions generally include performance measures for each annual EHR reporting period (Federal fiscal year ending September 30th). The related EHR incentive payments are paid out over a four year transition schedule and are based upon data that is captured in the System's cost reports. The payment calculation is based upon an initial amount as adjusted for discharges, Medicare and Medicaid utilization using inpatient days multiplied by a factor of total charges excluding charity care to total charges, and a transitional factor that ranges from 100% in first payment year and thereby decreasing by 25% each payment year until it is completely phased out in the fifth year.

The System recognizes EHR incentive payments as income when there is reasonable assurance that the System will comply with the conditions of the meaningful use objectives and any other specific requirements. In addition, the financial statement effects of the income must be both recognizable and measurable. During 2012 and 2011, the System recognized approximately \$6,891,000 and \$-0-, respectively, in EHR incentive payments as income.

EHR incentive income is included in other revenue in the consolidated statements of operations. EHR incentive income recognized is based on management's estimate and amounts are subject to change, with such changes impacting operations in the period the changes occur.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Receipt of these funds is subject to the fulfillment of certain obligations by the Hospital as prescribed by the program, subject to future audits and may be subject to repayment upon a determination of noncompliance.

Advertising Costs

Advertising costs are expensed as incurred. Total expense for 2012 and 2011 was approximately \$1,736,000 and \$1,991,000, respectively.

Functional Expenses

The System provides health care services to patients in the community and the surrounding areas. Health care services and other certain related expenses approximated 93% of total expenses in 2012 and 2011. General and administrative expenses approximated 6% in 2012 and 2011. Fundraising expenses comprised less than 1% of total expenses in 2012 and 2011.

Reclassification

Certain 2011 amounts in the consolidated financial statements have been reclassified to conform to the 2012 presentation.

Subsequent Events

The System evaluated events or transactions occurring subsequent to the consolidated balance sheet date for recognition and disclosure in the accompanying consolidated financial statements through the date the consolidated financial statements are issued which is December 12, 2012.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

2. NET ASSET RECLASSIFICATION

During 2012 as a result of the System's review of donor restricted contributions, the System determined that the classification of net assets should be restated to correctly reflect the intent of donor restrictions. The following is a summary of the net asset reclassification for 2011:

	September 30, 2011		
	Originally Reported	Adjustment	Restated
Consolidated balance sheet			
Investments limited as to use			
Board designated funds - Foundation	\$ -0-	\$ 4,879,650	\$ 4,879,650
Donor restricted - Foundation	8,353,428	(4,879,650)	3,473,778
	\$ 8,353,428	\$ -0-	\$ 8,353,428
Net assets - controlling interest			
Unrestricted	\$ 408,544,371	\$ 4,879,650	\$ 413,424,021
Temporarily restricted	8,353,428	(5,571,654)	2,781,774
Permanently restricted	-0-	692,004	692,004
Net assets - controlling interest	\$ 416,897,799	\$ -0-	\$ 416,897,799
Consolidated statement of operations			
Change in			
Unrestricted net assets	\$ 28,850,676	\$ 309,635	\$ 29,160,311
Temporarily restricted net assets	222,939	(309,706)	(86,767)
Permanently restricted net assets	-0-	71	71
Change in net assets	\$ 29,073,615	\$ -0-	\$ 29,073,615
Consolidated statement of changes in net assets			
Net assets - controlling interest			
September 30, 2010			
Unrestricted	\$ 386,970,013	\$ 4,570,015	\$ 391,540,028
Temporarily restricted	8,130,489	(5,261,948)	2,868,541
Permanently restricted	-0-	691,933	691,933
Net assets - controlling interest	\$ 395,100,502	\$ -0-	\$ 395,100,502

The impact of the net asset reclassification was not significant on the consolidated statement of cash flows.

3. NET PATIENT SERVICE REVENUE

Entities within the System have agreements with third-party payors that provide for payments at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Medicare

Inpatient acute care services, outpatient services and physician services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic and other factors. Certain outpatient services and defined medical education costs related to Medicare beneficiaries are paid based on cost reimbursement methodologies. The System's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. Inpatient non-acute care services are generally reimbursed based upon cost reimbursement methodologies.

Medicaid and Hospital Assessment Fee Program

Medicaid services are paid at prospectively determined rates per day or per discharge for inpatients or per occasion of service for outpatients. To the extent that services to Medicare and Medicaid program beneficiaries are reimbursed based on cost reimbursement methodologies, final settlement is determined after submission of annual cost reports and audits thereof by the fiscal intermediary.

During 2012, Hospital Assessment Fee (HAF) Program for the period July 1, 2011 through June 30, 2013 was approved by Centers for Medicare & Medicaid Services retroactive to July 1, 2011. The purpose of the HAF Program is to fund the State share of enhanced Medicaid payments and Medicaid Disproportionate Share (DSH) payments for Indiana hospitals as reflected in the HAF Program expense reported in the consolidated statements of operations. Previously, the State share was funded by governmental entities through intergovernmental transfers. The Medicaid enhanced payments relate to both fee for service and managed care claims. The Medicaid enhanced payments are designed to follow the patients and result in increased Medicaid rates. During 2012, the Hospital recognized HAF Program expense of approximately \$23,509,000 which resulted in Medicaid rate increases of approximately \$30,322,000. HAF Program expense is included in other expenses on the consolidated statements of operations.

Estimates for final settlements of all unaudited Medicare and Medicaid cost reports through September 30, 2012 have been recorded. Cost reports through September 30, 2006 have been audited and settled as of September 30, 2012.

Entities within the System also entered into payment agreements with certain other commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

A reconciliation of the amount of services provided to patients at established rates to net patient service revenue as presented in the consolidated statements of operations for 2012 and 2011 is as follows:

	2012	2011
Patient service revenue	\$ 1,805,742,287	\$ 1,675,143,029
Adjustments		
Charity care revenue foregone	86,824,440	81,452,985
Uninsured self pay discounts	15,541,694	2,948,832
Contractual adjustments	1,027,805,762	973,504,201
Total adjustments	1,130,171,896	1,057,906,018
Net patient service revenue	675,570,391	617,237,011
Less provision for bad debts	41,765,158	29,515,858
Net patient service revenue net of provision for bad debts	\$ 633,805,233	\$ 587,721,153

Changes to any previous year's estimated settlement are reflected in the period the intermediary finalizes its audit of cost reports, or when additional information becomes available. Settlements related to prior year cost reports and other estimated third-party items resulted in an increase to net patient service revenue of approximately \$2,356,000 and \$1,909,000 in 2012 and 2011, respectively.

The following is mix of gross patient accounts receivable and gross patient service revenue for 2012 and 2011:

	Receivable		Revenue	
	2012	2011	2012	2011
Medicare	24%	26%	46%	45%
Medicaid	13%	9%	10%	10%
Commercial and managed care	35%	41%	38%	39%
Self pay and other	28%	24%	6%	6%
	100%	100%	100%	100%

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that recorded estimates will change in the near term.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

4. INVESTMENTS

Investments at fair value consisted of the following as of September 30:

	2012	2011
Board designated funds		
Cash and short-term investments	\$ 2,992,774	\$ 591,494
Common stock	35,398,383	22,043,184
Preferred stock	450,005	-0-
Mutual funds	147,400,360	96,254,466
US Government and government agency obligations	20,761,205	18,048,393
Corporate bonds	30,024,887	37,769,979
Private equity	6,777,561	5,049,449
Mortgage backed securities	10,396,295	-0-
Accrued interest and other	-0-	409,558
	254,201,470	180,166,523
Funds held by trustee		
Cash and short-term investments	5,712,886	1,687,395
US Government and government agency obligations	-0-	5,559,934
	5,712,886	7,247,329
Less current portion	5,712,886	7,247,329
	-0-	-0-
Board designated - Foundation and donor restricted - Foundation		
Cash and short-term investments	169,841	164,989
Common stock	1,480,112	1,271,493
Preferred stock	57,710	-0-
Mutual funds	6,627,959	5,720,205
US Government and government agency obligations	997,321	953,936
Accrued interest and other	1,377,288	242,805
	10,710,231	8,353,428
Investments limited as to use, net	\$ 264,911,701	\$ 188,519,951

Investments reported as current assets are those that the System has made available for use in operations within the next twelve months. Investments limited as to use that are required for obligations classified as current liabilities are also reported in current assets.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

A detail of investment income for unrestricted and donor restricted for 2012 and 2011 is as follows:

	2012	2011
Interest and dividends	\$ 7,752,129	\$ 6,358,776
Net realized gain	308,747	838,075
Investment income, net	\$ 8,060,876	\$ 7,196,851

The following schedule summarizes the fair value of securities included in investments limited as to use that have gross unrealized losses (the amount by which historical cost exceeds the fair value) as of September 30, 2012 and 2011. The schedule further segregates the securities that have been in a gross unrealized position as of September 30, 2012 and 2011, for less than twelve months and those for twelve months or more. The gross unrealized losses of less than twelve months are a reflection of the normal fluctuations of the market and are therefore considered temporary.

The gross unrealized losses of twelve months or longer are reflective of current market fluctuations. The majority of the decline is attributable to several securities which industry experts expect recovery in the short-term future. These individual investments have projected recoveries in value in 2013. The decline in value is determined by management to be temporary, and unrealized losses have not been reclassified to realized losses as of September 30, 2012 and 2011.

Description of Securities	September 30, 2012					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government and government agency obligations	\$ 1,725,604	\$ 3,053	\$ -0-	\$ -0-	\$ 1,725,604	\$ 3,053
Common stocks	1,069,138	55,171	6,252,512	1,672,637	7,321,650	1,727,808
Preferred stocks	112,806	712	-0-	-0-	112,806	712
Mutual funds	-0-	-0-	3,264,368	445,497	3,264,368	445,497
Corporate bonds	1,401,616	22,597	1,385,162	37,924	2,786,778	60,521
Mortgage backed securities	784,727	6,121	338,052	14,735	1,122,779	20,856
Total temporarily impaired securities	\$ 5,093,891	\$ 87,654	\$ 11,240,094	\$ 2,170,793	\$ 16,333,985	\$ 2,258,447

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Description of Securities	September 30, 2011					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government and government agency obligations	\$ 1,574,306	\$ 6,786	\$ -0-	\$ -0-	\$ 1,574,306	\$ 6,786
Marketable debt securities	5,267,374	99,056	134,064	27,599	5,401,438	126,655
Marketable equity securities	897,406	118,979	32,170,595	5,562,816	33,068,001	5,681,795
Total temporarily impaired securities	<u>\$ 7,739,086</u>	<u>\$ 224,821</u>	<u>\$ 32,304,659</u>	<u>\$ 5,590,415</u>	<u>\$ 40,043,745</u>	<u>\$ 5,815,236</u>

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

5. FAIR VALUE MEASUREMENTS

The System's investments are reported at fair value in the accompanying consolidated balance sheets. Fair value is defined as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction, which requires an entity to maximize the use of observable inputs when measuring fair value.

The following provides a description of the three levels of inputs that may be used to measure fair value under the standard, the types of the System's investments that fall under each category and the valuation methodologies used to measure these investments at fair value.

Level 1 Fair Value Measurements

Inputs to the valuation methodology are quoted prices available in the active markets for identical investments as of the reporting date.

The fair value of common and preferred stocks is based on the closing price reported on the active market on which the individual securities are traded.

The fair value of mutual funds is based on quoted net asset values of the shares held by the System at year-end. The net asset value is based on the value of the underlying assets owned by the fund, minus its liabilities and then divided by the number of shares outstanding. The net asset value is quoted in an active market.

The fair value of US Government and government agency obligations is based on the closing price reported on the active market on which the securities are traded.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Level 2 Fair Value Measurements

Inputs to the valuation methodology are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date and fair value can be determined through the use of models or other valuation methodologies.

The fair value of corporate bonds and mortgage and other backed securities is based quoted prices in markets that are not active or for which significant inputs are observable either directly or indirectly.

Level 3 Fair Value Measurements

Inputs to the valuation methodology are unobservable inputs in situations where there is little or no market activity for the asset or liability and the reporting entity makes estimates and assumptions related to the pricing of the asset or liability including assumptions regarding risk.

Private equity investments, consisting of mainly limited partnerships, are valued at the percentage ownership of the net asset value as reported to the System by the individual managers. The limited partnerships invest in a variety of domestic and foreign equity and debt securities, managed accounts and other investment vehicles that employ diversified styles and strategies.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and 2011 are as follows:

	September 30, 2012			
	Total	Level 1	Level 2	Level 3
Assets				
Investments limited as to use				
Common stock				
Consumer	\$ 9,935,385	\$ 9,935,385	\$ -0-	\$ -0-
Financial services	4,242,989	4,242,989	-0-	-0-
Industrial and materials	9,109,406	9,109,406	-0-	-0-
Technology	6,406,306	6,406,306	-0-	-0-
Healthcare	3,278,723	3,278,723	-0-	-0-
Other	3,905,686	3,905,686	-0-	-0-
Total common stock	36,878,495	36,878,495	-0-	-0-
Preferred stock				
Financial	420,747	420,747	-0-	-0-
Other	86,968	86,968	-0-	-0-
Total preferred stock	507,715	507,715	-0-	-0-
Mutual funds				
Intermediate term bond	99,949,527	99,949,527	-0-	-0-
International equity	16,820,866	16,820,866	-0-	-0-
Large cap	34,588,657	34,588,657	-0-	-0-
Mid cap	1,233,567	1,233,567	-0-	-0-
Other	1,435,702	1,435,702	-0-	-0-
Total mutual funds	154,028,319	154,028,319	-0-	-0-
US Government and government agency obligations	21,758,526	21,758,526	-0-	-0-
Corporate bonds				
Consumer	4,111,625	-0-	4,111,625	-0-
Financial services	13,429,903	-0-	13,429,903	-0-
Industrial and materials	3,929,351	-0-	3,929,351	-0-
International	3,549,521	-0-	3,549,521	-0-
Other	5,004,487	-0-	5,004,487	-0-
Total corporate bonds	30,024,887	-0-	30,024,887	-0-
Mortgage backed securities	10,396,295	-0-	10,396,295	-0-
Private equity	6,777,561	-0-	-0-	6,777,561
	260,371,798	<u>\$ 213,173,055</u>	<u>\$ 40,421,182</u>	<u>\$ 6,777,561</u>
Cash and cash equivalents	8,875,501			
Accrued interest and other	1,377,288			
	<u>\$ 270,624,587</u>			

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

	September 30, 2011			
	Total	Level 1	Level 2	Level 3
Assets				
Investments limited as to use				
Common stock				
Consumer	\$ 6,192,511	\$ 6,192,511	\$ -0-	\$ -0-
Financial services	3,787,908	3,787,908	-0-	-0-
Industrial and materials	3,401,834	3,401,834	-0-	-0-
Technology	3,769,918	3,769,918	-0-	-0-
Other	6,162,506	6,162,506	-0-	-0-
Total common stock	23,314,677	23,314,677	-0-	-0-
Mutual funds				
Intermediate term bond	59,261,226	59,261,226	-0-	-0-
International equity	9,954,790	9,954,790	-0-	-0-
Large cap	18,339,899	18,339,899	-0-	-0-
Small cap	14,418,756	14,418,756	-0-	-0-
Total mutual funds	101,974,671	101,974,671	-0-	-0-
US Government and government agency obligations				
	24,562,263	24,562,263	-0-	-0-
Corporate bonds				
Financial services	14,224,594	-0-	14,224,594	-0-
Industrial and materials	6,267,542	-0-	6,267,542	-0-
Other	17,277,843	-0-	17,277,843	-0-
Total corporate bonds	37,769,979	-0-	37,769,979	-0-
Private equity				
	5,049,449	-0-	-0-	5,049,449
	192,671,039	\$ 149,851,611	\$ 37,769,979	\$ 5,049,449
Cash and cash equivalents				
	2,443,878			
Accrued interest and other				
	652,363			
	\$ 195,767,280			

The following table sets forth a summary of changes in the fair value of level 3 assets for the years ended September 30, 2012 and 2011:

	2012	2011
Beginning of year	\$ 5,049,449	\$ 2,655,254
Unrealized and realized gain	228,112	1,394,195
Purchases	1,500,000	1,000,000
End of year	\$ 6,777,561	\$ 5,049,449

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The following methods and assumptions were used by the System in estimating the fair value of its financial instruments:

Cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements: The carrying amount reported in the consolidated balance sheets for cash and cash equivalents, accounts payable, other current liabilities, salaries, wages and related liabilities and estimated third-party settlements approximate fair value based on short term maturity.

Long-term debt: Fair value of the System's fixed rate revenue bonds is based on current transacted value. The fair value of the System's remaining long-term debt approximates carrying value based upon the underlying nature of the related debt.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

6. LONG-TERM DEBT

The following is a summary of long-term debt as of September 30, 2012 and 2011:

	2012	2011
Hospital Revenue Bonds, Series 1992 Serial bonds, payable annually from January 2004 through January 2022 in amounts ranging from \$300,000 to \$1,700,000 plus interest at variable rates (.18% and .13% as of September 30, 2012 and 2011, respectively)	\$ 12,900,000	\$ 13,800,000
Hospital Revenue Refunding Bonds, Series 1993 Variable Rate Certificates with maturities beginning in 2004 and ending in 2015; interest rate at SIFMA plus 125 basis points (1.43% as of September 30, 2011); refinanced in 2012	-0-	11,140,000
Hospital Revenue Refunding Bonds, Series 1999A Term bonds, payable from March 2010 through March 2029 in amounts ranging from \$605,000 to \$1,715,000 with interest; rates ranging from 5.50% to 5.75%; refinanced in 2012	-0-	20,270,000
Hospital Revenue Bonds, Series 1999B (taxable) Serial bonds, payable annually from January 2003 through January 2019 in amounts ranging from \$500,000 to \$1,600,000 plus interest at variable rates (.27% and .36% as of September 30, 2012 and 2011, respectively)	9,200,000	10,200,000
Hospital Revenue Bonds, Series 2004A Term bonds, payable from March 2020 through March 2034 in amounts ranging from \$440,000 to \$8,065,000 with interest; rates ranging from 5.00% to 5.375%	54,765,000	54,765,000
Hospital Revenue Bonds, Series 2004B Serial bonds, payable annually from January 2010 through January 2029 in amounts ranging from \$870,000 to \$1,720,000 plus interest at variable rates (.19% and .16% as of September 30, 2012 and 2011, respectively)	22,290,000	23,225,000
Hospital Revenue Bonds, Series 2009A Term bonds, payable annually from March 2020 through March 2039 in amounts ranging from \$55,000 to \$12,110,000 with interest; fixed rate 6.75%	57,340,000	57,340,000

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

	2012	2011
Hospital Revenue Bonds, Series 2009B Serial bonds, payable annually from March 2016 through March 2039 in amounts ranging from \$195,000 to \$2,855,000 plus interest at variable rates (.17% and .19% as of September 30, 2012 and 2011, respectively)	\$ 40,000,000	\$ 40,000,000
Hospital Revenue Bonds, Series 2011A Term bonds, payable from March 2012 through March 2029 in amounts ranging from \$770,000 to \$1,630,000 with interest; rates ranging from 2.50% to 6.00%	19,305,000	-0-
Hospital Revenue Bonds, Series 2012A Term bonds, payable from March 2013 through March 2015 in amounts ranging from \$1,615,000 to \$3,370,000 with interest; fixed rate 1.58%	8,265,000	-0-
Original issue discounts and premiums, net	(985,211)	(1,474,081)
Capital lease obligations, payable in installments ranging from \$3,900 to \$159,000 with interest ranging from 3% to 11%, expiring through January 2016, secured by equipment	4,782,061	6,572,522
Notes payable, due in monthly installments through October 2014; interest ranging from 4.85% to 8.00%, secured by equipment	1,489,761	2,670,991
	229,351,611	238,509,432
Less current portion	10,488,544	10,257,530
Long-term debt, net of current portion	\$ 218,863,067	\$ 228,251,902

On December 12, 2011, the Hospital refinanced the Series 1999A Hospital Revenue Refunding Bonds with the Series 2011A Hospital Revenue Bonds with the terms discussed above.

On September 25, 2012, the Series 1993 Hospital Revenue Refunding Bonds were refinanced with the Series 2012A Hospital Revenue Bonds with the terms discussed above.

The refinancing of the Series 1999A and Series 1993 bonds resulted in a loss of approximately \$95,000 which is recorded in other nonoperating revenues (expenses) on the consolidated statements of operations.

In 2004, the Hospital refinanced its Series 1993 Fixed Rate Bonds and entered into a Total Return Distribution Agreement (Agreement) with a Financial Institution. As a result of the refinancing, the Hospital converted its fixed rate debt to variable rate debt which provided substantial future savings. Under the Agreement, the Hospital

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

paid a variable rate equal to the SIFMA Index plus 125 basis points and received a fixed rate of 5.75%. The Hospital still bore the risks and rewards of ownership of the Series 1993 bonds and the transaction was considered a derivative instrument which was marked to market each period. At termination, a total return payment was due equal to any gain (paid by the Financial Institution) or loss (paid by the Hospital) in the value of the Series 1993 bonds. As of September 30, 2011, the market value of the derivative was \$-0-. The Agreement expired September 1, 2012 and no amounts were required to settle the termination clause.

The fair value of the fixed rate Hospital Revenue and Revenue Refunding Bonds (Series 2004A, 2009A, 2011A and 2012A) approximated \$152,577,000 (carrying value of \$139,675,000) as of September 30, 2012. The fair value of the fixed rate obligations is estimated using discounted cash flow analyses, based on the Hospital's current incremental borrowing rates for similar types of borrowing arrangements. The fair value of variable rate debt (Series 1992, 1999B, 2004B and 2009B) approximates its carrying value based on the underlying nature of the related debt.

Interest rates for the variable rate Series 1992, 1999B, 2004B and 2009B bonds are determined on a weekly basis. As provided in the bond agreements, the interest rate determination is subject to conversion, as elected by the Hospital, to other interest modes which determine the frequency, dates, and calculation of interest payments. In addition, bondholders have the option to present the Series 1992 or 1999B bonds for purchase at various times during the year. Commercial banks have agreed, pursuant to two separate Standby Purchase and Credit Agreements (Agreements), to provide liquidity support should any of the Series 1992 or 1999B bonds presented by bondholders for purchase not be remarketed. The Agreements are subject to renegotiations and renewals.

The Series 1992 letter of credit, in the amount of approximately \$13,800,000 with no outstanding balance as of September 30, 2012 expires in August 2013. In the event of a failed remarketing, a liquidity advance bears interest at the bank's prime rate plus 1%, payable monthly. Principal on the liquidity advance is due in twelve equal quarterly installments beginning 367 days after the liquidity advance. Reimbursements of other than liquidity drawings are due on the date such drawing is honored.

The Series 1999B letter of credit, in the amount of approximately \$10,200,000 with no outstanding balance as of September 30, 2012 expires in July 2014. In the event of a liquidity drawing, the System will reimburse the bank in quarterly installments through the termination date unless the bonds are remarketed, redeemed or purchased at which time the liquidity advance is due. Reimbursements of other than liquidity drawings are due on the date such drawing is honored.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The Series 2004B letter of credit, in the amount of approximately \$23,225,000 with no outstanding balance as of September 30, 2012 expires in August 2013. Any liquidity advance is due at the earlier of the stated expiration date of the letter of credit (August 2013), the date the pledged bonds are redeemed pursuant to the bond indenture, the date the pledged bonds are remarketed or purchased by the Hospital or the date an alternative credit facility is issued. Principal on the liquidity advance is due in twelve equal quarterly installments beginning 367 days after the liquidity advance. Reimbursements of other than liquidity drawings are due on the date such drawing is honored.

The Series 2009B letter of credit, in the amount of approximately \$40,100,000 with no outstanding balance as of September 30, 2012 expires in July 2014. Any liquidity advance is due at the earlier of the stated expiration date of the letter of credit (June 2014), the date the pledged bonds are redeemed pursuant to the bond indenture, the date the pledged bonds are remarketed or purchased by the Hospital or the date an alternative credit facility is issued. Reimbursements of other than liquidity drawings are due on the date such drawing is honored.

Additionally, all of the Series bonds are secured by a security interest in the Hospital's revenue. The Hospital covenants that it will not permit any lien or security interest on the Hospital facility other than certain permitted encumbrances. In addition, the various agreements require maintenance of certain debt service income ratios, limit additional borrowings, and require compliance with various other restrictive covenants.

The asset cost on the capital leased assets as of September 30, 2012 and 2011 was approximately \$15,657,000 and \$13,272,000, respectively. The accumulated amortization on the capital leased assets as of September 30, 2012 and 2011 was approximately \$8,327,000 and \$6,230,000, respectively.

The net book value of the equipment securing the notes payable approximated the carrying value of the notes as of September 30, 2012 and 2011.

As of September 30, 2012, the System had outstanding construction commitments of approximately \$4,700,000.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Aggregate maturities of long-term debt are as follows and include the subsequent refinancing of the Series 1992 and 1999B bonds as discussed below:

Year Ending September 30,	
2013	\$ 10,488,544
2014	9,223,287
2015	6,356,820
2016	4,932,929
2017	5,029,593
Thereafter	<u>193,320,438</u>
	<u>\$ 229,351,611</u>

Subsequent to September 30, 2012, the Hospital refinanced the Series 1992 Hospital Revenue Bonds with the Series 2012B Hospital Revenue Bonds issued for \$13,005,000 with a fixed interest rate of 2.3%. The annual principal amounts are due January 2013 through January 2022 and range from \$880,000 to \$1,755,000.

Subsequent to September 30, 2012, the Hospital refinanced the Series 1999B Hospital Revenue Bonds with the Series 2012C Hospital Revenue Bonds issued for \$9,300,000 with a fixed interest rate of 2.28%. The annual principal amounts due January 2013 through January 2019 and range from \$1,100,000 to \$1,625,000.

7. LINE OF CREDIT

The Heart Hospital at Deaconess Gateway, LLC (Heart Hospital) has a line of credit available with a local financial institution. Amounts outstanding as of September 30, 2012 and 2011 were approximately \$-0- and \$1,100, respectively. As of September 30, 2012, the line of credit maximum amount was \$2,000,000 bearing interest at the one month LIBOR rate plus 1.75% but never to be less than 3.00%. Interest at September 30, 2012 was 3.00%. The line of credit is secured by accounts receivable, inventory and equipment matures April 2013.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

8. PENSION PLANS

The System offers a noncontributory defined benefit pension plan covering eligible employees. Benefits are based on each participant's years of service and compensation. Contributions to the plan are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants. During 2012, the defined benefit pension plan was closed to new participants. Additionally, changes were made to benefit accruals for certain participants. Participants should refer to the plan document for more complete information.

The following table sets forth the funded status of the defined benefit plan and amounts recognized in the financial statements as of and for the years ended September 30, 2012 and 2011.

	2012	2011
Change in benefit obligation		
Benefit obligation, beginning of year	\$ 190,785,744	\$ 178,156,621
Service cost	5,395,127	9,239,543
Interest cost	9,827,839	9,676,244
Benefits paid	(4,342,253)	(3,823,621)
Actuarial (gain) loss	38,259,719	(2,463,043)
Benefit obligation, end of year	\$ 239,926,176	\$ 190,785,744
Changes in plan assets		
Fair value of plan assets, beginning of year	\$ 126,825,040	\$ 122,468,339
Actual return on plan assets	24,950,657	176,322
Employer contributions	8,004,000	8,004,000
Benefits paid	(4,342,253)	(3,823,621)
Fair value of plan assets, end of year	\$ 155,437,444	\$ 126,825,040
Funded status		
Funded status of the plan, end of year	\$ (84,488,732)	\$ (63,960,704)
Amounts recognized in the consolidated balance sheets consist of		
Other long-term liabilities	\$ (84,488,732)	\$ (63,960,704)

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

Other pension disclosures for 2012 and 2011 include:

	2012	2011
Amounts not yet reflected in net periodic benefit cost and included in other changes in unrestricted net assets		
Transition obligation asset (obligation)	\$ -0-	\$ -0-
Prior service cost	(10,006)	(66,561)
Accumulated loss	<u>(90,624,030)</u>	<u>(70,031,545)</u>
Other changes in unrestricted net assets	(90,634,036)	(70,098,106)
Cumulative employer contributions in excess of net periodic pension cost	<u>6,145,304</u>	<u>6,137,402</u>
Net amount recognized in the consolidated balance sheets	<u>\$ (84,488,732)</u>	<u>\$ (63,960,704)</u>
Components of net periodic benefit cost		
Service cost	\$ 5,395,127	\$ 9,239,543
Interest cost	9,827,839	9,676,244
Expected return on plan assets	(11,519,349)	(10,537,762)
Amortization of prior year service cost	8,105	19,751
Amortization of loss	4,235,926	3,880,691
Curtailment loss recognized	<u>48,450</u>	<u>-0-</u>
Net periodic benefit cost	<u>\$ 7,996,098</u>	<u>\$ 12,278,467</u>
Other changes in unrestricted net assets		
Prior service cost arising during year	\$ -0-	\$ -0-
Net loss (gain) arising during year	24,828,411	7,898,398
Amortization of prior service cost	(56,555)	(19,751)
Amortization of loss	<u>(4,235,926)</u>	<u>(3,880,691)</u>
Total other changes in unrestricted net assets	<u>\$ 20,535,930</u>	<u>\$ 3,997,956</u>
Estimated amounts that will be amortized from other changes in unrestricted net assets over the next fiscal year		
Amortization of transition (obligation) asset	\$ -0-	
Amortization of prior service (cost) credit	\$ (4,222)	
Amortization of loss	\$ (6,285,982)	
Weighted-average actuarial assumptions to determine benefit obligations of September 30		
Discount rate	4.10%	5.40%
Rate of compensation increase	3.50%	3.50%
Measurement date	9/30/12	9/30/11

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

	2012	2011
Weighted-average actuarial assumptions to determine net periodic pension cost as of September 30		
Discount rate	5.40%	5.50%
Expected long-term rate of return	8.50%	8.50%
Rate of compensation increase	3.50%	3.50%
Additional year end information		
Projected benefit obligation	\$ 239,926,176	\$ 190,785,744
Accumulated benefit obligation	\$ 221,536,482	\$ 167,709,765
Fair value of plan assets	\$ 155,437,444	\$ 126,825,040

The following is a schedule by year of expected benefit payments as of September 30, 2012

Year Ending September 30,	
2013	\$ 5,386,000
2014	6,241,000
2015	6,963,000
2016	7,662,000
2017	8,498,000
2018-2022	58,117,000
	\$ 92,867,000

Determination of net periodic pension cost for the years ended September 30, 2012 and 2011 is based on assumptions and census data as of January 1, 2012 and 2011, respectively.

The principal long-term determinant of a portfolio's investment return is its asset allocation. The plan allocation includes growth assets (60%) and fixed income (40%). In addition, active management strategies have added value relative to passive benchmark returns. The expected long-term rate of return assumption is based on the mix of assets in the plan, the long-term earnings expected to be associated with each asset class, and the additional return expected through active management. This assumption is periodically benchmarked against peer plans.

The amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the plan.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The plan's weighted-average, asset allocations as of September 30, 2012 and 2011, by asset category, are as follows:

	<u>2012</u>	<u>2011</u>
Equity		
Mutual funds	34%	29%
Common/collective trusts	17%	18%
Common stocks	<u>4%</u>	<u>4%</u>
Total equity	<u>55%</u>	<u>51%</u>
Fixed income		
Mutual funds	32%	34%
Common/collective trusts	<u>9%</u>	<u>10%</u>
Total fixed income	<u>41%</u>	<u>44%</u>
Private equity	<u>4%</u>	<u>5%</u>
	<u>100%</u>	<u>100%</u>

The allocation strategy for the plan currently comprises approximately 50% to 70% growth investments (target of 60%) and 30% to 50% fixed-income investments (target of 40%). Within the growth investment classification, the plan asset strategy encompasses equity and equity-like instruments that are expected to represent approximately 60% of the System's plan asset portfolio of both public and private market investments. The largest component of these equity and equity-like instruments is public equity securities that are well diversified and invested in U.S. and international companies.

Fair value of mutual funds and marketable equity securities are based on the quoted prices in active markets. Common/collective trusts are valued at the net asset value on a private market that is not active. However, the underlying investments are traded on an active market. The fair value of the private equity funds is valued at the percentage ownership of the net asset value as reported to the plan by the individual managers.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The following is an analysis of fair value of the major classes of plan assets of September 30, 2012 and 2011:

	2012	2011
Level 1		
Mutual funds		
Intermediate bond	\$ 48,159,718	\$ 43,010,627
Large blend	34,384,374	23,118,109
Foreign	18,292,164	13,814,049
Total mutual funds	100,836,256	79,942,785
Common stocks		
Financial services	1,199,403	1,290,814
Industrial and materials	1,919,907	746,957
Other	2,564,466	2,651,926
Total common stocks	5,683,776	4,689,697
Total Level 1	106,520,032	84,632,482
Level 2		
Common/collective trusts	39,649,817	35,169,547
Level 3		
Private equity	6,247,198	6,253,887
Cash equivalents	152,417,047	126,055,916
Cash equivalents	3,020,397	769,124
	\$ 155,437,444	\$ 126,825,040

The following is a summary of changes in the fair value of the level 3 assets for 2012 and 2011:

	2012	2011
Balance, beginning of year	\$ 6,253,887	\$ 10,606,536
Unrealized gains (losses) relating to instruments still still held at the reporting date	(6,689)	(628,533)
Purchases, sales, issuances and settlements, net	-0-	(3,724,116)
	\$ 6,247,198	\$ 6,253,887

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

The System expects to contribute in excess of the required funding amounts to its pension plan in 2013, currently approximating \$8,000,000.

The System also offers a 401k plan to eligible employees. Total expense for the System's contributions for eligible employees for 2012 and 2011 was approximately \$6,667,000 and \$2,237,000, respectively. During 2012, the System changed the 401k plan to enhance employer contributions for discretionary and matching amounts.

9. RELATED PARTY TRANSACTIONS

The Hospital is a joint-owner of The Women's Hospital. The Hospital owns the building in which The Women's Hospital is located and leases the space to The Women's Hospital currently at \$230,000 per month with an option to increase that amount annually through June 2030. The Hospital provides ancillary services (lab, radiology) for The Women's Hospital. Ancillary services provided were approximately \$2,241,000 and \$1,961,000 in 2012 and 2011, respectively. The Hospital also has two notes receivable due from The Women's Hospital for equipment. The combined balance of the notes receivable was approximately \$152,000 and \$252,000 as of September 30, 2012 and 2011, respectively.

The Hospital is a joint owner of Evansville Surgery Center Associates, LLC (Surgery Center). The Hospital recorded contract service expense related to the Surgery Center of approximately \$28,922,000 in 2012 and \$28,237,000 in 2011. As of September 30, 2012 and 2011, the Hospital had a liability to the Surgery Center of approximately \$3,091,000 and \$2,653,000, respectively.

The Hospital is a joint-owner of HealthSouth Deaconess Rehabilitation Hospital. The Hospital provides ancillary services (lab, radiology) to HealthSouth Deaconess Rehabilitation Hospital. Ancillary services provided were approximately \$684,000 and \$508,000 in 2012 and 2011, respectively.

DEACONESS HEALTH SYSTEM

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2012 AND 2011

10. COMMITMENTS AND CONTINGENCIES

Operating leases

The System leases various equipment and facilities under operating leases expiring at various dates through 2020. Total lease expense for 2012 and 2011 was approximately \$11,506,000 and \$11,495,000, respectively. The following are the minimum lease payments for the years after September 30, 2012:

<u>Year Ending September 30,</u>	
2013	\$ 12,036,000
2014	10,519,000
2015	10,132,000
2016	7,749,000
2017	6,973,000
Thereafter	<u>22,051,000</u>
	<u>\$ 69,460,000</u>

Litigation

The System is involved in litigation and regulatory matters arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the System's future financial position, results from operations or cash flows.

Health Insurance

The System's employee health care insurance is provided through a combination of insured, self-insured and purchased re-insurance coverage from a commercial carrier. The System maintains an estimated liability for the amount of claims incurred but not reported. Substantially all employees are covered for major medical benefits. The self-insured health coverage carries a stop-loss maximum of \$200,000 per case with no aggregate limit.

SUPPLEMENTARY INFORMATION

DEACONESS HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS SEPTEMBER 30, 2012

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Heart Care Health System, LLC	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC
Assets										
Current assets										
Cash and cash equivalents	\$ 63,419,560	\$ -0-	\$ 56,706,670	\$ -0-	\$ -0-	\$ 754,324	\$ 1,974,497	\$ 1,807,179	\$ 2,176,890	\$ -0-
Funds held by trustee, current portion	5,712,886	-0-	5,712,886	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Patient accounts receivable, net	101,449,536	-0-	86,846,708	6,865,103	-0-	53,491	7,073,325	610,909	-0-	-0-
Inventories	6,362,040	-0-	5,592,070	-0-	-0-	4,400	765,570	-0-	-0-	-0-
Prepaid expenses and other current assets	11,060,431	(1,513,941)	9,817,210	1,349,513	-0-	1,235,983	81,249	90,417	-0-	-0-
Total current assets	188,004,453	(1,513,941)	164,675,544	8,214,616	-0-	2,048,198	9,894,641	2,508,505	2,176,890	-0-
Investments limited as to use, less current portion										
Board designated funds	254,201,470	-0-	254,079,240	122,230	-0-	-0-	-0-	-0-	-0-	-0-
Board designated funds - Foundation	5,653,343	-0-	5,653,343	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Donor restricted - Foundation	5,056,888	-0-	5,056,888	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total investments limited as to use	264,911,701	-0-	264,789,471	122,230	-0-	-0-	-0-	-0-	-0-	-0-
Property and equipment										
Land and improvements	18,316,168	-0-	18,316,168	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Buildings and improvements	493,491,934	-0-	492,832,278	-0-	-0-	18,401	-0-	641,255	-0-	-0-
Furniture, fixtures and equipment	254,137,426	-0-	238,344,246	6,562,741	-0-	100,540	5,964,110	2,971,387	194,402	-0-
	765,945,528	-0-	749,492,692	6,562,741	-0-	118,941	5,964,110	3,612,642	194,402	-0-
Less allowances for depreciation	422,607,617	-0-	415,028,235	3,465,490	-0-	77,557	2,785,917	1,056,333	194,085	-0-
	343,337,911	-0-	334,464,457	3,097,251	-0-	41,384	3,178,193	2,556,309	317	-0-
Construction in progress	9,884,463	-0-	9,500,253	379,241	-0-	-0-	4,969	-0-	-0-	-0-
Total property and equipment, net	353,222,374	-0-	343,964,710	3,476,492	-0-	41,384	3,183,162	2,556,309	317	-0-
Other assets										
Deferred financing costs	2,762,552	-0-	2,762,552	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Investments in joint ventures	22,865,777	(13,941,787)	36,707,090	100,474	-0-	-0-	-0-	-0-	-0-	-0-
Goodwill	22,217,481	-0-	15,522,010	36,656	-0-	-0-	6,658,815	-0-	-0-	-0-
Other	11,679,179	-0-	11,663,941	-0-	-0-	13,513	-0-	1,725	-0-	-0-
Total other assets	59,524,989	(13,941,787)	66,655,593	137,130	-0-	13,513	6,658,815	1,725	-0-	-0-
Total assets	\$ 865,663,517	\$ (15,455,728)	\$ 840,085,318	\$ 11,950,468	\$ -0-	\$ 2,103,095	\$ 19,736,618	\$ 5,066,539	\$ 2,177,207	\$ -0-

See report of independent auditors on page 1.

DEACONESS HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS SEPTEMBER 30, 2012

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Heart Care Health System, LLC	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC
Liabilities and net assets										
Current liabilities										
Accounts payable and other current liabilities	\$ 33,058,097	\$ (1,513,941)	\$ 28,493,016	\$ 1,366,221	\$ -0-	\$ 174,980	\$ 3,699,972	\$ 738,264	\$ 70,149	\$ 29,436
Salaries, wages and related liabilities	39,843,727	-0-	31,659,485	7,538,825	-0-	473,178	-0-	172,239	-0-	-0-
Estimated third-party payor settlements	6,415,881	-0-	4,311,195	-0-	-0-	-0-	2,104,686	-0-	-0-	-0-
Accrued interest	651,549	-0-	651,549	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Line of credit	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Current portion of long-term debt	10,488,544	-0-	9,642,108	-0-	-0-	-0-	-0-	846,436	-0-	-0-
Total current liabilities	90,457,798	(1,513,941)	74,757,353	8,905,046	-0-	648,158	5,804,658	1,756,939	70,149	29,436
Long-term liabilities										
Long-term debt, less current portion	218,863,067	-0-	217,809,270	-0-	-0-	-0-	-0-	1,053,797	-0-	-0-
Other long-term liabilities	90,803,439	-0-	90,715,760	-0-	-0-	-0-	-0-	87,679	-0-	-0-
Total long-term liabilities	309,666,506	-0-	308,525,030	-0-	-0-	-0-	-0-	1,141,476	-0-	-0-
Total liabilities	400,124,304	(1,513,941)	383,282,383	8,905,046	-0-	648,158	5,804,658	2,898,415	70,149	29,436
Net assets										
Unrestricted	451,746,047	(22,678,065)	451,746,047	3,045,422	-0-	1,454,937	13,931,960	2,168,124	2,107,058	(29,436)
Temporarily restricted	3,293,842	-0-	3,293,842	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Permanently restricted	1,763,046	-0-	1,763,046	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets - controlling interest	456,802,935	(22,678,065)	456,802,935	3,045,422	-0-	1,454,937	13,931,960	2,168,124	2,107,058	(29,436)
Non-controlling interest	8,736,278	8,736,278	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total net assets	465,539,213	(13,941,787)	456,802,935	3,045,422	-0-	1,454,937	13,931,960	2,168,124	2,107,058	(29,436)
Total liabilities and net assets	\$ 865,663,517	\$ (15,455,728)	\$ 840,085,318	\$ 11,950,468	\$ -0-	\$ 2,103,095	\$ 19,736,618	\$ 5,066,539	\$ 2,177,207	\$ -0-

See report of independent auditors on page 1.

DEACONESS HEALTH SYSTEM

CONSOLIDATING STATEMENTS OF OPERATIONS YEAR ENDED SEPTEMBER 30, 2012

	Consolidated Deaconess Health System	Eliminations	Deaconess Health System Obligated Group	Deaconess Clinic, Inc.	Heart Care Health System, LLC	Progressive Health of Indiana, LLC	The Heart Hospital At Deaconess Gateway, LLC	Tri-State Radiation Oncology, LLC	Deaconess Health Plans, LLC	Deaconess Care Integration, LLC
Unrestricted revenue and other support										
Net patient service revenue	\$ 675,570,391	\$ -0-	\$ 566,491,846	\$ 52,002,658	\$ -0-	\$ 1,442,597	\$ 51,771,272	\$ 3,862,018	\$ -0-	\$ -0-
Less provision for bad debts	41,765,158	-0-	39,321,491	830,976	-0-	36,362	1,537,873	38,456	-0-	-0-
Net patient service revenue net of provision for bad debts	633,805,233	-0-	527,170,355	51,171,682	-0-	1,406,235	50,233,399	3,823,562	-0-	-0-
Other revenue	42,835,021	(5,413,741)	26,080,204	4,550,306	-0-	12,509,863	1,333,384	2,618,613	1,156,392	-0-
Total unrestricted revenue and other support	676,640,254	(5,413,741)	553,250,559	55,721,988	-0-	13,916,098	51,566,783	6,442,175	1,156,392	-0-
Expenses										
Salaries and wages	251,853,175	-0-	198,890,651	44,185,624	-0-	6,882,692	-0-	1,416,656	477,552	-0-
Employee benefits	70,832,778	-0-	61,256,501	8,120,049	-0-	1,065,851	-0-	245,222	145,155	-0-
Supplies	110,192,200	-0-	90,686,185	4,857,174	-0-	56,950	14,486,674	93,230	11,835	152
Contract services	69,608,219	(13,018,833)	55,242,428	6,699,651	-0-	1,356,539	18,640,735	461,765	71,778	154,156
Repairs and maintenance	19,689,741	-0-	18,924,274	397,886	-0-	7,610	359,971	-0-	-0-	-0-
Depreciation	39,625,915	-0-	37,687,754	851,035	-0-	17,839	463,740	605,463	84	-0-
Interest	9,227,267	-0-	9,043,962	-0-	-0-	-0-	4,412	178,893	-0-	-0-
Utilities	13,209,277	-0-	11,166,563	1,620,386	-0-	47,527	305,712	56,543	12,546	-0-
Other	51,909,459	(477,216)	39,342,459	7,045,935	41	494,927	4,003,792	1,364,311	133,254	1,956
Total expenses	636,148,031	(13,496,049)	522,240,777	73,777,740	41	9,929,935	38,265,036	4,422,083	852,204	156,264
Income (loss) from operations	40,492,223	8,082,308	31,009,782	(18,055,752)	(41)	3,986,163	13,301,747	2,020,092	304,188	(156,264)
Nonoperating revenues (expenses)										
Investment income	8,036,317	-0-	8,033,047	(825)	-0-	-0-	1,435	-0-	2,660	-0-
Contributions, gifts, and bequests	469,250	-0-	469,250	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Grants	(1,525,180)	-0-	(1,525,180)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Other nonoperating	(4,574)	-0-	(4,574)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Total nonoperating revenues (expenses)	6,975,813	-0-	6,972,543	(825)	-0-	-0-	1,435	-0-	2,660	-0-
Excess revenues over (under) expenses	47,468,036	8,082,308	37,982,325	(18,056,577)	(41)	3,986,163	13,303,182	2,020,092	306,848	(156,264)
Other changes in unrestricted net assets										
Net unrealized gain on investments	20,183,539	-0-	20,183,539	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Pension related changes other than net periodic pension cost	(20,535,930)	-0-	(20,535,930)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	692,091	-0-	692,091	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Capital contributions	-0-	(17,934,670)	-0-	17,807,842	-0-	-0-	-0-	-0-	-0-	126,828
Distributions	-0-	20,862,580	-0-	-0-	(112,373)	(3,930,455)	(14,895,113)	(1,920,999)	(3,640)	-0-
Change in unrestricted net assets	47,807,736	11,010,218	38,322,025	(248,735)	(112,414)	55,708	(1,591,931)	99,093	303,208	(29,436)
Temporarily restricted net assets										
Contributions, gifts, and bequests	1,122,293	-0-	1,122,293	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net unrealized gain on investments	57,307	-0-	57,307	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Investment income	24,559	-0-	24,559	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Net assets released from restriction	(692,091)	-0-	(692,091)	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Change in temporarily restricted net assets	512,068	-0-	512,068	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Permanently restricted net assets										
Contributions, gifts, and bequests	1,071,042	-0-	1,071,042	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Consolidated change in net assets	49,390,846	11,010,218	39,905,135	(248,735)	(112,414)	55,708	(1,591,931)	99,093	303,208	(29,436)
Less amount attributable to non-controlling interest	(9,485,710)	(9,485,710)	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Change in net assets attributable to controlling interest	<u>\$ 39,905,136</u>	<u>\$ 1,524,508</u>	<u>\$ 39,905,135</u>	<u>\$ (248,735)</u>	<u>\$ (112,414)</u>	<u>\$ 55,708</u>	<u>\$ (1,591,931)</u>	<u>\$ 99,093</u>	<u>\$ 303,208</u>	<u>\$ (29,436)</u>

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DEACONESS HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2012

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
Assets				
Current assets				
Cash and cash equivalents	\$ 56,706,670	\$ -0-	\$ 2,035,208	\$ 54,671,462
Funds held by trustee, current portion	5,712,886	-0-	-0-	5,712,886
Patient accounts receivable, net	86,846,708	-0-	-0-	86,846,708
Inventories	5,592,070	-0-	-0-	5,592,070
Prepaid expenses and other current assets	9,817,210	(104,032)	134,339	9,786,903
Total current assets	<u>164,675,544</u>	<u>(104,032)</u>	<u>2,169,547</u>	<u>162,610,029</u>
Investments limited as to use, less current portion				
Board designated funds	254,079,240	-0-	-0-	254,079,240
Board designated funds - Foundation	5,653,343	-0-	-0-	5,653,343
Donor restricted - Foundation	5,056,888	-0-	-0-	5,056,888
Total investments limited as to use	<u>264,789,471</u>	<u>-0-</u>	<u>-0-</u>	<u>264,789,471</u>
Property and equipment				
Land and improvements	18,316,168	-0-	3,460,502	14,855,666
Buildings and improvements	492,832,278	-0-	38,582,864	454,249,414
Furniture, fixtures and equipment	238,344,246	-0-	224,545	238,119,701
	<u>749,492,692</u>	<u>-0-</u>	<u>42,267,911</u>	<u>707,224,781</u>
Less allowances for depreciation	415,028,235	-0-	27,109,258	387,918,977
	<u>334,464,457</u>	<u>-0-</u>	<u>15,158,653</u>	<u>319,305,804</u>
Construction in progress	9,500,253	-0-	97,307	9,402,946
Total property and equipment, net	<u>343,964,710</u>	<u>-0-</u>	<u>15,255,960</u>	<u>328,708,750</u>
Other assets				
Deferred financing costs	2,762,552	-0-	-0-	2,762,552
Investments in joint ventures	36,707,090	-0-	3,015,986	33,691,104
Goodwill	15,522,010	-0-	-0-	15,522,010
Other	11,663,941	(73,229)	-0-	11,737,170
Total other assets	<u>66,655,593</u>	<u>(73,229)</u>	<u>3,015,986</u>	<u>63,712,836</u>
Total assets	<u>\$ 840,085,318</u>	<u>\$ (177,261)</u>	<u>\$ 20,441,493</u>	<u>\$ 819,821,086</u>

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DEACONESS HEALTH SYSTEM

CONSOLIDATING BALANCE SHEETS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP SEPTEMBER 30, 2012

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
Liabilities and net assets				
Current liabilities				
Accounts payable and other current liabilities	\$ 28,493,016	\$ (104,032)	\$ 822,768	\$ 27,774,280
Salaries, wages and related liabilities	31,659,485	-0-	-0-	31,659,485
Estimated third-party payor settlements	4,311,195	-0-	-0-	4,311,195
Accrued interest	651,549	-0-	-0-	651,549
Current portion of long-term debt	9,642,108	-0-	-0-	9,642,108
Total current liabilities	<u>74,757,353</u>	<u>(104,032)</u>	<u>822,768</u>	<u>74,038,617</u>
Long-term liabilities				
Long-term debt, less current portion	217,809,270	-0-	-0-	217,809,270
Other long-term liabilities	90,715,760	-0-	-0-	90,715,760
Total long-term liabilities	<u>308,525,030</u>	<u>-0-</u>	<u>-0-</u>	<u>308,525,030</u>
Total liabilities	383,282,383	(104,032)	822,768	382,563,647
Net assets				
Unrestricted	451,746,047	(73,229)	19,618,725	432,200,551
Temporarily restricted	3,293,842	-0-	-0-	3,293,842
Permanently restricted	1,763,046	-0-	-0-	1,763,046
Net assets - controlling interest	456,802,935	(73,229)	19,618,725	437,257,439
Non-controlling interest	-0-	-0-	-0-	-0-
Total net assets	<u>456,802,935</u>	<u>(73,229)</u>	<u>19,618,725</u>	<u>437,257,439</u>
Total liabilities and net assets	<u>\$ 840,085,318</u>	<u>\$ (177,261)</u>	<u>\$ 20,441,493</u>	<u>\$ 819,821,086</u>

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DEACONESS HEALTH SYSTEM

CONSOLIDATING STATEMENTS OF OPERATIONS – DEACONESS HEALTH SYSTEM OBLIGATED GROUP YEAR ENDED SEPTEMBER 30, 2012

	Deaconess Health System Obligated Group	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
Unrestricted revenue and other support				
Net patient service revenue	\$ 566,491,846	\$ -0-	\$ -0-	\$ 566,491,846
Less provision for bad debts	39,321,491	-0-	-0-	39,321,491
Net patient service revenue net of provision for bad debts	527,170,355	-0-	-0-	527,170,355
Other revenue (expense)	26,080,204	(1,688,564)	(14,746,479)	42,515,247
Total unrestricted revenue and other support	553,250,559	(1,688,564)	(14,746,479)	569,685,602
Expenses				
Salaries and wages	198,890,651	-0-	-0-	198,890,651
Employee benefits	61,256,501	-0-	-0-	61,256,501
Supplies	90,686,185	-0-	10,049	90,676,136
Contract services	55,242,428	-0-	1,053,724	54,188,704
Repairs and maintenance	18,924,274	-0-	433,861	18,490,413
Depreciation	37,687,754	-0-	950,125	36,737,629
Interest	9,043,962	-0-	-0-	9,043,962
Utilities	11,166,563	-0-	614,428	10,552,135
Other	39,342,459	(1,688,564)	575,365	40,455,658
Total expenses	522,240,777	(1,688,564)	3,637,552	520,291,789
Income (loss) from operations	31,009,782	-0-	(18,384,031)	49,393,813
Nonoperating revenues (expenses)				
Investment income	8,033,047	-0-	2,451	8,030,596
Contributions, gifts, and bequests	469,250	-0-	-0-	469,250
Grants	(1,525,180)	-0-	-0-	(1,525,180)
Other nonoperating	(4,574)	-0-	-0-	(4,574)
Total nonoperating revenues (expenses)	6,972,543	-0-	2,451	6,970,092
Excess revenues over (under) expenses	37,982,325	-0-	(18,381,580)	56,363,905
Other changes in unrestricted net assets				
Net unrealized loss on investments	20,183,539	-0-	-0-	20,183,539
Pension related changes other than net periodic pension cost	(20,535,930)	-0-	-0-	(20,535,930)
Net assets released from restriction	692,091	-0-	-0-	692,091
Transfers	-0-	-0-	17,807,845	(17,807,845)
Change in unrestricted net assets	38,322,025	-0-	(573,735)	38,895,760
Temporarily restricted net assets				
Contributions, gifts, and bequests	1,122,293	-0-	-0-	1,122,293
Net unrealized gain on investments	57,307	-0-	-0-	57,307
Investment income	24,559	-0-	-0-	24,559
Net assets released from restriction	(692,091)	-0-	-0-	(692,091)
Change in temporarily restricted net assets	512,068	-0-	-0-	512,068
Permanently restricted net assets				
Contributions, gifts, and bequests	1,071,042	-0-	-0-	1,071,042
Consolidated change in net assets	\$ 39,905,135	\$ -0-	\$ (573,735)	\$ 40,478,870

See report of independent auditors on page 1.