

STATE OF NEW YORK
DEPARTMENT OF STATE

I hereby certify that the annexed copy has been compared with the original document in the custody of the Secretary of State and that the same is a true copy of said original.

WITNESS my hand and official seal of the
Department of State, at the City of Albany, on
March 7, 2013.



A handwritten signature in black ink, appearing to read "Daniel E. Shapiro".

Daniel E. Shapiro
First Deputy Secretary of State

CERTIFICATE OF INCORPORATION**OF****PARTNERS IN FRANCISCAN MINISTRIES, INC.****Under Section 402 of the Not-for-Profit Corporation Law**

The undersigned, for the purpose of forming a corporation under the provisions of Section 402 of the Not-for-Profit Corporation Law of the State of New York, hereby certifies:

1. The name of the Corporation is Partners in Franciscan Ministries, Inc..
2. The Corporation is a Corporation as defined in subparagraph (a)(5) of Section 102 of the Not-for-Profit Corporation Law in that it is not formed for pecuniary profit or financial gain, and no part of the assets, income, or profit of the Corporation is distributable to, or inures to the benefit of its members, directors, officers or any private person, except to the extent permitted under the New York Not-for-Profit Corporation Law.
3. The Corporation is a Type B corporation as defined in Section 201 of the Not-for-Profit Corporation Law.
4. The purposes for which this corporation is formed are:
 - A. To monitor and lend support to the implementation of mission, philosophy, purpose and operation of the sponsored ministries of the Sisters of St. Francis of the Neumann Communities consistent with Franciscan values.
 - B. To have and exercise all powers necessary and convenient to effect any and all of the foregoing purposes for which the Corporation is found, together with all the powers now or hereafter granted to it by the State of New York.
5. The Corporation shall have power to take and hold by bequest, gift, purchase or lease, for any of its purposes, any property real or personal, without limitation as to amount or value, except such limitations, if any, as imposed by law; to convey such property, and to invest and reinvest any principal and to deal with and expand the income and principal of the Corporation in such manner as in the judgment of its officers and directors best promotes its objects.
6. No part of the net earnings of the Corporation shall inure the benefit of any member, trustee, director, officer of the Corporation or any private individual (except that reasonable compensation may be paid for services rendered to or for the Corporation) and no member, trustee, officer of the Corporation or any private individual shall be entitled to share in the distribution of any of the corporate assets on dissolution of the Corporation.

7. The office of the Corporation shall be located in the County of Onondaga, State of New York.

8. No substantial part of the activities of the Corporation shall be carrying on propaganda, or otherwise attempting to influence legislation, (except as otherwise provided by Internal Revenue Code Section 501(h)) or participating in, or intervening in (including the publication or distribution of statements) any political campaign on behalf of any candidate for public office.

9. In any taxable year in which the Corporation is a private foundation as described in Internal Revenue Code Section 509(a), the Corporation shall contribute its income for said period at such time and manner as not to subject it to tax under Internal Revenue Code Section 4942, and the Corporation shall not: (a) engage in any act of self-dealing as defined in Internal Revenue Code Section 4941(d); (b) retain any excess business holdings as defined in Internal Revenue Code Section 4943(c); (c) make any investments in such a manner as to subject the Corporation to tax under Internal Revenue Code Section 4944; or (d) make any taxable expenditure as defined in Internal Revenue Code Section 4945(d) or corresponding provisions of any subsequent Federal Tax Laws.

10. Notwithstanding any provision of this Certificate of Incorporation, the Corporation is organized exclusively for one or more purposes as specified in Section 501(c)(3) of the Internal Revenue Code, and shall not carry on any other activities not permitted to be carried on by a corporation exempt from Federal Income Tax under Section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal Tax Code.

11. In the event of dissolution, all of the remaining assets and property of the Corporation shall, after payment of all necessary expenses, shall first be distributed to the Sisters of St. Francis of the Neumann Communities, a New York Corporation exempt from income tax pursuant to Internal Revenue Code Section 501(c)(3), or if such organization is not in existence, then such other not-for-profit corporation for one or more exempt purposes within the meaning of the Internal Revenue Code Section 501(c)(3), or corresponding provisions of any future Federal Tax Law, or shall be distributed to the Federal Government or State or Local Government for a public purpose upon approval of the Justice of the Supreme Court of the State of New York.

12. The Corporation shall be operated by a Board of Directors, the number of which is to be no less than three (3). The names and addresses of the initial directors until the first annual meeting are:

<u>NAME</u>	<u>ADDRESS</u>
Sister Patricia Burkard, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208
Sister Frances Kowalski, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208



Sister Marian Rose Mansius, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208
Sister Maria Salerno, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208
Sister Roberta Smith, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208
Sister Barbara Woody, OSF	2500 Grant Boulevard, Suite 3 Syracuse, New York 13208


13. The Secretary of State of the State of New York is hereby designated as the agent of the Corporation upon whom process against it may be served. The post office address to which the Secretary of State shall mail a copy of any process against the Corporation served upon him as agent of the Corporation is 250 South Clinton Street, Suite 502, Syracuse, New York 13202-1262.

14. Notwithstanding any other provision of this Certificate of Incorporation to the contrary, the Corporation shall not be authorized to establish, operate, construct, lease or maintain a hospital or to provide a hospital service or health related service or to operate a skilled nursing facility, to operate a drug maintenance program, a certified home health agency, a hospice or a health maintenance organization or to provide a comprehensive health services plan as defined in Articles 28, 33, 36, 40, and 44, respectively, of the Public Health Law of the State of New York, or to perform any of the activities specified in Section 4040(b) through 404(v) of the Not-for-Profit Corporation Law of the State of New York.

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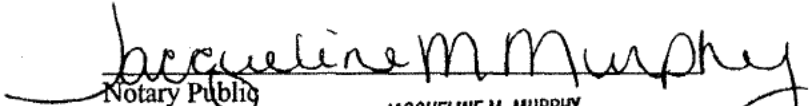


IN WITNESS WHEREOF, the undersigned incorporator has signed this Certificate of Incorporation, affirms the truth of the statements made herein under penalties of perjury this 25th day of April, 2011.


PAUL J. CURTIN, JR., Incorporator
SHULMAN CURTIN & GRUNDNER, P.C.
250 South Clinton Street, Suite 502
Syracuse, New York 13202-1262
Tel: (315) 424-8944
Fax: (315) 424-8205

STATE OF NEW YORK)
COUNTY OF ONONDAGA) SS:

On the 25th day of April, 2011 before me the undersigned, a notary public in and for state, personally appeared PAUL J. CURTIN, JR., personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his capacity and that by his signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed this instrument.


Notary Public
JACQUELINE M. MURPHY
Notary Public, State of New York
Qual. in Onondaga Co. No. 01MUG090533
Commission Expires April 14, 2015

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CERTIFICATE OF INCORPORATION

OF

PARTNERS IN FRANCISCAN MINISTRIES, INC.

Under Section 402 of the Not-for-Profit Corporation Law of the State of New York

Shulman Curtin Grundner & Regan, P.C.
250 S. Clinton St., Suite 502
Syracuse, NY 13202-1262

Handwritten initials/signature

STATE OF NEW YORK
DEPARTMENT OF STATE
FILED

APR 28 2011

TAX \$ _____

BY: *Handwritten signature*

Customer Reference # PARTN32004

Handwritten initials/signature

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**FAXTON-ST. LUKE'S HEALTHCARE
AND CONSOLIDATED SUBSIDIARIES**

Consolidated Financial Statements
(Governmental Filing Requirements)

December 31, 2011 and 2010

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Faxton-St. Luke's Healthcare:

We have audited the accompanying consolidated balance sheets of Faxton-St. Luke's Healthcare and Consolidated Subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the management of Faxton-St. Luke's Healthcare. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free 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 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 Faxton-St. Luke's Healthcare and Consolidated Subsidiaries as of December 31, 2011 and 2010, and the results of their operations and 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.

The consolidated financial statements referred to above were prepared primarily to meet credit analysis and governmental filing requirements. Such financial statements are not intended to be general purpose financial statements (see note to consolidated financial statements 1(b)).

This report is intended solely for the information and use of the board of directors and management of Faxton-St. Luke's Healthcare and subsidiaries, the New York State Department of Health and other Offices and Agencies of the State of New York and selected financial institutions and is not intended to be and should not be used by anyone other than these specified parties.

As discussed in note 1(p) to the consolidated financial statements, the Hospital adopted new guidance in presenting insurance claims and related insurance recoveries within the consolidated financial statements.

Fust Charles Chambers LLP

May 16, 2012

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2011 and 2010

Assets	2011	2010
Current assets:		
Cash and cash equivalents	\$ 1,120,275	2,229,739
Assets limited as to use	-	4,494,491
Investments	48,103,626	57,388,822
Patient accounts receivable, net of reserve for doubtful accounts of \$8,382,207 in 2011 and \$7,784,057 in 2010	40,666,564	40,499,957
Inventories	5,231,856	5,346,833
Prepaid expenses and other current assets	13,042,408	3,642,199
Due from affiliates, net	204,340	1,984,133
Net investment in direct financing lease	547,116	547,116
Estimated third-party payor settlements, net	7,977,712	3,193,208
	<hr/>	<hr/>
Total current assets	116,893,897	119,326,498
Interest in Faxton-St. Luke's Healthcare Foundation	7,229,709	8,964,355
Investment in affiliates	129,203	424,962
Due from affiliates, net	1,412,482	1,035,468
Assets limited as to use	-	5,108,055
Investments	4,528,164	4,528,164
Net investment in direct financing lease	3,288,328	3,543,238
Property and equipment, net	96,624,341	100,423,564
Unamortized debt issuance costs	498,240	1,078,724
Other assets	21,902,974	4,299,471
	<hr/>	<hr/>
 Total assets	 \$ <u>252,507,338</u>	 <u>248,732,499</u>

<u>Liabilities and Net Assets</u>	<u>2011</u>	<u>2010</u>
Current liabilities:		
Current portion of long-term debt	\$ 8,541,967	13,171,732
Current portion of capital lease obligations	3,534,395	4,549,596
Accounts payable and accrued expenses	12,364,645	11,316,870
Accrued payroll, payroll taxes and benefits	11,539,608	9,301,636
Current portion of estimated self-insured liabilities	1,671,472	1,339,215
Other current liabilities	8,902,002	843,831
	<u>46,554,089</u>	<u>40,522,880</u>
Long-term debt, net of current portion:		
Notes payable	17,339,959	21,364,424
Civic facility revenue bonds	17,355,000	31,476,571
Capital lease obligations	8,209,973	9,449,700
	<u>42,904,932</u>	<u>62,290,695</u>
Other liabilities	31,757,765	9,854,184
Unrealized loss on interest rate swaps	6,299,513	3,967,565
Estimated self-insured liabilities, net of current portion	3,071,196	3,555,155
	<u>130,587,495</u>	<u>120,190,479</u>
Net assets:		
Unrestricted	113,859,059	119,443,075
Temporarily restricted	3,532,620	4,570,781
Permanently restricted	4,528,164	4,528,164
	<u>121,919,843</u>	<u>128,542,020</u>
Commitments and contingencies (notes 4, 7 and 11)		
	<u>\$ 252,507,338</u>	<u>248,732,499</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Unrestricted revenues, gains and other support:		
Net patient service revenue	\$ 278,143,227	273,350,392
Other revenue (note 10)	9,263,623	4,881,215
Investment income, net of fees	603,919	1,446,121
Contributions	557,986	457,954
Net assets released from restrictions used for operations	<u>339</u>	<u>-</u>
Total unrestricted revenues, gains and other support	<u>288,569,094</u>	<u>280,135,682</u>
Expenses:		
Salaries and wages	117,781,430	116,108,425
Employee benefits	33,341,849	31,015,344
Supplies and other	103,336,194	107,497,208
Depreciation and amortization	16,068,688	14,777,786
Provision for bad debts	8,987,088	8,589,774
Interest	3,943,250	3,803,042
Loss on extinguishment of debt	871,935	-
NYS gross receipts taxes	<u>995,149</u>	<u>969,204</u>
Total expenses	<u>285,325,583</u>	<u>282,760,783</u>
Net income (loss) from continuing operations	<u>3,243,511</u>	<u>(2,625,101)</u>
Discontinued operations	<u>(235,825)</u>	<u>791,987</u>
Excess (deficiency) of revenues over expenses	<u>\$ 3,007,686</u>	<u>(1,833,114)</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets, Continued

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Unrestricted net assets:		
Excess (deficiency) of revenues over expenses	\$ 3,007,686	(1,833,114)
Change in fair value of interest rate swaps	(2,331,948)	(809,818)
Change in interest in unrestricted net assets of Foundation	(696,720)	286,153
Contributions used for capital acquisitions	1,525,621	530,254
Change in net unrealized gains and losses on investments	(2,016,122)	3,409,058
Cumulative effect of change in accounting principle	(5,000,000)	-
Other	<u>(72,533)</u>	<u>(488,338)</u>
Increase (decrease) in unrestricted net assets	<u>(5,584,016)</u>	<u>1,094,195</u>
Temporarily restricted net assets:		
Income on investments	104	745
Change in interest in temporarily restricted net assets of Foundation	(1,037,926)	2,077,766
Net assets released from restrictions	<u>(339)</u>	<u>-</u>
Increase (decrease) in temporarily restricted net assets	<u>(1,038,161)</u>	<u>2,078,511</u>
Total increase (decrease) in net assets	<u>(6,622,177)</u>	<u>3,172,706</u>
Net assets at beginning of year	<u>128,542,020</u>	<u>125,369,314</u>
Net assets at end of year	<u>\$ 121,919,843</u>	<u>128,542,020</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Change in net assets	\$ (6,622,177)	3,172,706
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	16,068,688	14,777,786
Provision for bad debts	8,987,088	8,589,774
Loss on extinguishment of debt	364,939	-
Cumulative effect of change in accounting principle	3,825,000	-
Change in interest in net assets of Faxton-St. Luke's Healthcare Foundation	1,734,646	(2,363,919)
Change in net unrealized gains and losses on investments	2,016,122	(3,409,058)
Change in fair value of interest rate swaps	2,331,948	809,818
Other	72,533	488,338
Amortization of unearned lease income	(292,206)	(310,419)
Net realized loss on sale of investments	508,984	253,786
Gain on disposition of property and equipment	(4,636)	(7,500)
(Gain) loss in earnings of investees	295,759	(242,079)
(Gain) loss on discontinued component	235,825	(791,987)
Contributions for capital acquisitions	(1,525,621)	(530,254)
Changes in operating assets and liabilities:		
Patient accounts receivables	(9,153,695)	(8,311,744)
Inventories, prepaid expenses and other current assets	(644,578)	2,904,628
Due from affiliates, net	1,402,779	1,223,795
Accounts payable, accrued expenses and other liabilities	2,678,605	(3,258,277)
Estimated self-insured liabilities	(151,702)	(92,257)
Estimated third-party payor settlements	(4,784,504)	(3,633,189)
Net cash provided by operating activities	<u>17,343,797</u>	<u>9,269,948</u>
Cash flows from investing activities:		
Purchases of property and equipment	(9,016,156)	(12,407,586)
Proceeds from sale of property and equipment	14,838	7,500
Proceeds (purchases) from sale of investments, net	6,743,975	(36,966,556)
Discontinued operations	(235,825)	791,987
Increase in other assets	(269,900)	(461,094)
Net (increase) decrease in assets limited as to use	<u>9,618,661</u>	<u>(799,278)</u>
Net cash provided by (used in) investing activities	<u>6,855,593</u>	<u>(49,835,027)</u>
Cash flows from financing activities:		
Proceeds from long-term debt	72,827	16,447,313
Principal payments on long-term debt and capitalized lease obligations	(27,454,418)	(10,441,275)
Minimum direct financing lease payments received	547,116	547,116
Contributions for capital acquisitions	1,525,621	530,254
Net cash provided by (used in) financing activities	<u>(25,308,854)</u>	<u>7,083,408</u>
Decrease in cash and cash equivalents	(1,109,464)	(33,481,671)
Cash and cash equivalents at beginning of year	<u>2,229,739</u>	<u>35,711,410</u>
Cash and cash equivalents at end of year	<u>\$ 1,120,275</u>	<u>2,229,739</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2011 and 2010

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

Faxton-St. Luke's Healthcare (Healthcare), located in Utica, New York, is a not-for-profit healthcare delivery system providing inpatient, outpatient, emergency care, cancer treatment, rehabilitation, dialysis, maternity, child care, long term care, surgical, psychiatric and community services to residents of the Mohawk Valley Region. Admitting physicians are primarily practitioners in the local area. Mohawk Valley Network, Inc. (MVN), a not-for-profit corporation, is the sole corporate member of Healthcare and various other organizations involved in providing health care services to the Mohawk Valley Region.

(b) Principles of Consolidation

The accompanying consolidated financial statements were prepared primarily to meet credit analysis and governmental filing requirements, and are not intended to be general purpose financial statements of a primary reporting entity. Accordingly, such statements do not include the assets, liabilities or results of operations of all subsidiaries or controlled corporations as such terms are defined under generally accepted accounting principles for consolidated financial statements. Healthcare separately issues consolidated primary reporting entity financial statements.

The accompanying consolidated financial statements include the accounts of Healthcare and its 55.5% owned subsidiary, Faxton Leasing, LLC (Leasing). Faxton-St. Luke's Healthcare Foundation (Foundation), of which Healthcare is the sole member, SLM Corporation, whose stock is owned by a trust, of which Healthcare is the sole beneficiary, and Faxchil Realty, Inc. (Faxchil), a wholly owned for-profit subsidiary, and Paraffin, LLC (Paraffin), of which Healthcare is the sole member, on the equity method of accounting. Centrex Clinical Laboratories, Inc. (Centrex) was the wholly owned subsidiary of Faxchil. In December 2009, Healthcare sold Faxchil (see note 2). St. Luke's Home Residential Health Care Facility, Inc. (Home), in which Healthcare has a sole financial interest at dissolution, is excluded from these consolidated financial statements. All significant intercompany transactions and balances with Leasing have been eliminated in consolidation.

Leasing leased property and equipment to Healthcare for radiation therapy services prior to its dissolution in February 2011. The Foundation is a not-for-profit, tax-exempt corporation that carries out fund raising activities which benefit Healthcare and the Home. Paraffin is a not-for-profit limited liability company that provides laboratory services to a local hospital.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(c) Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(d) Collective Bargaining Agreements

At December 31, 2011, Healthcare has approximately 31% of its employees working under collective bargaining agreements.

(e) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturity of three months or less, excluding temporary investments included in assets limited as to use and long-term investments.

(f) Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value which is determined utilizing quoted market prices. Investments in insurance group fixed annuity contracts (Guaranteed Investment Contracts) are valued at contract value, which is considered the best representation of fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess (deficiency) of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess (deficiency) of revenues over expenses since none of the investments are classified as trading securities.

Certain investments that do not have readily determinable fair values are valued by using the net asset value (NAV) per share (or its equivalent), as a practical expedient permitted under Accounting Standards Update (ASU) 2009-12, Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent).

Healthcare invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect Healthcare's net assets.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(g) Assets Limited as to Use

Assets limited as to use represent assets held by trustees under indenture agreements and amounts held in escrow related to the sale of Faxchil. During 2011, the Faxchil reserve was released from escrow and assets held by trustees were utilized in conjunction with the repayment of debt.

(h) Inventories

Inventories are stated at the lower of average cost or market.

(i) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is calculated over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years using the straight-line method. Property and equipment under capital leases and leasehold improvements are amortized on the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Amortization of equipment under capital leases and leasehold improvements is included in depreciation and amortization expense.

Interest cost incurred on borrowed funds during the construction of capital assets is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized amounted to approximately \$121,000 in 2011 and \$172,000 in 2010.

Gifts of long-lived assets, such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess (deficiency) of revenues over expenses, unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(j) Unamortized Debt Issuance Costs

Debt issuance costs are amortized using the straight-line method, which approximates the effective interest method, over the terms of the related debt.

(k) Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

(l) Permanently Restricted Net Assets (Endowment Funds)

Healthcare maintains various donor-restricted and board-designated funds whose purpose is to provide long-term support for its charitable programs. In classifying such funds for financial statement purposes as either permanently restricted, temporarily restricted or unrestricted net assets, the Board of Directors looks to the explicit directions of the donor where applicable and the provisions of the laws of the State of New York. To constitute an endowment under New York State law, the restriction must arise from a clearly expressed donor limitation, not a limitation from within the beneficiary organization. The Board has determined that, absent donor stipulations to the contrary, the provisions of New York State law do not impose either a permanent or temporary restriction on the income or capital appreciation derived from the original gift. Therefore, all income and appreciation derived from the original gift are transferred to unrestricted net assets absent any restrictions on the use made by the donor. Permanently restricted net assets consist of endowment funds of \$4,528,164 at December 31, 2011 and 2010, and are included in long-term investments in the consolidated balance sheets.

Healthcare utilizes an investment strategy that emphasizes preservation of principal and total return consistent with prudent levels of risk. Investments are allocated over a diversified portfolio of multiple asset classes of domestic and international equities and bonds.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(1) Permanently Restricted Net Assets (Endowment Funds), Continued

Interpretation of Relevant Law

Previous to September 17, 2010, New York State law required the preservation of an endowment fund's historic dollar value. Historic dollar value is defined as the aggregate fair value in dollars of an endowment fund at the time it becomes an endowment fund, each subsequent donation to the fund at the time it is made and each accumulation made pursuant to a direction in applicable gift instrument at the time an accumulation is added to the fund. The law permitted an organization to spend the income earned by an endowment fund (i.e. interest, dividends), as well as the net appreciation (realized with respect to all assets and unrealized with respect to readily marketable assets) of such fund.

On September 17, 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) was signed into New York State law. The most prominent feature of NYPMIFA is the elimination of the requirement to preserve an endowment fund's historic dollar value which allows an organization to spend from an endowment whose market value has dropped below the historic dollar value, as long as it is deemed prudent under the organization's policies. In accordance with NYPMIFA, an organization must consider the following factors in exercising a standard of prudence:

1. The duration and preservation of the endowment fund
2. The purposes of the organization and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the organization
7. The investment policies of the organization
8. Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization

NYPMIFA requires compliance with donor intent when making investment or spending decisions with respect to an endowment fund. In addition, NYPMIFA creates a restriction on the portion of an endowment fund that is not classified as permanently restricted net assets, even in the absence of a donor restriction. Such portion is classified as temporarily restricted net assets until appropriated for expenditure by the organization.

As of December 31, 2011, the Board of Directors of Healthcare has not adopted and is currently evaluating the provisions of NYPMIFA. As a result, Healthcare continues to classify permanently restricted net assets at the historic dollar value of the fund in accordance with donor instructions.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or NYPMIFA requires the Hospital to retain as a fund of perpetual duration. If the situation were to occur, the deficiency would be recorded in the Hospital's unrestricted net assets. The deficiency recorded in unrestricted net assets at December 31, 2011 and 2010 was approximately \$141,000 and \$108,000, respectively.

Return Objectives, Strategies, Spending Policy and Investment Objectives

Healthcare has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in a well diversified asset mix that can be expected to generate acceptable long-term returns at an acceptable level of risk. Healthcare targets a diversified asset allocation that places a greater emphasis on equity-based investments and bonds to achieve its long-term return objectives within prudent risk constraints.

Changes in Endowment Net Assets

		2011	
	Unrestricted	Permanently restricted	Total
Endowment net assets, January 1, 2011	\$ (107,940)	4,528,164	4,420,224
Investment return:			
Investment income	-	91,367	91,367
Net depreciation (realized and unrealized)	-	(124,388)	(124,388)
Other	(33,021)	33,021	-
Endowment net assets, December 31, 2011	\$ (140,961)	4,528,164	4,387,203

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

	2010		
	Unrestricted	Permanently restricted	Total
Endowment net assets, January 1, 2010	\$ (552,159)	4,528,164	3,976,005
Investment return:			
Investment income	-	80,741	80,741
Net appreciation (realized and unrealized)	-	363,478	363,478
Other	444,219	(444,219)	-
Endowment net assets, December 31, 2010	\$ (107,940)	4,528,164	4,420,224

(m) Net Patient Service Revenue and Patient Accounts Receivable

Healthcare has agreements with third-party payors that provide for payments to the various organizations within its healthcare delivery system at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge or visit, cost-based reimbursement, discounted charges, per diem payments and fee-for-service payments. Net patient service revenue and the related patient accounts receivable are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. Retroactive adjustments are included in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations.

An allowance for doubtful accounts receivable is estimated by management based on periodic reviews of the collectibility of accounts receivable considering historical experience and prevailing economic conditions.

Revenue from the Medicare and Medicaid programs accounted for approximately 52% of Healthcare's net patient service revenue for 2011 and 2010. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Patient service revenue increased by approximately \$1,200,000 in 2011 and decreased by approximately \$275,000 in 2010 related to either settlement of prior year issues or changes in estimates associated with third-party issues.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(m) Net Patient Service Revenue and Patient Accounts Receivable, Continued

Healthcare grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2011</u>	<u>2010</u>
Medicare	23%	27%
Medicaid	18%	14%
Private payors	10%	16%
Insurance and all others	<u>49%</u>	<u>43%</u>
	<u>100%</u>	<u>100%</u>

(n) Charity Care

Healthcare provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Healthcare does not pursue collection of such amounts, they are not reported as net patient service revenue. During 2011, Healthcare adopted Accounting Standards Update (ASU) 2010-23, *Health Care Entities (Topic 954): Measuring Charity Care for Disclosure*. The ASU requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect costs of providing the charity care. In addition, the ASU requires disclosure of the method used to identify or determine such costs. The ASU was effective for fiscal years beginning after December 15, 2010 with retrospective application required to all prior periods presented. Prior to the adoption of the ASU, Healthcare disclosed the level of charity care provided based on its standard charges for services. The ASU did not have any effect on amounts reported in the financial statements. During 2011 and 2010, costs incurred by Healthcare in the provision of charity care were based on the ratio of Healthcare's costs to gross charges and approximated \$669,000 and \$682,000, respectively.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Contributions

Unconditional promises to give cash and other assets 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. Contributions 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 statements of operations and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated statements of operations and changes in net assets.

(p) Insurance Claims and Related Recoveries

On January 1, 2011, Healthcare adopted Accounting Standards Update (ASU) 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries*. The ASU requires that a health care entity no longer net insurance recoveries (asset) against a related claim liability. The amount of the liability should be determined without consideration of any insurance recoveries. The amendments in this update should be applied to a health care entity's medical malpractice claims and similar liabilities. The ASU was effective for fiscal years beginning after December 15, 2010. Prior to adoption of the ASU, Healthcare netted anticipated insurance recoveries (asset) against the related claim liability. In connection with Healthcare's adoption of the ASU, Healthcare recorded an increase to other assets of approximately \$26,066,000 and an increase to other liabilities of approximately \$31,066,000 in the accompanying consolidated balance sheet as of December 31, 2011. The increase to both other assets and other liabilities represents the Company's estimate of its recoveries and reserves for certain workers compensation claims and professional liability claims. The ASU did not have any effect on Healthcare's 2011 excess (deficiency) of revenues over expenses and cash flows; however, resulted in a cumulative effect adjustment to 2011 opening unrestricted net assets amounting to \$5,000,000 and the 2011 balance sheet presents anticipated insurance recoveries (asset) and related claim liabilities on a gross basis.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(q) Excess (Deficiency) of Revenues over Expenses

The consolidated statements of operations and changes in net assets include excess (deficiency) of revenues over expenses. Changes in unrestricted net assets which are excluded from excess (deficiency) of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

(r) Income Taxes

Healthcare is a not-for-profit corporation and has been recognized as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

The standards for accounting for uncertainty in income taxes establish a recognition threshold and measurement for income tax positions recognized in a Hospital's financial statements. These standards had no impact on the accompanying consolidated financial statements.

The tax years open to examination by federal and state taxing authorities are 2008 through 2011.

(s) Concentration of Credit Risk

Healthcare invests cash and cash equivalents with financial institutions, and has determined that the amount of credit exposure at any one financial institution is immaterial to Healthcare's financial position.

(t) Reclassifications

Certain 2010 amounts have been reclassified to conform with the 2011 financial statement presentation.

(u) Subsequent Events

Subsequent events have been evaluated through May 16, 2012, which is the date financial statements were issued.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(2) Discontinued Operations

In December 2009, Healthcare sold its wholly owned, for-profit subsidiary, Faxchil Realty, Inc. (Faxchil), including Faxchil's wholly owned, for-profit subsidiary, Centrex Clinical Laboratories, Inc. (Centrex), to Laboratory Corporation of America Holdings for \$42,000,000 with certain assets and liabilities assumed by Healthcare, plus an additional earn-out opportunity not to exceed \$5,000,000 if certain revenue targets are achieved during two separate one year earn-out periods. Healthcare did not achieve the revenue targets for the first earn-out period and have not recorded any amount at December 31, 2011 for the second earn-out period. Healthcare recorded a gain in connection with the sale of approximately \$792,000 in 2010 and a loss of approximately \$236,000 in 2011, related to covenant not to compete agreements, changes in accounts receivable and outstanding liabilities. It is expected that all significant transactions related to the sale of Faxchil Realty have been recorded.

(3) Investments

Assets Limited as to Use

At December 31, 2010, assets limited as to use, at fair value, are comprised of and are to be used for the following purposes:

Cash and cash equivalents	\$ 2,395,675
Cash equivalents - in escrow	4,202,964
Guaranteed Investments Contracts	2,750,415
Mutual funds	253,492
	<u>9,602,546</u>
Classified as current assets	<u>4,494,491</u>
Classified as non-current assets	\$ <u><u>5,108,055</u></u>
Debt service and debt service reserve funds	5,108,055
Amounts held in escrow	4,202,964
Amounts held for other purposes	<u>291,527</u>
	\$ <u><u>9,602,546</u></u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) Investments, Continued

Investments

At December 31, investments, at fair value, are comprised of the following:

	<u>2011</u>	<u>2010</u>
Cash and cash equivalents	\$ 1,059,805	523,015
Mutual funds	23,661,365	42,183,433
Common stock	3,187,051	3,093,774
Pooled investment funds	<u>25,639,216</u>	<u>16,613,950</u>
	<u>\$ 53,547,437</u>	<u>62,414,172</u>

The above amounts are included in the accompanying financial statements as follows:

	<u>2011</u>	<u>2010</u>
Investments - current assets	\$ 48,103,626	57,388,822
Cash and cash equivalents	915,647	497,186
Long-term investments	<u>4,528,164</u>	<u>4,528,164</u>
	<u>\$ 53,547,437</u>	<u>62,414,172</u>

Investment income and gains (losses) on unrestricted investments are comprised of the following for the years ended December 31:

	<u>2011</u>	<u>2010</u>
Investment income:		
Interest income and dividends, net of fees	\$ 1,112,903	1,192,335
Realized gains (losses)	<u>(508,984)</u>	<u>253,786</u>
	603,919	1,446,121
Change in net unrealized gains and losses on investments	<u>(2,016,122)</u>	<u>3,409,058</u>
	<u>\$ (1,412,203)</u>	<u>4,855,179</u>

Healthcare continually reviews investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. In the evaluation of whether an impairment is other-than-temporary, Healthcare considers the reasons for the impairment, its ability and intent to hold the investment until the market price recovers or the investment matures, compliance with its investment policy, the severity and duration of the impairment, and expected future performance.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) Investments, Continued

Healthcare's investments in common stocks and mutual funds consist of investments diversified in several different industries. Healthcare evaluated the near-term prospects of the issuer in relation to the severity and duration of impairment. Based upon the evaluation and Healthcare's ability and intent to hold the securities for a reasonable period of time sufficient for a forecasted recovery of fair value, Healthcare does not consider the securities in an unrealized loss position to be other-than-temporarily impaired at December 31, 2011 and 2010.

Healthcare and the Foundation have a commingled investment portfolio. The following table presents the gross unrealized losses and fair value of the commingled investment portfolio with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2011 and 2010:

		2011					
		Less than Twelve Months		Twelve Months or Greater		Total	
<u>Securities</u>		<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>
Mutual funds	\$	3,285,837	(246,604)	-	-	3,285,837	(246,604)
Common stocks		3,031,860	(251,543)	210,930	(65,441)	3,242,790	(316,984)
Pooled investment funds		<u>1,423,385</u>	<u>(76,615)</u>	<u>155,591</u>	<u>(41,922)</u>	<u>1,578,976</u>	<u>(118,537)</u>
	\$	<u>7,741,082</u>	<u>(574,762)</u>	<u>366,521</u>	<u>(107,363)</u>	<u>8,107,603</u>	<u>(682,125)</u>
		2010					
		Less than Twelve Months		Twelve Months or Greater		Total	
<u>Securities</u>		<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>
Mutual funds	\$	863,395	(36,605)	3,859,556	(1,074,145)	4,722,951	(1,110,750)
Common stocks		152,401	(11,621)	193,122	(40,731)	345,523	(52,352)
Pooled investment funds		<u>-</u>	<u>-</u>	<u>569,366</u>	<u>(277,611)</u>	<u>569,366</u>	<u>(277,611)</u>
	\$	<u>1,015,796</u>	<u>(48,226)</u>	<u>4,622,044</u>	<u>(1,392,487)</u>	<u>5,637,840</u>	<u>(1,440,713)</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Property and Equipment

Property and equipment is comprised of the following at December 31:

	<u>2011</u>	<u>2010</u>
Land and land improvements	\$ 5,955,732	5,890,704
Buildings	110,562,837	109,696,683
Fixed equipment	34,934,873	35,503,948
Movable equipment	93,437,080	73,826,905
Property and equipment under capitalized leases	<u>20,247,109</u>	<u>25,103,273</u>
	265,137,631	250,021,513
Less accumulated depreciation	<u>172,366,589</u>	<u>158,684,058</u>
	92,771,042	91,337,455
Construction-in-progress	<u>3,853,299</u>	<u>9,086,109</u>
Property and equipment, net	<u>\$ 96,624,341</u>	<u>100,423,564</u>

Depreciation expense amounted to approximately \$15.8 million and \$14.5 million for the years ended December 31, 2011 and 2010, respectively. At December 31, 2011, commitments to purchase in association with ongoing projects totalled approximately \$1.7 million.

(5) Direct Financing Lease

In 2001, Healthcare completed construction of a medical office building with a cost of approximately \$5 million on land owned by an affiliate of Slocum-Dickson Medical Group, P.C. (SDMG). The building is leased to SDMG under a direct financing lease for minimum lease payments of \$45,393 per month through 2022. Healthcare financed 80% of the building cost with a mortgage described in note 7.

The balance sheet presentation of the direct financing lease at December 31 is as follows:

	<u>2011</u>	<u>2010</u>
Minimum lease payments receivable	\$ 5,406,595	5,953,711
Unearned lease income	<u>(1,571,151)</u>	<u>(1,863,357)</u>
Net investment in direct financing lease	3,835,444	4,090,354
Less current portion	<u>547,116</u>	<u>547,116</u>
Long-term net investment in direct financing lease	<u>\$ 3,288,328</u>	<u>3,543,238</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(6) Extended Sick Leave

Healthcare employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. Healthcare accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. Healthcare has accrued an estimated liability of approximately \$9,869,000 and \$10,040,000 at December 31, 2011 and 2010, respectively, for these anticipated termination payments.

Amounts are included in the accompanying consolidated financial statements as follows at December 31:

	<u>2011</u>	<u>2010</u>
Accrued payroll, payroll taxes and benefits	\$ 536,000	1,220,000
Other liabilities	<u>9,333,000</u>	<u>8,820,000</u>
	<u>\$ 9,869,000</u>	<u>10,040,000</u>

(7) Long-Term Debt and Lease Obligations

Long-term debt consists of the following at December 31:

	<u>2011</u>	<u>2010</u>
Variable rate demand 2006 Civic Facility Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton-St. Luke's Healthcare) (a)	\$ 17,840,000	18,295,000
Civic Facility 1998 and 1999 Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton Hospital Facility) (c)	-	10,515,000
Civic Facility 1998 and 1999 Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; St. Luke's-Memorial Hospital Center Facility) (c)	-	7,615,000
Revolving note payable (b)	3,959,000	4,200,000
Unsecured notes payable in varying monthly installments maturing from January 2013 through January 2016 at interest rates ranging from 5% to 6%	5,690,632	7,277,314

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Long-Term Debt and Lease Obligations, Continued

	<u>2011</u>	<u>2010</u>
Note payable in monthly installments of \$116,667 at a fixed rate of 5.3%, maturing June 2015 and collateralized by Healthcare's gross receipts	5,016,667	6,416,666
Mortgage note payable in monthly installments of \$26,230 at a fixed rate of 4.0% through January 2017, thereafter varying installments at interest rates ranging from 4.0% to 6.0%, secured by property under direct financing lease (note 5)	2,583,712	2,748,010
Unamortized premium on Civic Facility Revenue Bonds	-	91,571
Note payable to SLM at a fixed interest rate of 3.65% with a balloon payment for the remaining amount due December 2016	1,475,676	1,551,049
Mortgage payable in monthly installments of \$44,248 at a fixed rate of 6.5%, maturing January 2020 and collateralized by the related building	3,284,603	3,587,948
Note payable in varying monthly installments at LIBOR plus 2.15%, with a cap between 6% to 9% (6.0% at December 31, 2011) with a balloon payment estimated at \$1,947,000 due January 2020, collateralized by certain property	2,865,335	2,950,580
Note payable in varying monthly installments at a variable interest rate of 3.0% at December 31, 2011, with a balloon payment estimated at \$279,000 due April 2020, collateralized by certain property	452,650	470,934

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Long-Term Debt and Lease Obligations, Continued

	<u>2011</u>	<u>2010</u>
Notes payable in varying monthly installments maturing November 2012 (interest rates ranging from 6.25% to 6.75%)	68,651	293,655
Capital lease obligations (interest rates ranging from 3.06% to 8.51%)	11,744,368	13,999,296
	54,981,294	80,012,023
Less current portion:		
Debt	(8,541,967)	(13,171,732)
Capital lease obligations	(3,534,395)	(4,549,596)
Long-term debt, net of current portion	\$ 42,904,932	62,290,695

(a) Healthcare, through the Oneida County Industrial Development Agency (OCIDA), has issued serial and term Civic Facility Revenue Bonds as follows:

<u>Series</u>	<u>Term</u>	<u>Principal Payments</u>	<u>Rate</u>
Faxton-St. Luke's Healthcare:			
2006E - tax-exempt	2031	\$ 205,000 - 525,000	4.873 - 4.995%
2006F - taxable	2031	280,000 - 955,000	4.873 - 4.995%

The bonds are insured and are collateralized by Healthcare's gross receipts (as defined), including all rights to receive such receipts whether in the form of accounts receivable, contract rights or other rights. Healthcare entered into a lease agreement with OCIDA, which also acts as security for payment of the revenue bonds. Additional security is provided by a Master Trust Indenture under which the initial Members of the Obligated Group (Healthcare and MVN) are jointly and severally responsible for payment of the bonds.

The bonds bear interest based on one of three modes - the weekly rate, the term rate, or the fixed rate - for periods selected by Healthcare. The interest rate for each mode will be the current market interest rate as determined by the remarketing agent of the bonds. Healthcare used the weekly rate during 2011 and 2010. At December 31, 2011, the bonds carried interest at rates of .40% and .18%. At December 31, 2010 the bonds carried interest at rates of .35% and .33%.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Long-Term Debt and Lease Obligations, Continued

The bonds are remarketed by a remarketing agent in accordance with the terms of a remarketing agreement. The bonds will be remarketed whenever a new interest rate is in effect. If the bonds cannot be remarketed, they would be due and payable under the terms of the remarketing agreement; however, the bonds are credit-enhanced by an irrevocable Bank of America letter of credit, which is set to expire June 25, 2013. In the event that the remarketing agent is unable to remarket the bonds, the bond trustee will make a draw on the letter of credit and the tendered variable rate bonds will become bank bonds.

Various agreements relating to the bonds establish covenants with which Healthcare has agreed to comply, including the following, among others. In any year, Healthcare will not dispose of operating assets exceeding 2.5% of the total book value of operating assets or accounts receivable with recourse having a book value in excess of 50% of the total book value of accounts receivable. The Obligated Group may not merge or consolidate with another entity unless certain conditions are met. Additional indebtedness is limited to certain provisions including borrowings not to exceed 15% of total operating revenue. The Obligated Group agreed to maintain a minimum debt service coverage ratio, as defined, of 120% annually or employ a management consultant. The Obligated Group did not achieve the required debt service coverage ratio for the year ended December 31, 2010 and retained a consultant as required. At December 31, 2011, the Obligated Group was in compliance with the covenants that are considered events of default.

As a result of the aforementioned 2006 bond issuances, Healthcare has entered into two interest rate swap contracts to reduce its risk of exposure to changes in interest rates. The interest rate swaps effectively convert the variable rates of the 2006 bonds to fixed rates of 5.938% and 4.216% through June 2031. The swaps have been designated as cash flow hedges of the variable interest rates and are recorded at fair value as a liability of \$6,299,513 on the accompanying consolidated balance sheet as of December 31, 2011. The swaps have effective dates of June 26, 2006 and termination dates of June 1, 2031. The amounts exchanged are based on the notional amounts whereby Healthcare pays the swap counter-party interest at a fixed rate (4.216% - tax-exempt, 5.938% - taxable) and the swap counter-party pays Healthcare a variable rate (based on 70% of 1 month LIBOR tax-exempt, BMA Rate - taxable). The notional amounts and fair values based on quoted market prices, of Healthcare's interest rate swaps are as follows at December 31, 2011:

	<u>Notional amount</u>	<u>Liability market value</u>
Healthcare - Series E	\$ 11,055,000	4,416,128
Healthcare - Series F	6,785,000	1,883,385
	\$ 17,840,000	6,299,513

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Long-Term Debt and Lease Obligations, Continued

The mark-to-market adjustments resulted in decreases in unrestricted net assets of \$2,331,948 and \$809,818 for the years ended December 31, 2011 and 2010, respectively. Changes in value of the swaps determined to arise from ineffectiveness of the instruments, as determined through the hypothetical derivative method, are recorded as a component of interest expense in the consolidated statements of operations and changes in net assets. For the years ended December 31, 2011 and 2010, there was no significant ineffectiveness. Healthcare expects that the loss existing in unrestricted net assets to be reclassified into income from operations within the next 12 months will not be significant.

- (b) At December 31, 2011 and 2010, Healthcare had a \$19,500,000 revolving note payable with a bank, collateralized by substantially all of Healthcare's investments. The revolving note payable on short-term borrowings bears a daily interest rate at prime (3.25% at December 31, 2011). The revolving note payable on long-term borrowings bears a monthly interest rate at LIBOR (1.24% at December 31, 2011). The revolving note payable is available through July 2012. At December 31, 2011, a portion of the revolving note payable was reserved for three letters of credit totaling approximately \$4,875,000 related to self-insured liabilities. At December 31, 2011 and 2010, Healthcare had \$959,000 and \$200,000 outstanding on the short-term borrowings, respectively. At December 31, 2011 and 2010, Healthcare had \$3,000,000 and \$4,000,000 outstanding on the long-term borrowings, respectively. The revolving note payable contains financial covenants including a debt service coverage ratio requirement, a day's cash on hand requirement and a minimum unrestricted liquidity to funded debt ratio. At December 31, 2010, Healthcare was not in compliance with the debt service coverage ratio for which it obtained a waiver. At December 31, 2011, Healthcare was in compliance with the covenants that are considered events of default.
- (c) During 2011, Healthcare placed funds into an irrevocable trust and the bonds were legally defeased. Healthcare recorded a \$871,935 loss on extinguishment of debt related to these transactions.

Healthcare leases certain equipment under capital leases. Healthcare also leases equipment and facilities under non-cancelable operating leases, including leases with affiliates. The net book value of the equipment capitalized under lease agreements at December 31, 2011 and 2010 amounted to approximately \$13,129,000 and \$15,826,000, respectively.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Long-Term Debt and Lease Obligations, Continued

Scheduled principal payments on long-term debt and payments under non-cancelable operating leases and the present value of future minimum capital lease payments at December 31, 2011 are:

	<u>Long-term debt</u>	<u>Capital leases</u>	<u>Operating leases</u>	
			<u>Affiliates</u>	<u>Other</u>
Years ended December 31:				
2012	\$ 8,541,967	3,990,421	897,197	1,455,251
2013	20,725,396	3,670,938	714,597	1,444,785
2014	3,372,705	2,230,986	714,597	1,419,653
2015	4,078,718	1,514,887	714,597	1,014,526
2016	907,965	574,990	714,597	955,779
Thereafter	<u>5,610,175</u>	<u>1,113,838</u>		
Total payments	43,236,926	13,096,060		
Less amounts representing interest		<u>1,351,692</u>		
Present value of capital lease obligations		11,744,368		
Less current portion		<u>3,534,395</u>		
Capital lease obligations, net of current portion		<u>\$ 8,209,973</u>		

Rent expense under operating leases amounted to approximately \$3,177,000 in 2011 and \$1,585,000 in 2010.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(8) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2011</u>	<u>2010</u>
Funds held in trust by others (for capital)	\$ 2,005,000	2,032,000
Children's Miracle Network	646,182	991,461
Continuous Learning Center	248,957	212,655
Scholarship assistance	30,869	31,104
Programs	335,121	188,617
Renovations	<u>266,491</u>	<u>1,114,944</u>
	<u>\$ 3,532,620</u>	<u>4,570,781</u>

Permanently restricted net assets at December 31 are restricted to:

	<u>2011</u>	<u>2010</u>
Investments to be held in perpetuity, the income from which is to support charity care, health care services, scholarships and facility maintenance	<u>\$ 4,528,164</u>	<u>4,528,164</u>

(9) Pension Plans

Healthcare sponsors a 401(k) plan that covers substantially all full-time non-union employees. Healthcare contributes 4% of eligible compensation to the plan (5% for employees hired before December 1, 2001). Healthcare also makes a matching contribution up to 100% of the first 4% of employee contributions to the 401(k) plan. Healthcare also sponsors a 403(b) plan that covers union and certain other employees. Healthcare contributes 5% to 7% of eligible compensation to the 403(b) plan.

Pension expense under all plans aggregated approximately \$6,830,000 in 2011 and approximately \$6,410,000 in 2010.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Other Revenue

Other revenue consists of the following for the years ended December 31:

	<u>2011</u>	<u>2010</u>
Rent	\$ 868,983	759,702
Affiliate sold services	415,285	488,525
Other interest income	350,086	323,854
Mohawk Valley Heart Institute	(373,765)	(168,751)
Equity (deficit) in earnings of investees	(295,759)	242,079
New Hartford Scanner	1,009,764	1,154,334
Grant revenue	491,142	508,028
EMS education classes	546,435	584,687
CMIC Partnership income	191,178	154,413
School of Radiology tuition	224,241	232,059
VHA partnership equity earnings	237,321	274,384
Managed care incentive income	468,780	203,759
Medicare and Medicaid health information technology income	4,880,080	-
Other	<u>249,852</u>	<u>124,142</u>
	<u>\$ 9,263,623</u>	<u>4,881,215</u>

The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) was enacted to stimulate the U.S. economy. The law created federal tax incentives, expanded unemployment benefits and other social welfare provisions, and increased domestic spending on education, infrastructure and health care, including \$31 billion in new spending on health information technology, most of which is for incentive Medicare and Medicaid payments to physicians and hospitals. ARRA requires that hospitals and physicians become “meaningful users” of electronic health records (EHRs) and submit quality data as a condition of receiving the incentive payments, which began in 2011. On July 13, 2010, CMS issued two final rules related to the adoption and dissemination of EHRs. One of the rules defines the “meaningful use” requirements that hospitals and other providers must meet to qualify for federal incentive payments for adopting EHRs under ARRA, and the other final rule describes the technical capabilities required for certified EHR technology.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Other Revenue, Continued

The American Recovery and Reinvestment Act of 2009, Continued

The Medicaid Electronic Health Record Incentive Program provides incentive payments to eligible hospitals, physicians and certain other professionals (Providers) as they adopt, implement, upgrade or demonstrate meaningful use of certified EHR technology in their first year of participation and demonstrate meaningful use for up to five remaining participation years. Medicaid EHR incentive payments to Providers are 100% federally funded.

The Medicare incentive payments to individual hospitals are made over a four-year, front-weighted transition period. The Medicaid incentive payments, which are administered by the states, are subject to more flexible payment and compliance standards than Medicare incentive payments. Healthcare anticipates that, in addition to the expenditures Healthcare incurs to qualify for these incentive payments, operating expenses have increased and will increase in the future as a result of these information system investments. However, Healthcare anticipates there will be other operational benefits that Healthcare can realize as a result of these Healthcare Information Technology (HIT) enhancements that are not included in the above Medicare and Medicaid health information technology income. Hospitals that fail to become meaningful users of EHRs or fail to submit quality data by 2015 will be subject to penalties in the form of a reduction to Medicare payments.

Electronic Health Record Incentives

Healthcare recognizes Medicaid EHR incentive payments in the consolidated statements of operations and changes in net assets for the first payment year when: (1) CMS approves EHR incentive plan; and (2) Healthcare acquires certified EHR technology. Medicaid EHR incentive payments for subsequent payment years are recognized in the period during which the specified meaningful use criteria are met. Healthcare recognizes Medicare EHR incentive payments when: (1) the specified meaningful use criteria are met; and (2) contingencies in estimating the amount of the incentive payments to be received are resolved. During 2011, Healthcare satisfied the CMS meaningful use criteria. As a result, Healthcare recognized approximately \$4,880,000 of Medicare and Medicaid EHR incentive payments as other revenue in the consolidated statement of operations and changes in net assets for that period.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Other Revenue, Continued

Electronic Health Record Incentives, Continued

The meaningful use information submitted to CMS is subject to review, verification and audit. Additionally, the final Medicare and Medicaid EHR incentive payments under ARRA are based on financial and statistical data, which may be estimated using historical trends and current factors, in the settled Medicare cost report for the cost reporting period that begins in the federal fiscal year in which the criteria are met. We have acquired, developed and implemented systems to accumulate the information necessary to demonstrate meaningful use of EHR technology. We also have a system and estimation process for recording the financial and statistical data utilized as part of the cost reporting process. Cost reports must generally be filed within five months after the end of the annual cost report reporting period. Cost report settlements are subject to audit by Medicare and Medicaid auditors and administrative and judicial review, and it can take several years until final settlement of such matters is determined and completely resolved. Because the laws, regulations, instructions and rule interpretations governing Medicare and Medicaid reimbursement are complex and change frequently, the estimates recorded by us could change by material amounts. Final settlement of cost reports, which could impact the financial and statistical data on which EHR incentives are based, or a determination that meaningful use was not attained could result in adjustment to previously-recognized EHR incentive payments or retrospective recoupment of incentive payments.

(11) Contingencies

General and malpractice insurance coverage is provided under a claims-made based policy, which provide for \$1,000,000 coverage for each claim, not to exceed \$3,000,000 in aggregate annual coverage. In addition, Healthcare has purchased an excess insurance policy. Claims alleging malpractice have been asserted against Healthcare and are currently in various stages of litigation. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted relating to services provided to patients. Accrued malpractice losses in management's opinion provide an adequate reserve for loss contingencies. Healthcare has accrued a liability included in other liabilities of approximately \$25,952,000 at December 31, 2011.

Healthcare and its affiliates are self-insured for employee healthcare costs. The group has obtained a stop loss coverage policy for healthcare costs to supplement its self insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(11) Contingencies, Continued

Healthcare is primarily self-insured for employee workers' compensation and disability claims along with Healthcare and certain of its other affiliates for the years 2007 and prior. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, Healthcare has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. Each affiliate is jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2011 and 2010. Effective January 1, 2010, Healthcare and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of Healthcare and its affiliates.

Health Care Reform

In March 2010, President Obama signed the Patient Protection and Affordable Care Act (PPACA) into law. PPACA will result in sweeping changes across the health care industry, including how care is provided and paid for. A primary goal of this comprehensive reform legislation is to extend health coverage to approximately 32 million uninsured legal U.S. residents through a combination of public program expansion and private sector health insurance reforms. To fund the expansion of insurance coverage, the legislation contains measures designed to promote quality and cost efficiency in health care delivery and to generate budgetary savings in the Medicare and Medicaid programs. Given that the final regulations and interpretive guidelines have yet to be published, Healthcare is unable to fully predict the impact of PPACA on its operations and financial results. There are multiple lawsuits challenging the constitutionality of major portions of PPACA; to the extent that any significant elements of the law are overturned, additional uncertainty is introduced into the prediction of operational and financial impacts. Management of Healthcare is studying and evaluating the anticipated impacts and developing strategies needed to prepare for implementation, and is preparing to work cooperatively with other constituents to optimize available reimbursement.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(12) Affiliated Entities

The following represents summarized financial information from the financial statements of Healthcare's affiliates that are included in the accompanying financial statements on the equity method of accounting.

<u>2011</u>	<u>Foundation</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 7,904,192	5,435,916	132,103
Total liabilities	<u>674,483</u>	<u>5,061,878</u>	<u>376,938</u>
Net assets (deficit)	<u>\$ 7,229,709</u>	<u>374,038</u>	<u>(244,835)</u>
Total revenue	2,413,980	1,247,565	1,918,632
Total expenses	<u>(3,110,700)</u>	<u>(1,150,892)</u>	<u>(2,083,332)</u>
Excess (deficiency) of revenue over expenses	(696,720)	96,673	(164,700)
Change in fair value of interest rate swap	<u>-</u>	<u>(227,732)</u>	<u>-</u>
Decrease in unrestricted net assets (deficit)	<u>\$ (696,720)</u>	<u>(131,059)</u>	<u>(164,700)</u>
<u>2010</u>	<u>Foundation</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 9,307,849	6,797,705	125,455
Total liabilities	<u>343,494</u>	<u>6,292,608</u>	<u>205,590</u>
Net assets (deficit)	<u>\$ 8,964,355</u>	<u>505,097</u>	<u>(80,135)</u>
Total revenue	2,103,999	1,264,020	2,069,134
Total expenses	<u>(1,817,846)</u>	<u>(1,196,187)</u>	<u>(2,120,505)</u>
Excess (deficiency) of revenue over expenses	286,153	67,833	(51,371)
Change in fair value of interest rate swap	<u>-</u>	<u>225,617</u>	<u>-</u>
Increase (decrease) in unrestricted net assets (deficit)	<u>\$ 286,153</u>	<u>293,450</u>	<u>(51,371)</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(12) Affiliated Entities, Continued

The following are approximate dollar amounts of significant transactions and balances with affiliated entities.

Contributions from the Foundation to Healthcare amounted to approximately \$2,075,000 and \$980,000 in 2011 and 2010, respectively.

Healthcare rents space from SLM and provides utilities, maintenance and accounting services to SLM. Rent totalled approximately \$116,000 and \$77,000 in 2011 and 2010 and utilities and maintenance services sold totalled approximately \$513,000 and \$468,000 in 2011 and 2010, respectively.

Net receivables (payables) at December 31 from the following affiliates were approximately:

	<u>2011</u>	<u>2010</u>
Home	\$ (60,000)	1,082,000
MVN	568,000	1,035,000
New Hartford Scanner Associates	460,000	676,000
Foundation	574,000	201,000
VNA	120,000	61,000
SLM	17,000	(82,000)
Paraffin	157,000	27,000
Heart Institute	(260,000)	(28,000)
Other	41,000	47,000
	<u>\$ 1,617,000</u>	<u>3,019,000</u>

New Hartford Scanner Associates (NHSA) is a joint venture between Healthcare and several radiologists to provide CT scan services. Healthcare receives income from NHSA, which amounted to approximately \$715,000 and \$878,000 in 2011 and 2010, respectively. Healthcare also provides payroll services and leased equipment to NHSA, which amounted to approximately \$295,000 and \$276,000 in 2011 and 2010, respectively.

In addition to the foregoing, Healthcare, through its affiliation with MVN, is affiliated with several other entities all of which are independent from Healthcare and are engaged in serving the Mohawk Valley Region as providers of various healthcare related services.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Statements of Cash Flows - Supplemental Disclosures

Healthcare's non-cash investing and financing activity and cash payments for interest for the years ended December 31 were as follows:

	<u>2011</u>	<u>2010</u>
Capital lease obligations issued for property and equipment	\$ 2,350,862	5,499,994
Purchases of property and equipment financed through accounts payable	678,173	-
Cash paid for interest, net of capitalized interest	4,471,619	3,919,736

(14) Functional Expenses

Healthcare provides general health care services to residents of the Mohawk Valley Region. Expenses related to providing these services are as follows:

	<u>2011</u>	<u>2010</u>
Health care services	\$ 246,381,558	243,066,004
General and administrative	<u>38,944,025</u>	<u>39,694,779</u>
	<u>\$ 285,325,583</u>	<u>282,760,783</u>

(15) Fair Value of Financial Instruments

The Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Fair Value of Financial Instruments, Continued

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

Cash and Cash Equivalents: The amount reported on the balance sheet for cash and cash equivalents approximates fair value.

Investments including Assets Limited as to Use: The fair values, which are the amounts reported on the balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pooled Investment Hedge Funds and Real Estate Funds: Fair values are based on NAV per share as determined by the fund's investment manager or general partner.

Estimated Third-Party Payor Settlements: The amount reported on the balance sheet for estimated third-party payor settlements approximates its fair value.

Long-Term Debt: The fair value of fixed rate issues was determined by price quotes from an investment banker or estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements. The fair value of variable rate debt approximates its reported value on the balance sheet. Fixed rate long-term debt is the only financial instrument with a difference between recorded and fair value. The recorded value of fixed rate long-term debt on the balance sheet at December 31, 2011 approximates its fair value.

The following tables present information about assets and liabilities that are measured at fair value on a recurring basis as of December 31 and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. Healthcare considers a security that trades at least weekly to have an active market. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Investments valued using NAV as a practical expedient are classified as Level 2 if the investment is redeemable at NAV (as adjusted for subsequent gains or losses through the effective date of redemption) in the near-term (generally within a 3-month period) without significant restrictions on redemption. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Investments valued using NAV as a practical expedient are classified as Level 3 if the investment is not redeemable in the near-term or has significant restrictions.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2011	Fair value measurements at December 31, 2011		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 915,647	915,647	-	-
Investments:				
Cash and cash equivalents	144,158	144,158	-	-
Mutual funds:				
Index funds	2,598,339	2,598,339	-	-
Growth funds	13,680,789	13,680,789	-	-
Fixed income funds	7,382,237	7,382,237	-	-
	<u>23,661,365</u>	<u>23,661,365</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	833,125	833,125	-	-
Energy	276,411	276,411	-	-
Financial	336,363	336,363	-	-
Healthcare	422,254	422,254	-	-
Industrial	468,071	468,071	-	-
Information technology	723,387	723,387	-	-
Materials	127,440	127,440	-	-
	<u>3,187,051</u>	<u>3,187,051</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	14,583,412	-	14,583,412	-
Real estate funds	2,305,759	-	2,171,851	133,908
Bond funds	3,389,669	-	3,389,669	-
Foreign equity funds	5,360,376	-	5,360,376	-
	<u>25,639,216</u>	<u>-</u>	<u>25,505,308</u>	<u>133,908</u>
Total	\$ 53,547,437	29,520,450	23,893,079	133,908
Liabilities:				
Interest rate swaps	6,299,513	-	6,299,513	-
Total	\$ 6,299,513	-	6,299,513	-

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2010	Fair value measurements at December 31, 2010		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 497,186	497,186	-	-
Investments:				
Cash and cash equivalents	25,829	25,829	-	-
Mutual funds:				
Index funds	1,413,338	1,413,338	-	-
Growth funds	9,535,549	9,535,549	-	-
Fixed income funds	31,234,546	31,234,546	-	-
	42,183,433	42,183,433	-	-
Common stock:				
Consumer	649,740	649,740	-	-
Energy	282,906	282,906	-	-
Financial	283,861	283,861	-	-
Healthcare	403,311	403,311	-	-
Industrial	577,593	577,593	-	-
Information technology	732,605	732,605	-	-
Materials	163,758	163,758	-	-
	3,093,774	3,093,774	-	-
Pooled investment funds:				
Hedge funds	13,517,999	-	13,517,999	-
Real estate funds	485,484	-	-	485,484
Bond funds	2,610,467	-	2,610,467	-
	16,613,950		16,128,466	485,484
Assets limited as to use:				
Cash & cash equivalents	6,598,639	6,598,639	-	-
Mutual fund - growth fund	253,492	253,492	-	-
Guaranteed income contracts	2,750,415	-	2,750,415	-
Total	\$ 72,016,718	52,652,353	18,878,881	485,484
Liabilities:				
Interest rate swaps	3,967,565	-	3,967,565	-
Total	\$ 3,967,565	-	3,967,565	-

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Fair Value of Financial Instruments, Continued

The following table sets forth a summary of changes in the fair value of Healthcare's level 3 assets for the years ended December 31, 2011 and 2010.

	<u>2011</u>	<u>2010</u>
Balance, beginning of year	\$ 485,484	536,920
Interest and dividends, net of investment manager fees	9,229	25,260
Net realized gains (losses) on sale of investments	(8,242)	6,492
Change in net unrealized gains and losses on investments	40,722	37,394
Sales	<u>(393,285)</u>	<u>(120,582)</u>
Balance, end of year	<u>\$ 133,908</u>	<u>485,484</u>

The following is a summary of the investments whose NAV approximates fair value and the related redemption restrictions associated with each major category at December 31, 2011 and 2010.

<u>Pooled investment fund</u>	<u>2011</u>		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 14,583,412	Monthly	90 days
Real estate funds	2,171,851	Monthly	None
Real estate funds	133,908	Restricted	Upon approval
Bond funds	3,389,669	Monthly	10 days
Foreign equity funds	<u>5,360,376</u>	Monthly	10 days
	<u>\$ 25,639,216</u>		
<u>Pooled investment fund</u>	<u>2010</u>		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 13,517,999	Monthly	90 days
Real estate funds	485,484	Restricted	Upon approval
Bond funds	<u>2,610,467</u>	Monthly	10 days
	<u>\$ 16,613,950</u>		

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Fair Value of Financial Instruments, Continued

Hedge Funds

Hedge fund strategies involve funds with investment managers who have the authority to invest in various asset classes at their discretion and who have the ability to employ multiple investments strategies within their respective portfolios. Investment strategies may include the following categories: merger arbitrage, distressed, long/short credit, fixed income arbitrage and convertible arbitrage. These funds attempt to reduce individual manager risk by allocating capital among multiple investment managers. Funds with hedged strategies generally hold securities or other financial instruments for which a ready market exists and may include stocks, bonds, put or call options, swaps, currency hedges, and other instruments, and are valued accordingly.

Real Estate Funds

Real estate funds hold interests in publicly traded equity securities issued by real estate investment trusts ("REIT"), private real estate partnerships, and privately held REIT's. Strategies of these funds often require the estimation of fair values by the fund managers in the absence of readily determinable market values. Because of the inherent uncertainties of valuation, these estimated fair values may differ significantly from values that would have been used had a ready market existed, and the differences could be material. Such valuations are determined by fund managers and generally consider variables such as operating results, comparable earnings multiples, projected cash flows, recent sales prices, and other pertinent information, and may reflect discounts for the illiquid nature of certain investments held. Moreover, the fair values of Healthcare's interests in shares or units of these funds, because of the liquidity and capital commitment terms that vary depending on the specific fund or partnership agreement, may differ from the fair value of the funds' underlying net assets.

Bond Funds

Bond funds are invested in a globally diversified portfolio of primarily debt and debt-like securities. The funds are controlled by an investment manager. The investment manager generally will acquire positions in debt securities and currencies that are rated investment grade by Standard & Poor's Credit Market Services, or if unrated, an equivalent rating determined by the investment manager at its sole discretion.

Foreign Equity Funds

Foreign equity funds are invested in a diversified portfolio of equity securities of companies ordinarily located in any country other than the United States and Canada. The funds are controlled by an investment manager.

**FAXTON-ST. LUKE'S HEALTHCARE
AND CONSOLIDATED SUBSIDIARIES**

Consolidated Financial Statements

December 31, 2012 and 2011

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Faxton-St. Luke's Healthcare:

We have audited the accompanying consolidated financial statements of Faxton-St. Luke's Healthcare and Consolidated Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

The Board of Directors
Page 2 of 2

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Faxton-St. Luke's Healthcare and Consolidated Subsidiaries as of December 31, 2012 and 2011, and the results of their operations, changes in net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Fust Charles Chambers LLP

June 27, 2013

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2012 and 2011

<u>Assets</u>	<u>2012</u>	<u>2011</u>
Current assets:		
Cash and cash equivalents	\$ 3,783,955	2,263,868
Investments	63,621,477	51,643,808
Patient accounts receivable, net of reserve for doubtful accounts of \$10,666,909 in 2012 and \$8,761,207 in 2011	46,151,404	43,667,397
Pledges receivable	135,446	130,702
Inventories	5,680,655	5,231,856
Prepaid expenses and other current assets	18,561,582	13,638,870
Due from affiliates, net	5,620,428	2,239,930
Net investment in direct financing lease	547,116	547,116
Estimated third-party payor settlements, net	9,576,424	8,488,264
Total current assets	153,678,487	127,851,811
Investment in affiliates	137,248	129,203
Due from affiliates, net	1,186,739	13,881,063
Investments	4,528,164	4,528,164
Beneficial interest in charitable trusts	1,247,000	2,005,000
Residents' funds held in trust	90,429	72,091
Net investment in direct financing lease	3,013,803	3,288,328
Property and equipment, net	114,245,198	106,297,759
Unamortized debt issuance costs	472,689	498,240
Other assets	29,509,198	24,077,475
Total assets	\$ 308,108,955	282,629,134

<u>Liabilities and Net Assets</u>	<u>2012</u>	<u>2011</u>
Current liabilities:		
Bank overdraft	\$ -	158,431
Short-term borrowings	3,000,000	-
Revolving note payable	12,678,000	3,959,000
Current portion of long-term debt	3,597,989	4,582,967
Current portion of capital lease obligations	4,035,695	3,534,395
Accounts payable and accrued expenses	15,038,156	13,198,840
Accrued payroll, payroll taxes and benefits	13,147,857	11,812,545
Current portion of estimated self-insured liabilities	1,997,985	1,671,472
Other current liabilities	11,928,487	9,963,365
	<u>65,424,169</u>	<u>48,881,015</u>
Total current liabilities		
Long-term debt, net of current portion:		
Notes payable	8,824,057	17,339,959
Civic facility revenue bonds	16,845,000	17,355,000
Capital lease obligations	7,779,365	8,209,973
	<u>33,448,422</u>	<u>42,904,932</u>
Total long-term debt, net of current portion		
Other liabilities	39,125,417	34,168,477
Unrealized loss on interest rate swaps	6,144,832	6,299,513
Estimated self-insured liabilities, net of current portion	2,911,610	3,569,133
Residents' funds held in trust	90,429	72,091
	<u>147,144,879</u>	<u>135,895,161</u>
Total liabilities		
Net assets:		
Unrestricted	152,631,544	126,204,608
Temporarily restricted	3,804,368	16,001,201
Permanently restricted	4,528,164	4,528,164
	<u>160,964,076</u>	<u>146,733,973</u>
Total net assets		
Commitments and contingencies (notes 5, 9 and 13)		
Total liabilities and net assets	<u>\$ 308,108,955</u>	<u>282,629,134</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted revenues, gains and other support:		
Patient service revenue (net of contractual allowances and discounts)	\$ 295,200,895	292,249,708
Provision for bad debts	<u>(9,141,846)</u>	<u>(9,179,130)</u>
Net patient service revenue less provision for bad debts	286,059,049	283,070,578
Other revenue (note 12)	9,604,885	11,224,806
Investment income, net of fees	<u>2,375,465</u>	<u>610,358</u>
Total unrestricted revenues, gains and other support	<u>298,039,399</u>	<u>294,905,742</u>
Expenses:		
Salaries and wages	134,512,624	128,105,329
Employee benefits	30,422,504	32,484,823
Supplies and other	111,625,944	108,997,177
Depreciation and amortization	17,660,110	17,158,260
Interest	2,695,394	4,795,766
New York State gross receipts taxes	1,883,934	1,771,613
Loss on extinguishment of debt	<u>-</u>	<u>871,935</u>
Total expenses	<u>298,800,510</u>	<u>294,184,903</u>
Net income (loss) from continuing operations	(761,111)	720,839
Discontinued operations	<u>2,354,183</u>	<u>(235,825)</u>
Excess of revenues over expenses	<u>\$ 1,593,072</u>	<u>485,014</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets, Continued

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 1,593,072	485,014
Change in fair value of interest rate swaps	154,681	(2,331,948)
Change in net unrealized gains and losses on investments	5,272,464	(1,989,374)
Net assets released for capital acquisitions	12,787,932	1,525,621
Contributions from HEAL grant	6,685,500	16,748,102
Cumulative effect of change in accounting principle	-	(5,000,000)
Other	<u>(66,713)</u>	<u>(72,533)</u>
Increase in unrestricted net assets	<u>26,426,936</u>	<u>9,364,882</u>
Temporarily restricted net assets:		
Contributions and grants	1,265,409	1,331,110
Contributions from HEAL grant	-	12,468,581
Income on investments	1,669	104
Change in value of charitable trusts	142,000	(27,000)
Net assets released from restrictions	<u>(13,605,911)</u>	<u>(2,342,375)</u>
Increase (decrease) in temporarily restricted net assets	<u>(12,196,833)</u>	<u>11,430,420</u>
Total increase in net assets	14,230,103	20,795,302
Net assets at beginning of year	<u>146,733,973</u>	<u>125,938,671</u>
Net assets at end of year	<u>\$ 160,964,076</u>	<u>146,733,973</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Change in net assets	\$ 14,230,103	20,795,302
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	17,660,110	17,158,260
Provision for bad debts	9,141,846	9,179,130
Loss on extinguishment of debt	-	1,621,287
Contributions from HEAL grant, net	(6,685,500)	(30,546,851)
Cumulative effect of change in accounting principle	-	5,000,000
Change in net unrealized gains and losses on investments	(5,272,464)	1,989,374
Change in fair value of interest rate swaps	(154,681)	2,331,948
Other	-	72,533
Amortization of unearned lease income	(272,591)	(292,206)
Net realized (gain) loss on sale of investments	(1,174,399)	588,383
(Gain) loss on disposition of property and equipment	398,197	(4,636)
(Gain) loss on discontinued component	(2,354,183)	235,825
Contributions for capital acquisitions	(110,000)	(166,934)
Change in value of charitable trusts	(142,000)	-
(Gain) loss in earnings of investees	(8,045)	295,759
Changes in operating assets and liabilities:		
Bank overdraft	(158,431)	158,431
Patient accounts receivable	(11,625,853)	(9,888,577)
Inventories, prepaid expenses and other current assets	(1,032,042)	(606,950)
Beneficial interest in charitable trusts	900,000	27,000
Grant receivable from affiliated entity	706,147	(706,147)
Due from affiliates, net	(905,205)	776,535
Accounts payable, accrued expenses and other liabilities	2,659,349	1,616,800
Estimated self-insured liabilities	(686,376)	(107,273)
Estimated third-party payor settlements	(1,088,160)	(4,408,750)
	14,025,822	15,118,243
Cash flows from investing activities:		
Purchases of property and equipment	(20,463,330)	(10,781,358)
Proceeds from sale of property and equipment	487,010	14,838
Proceeds from sale (purchases) of investments, net	(5,530,806)	6,959,693
Discontinued operations	-	(235,825)
Increase in other assets	(648,179)	(269,900)
Net decrease in assets limited as to use	-	9,363,861
Use of project escrow funds	-	4,691,321
	(26,155,305)	9,742,630

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from financing activities:		
Proceeds from short-term borrowing	3,000,000	-
Proceeds (payments) on revolving note payable, net	8,719,000	(241,000)
Proceeds from long-term debt	1,400,000	72,827
Principal payments on long-term debt and capitalized lease obligations	(9,639,430)	(43,253,990)
Prepayment penalty on debt extinguishment	-	(621,667)
Contributions from HEAL grant, net	9,512,884	16,163,323
Minimum direct financing lease payments received	547,116	547,116
Contributions for capital acquisitions	<u>110,000</u>	<u>166,934</u>
Net cash provided by (used in) financing activities	<u>13,649,570</u>	<u>(27,166,457)</u>
Increase (decrease) in cash and cash equivalents	1,520,087	(2,305,584)
Cash and cash equivalents at beginning of year	<u>2,263,868</u>	<u>4,569,452</u>
Cash and cash equivalents at end of year	<u>\$ 3,783,955</u>	<u>2,263,868</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2012 and 2011

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

Faxton-St. Luke's Healthcare (Healthcare) and Consolidated Subsidiaries (the Company) is a healthcare delivery system providing inpatient, outpatient, emergency care, cancer treatment, rehabilitation, dialysis, maternity, child care, long term care, surgical, psychiatric and community services to residents of the Mohawk Valley Region. Mohawk Valley Network, Inc. (MVN), a not-for-profit corporation, is the sole corporate member of Healthcare, and various other organizations involved in providing health care services to the Mohawk Valley Region.

(b) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Healthcare and the following affiliated entities: Faxton-St. Luke's Healthcare Foundation (Foundation), of which Healthcare is the sole member and St. Luke's Home Residential Health Care Facility, Inc. (Home), in which Healthcare has a sole financial interest at dissolution. Included on the equity method of accounting are SLM Corporation (SLM), whose stock is owned by a trust, of which Healthcare is the sole beneficiary, and Paraffin, LLC (Paraffin). All significant intercompany transactions and balances have been eliminated in consolidation.

The Foundation is a not-for-profit, tax-exempt corporation that carries out fund raising activities which benefit Healthcare and the Home. The Home is a not-for-profit, tax-exempt corporation that operates a 202-bed skilled nursing facility. Paraffin is a not-for-profit limited liability company that subcontracts laboratory management and supervision of technical services to a local hospital.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies

(c) Adoption of Accounting Pronouncement

In July 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2011-07 requires health care entities that recognize significant amounts of patient service revenue at the time of service, even though they do not assess the patient's ability to pay, to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue on the statement of operations and changes in net assets. In addition, enhanced disclosure about the entity's policies for recognizing revenue and assessing bad debts, including disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts is required. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011. The Company adopted this guidance as of and for the year ended December 31, 2012, with retrospective application to all periods presented for the amendments relating to the presentation of the provision for bad debts related to patient service revenue; however, the enhanced disclosures required by the amendments are provided for the period of adoption and subsequent reporting periods. The adoption of ASU 2011-07 had the effect of reducing net patient service revenue by \$9,179,130, with an offsetting reduction in operating expenses for the year ended December 31, 2011, on the consolidated statements of operations and changes in net assets, and no effect on excess of revenues over expenses.

(d) Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(e) Collective Bargaining Agreement

At December 31, 2012, the Company has approximately 30% of its employees working under collective bargaining agreements.

(f) Cash and Cash Equivalents

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

(g) Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value which is determined utilizing quoted market prices. Investments in insurance group fixed annuity contracts (Guaranteed Investment Contracts) are valued at contract value, which is considered the best representation of fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses since none of the investments are classified as trading securities.

Certain investments that do not have readily determinable fair values are valued by using the net asset value (NAV) per share (or its equivalent), as a practical expedient permitted under the Fair Value Measurements Topic of the FASB Accounting Standards Codification.

The Company invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the Company's net assets.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(h) Beneficial Interest in Charitable Trusts

The Company has beneficial interests in various irrevocable split-interest agreements that are administered by independent trustees which consist of charitable remainder unitrusts (CRUT). The Company's interest in these trusts is recorded at the present value of the estimated future cash flows from the trust's assets using a discount rate that reflects current market conditions and is included in temporarily restricted net assets for renovations and equipment. The Company used a discount rate of 1.2% and 1.6% at December 31, 2012 and 2011, respectively. Changes in the fair value of the beneficial interest are reflected as a change in value of charitable trusts in the consolidated statement of operations and changes in net assets.

(i) Inventories

Inventories are stated at the lower of average cost or market.

(j) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is calculated over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years using the straight-line method. Property and equipment under capital leases and leasehold improvements are amortized on the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Amortization of equipment under capital leases and leasehold improvements is included in depreciation and amortization expense.

Interest cost incurred on borrowed funds during the construction of capital assets is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized amounted to approximately \$163,000 in 2012 and \$121,000 in 2011.

Gifts of long-lived assets, such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(k) Unamortized Debt Issuance Costs

Debt issuance costs are amortized using the straight-line method, which approximates the effective interest method, over the terms of the related debt.

(l) Contributions and Pledges Receivable

Unconditional promises to give cash and other assets 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. Contributions 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 and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated statements of operations and changes in net assets.

Pledges receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a provision for bad debts and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to pledges receivable. At December 31, 2012 and 2011, no allowance was recorded. The original pledge amount at December 31, 2012 and 2011 approximates the net present value.

(m) Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds)

The Company maintains various donor-restricted and board-designated funds whose purpose is to provide long-term support for its charitable programs. In classifying such funds for financial statement purposes as either permanently restricted, temporarily restricted or unrestricted net assets, the Board of Directors looks to the explicit directions of the donor where applicable and the provisions of the laws of the State of New York. To constitute an endowment under New York State law, the restriction must arise from a clearly expressed donor limitation, not a limitation from within the beneficiary organization. The Board has determined that, absent donor stipulations to the contrary, the provisions of New York State law do not impose either a permanent or temporary restriction on the income or capital appreciation derived from the original gift. Therefore, all income and appreciation derived from the original gift are transferred to unrestricted net assets absent any restrictions on the use made by the donor. Permanently restricted net assets consist of endowment funds of \$4,528,164 at December 31, 2012 and 2011 and are included in long-term investments in the consolidated balance sheets.

The Company utilizes an investment strategy that emphasizes preservation of principal and total return consistent with prudent levels of risk. Investments are allocated over a diversified portfolio of multiple asset classes of domestic and international equities and bonds.

Interpretation of Relevant Law

Previous to September 17, 2010, New York State law required the preservation of an endowment fund's historic dollar value. Historic dollar value is defined as the aggregate fair value in dollars of an endowment fund at the time it becomes an endowment fund, each subsequent donation to the fund at the time it is made and each accumulation made pursuant to a direction in applicable gift instrument at the time an accumulation is added to the fund. The law permitted an organization to spend the income earned by an endowment fund (i.e. interest, dividends), as well as the net appreciation (realized with respect to all assets and unrealized with respect to readily marketable assets) of such fund.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds), Continued

Interpretation of Relevant Law, Continued

On September 17, 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) was signed into New York State law. The most prominent feature of NYPMIFA is the elimination of the requirement to preserve an endowment fund's historic dollar value which allows an organization to spend from an endowment whose market value has dropped below the historic dollar value, as long as it is deemed prudent under the organization's policies. In accordance with NYPMIFA, an organization must consider the following factors in exercising a standard of prudence:

1. The duration and preservation of the endowment fund
2. The purposes of the organization and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the organization
7. The investment policies of the organization
8. Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization

NYPMIFA requires compliance with donor intent when making investment or spending decisions with respect to an endowment fund. In addition, NYPMIFA creates a restriction on the portion of an endowment fund that is not classified as permanently restricted net assets, even in the absence of a donor restriction. Such portion is classified as temporarily restricted net assets until appropriated for expenditure by the organization.

As of December 31, 2012, the Board of Directors has not adopted and is currently evaluating the provisions of NYPMIFA. As a result, the Company continues to classify permanently restricted net assets at the historic dollar value of the fund in accordance with donor instructions.

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or NYPMIFA requires the Company to retain as a fund of perpetual duration. If the situation were to occur, the deficiency would be recorded in the Company's unrestricted net assets. The deficiency recorded in unrestricted net assets at December 31, 2011 was approximately \$141,000. There was not a deficiency at December 31, 2012.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds), Continued

Return Objectives, Strategies, Spending Policy and Investment Objectives

The Company has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in a well diversified asset mix that can be expected to generate acceptable long-term returns at an acceptable level of risk. The Company targets a diversified asset allocation that places a greater emphasis on equity-based investments and bonds to achieve its long-term return objectives within prudent risk constraints.

Changes in Endowment Net Assets

	2012		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2012	\$ (140,961)	4,528,164	4,387,203
Investment return:			
Investment income	-	95,620	95,620
Net appreciation (realized and unrealized)	-	435,114	435,114
Other	530,734	(530,734)	-
Endowment net assets, December 31, 2012	\$ 389,773	4,528,164	4,917,937
	2011		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2011	\$ (107,940)	4,528,164	4,420,224
Investment return:			
Investment income	-	91,367	91,367
Net appreciation (realized and unrealized)	-	(124,388)	(124,388)
Other	(33,021)	33,021	-
Endowment net assets, December 31, 2011	\$ (140,961)	4,528,164	4,387,203

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Net Patient Service Revenue and Patient Accounts Receivable

The Company has agreements with third-party payors that provide for payments to the various organizations within its healthcare delivery system at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge or visit, cost-based reimbursement, discounted charges, per diem payments and fee-for-service payments. The Company recognizes patient service revenue associated with services provided to patients who have third-party coverage on the basis of contractual rates for the services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. Retroactive adjustments are included in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. For uninsured patients that do not qualify for charity care, the Company recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the Company's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Company records a provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts) from these major payor sources, is as follows for the year ended December 31, 2012:

	<u>Government payors</u>	<u>Commercial insurance and others</u>	<u>Self-pay</u>	<u>Total</u>
Patient service revenue (net of contractual allowances and discounts)	\$ 164,057,018	122,296,039	8,847,838	295,200,895

Revenue from the Medicare and Medicaid programs accounted for approximately 56% and 54% of the Company's patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts) for 2012 and 2011, respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Patient service revenue increased by approximately \$47,000 and \$1,080,000 in 2012 and 2011, respectively, related to either settlement of prior year issues or changes in estimates associated with third-party issues.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Net Patient Service Revenue and Patient Accounts Receivable, Continued

The Company grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2012</u>	<u>2011</u>
Medicare	26%	22%
Medicaid	20%	20%
Private payors	12%	12%
Insurance and all others	<u>42%</u>	<u>46%</u>
	<u>100%</u>	<u>100%</u>

Patient accounts receivable are reduced by a reserve for doubtful accounts. In evaluating the collectibility of patient accounts receivable, the Company analyzes past payment history and identifies trends for each of its major payor sources of revenue to estimate the appropriate reserve for doubtful accounts and provision for bad debts. For receivables associated with patients who have third-party coverage, the Company analyzes contractually due amounts and provides a reserve for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Company records a reserve for doubtful accounts and a provision for bad debts in the period of service based on 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 standards rates (or the discounted rates if negotiated) and the amount actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

The Company's reserve for doubtful accounts for self-pay patients increased from 57% of self-pay accounts receivable at December 31, 2011 to 62% of self-pay accounts receivable at December 31, 2012. The increase relates to negative trends experienced in the collection of amounts from self-pay patients in recent years as a result of unstable economic conditions. In addition, the Company's self-pay write offs decreased \$2,339,854 from \$9,898,546 for fiscal year 2011 to \$7,558,692 for fiscal year 2012.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(p) Charity Care

Healthcare provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Healthcare does not pursue collection of such amounts, they are not reported as patient service revenue. During 2012 and 2011, costs incurred by Healthcare in the provision of charity care were based on the ratio of Healthcare's costs to gross charges and approximated \$340,000 and \$657,000, respectively.

(q) Excess of Revenues over Expenses

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, the effective portion of gains and losses on derivative instruments, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

(r) Income Taxes

Healthcare, Foundation and the Home are not-for-profit corporations and have been recognized as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

As of December 31, 2012 and 2011, Healthcare, the Foundation and the Home did not have any unrecognized tax benefits or any related accrued interest or penalties. The tax years open to examination by federal and state taxing authorities are 2009 through 2012.

(s) Concentration of Credit Risk

The Company invests cash and cash equivalents with financial institutions, and has determined that the amount of credit exposure at any one financial institution is immaterial to the Company's financial position.

(t) Reclassifications

Certain 2011 amounts have been reclassified to conform with the 2012 financial statement presentation.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(u) Subsequent Events

Subsequent events have been evaluated through June 27, 2013, which is the date consolidated financial statements were issued.

(2) Discontinued Operations

In 2009, the Company sold its wholly owned, for-profit subsidiary, Faxchil Realty, Inc. (Faxchil), including Faxchil's wholly owned, for-profit subsidiary, Centrex Clinical Laboratories, Inc. (Centrex). The sale included an earn-out opportunity not to exceed \$5,000,000 if certain revenue targets were achieved during two separate one year earn-out periods ending December 31, 2010 and 2011. These revenue targets were not achieved for the first two earn-out periods. During 2012, the earn-out period was extended for two additional one-year periods. For the year ended December 31, 2012, an earn-out of approximately \$2,354,000 was earned and recorded by the Company. During 2011, the Company recorded a loss of approximately \$236,000 related to covenant not to compete agreements, changes in accounts receivable and outstanding liabilities. It is expected that all other significant transactions related to the sale of Faxchil Realty, other than the final earn-out, have been recorded.

(3) HEAL Grant

During 2012, Healthcare was approved for a grant award of \$7,135,500 as part of the New York State HEAL grant program. The grant award is primarily to be used for restructuring initiatives in Medicaid redesign. The award included \$6,685,500 for the discharge of debt and \$450,000 for facility integration with St. Elizabeth Medical Center.

During 2011, MVN was approved for a grant award of \$31,329,508 as part of the New York State HEAL grant program. The grant award is primarily to be used to construct new and renovate existing portions of the Home's facility in order to centralize and expand long-term care services; to pay off the outstanding HUD mortgages at the Home; and for capital acquisitions for certain affiliates. In 2011, the Home applied to decertify 40 of its RHCf beds and closed one of its nursing wings to make space for these renovations. The beds were decertified as of January 13, 2012.

For accounting purposes, MVN is being treated as a pass-through entity for the grant as these funds are primarily being utilized by the Home in accordance with the Revenue Recognition Topic of the FASB Accounting Standards Codification. As such, the activity is recorded through the net assets of the Home. At December 31, 2012 and 2011, the Home had a receivable due from MVN of approximately \$4,871,000 and \$15,090,000, respectively, related to the HEAL grant (refer to note 14).

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) HEAL Grant, Continued

During 2011, the Home recorded approximately \$18,861,000 of contributions from HEAL grant as unrestricted contributions. The funds were utilized as follows:

Payment of HUD guaranteed mortgages including penalties	\$ 17,211,000
Renovations and construction at St. Luke's Home	1,489,000
Reimbursement of costs for wing closure at St. Luke's Home	87,000
Capital acquisitions for VNA	<u>74,000</u>
	<u>\$ 18,861,000</u>

(4) Investments

At December 31, investments, at fair value, are comprised of the following:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 2,437,457	1,200,315
Mutual funds	34,657,265	25,841,402
Common stock	4,158,057	3,716,436
Pooled investment funds	<u>29,291,303</u>	<u>26,469,976</u>
	<u>\$ 70,544,082</u>	<u>57,228,129</u>

The above amounts are included in the accompanying consolidated financial statements as follows:

	<u>2012</u>	<u>2011</u>
Investments - current assets	\$ 63,621,477	51,643,808
Cash and cash equivalents	2,394,441	1,056,157
Long-term investments	<u>4,528,164</u>	<u>4,528,164</u>
	<u>\$ 70,544,082</u>	<u>57,228,129</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Investments, Continued

Investment income and gains (losses) on investments are comprised of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Investment income:		
Interest income and dividends, net of fees	\$ 1,201,066	1,198,741
Realized gains (losses)	<u>1,174,399</u>	<u>(588,383)</u>
	2,375,465	610,358
Change in net unrealized gains and losses on investments	<u>5,272,464</u>	<u>(1,989,374)</u>
	<u>\$ 7,647,929</u>	<u>(1,379,016)</u>

The Company continually reviews investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. In the evaluation of whether an impairment is other-than-temporary, the Company considers the reasons for the impairment, its ability and intent to hold the investment until the market price recovers or the investment matures, compliance with its investment policy, the severity and duration of the impairment, and expected future performance.

The Company's investments in common stocks and mutual funds consist of investments diversified in several different industries. The Company evaluated the near-term prospects of the issuer in relation to the severity and duration of impairment. Based upon the evaluation and the Company's ability and intent to hold the securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider the securities in an unrealized loss position to be other-than-temporarily impaired at December 31, 2012 and 2011.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(5) Property and Equipment

Property and equipment is comprised of the following at December 31:

	<u>2012</u>	<u>2011</u>
Land and land improvements	\$ 10,217,935	8,387,601
Buildings	135,914,632	129,532,241
Fixed equipment	40,309,297	35,349,782
Movable equipment	99,826,955	96,797,433
Property and equipment under capitalized leases	<u>20,899,600</u>	<u>20,247,109</u>
	307,168,419	290,314,166
Less accumulated depreciation	<u>204,273,773</u>	<u>189,371,765</u>
	102,894,646	100,942,401
Construction-in-progress	<u>11,350,552</u>	<u>5,355,358</u>
Property and equipment, net	<u>\$ 114,245,198</u>	<u>106,297,759</u>

Depreciation expense amounted to approximately \$17,634,000 and \$16,906,000 for the years ended December 31, 2012 and 2011, respectively. At December 31, 2012, commitments to purchase in association with ongoing projects totalled approximately \$5.6 million.

(6) Direct Financing Lease

In 2001, Healthcare completed construction of a medical office building with a cost of approximately \$5 million on land owned by an affiliate of Slocum-Dickson Medical Group, P.C. (SDMG). The building is leased to SDMG under a direct financing lease for minimum lease payments of \$45,393 per month through 2022. Healthcare financed 80% of the building cost with a mortgage described in detail in note 9 which was paid off in 2012.

The consolidated balance sheet presentation of the direct financing lease at December 31 is as follows:

	<u>2012</u>	<u>2011</u>
Minimum lease payments receivable	\$ 4,859,479	5,406,595
Unearned lease income	<u>(1,298,560)</u>	<u>(1,571,151)</u>
Net investment in direct financing lease	3,560,919	3,835,444
Less current portion	<u>547,116</u>	<u>547,116</u>
Long-term net investment in direct financing lease	<u>\$ 3,013,803</u>	<u>3,288,328</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Extended Sick Leave

The Company's employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. The Company accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. The Company has accrued an estimated liability of approximately \$10,984,000 and \$10,118,000 at December 31, 2012 and 2011, respectively, for these anticipated termination payments.

Amounts are included in the accompanying consolidated financial statements as follows at December 31:

	<u>2012</u>	<u>2011</u>
Accrued payroll, payroll taxes and benefits	\$ 547,000	549,000
Other liabilities	<u>10,437,000</u>	<u>9,569,000</u>
	<u>\$ 10,984,000</u>	<u>10,118,000</u>

(8) Short-Term Borrowings

The Home has a line of credit with an available and outstanding balance of \$3,000,000 through a bank. The Foundation acts as a guarantor on this line of credit. Interest is calculated at the thirty-day LIBOR rate (0.21% at December 31, 2012) plus 2.25%.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations

Long-term debt consists of the following at December 31:

	<u>2012</u>	<u>2011</u>
Variable rate demand 2006 Civic Facility Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton-St. Luke's Healthcare) (a)	\$ 17,355,000	17,840,000
Revolving note payable (b)	12,678,000	3,959,000
Unsecured notes payable in varying monthly installments maturing from January 2013 through January 2016 at interest rates ranging from 5% to 6% (c)	3,262,988	5,690,632
Note payable in monthly installments of \$116,667 at a fixed rate of 5.3%, maturing June 2015 and collateralized by Healthcare's gross receipts	3,616,667	5,016,667
Note payable in monthly installments of \$15,249 at a fixed rate of 5.5% through March 2017 (c)	687,457	-
Mortgage note payable in monthly installments of \$26,230 at a fixed rate of 4.0%, secured by property under direct financing lease (note 6) (c)	-	2,583,712
Note payable to SLM at a fixed interest rate of 3.65% with a balloon payment for the remaining amount due December 2016	1,400,305	1,475,676
Mortgage payable in monthly installments of \$44,248 at a fixed rate of 6.5%, maturing January 2020 and collateralized by the related building	2,944,629	3,284,603
Notes payable in varying monthly installments at interest rates of 3.0% to 6.0%, collateralized by certain property (c)	-	3,317,985

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

	<u>2012</u>	<u>2011</u>
Notes payable in varying monthly installments maturing November 2012 (interest rates ranging from 6.25% to 6.75%)	-	68,651
Capital lease obligations (interest rates ranging from 2.9% to 8.5%)	<u>11,815,060</u>	<u>11,744,368</u>
	53,760,106	54,981,294
Less current portion:		
Revolving note payable	(12,678,000)	(3,959,000)
Debt	(3,597,989)	(4,582,967)
Capital lease obligations	<u>(4,035,695)</u>	<u>(3,534,395)</u>
Long-term debt, net of current portion	<u>\$ 33,448,422</u>	<u>42,904,932</u>

(a) Healthcare, through the Oneida County Industrial Development Agency (OCIDA), has issued serial and term Civic Facility Revenue Bonds as follows:

<u>Series</u>	<u>Term</u>	<u>Principal Payments</u>	<u>Rate</u>
Faxton-St. Luke's Healthcare:			
2006E - tax-exempt	2031	\$ 210,000 - 525,000	4.903 - 4.995%
2006F - taxable	2031	300,000 - 955,000	4.903 - 4.995%

The bonds are insured and are collateralized by Healthcare's gross receipts (as defined), including all rights to receive such receipts whether in the form of accounts receivable, contract rights or other rights. Healthcare entered into a lease agreement with OCIDA, which also acts as security for payment of the revenue bonds. Additional security is provided by a Master Trust Indenture under which the initial Members of the Obligated Group (Healthcare and MVN) are jointly and severally responsible for payment of the bonds.

The bonds bear interest based on one of three modes - the weekly rate, the term rate, or the fixed rate - for periods selected by Healthcare. The interest rate for each mode will be the current market interest rate as determined by the remarketing agent of the bonds. Healthcare used the weekly rate during 2012 and 2011. At December 31, 2012, the bonds carried interest at rates of .52% and .19%. At December 31, 2011 the bonds carried interest at rates of .40% and .18%.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

The bonds are remarketed by a remarketing agent in accordance with the terms of a remarketing agreement. The bonds will be remarketed whenever a new interest rate is in effect. If the bonds cannot be remarketed, they would be due and payable under the terms of the remarketing agreement; however, the bonds are credit-enhanced by an irrevocable Bank of America letter of credit, which is set to expire June 25, 2016. In the event that the remarketing agent is unable to remarket the bonds, the bond trustee will make a draw on the letter of credit and the tendered variable rate bonds will become bank bonds.

Various agreements relating to the bonds establish covenants with which Healthcare has agreed to comply, including the following, among others. In any year, Healthcare will not dispose of operating assets exceeding 2.5% of the total book value of operating assets or accounts receivable with recourse having a book value in excess of 50% of the total book value of accounts receivable. The Obligated Group may not merge or consolidate with another entity unless certain conditions are met. Additional indebtedness is limited to certain provisions including borrowings not to exceed 15% of total operating revenue. The Obligated Group agreed to maintain a minimum debt service coverage ratio, as defined, of 120% annually or employ a management consultant. At December 31, 2012 and 2011, the Obligated Group was in compliance with the covenants that are considered events of default.

As a result of the aforementioned 2006 bond issuances, the Healthcare has entered into two interest rate swap contracts to reduce its risk of exposure to changes in interest rates. The interest rate swaps effectively convert the variable rates of the 2006 bonds to fixed rates of 5.938% and 4.216% through June 2031. The swaps have been designated as cash flow hedges of the variable interest rates and are recorded at fair value as a liability of \$6,144,832 on the accompanying consolidated balance sheet as of December 31, 2012. The swaps have effective dates in June 2006 and termination dates of June 2031. The amounts exchanged are based on the notional amounts whereby Healthcare pays the swap counter-party interest at a fixed rate (4.216% - tax-exempt, 5.938% - taxable) and the swap counter-party pays Healthcare a variable rate (based on 70% of 1 month LIBOR tax-exempt, BMA Rate - taxable). The notional amounts and fair values based on quoted market prices of Healthcare's interest rate swaps are as follows at December 31, 2012:

	<u>Notional amount</u>	<u>Liability market value</u>
Healthcare - Series E	\$ 10,775,000	4,311,511
Healthcare - Series F	6,580,000	1,833,321
	\$ 17,355,000	6,144,832

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

The mark-to-market adjustments resulted in an increase of \$154,681 and a decrease of \$2,331,948 in unrestricted net assets for the years ended December 31, 2012 and 2011, respectively. Changes in value of the swaps determined to arise from ineffectiveness of the instruments, as determined through the hypothetical derivative method, are recorded as a component of interest expense in the consolidated statements of operations and changes in net assets. For the years ended December 31, 2012 and 2011, there was no significant ineffectiveness. Healthcare expects that the loss existing in unrestricted net assets to be reclassified into net income (loss) from continuing operations within the next 12 months will not be significant.

- (b) At December 31, 2012 and 2011, Healthcare had a \$19,500,000 revolving note payable with a bank, collateralized by substantially all of Healthcare's investments. The revolving note payable on short-term borrowings bears a daily interest rate at prime (3.25% at December 31, 2012). The revolving note payable on long-term borrowings bears a monthly interest rate at LIBOR plus 95 basis points (1.16% at December 31, 2012). The revolving note payable is available through July 2013. At December 31, 2012, a portion of the revolving note payable was reserved for three letters of credit totaling approximately \$4,357,000 related to self-insured liabilities. At December 31, 2012 and 2011, Healthcare had \$3,678,000 and \$959,000 outstanding on the short-term borrowings, respectively. At December 31, 2012 and 2011, Healthcare had \$9,000,000 and \$3,000,000 outstanding on the long-term borrowings, respectively. The revolving note payable contains financial covenants including a debt service coverage ratio requirement, a day's cash on hand requirement and a minimum unrestricted liquidity to funded debt ratio. At December 31, 2012 and 2011, Healthcare was in compliance with the covenants that are considered events of default.
- (c) Healthcare utilized funds as awarded by New York State through the HEAL grant of \$6,685,500 for the discharge of debt, which was used to pay off or pay down this debt. The HEAL grant is further described in note 3.

Healthcare leases certain equipment under capital leases. Healthcare also leases equipment and facilities under non-cancelable operating leases, including leases with affiliates. The net book value of the equipment capitalized under lease agreements at December 31, 2012 and 2011 amounted to approximately \$13,312,000 and \$13,129,000, respectively.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

Scheduled principal payments on long-term debt and payments under non-cancelable operating leases and the present value of future minimum capital lease payments at December 31, 2012 are:

Years ended	Revolving note payable	Long-term debt	Capital leases	<u>Operating leases</u>	
December 31:				<u>Affiliates</u>	<u>Other</u>
2013	\$ 12,678,000	3,597,989	4,446,951	154,867	2,458,616
2014	-	3,611,816	3,134,274	154,867	2,278,747
2015	-	4,301,607	2,376,501	154,867	1,859,220
2016	-	16,349,808	1,436,603	154,867	1,790,673
2017	-	471,800	848,409	154,867	1,705,624
Thereafter	-	<u>934,026</u>	<u>719,339</u>		
Total payments	12,678,000	29,267,046	12,962,077		
Less amounts representing interest			<u>1,147,017</u>		
Present value of capital lease obligations			11,815,060		
Less current portion			<u>4,035,695</u>		
Capital lease obligations, net of current portion			<u>\$ 7,779,365</u>		

Rent expense under operating leases amounted to approximately \$4,439,000 in 2012 and \$3,177,000 in 2011.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2012</u>	<u>2011</u>
Funds held in trust by others (for capital)	\$ 1,247,000	2,005,000
Children's Miracle Network	665,282	646,182
Continuous Learning Center	239,738	248,957
Scholarship assistance	31,199	30,869
Programs	530,051	355,605
Renovations	328,324	246,007
HEAL Grant - capital purchases	<u>762,774</u>	<u>12,468,581</u>
	<u>\$ 3,804,368</u>	<u>16,001,201</u>

Permanently restricted net assets at December 31 are restricted to:

Investments to be held in perpetuity, the income from which is to support charity care, health care services, scholarships and facility maintenance	<u>\$ 4,528,164</u>	<u>4,528,164</u>
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(11) Pension Plans

Healthcare and the Home sponsor a 401(k) plan that covers substantially all full-time non-union employees. Each sponsor contributes 4% of eligible compensation to the plan (5% for employees hired before December 1, 2001). Each sponsor also makes a matching contribution up to 100% of the first 4% of employee contributions to the 401(k) plan. Healthcare also sponsors a 403(b) plan that covers union and certain other employees. Healthcare contributes 5% to 7% of eligible compensation to the 403(b) plan.

Pension expense under all plans aggregated approximately \$7,312,000 in 2012 and \$7,222,000 in 2011.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(12) Other Revenue

Other revenue consists of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Rent	\$ 797,434	868,983
Mohawk Valley Heart Institute	(966,681)	(373,765)
New Hartford Scanner	845,776	1,009,764
Grant revenue and contributions	2,085,243	491,142
Medicare and Medicaid health information technology income	3,089,004	4,880,080
CMIC Partnership income	197,886	191,178
VHA Partnership equity earnings	225,704	237,321
Net assets released for operations	817,979	816,754
Other	<u>2,512,540</u>	<u>3,103,349</u>
	<u>\$ 9,604,885</u>	<u>11,224,806</u>

The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 included provisions for implementing health information technology under the Health Information Technology for Economic and Clinical Health Act (HITECH). The provisions were designed to increase the use of electronic health record (EHR) technology and to establish the requirements for a Medicare and Medicaid incentive payment program beginning in 2011 for eligible providers that adopt and meaningfully use certified EHR technology. Eligibility for annual Medicare incentive payments is dependent on providers demonstrating meaningful use of EHR technology in each period over a four-year period. Initial Medicaid payments are available to providers that adopt, implement or upgrade certified EHR technology. Providers must demonstrate meaningful use of such technology in subsequent years to qualify for additional Medicaid incentive payments.

The Company recognizes HITECH incentive payments as revenue when it is reasonably assured that the meaningful use objectives have been achieved. The Company recognized Medicare and Medicaid incentive payments totalling approximately \$3,089,000 and \$4,880,000 for the years ended December 31, 2012 and 2011, respectively, as other operating revenue in the accompanying statements of operations and changes in net assets. The Company's compliance with the meaningful use criteria is subject to audit by the federal and New York State governments.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Contingencies

General and malpractice insurance coverage is provided under a claims-made based policy for Healthcare and an occurrence-based policy for the Home, which provide for \$1,000,000 coverage for each claim, not to exceed \$3,000,000 in aggregate annual coverage. In addition, the Company has purchased an excess insurance policy. Claims alleging malpractice have been asserted against the Company and are currently in various stages of litigation. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted relating to services provided to patients. Accrued malpractice losses in management's opinion provide an adequate reserve for loss contingencies. The Company has accrued a liability included in other liabilities of approximately \$27,344,000 and \$27,288,000 at December 31, 2012 and 2011, respectively.

The Company and its affiliates are self-insured for employee healthcare costs. The group has obtained a stop loss coverage policy for healthcare costs to supplement its self insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

The Company is primarily self-insured for employee workers' compensation and disability claims along with certain of its affiliates for the years 2007 and prior. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, the Company has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. Each affiliate is jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2012 and 2011. Effective 2010, the Company and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of the Company and its affiliates.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Contingencies, Continued

Health Care Reform

The Affordable Care Act was signed into law, in two parts, on March 23, 2010 and March 30, 2010. The Affordable Care Act dramatically alters the U.S. healthcare system and is intended to decrease the number of uninsured Americans and reduce the overall cost of healthcare. The Affordable Care Act attempts to achieve these goals by, among other things, requiring most Americans to obtain health insurance, expanding Medicare and Medicaid eligibility, reducing Medicare payments and Medicaid DSH payments to providers, expanding the Medicare program's use of value-based purchasing programs, tying hospital payments to the satisfaction of certain quality criteria, bundling payments to hospitals and other providers, and instituting certain private health insurance reforms. Although a majority of the measures contained in the Affordable Care Act do not take effect until 2013 and 2014, certain of the reductions in Medicare spending, such as negative adjustments to the Medicare hospital inpatient and outpatient prospective payment system market basket updates and the incorporation of productivity adjustments to the Medicare program's annual inflation updates, became effective in 2010, 2011 and 2012.

On June 28, 2012, the U.S. Supreme Court upheld the "individual mandate" provision of the Affordable Care Act that generally requires all individuals to obtain healthcare insurance or pay a penalty. However, the U.S. Supreme Court also held that the provision of the Affordable Care Act that authorized the Secretary of the Department of Health and Human Services (HHS) to penalize states that choose not to participate in the expansion of the Medicaid program by removing all of their existing Medicaid funding was unconstitutional. In response to the ruling, a number of states have already indicated that they will not expand their Medicaid programs, which would result in the Affordable Care Act not providing coverage to some low-income persons in those states. In addition, several bills have been and may continue to be introduced in Congress to repeal or amend all or significant provisions of the Affordable Care Act. It is difficult to predict the full impact of the Affordable Care Act on our revenue and results of operations due to its complexity, lack of implementing regulations and interpretive guidance, gradual and potentially delayed implementation, potential future legal challenges, possible repeal and/or amendment and how individuals and businesses will respond to the choices afforded them by the Affordable Care Act.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities

The following represents summarized financial information from the financial statements of the Company's affiliates that are included in the accompanying consolidated financial statements on the equity method of accounting.

<u>2012</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 5,202,961	148,893
Total liabilities	<u>4,757,631</u>	<u>456,975</u>
Net assets (deficit)	\$ <u>445,330</u>	<u>(308,082)</u>
Total revenues	1,455,963	1,842,269
Total expenses	<u>(1,384,671)</u>	<u>(1,905,516)</u>
Excess (deficiency) of revenues over expenses	\$ <u>71,292</u>	<u>(63,247)</u>
 <u>2011</u>	 <u>SLM</u>	 <u>Paraffin</u>
Total assets	\$ 5,435,916	132,103
Total liabilities	<u>5,061,878</u>	<u>376,938</u>
Net assets (deficit)	\$ <u>374,038</u>	<u>(244,835)</u>
Total revenues	1,247,565	1,918,632
Total expenses	<u>(1,378,624)</u>	<u>(2,083,332)</u>
Deficiency of revenues over expenses	\$ <u>(131,059)</u>	<u>(164,700)</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities, Continued

The following are approximate dollar amounts of significant transactions and balances with affiliated entities.

Healthcare rents space from SLM and provides utilities, maintenance and accounting services to SLM. Rent totalled approximately \$124,000 and \$116,000 for 2012 and 2011 and utilities, maintenance and accounting services sold totalled approximately \$773,000 and \$513,000 and in 2012 and 2011, respectively.

Net receivables at December 31 from the following affiliates were approximately:

	<u>2012</u>	<u>2011</u>
MVN – HEAL grant	\$ 4,871,000	15,090,000
MVN	499,000	568,000
New Hartford Scanner Associates	355,000	460,000
Others	<u>1,082,000</u>	<u>3,000</u>
	<u>\$ 6,807,000</u>	<u>16,121,000</u>

New Hartford Scanner Associates (NHSA) is a joint venture between Healthcare and several radiologists to provide CT scan services. Healthcare receives income from NHSA, which amounted to approximately \$685,000 and \$715,000 in 2012 and 2011, respectively. Healthcare also provides leased equipment to NHSA, which amounted to approximately \$161,000 in 2012 and 2011.

In addition to the foregoing, the Company, through its affiliation with MVN, is affiliated with other entities all of which are independent from the Company and are engaged in serving the Mohawk Valley Region as providers of various healthcare related services.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(15) Consolidated Statements of Cash Flows - Supplemental Disclosures

The Company's non-cash investing and financing activities and cash payments for interest for the years ended December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Capital lease obligations issued for property and equipment	\$ 4,984,742	2,350,862
Purchases of property and equipment financed through accounts payable	340,960	678,173
Cash paid for interest, net of capitalized interest	2,852,779	5,403,102

(16) Functional Expenses

The Company provides general health care services to residents of the Mohawk Valley Region. Expenses related to providing these services are as follows:

	<u>2012</u>	<u>2011</u>
Health care services	\$ 254,788,883	254,626,905
General and administrative	43,188,508	38,684,325
Fund raising	<u>823,119</u>	<u>873,673</u>
	<u>\$ 298,800,510</u>	<u>294,184,903</u>

(17) Fair Value of Financial Instruments

The Fair Value Measurement Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

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

Cash and Cash Equivalents: The amount reported on the consolidated balance sheets for cash and cash equivalents approximates fair value.

Mutual Funds and Common Stock: The fair values, which are the amounts reported on the consolidated balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pooled Investment Hedge Funds and Real Estate Funds: Fair values are based on net asset value (NAV) per share as determined by the fund's investment manager or general partner.

Estimated Third-Party Payor Settlements: The amount reported on the consolidated balance sheet for estimated third-party payor settlements approximates its fair value.

Beneficial Interest in Charitable Trusts: Valued at the present value of the estimated future cash flows from the trust's assets using the Section 7520 interest rate as published by the Internal Revenue Service.

Long-Term Debt: The fair value of fixed rate issues was determined by price quotes from an investment banker or estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements (considered a Level 2 input). The fair value of variable rate debt approximates its reported value on the consolidated balance sheet. Fixed rate long-term debt is the only financial instrument with a difference between recorded and fair value. The recorded value of fixed rate long-term debt on the consolidated balance sheet at December 31, 2012 approximates its fair value.

The following tables present information about assets and liabilities and are measured at fair value on a recurring basis as of December 31 and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. The Company considers a security that trades at least weekly to have an active market. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Investments valued using NAV as a practical expedient are classified as Level 2 if the investment is redeemable at NAV (as adjusted for subsequent gains or losses through the effective date of redemption) in the near-term (generally within a 3-month period) without significant restrictions on redemption. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Investments valued using NAV as a practical expedient are classified as Level 3 if the investment is not redeemable in the near-term or has significant restrictions.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2012	Fair value measurements at December 31, 2012		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 2,394,441	2,394,441	-	-
Investments:				
Cash and cash equivalents	43,016	43,016	-	-
Mutual funds:				
U.S. large cap	8,792,411	8,792,411	-	-
U.S. mid cap	3,026,320	3,026,320	-	-
U.S. small cap	179,040	179,040	-	-
Internationally developed	7,760,066	7,760,066	-	-
Emerging markets	3,355,237	3,355,237	-	-
Fixed income funds	9,135,743	9,135,743	-	-
Other	2,428,448	2,428,448	-	-
	<u>34,657,265</u>	<u>34,657,265</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	1,023,309	1,023,309	-	-
Energy	494,961	494,961	-	-
Financial	240,645	240,645	-	-
Healthcare	527,160	527,160	-	-
Industrial	610,570	610,570	-	-
Information technology	1,039,703	1,039,703	-	-
Materials	221,709	221,709	-	-
	<u>4,158,057</u>	<u>4,158,057</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	15,573,023	-	15,573,023	-
Real estate funds	3,544,548	2,943	3,541,605	-
Bond funds	3,688,542	-	3,688,542	-
Foreign equity funds	6,485,190	-	6,485,190	-
	<u>29,291,303</u>	<u>2,943</u>	<u>29,288,360</u>	<u>-</u>
Beneficial interest in charitable trusts				
	<u>1,247,000</u>	<u>-</u>	<u>-</u>	<u>1,247,000</u>
Total	<u>\$ 71,791,082</u>	<u>41,255,722</u>	<u>29,288,360</u>	<u>1,247,000</u>
Liabilities:				
Interest rate swaps	6,144,832	-	6,144,832	-
Total	<u>\$ 6,144,832</u>	<u>-</u>	<u>6,144,832</u>	<u>-</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2011	Fair value measurements at December 31, 2011		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 1,056,157	1,056,157	-	-
Investments:				
Cash and cash equivalents	144,158	144,158	-	-
Mutual funds:				
U.S. large cap	5,610,039	5,610,039	-	-
U.S. mid cap	2,481,156	2,481,156	-	-
U.S. small cap	893,655	893,655	-	-
Internationally developed	5,066,565	5,066,565	-	-
Emerging markets	2,298,715	2,298,715	-	-
Fixed income funds	8,517,423	8,517,423	-	-
Other	973,849	973,849	-	-
	<u>25,841,402</u>	<u>25,841,402</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	971,511	971,511	-	-
Energy	322,324	322,324	-	-
Financial	392,234	392,234	-	-
Healthcare	492,393	492,393	-	-
Industrial	545,820	545,820	-	-
Information technology	843,545	843,545	-	-
Materials	148,609	148,609	-	-
	<u>3,716,436</u>	<u>3,716,436</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	15,189,176	-	15,189,176	-
Real estate funds	2,530,755	-	2,374,604	156,151
Bond funds	3,389,669	-	3,389,669	-
Foreign equity funds	5,360,376	-	5,360,376	-
	<u>26,469,976</u>	<u>-</u>	<u>26,313,825</u>	<u>156,151</u>
Beneficial interest in charitable trusts				
	<u>2,005,000</u>	<u>-</u>	<u>-</u>	<u>2,005,000</u>
Total	<u>\$ 59,233,129</u>	<u>30,758,153</u>	<u>26,313,825</u>	<u>2,161,151</u>
Liabilities:				
Interest rate swaps	<u>6,299,513</u>	<u>-</u>	<u>6,299,513</u>	<u>-</u>
Total	<u>\$ 6,299,513</u>	<u>-</u>	<u>6,299,513</u>	<u>-</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

The following tables set forth a summary of changes in the fair value of the Company's level 3 assets for the years ended December 31, 2012 and 2011.

	2012		2011	
	<u>Real estate funds</u>	<u>Beneficial interest in charitable trusts</u>	<u>Real estate funds</u>	<u>Beneficial interest in charitable trusts</u>
Balance, beginning of year	\$ 156,151	2,005,000	569,926	2,032,000
Payment received	-	(900,000)	-	-
Change in value of charitable trusts	-	142,000	-	(27,000)
Interest and dividends, net of investment manager fees	200	-	10,795	-
Net realized gains (losses) on sale of investments	507	-	(9,595)	-
Change in net unrealized gains on investments	-	-	47,603	-
Sales	(156,858)	-	(462,578)	-
Balance, end of year	\$ <u>-</u>	<u>1,247,000</u>	<u>156,151</u>	<u>2,005,000</u>

The following is a summary of the investments whose NAV approximates fair value and the related redemption restrictions associated with each major category at December 31, 2012 and 2011.

<u>Pooled investment fund</u>	2012		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 15,573,023	Monthly	90 days
Real estate funds	3,541,605	Monthly	None
Bond funds	3,688,542	Monthly	10 days
Foreign equity funds	6,485,190	Monthly	10 days
	\$ <u>29,288,360</u>		

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

<u>Pooled investment fund</u>	2011		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 15,189,176	Monthly	90 days
Real estate funds	2,374,604	Monthly	None
Real estate funds	156,151	Restricted	Upon approval
Bond funds	3,389,669	Monthly	10 days
Foreign equity funds	5,360,376	Monthly	10 days
	\$ 26,469,976		

Hedge Funds

Hedge fund strategies involve funds with investment managers who have the authority to invest in various asset classes at their discretion and who have the ability to employ multiple investments strategies within their respective portfolios. Investment strategies may include the following categories: merger arbitrage, distressed, long/short credit, fixed income arbitrage and convertible arbitrage. These funds attempt to reduce individual manager risk by allocating capital among multiple investment managers. Funds with hedged strategies generally hold securities or other financial instruments for which a ready market exists and may include stocks, bonds, put or call options, swaps, currency hedges, and other instruments, and are valued accordingly.

Real Estate Funds

Real estate funds hold interests in publicly traded equity securities issued by real estate investment trusts ("REIT"), private real estate partnerships, and privately held REIT's. Strategies of these funds often require the estimation of fair values by the fund managers in the absence of readily determinable market values. Because of the inherent uncertainties of valuation, these estimated fair values may differ significantly from values that would have been used had a ready market existed, and the differences could be material. Such valuations are determined by fund managers and generally consider variables such as operating results, comparable earnings multiples, projected cash flows, recent sales prices, and other pertinent information, and may reflect discounts for the illiquid nature of certain investments held. Moreover, the fair values of the Company's interests in shares or units of these funds, because of the liquidity and capital commitment terms that vary depending on the specific fund or partnership agreement, may differ from the fair value of the funds' underlying net assets.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

Bond Funds

Bond funds are invested in a globally diversified portfolio of primarily debt and debt-like securities. The funds are controlled by an investment manager. The investment manager generally will acquire positions in debt securities and currencies that are rated investment grade by Standard & Poor's Credit Market Services, or if unrated, an equivalent rating determined by the investment manager at its sole discretion.

Foreign Equity Funds

Foreign equity funds are invested in a diversified portfolio of equity securities of companies ordinarily located in any country other than the United States and Canada. The funds are controlled by an investment manager.

**FAXTON-ST. LUKE'S HEALTHCARE
AND CONSOLIDATED SUBSIDIARIES**

Consolidated Financial Statements
(Governmental Filing Requirements)

December 31, 2010 and 2009

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Faxton-St. Luke's Healthcare:

We have audited the accompanying consolidated balance sheets of Faxton-St. Luke's Healthcare and Consolidated Subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the management of Faxton-St. Luke's Healthcare. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free 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 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 Faxton-St. Luke's Healthcare and Consolidated Subsidiaries as of December 31, 2010 and 2009, and the results of their operations and 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.

As discussed in note 2 to the consolidated financial statements, the financial statements for 2009 have been restated to reflect a change in accounting for employee extended sick leave time.

The consolidated financial statements referred to above were prepared primarily to meet credit analysis and governmental filing requirements. Such financial statements are not intended to be general purpose financial statements (see note to consolidated financial statements 1(b)).

This report is intended solely for the information and use of the board of directors and management of Faxton-St. Luke's Healthcare and subsidiaries, the New York State Department of Health and other Offices and Agencies of the State of New York and selected financial institutions and is not intended to be and should not be used by anyone other than these specified parties.

Fust Charles Chambers LLP

June 29, 2011

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2010 and 2009

<u>Assets</u>	<u>2010</u>	<u>2009</u>
Current assets:		
Cash and cash equivalents	\$ 2,229,739	35,711,410
Assets limited as to use	4,494,491	3,452,108
Investments	57,388,822	17,473,296
Patient accounts receivable, net of reserve for doubtful accounts of \$7,784,057 in 2010 and \$7,197,470 in 2009	40,499,957	40,777,987
Other receivables	969,146	3,832,674
Inventories	5,346,833	5,549,066
Prepaid expenses and other current assets	2,673,053	2,511,920
Due from affiliates, net	1,984,133	2,376,421
Net investment in direct financing lease	547,116	547,116
Estimated third-party payor settlements, net	3,193,208	-
	<hr/>	<hr/>
Total current assets	119,326,498	112,231,998
Interest in Faxton-St. Luke's Healthcare Foundation	8,964,355	6,600,436
Investment in affiliates	424,962	182,883
Due from affiliates, net	1,035,468	1,817,792
Assets limited as to use	5,108,055	5,144,858
Investments	4,528,164	4,528,164
Net investment in direct financing lease	3,543,238	3,779,935
Property and equipment, net	100,423,564	96,851,893
Unamortized debt issuance costs	1,078,724	1,294,268
Other assets	4,299,471	4,393,381
	<hr/>	<hr/>
	\$ 248,732,499	236,825,608
	<hr/> <hr/>	<hr/> <hr/>

<u>Liabilities and Net Assets</u>	<u>2010</u>	<u>2009</u>
Current liabilities:		
Line of credit	\$ 4,200,000	2,030,000
Current portion of long-term debt	8,971,732	5,583,224
Current portion of capital lease obligations	4,549,596	3,756,113
Accounts payable and accrued expenses	11,316,870	14,365,982
Accrued payroll, payroll taxes and benefits	9,238,638	8,686,379
Current portion of estimated self-insured liabilities	1,402,213	1,546,323
Other current liabilities	843,831	912,963
Estimated third-party payor settlements, net	-	439,981
Total current liabilities	<u>40,522,880</u>	<u>37,320,965</u>
Long-term debt, net of current portion:		
Notes payable	21,364,424	11,642,070
Civic facility revenue bonds	31,476,571	36,541,481
Capital lease obligations	9,449,700	8,744,253
Total long-term debt, net of current portion	<u>62,290,695</u>	<u>56,927,804</u>
Other liabilities	9,854,184	10,609,474
Unrealized loss on interest rate swaps	3,967,565	3,157,747
Estimated self-insured liabilities, net of current portion	3,555,155	3,440,304
Total liabilities	<u>120,190,479</u>	<u>111,456,294</u>
Net assets:		
Unrestricted	119,443,075	118,348,880
Temporarily restricted	4,570,781	2,492,270
Permanently restricted	4,528,164	4,528,164
Total net assets	<u>128,542,020</u>	<u>125,369,314</u>
Commitments and contingencies (notes 5, 8 and 13)		
Total liabilities and net assets	<u>\$ 248,732,499</u>	<u>236,825,608</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Unrestricted revenues, gains and other support:		
Net patient service revenue	\$ 273,350,392	261,722,350
Other revenue	4,881,215	6,950,804
Investment income, net of fees	1,446,121	316,834
Contributions	457,954	551,780
Net assets released from restrictions used for operations	-	565
	<u>280,135,682</u>	<u>269,542,333</u>
Expenses:		
Salaries and wages	116,108,425	110,584,124
Employee benefits	31,015,344	31,223,419
Supplies and other	107,504,708	101,116,207
Depreciation and amortization	14,777,786	13,348,634
Provision for bad debts	8,589,774	9,259,582
Interest	3,803,042	3,918,905
Loss (gain) on disposal of property and equipment	(7,500)	326,246
NYS gross receipts taxes	969,204	671,614
	<u>282,760,783</u>	<u>270,448,731</u>
Total expenses		
	<u>(2,625,101)</u>	<u>(906,398)</u>
Discontinued operations:		
Gain on operations of discontinued component	-	1,707,633
Gain on sale of discontinued component	791,987	30,761,534
	<u>791,987</u>	<u>32,469,167</u>
Gain on discontinued operations		
	<u>(1,833,114)</u>	<u>31,562,769</u>
Excess (deficiency) of revenues over expenses	<u>\$ (1,833,114)</u>	<u>31,562,769</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets, Continued

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Unrestricted net assets:		
Excess (deficiency) of revenues over expenses	\$ (1,833,114)	31,562,769
Change in fair value of interest rate swaps	(809,818)	3,215,813
Change in interest in unrestricted net assets of Foundation	286,153	194,280
Contributions used for capital acquisitions	530,254	541,154
Change in net unrealized gains and losses on investments	3,409,058	3,569,818
Other	(488,338)	-
	<u>1,094,195</u>	<u>39,083,834</u>
Increase in unrestricted net assets		
Temporarily restricted net assets:		
Income on investments	745	508
Change in interest in temporarily restricted net assets of Foundation	2,077,766	686,817
Net assets released from restrictions	-	(565)
	<u>2,078,511</u>	<u>686,760</u>
Increase in temporarily restricted net assets		
Total increase in net assets	3,172,706	39,770,594
Net assets at beginning of year, as previously reported	<u>125,369,314</u>	<u>93,606,441</u>
Restatement (note 2)	<u>-</u>	<u>(8,007,721)</u>
Net assets at beginning of year, as restated	<u>125,369,314</u>	<u>85,598,720</u>
Net assets at end of year	<u>\$ 128,542,020</u>	<u>125,369,314</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Change in net assets	\$ 3,172,706	39,770,594
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	14,777,786	13,348,634
Provision for bad debts	8,589,774	9,259,582
Change in interest in net assets of Faxton-St. Luke's Healthcare Foundation	(2,363,919)	(881,097)
Change in net unrealized gains and losses on investments	(3,409,058)	(3,569,818)
Change in fair value of interest rate swap	809,818	(3,215,813)
Other	488,338	-
Amortization of unearned lease income	(310,419)	(327,332)
Net realized (gain) loss on sale of investments	(1,446,121)	306,431
Loss (gain) on disposition of property and equipment	(7,500)	326,246
Gain in earnings of investees	(242,079)	(186,475)
Gain on sale of discontinued component	(791,987)	(30,761,534)
Contributions for capital acquisitions	(530,254)	(541,154)
Changes in operating assets and liabilities:		
Receivables	(5,448,216)	(12,596,259)
Inventories, prepaid expenses and other current assets	41,100	(245,419)
Due from affiliates, net	1,223,795	518,134
Accounts payable, accrued expenses and other liabilities	(3,321,275)	2,389,178
Estimated self-insured liabilities	(29,259)	1,915,768
Estimated third-party payor settlements	(3,633,189)	4,885,326
Net cash provided by operating activities	<u>7,570,041</u>	<u>20,394,992</u>
Cash flows from investing activities:		
Purchases of property and equipment	(12,407,586)	(17,251,239)
Proceeds from sale of property and equipment	7,500	440,681
Proceeds (purchases) from sale of investments, net	(35,266,649)	1,186,880
Proceeds on sale of discontinued component, net	791,987	30,761,534
Increase in other assets	(461,094)	(179,646)
Net (increase) decrease in assets limited as to use	(799,278)	200,130
Net cash provided by (used in) investing activities	<u>(48,135,120)</u>	<u>15,158,340</u>
Cash flows from financing activities:		
Proceeds from short-term borrowings, net	2,170,000	2,030,000
Proceeds from long-term debt	14,277,313	2,300,000
Principal payments on long-term debt and capitalized lease obligations	(10,441,275)	(8,798,997)
Minimum direct financing lease payments received	547,116	547,116
Contributions for capital acquisitions	530,254	541,154
Net cash provided by (used in) financing activities	<u>7,083,408</u>	<u>(3,380,727)</u>
Increase (decrease) in cash and cash equivalents	(33,481,671)	32,172,605
Cash and cash equivalents at beginning of year	<u>35,711,410</u>	<u>3,538,805</u>
Cash and cash equivalents at end of year	<u>\$ 2,229,739</u>	<u>35,711,410</u>

See accompanying notes to consolidated financial statements.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2010 and 2009

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

Faxton-St. Luke's Healthcare (Healthcare), located in Utica, New York, is a not-for-profit healthcare delivery system providing inpatient, outpatient, emergency care, cancer treatment, rehabilitation, dialysis, maternity, child care, long term care, surgical, psychiatric and community services to residents of the Mohawk Valley Region. Admitting physicians are primarily practitioners in the local area. Mohawk Valley Network, Inc. (MVN), a not-for-profit corporation, is the sole corporate member of Healthcare and various other organizations involved in providing health care services to the Mohawk Valley Region.

(b) Principles of Consolidation

The accompanying consolidated financial statements were prepared primarily to meet credit analysis and governmental filing requirements, and are not intended to be general purpose financial statements of a primary reporting entity. Accordingly, such statements do not include the assets, liabilities or results of operations of all subsidiaries or controlled corporations as such terms are defined under generally accepted accounting principles for consolidated financial statements. Healthcare separately issues consolidated primary reporting entity financial statements.

The accompanying consolidated financial statements include the accounts of Healthcare and its 55.5% owned subsidiary, Faxton Leasing, LLC (Leasing). Faxton-St. Luke's Healthcare Foundation (Foundation), of which Healthcare is the sole member, SLM Corporation, whose stock is owned by a trust, of which Healthcare is the sole beneficiary, and Faxchil Realty, Inc. (Faxchil), a wholly owned for-profit subsidiary, and Paraffin, LLC (Paraffin), of which Healthcare is the sole member, are included on the equity method of accounting. Centrex Clinical Laboratories, Inc. (Centrex) is the wholly owned subsidiary of Faxchil. On December 9, 2009, Healthcare sold Faxchil (see note 3). St. Luke's Home Residential Health Care Facility, Inc. (Home), in which Healthcare has a sole financial interest at dissolution, is excluded from these consolidated financial statements. All significant intercompany transactions and balances with Leasing have been eliminated in consolidation.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(b) Principles of Consolidation, Continued

Leasing leases property and equipment to Healthcare for radiation therapy services. The Foundation is a not-for-profit, tax-exempt corporation that carries out fund raising activities which benefit Healthcare and the Home. Faxchil is a for-profit corporation that manages real property. Centrex was a for-profit corporation that provided clinical laboratory services to Healthcare, physicians and other entities prior to its sale in 2009 (Note 3). Paraffin is a not-for-profit limited liability company that provides laboratory services to a local hospital.

(c) Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(d) Collective Bargaining Agreements

At December 31, 2010, Healthcare has approximately 30% of its employees working under collective bargaining agreements.

(e) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturity of three months or less, excluding temporary investments included in assets limited as to use and long-term investments.

(f) Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value which is determined utilizing quoted market prices. Investments in insurance group fixed annuity contracts (Guaranteed Investment Contracts) are valued at contract value, which is considered the best representation of fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses since none of the investments are classified as trading securities.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(f) Investments, Continued

Healthcare invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect Healthcare's net assets.

(g) Assets Limited as to Use

Assets limited as to use represent assets held by trustees under indenture agreements and amounts held in escrow related to the sale of Faxchil. Amounts required to meet current liabilities are classified in the balance sheets as current assets.

(h) Inventories

Inventories are stated at the lower of average cost or market.

(i) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is calculated over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years using the straight-line method. Property and equipment under capital leases and leasehold improvements are amortized on the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Amortization of equipment under capital leases and leasehold improvements is included in depreciation expense.

Interest cost incurred on borrowed funds during the construction of capital assets is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized amounted to approximately \$172,000 in 2010 and \$97,000 in 2009.

Gifts of long-lived assets, such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(j) Unamortized Debt Issuance Costs and Bond Premium

Debt issuance costs and bond premium are amortized using the straight-line method, which approximates the effective interest method, over the terms of the related debt.

(k) Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

(l) Permanently Restricted Net Assets (Endowment Funds)

Healthcare maintains various donor-restricted and board-designated funds whose purpose is to provide long-term support for its charitable programs. In classifying such funds for financial statement purposes as either permanently restricted, temporarily restricted or unrestricted net assets, the Board of Directors looks to the explicit directions of the donor where applicable and the provisions of the laws of the State of New York. To constitute an endowment under New York State law, the restriction must arise from a clearly expressed donor limitation, not a limitation from within the beneficiary organization. The Board has determined that, absent donor stipulations to the contrary, the provisions of New York State law do not impose either a permanent or temporary restriction on the income or capital appreciation derived from the original gift. Therefore, all income and appreciation derived from the original gift are transferred to unrestricted net assets absent any restrictions on the use made by the donor. Permanently restricted net assets consist of endowment funds of \$4,528,164 at December 31, 2010 and 2009, and are included in long-term investments in the consolidated balance sheets.

Healthcare utilizes an investment strategy that emphasizes preservation of principal and total return consistent with prudent levels of risk. Investments are allocated over a diversified portfolio of multiple asset classes of domestic and international equities and bonds.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

Interpretation of Relevant Law

Previous to September 17, 2010, New York State law required the preservation of an endowment fund's historic dollar value. Historic dollar value is defined as the aggregate fair value in dollars of an endowment fund at the time it becomes an endowment fund, each subsequent donation to the fund at the time it is made and each accumulation made pursuant to a direction in applicable gift instrument at the time an accumulation is added to the fund. The law permitted an organization to spend the income earned by an endowment fund (i.e. interest, dividends), as well as the net appreciation (realized with respect to all assets and unrealized with respect to readily marketable assets) of such fund.

On September 17, 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) was signed into New York State law. The most prominent feature of NYPMIFA is the elimination of the requirement to preserve an endowment fund's historic dollar value which allows an organization to spend from an endowment whose market value has dropped below the historic dollar value, as long as it is deemed prudent under the organization's policies. In accordance with NYPMIFA, an organization must consider the following factors in exercising a standard of prudence:

1. The duration and preservation of the endowment fund
2. The purposes of the organization and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the organization
7. The investment policies of the organization
8. Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization

NYPMIFA requires compliance with donor intent when making investment or spending decisions with respect to an endowment fund. In addition, NYPMIFA creates a restriction on the portion of an endowment fund that is not classified as permanently restricted net assets, even in the absence of a donor restriction. Such portion is classified as temporarily restricted net assets until appropriated for expenditure by the organization.

As of December 31, 2010, the Board of Directors of Healthcare has not adopted and is currently evaluating the provisions of NYPMIFA. As a result, Healthcare continues to classify permanently restricted net assets at the historic dollar value of the fund in accordance with donor instructions.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or NYPMIFA requires the Hospital to retain as a fund of perpetual duration. If the situation were to occur, the deficiency would be recorded in the Hospital's unrestricted net assets. The deficiency recorded in unrestricted net assets at December 31, 2010 and 2009 was approximately \$108,000 and \$552,000, respectively.

Changes in Endowment Net Assets

	2010		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2010	\$ (552,159)	4,528,164	3,976,005
Investment return:			
Investment income	-	80,741	80,741
Net appreciation (realized and unrealized)	-	363,478	363,478
Other	444,219	(444,219)	-
Endowment net assets, December 31, 2010	\$ (107,940)	4,528,164	4,420,224

Return Objectives, Strategies, Spending Policy and Investment Objectives

Healthcare has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in well diversified asset mix that can be expected to generate acceptable long-term returns at an acceptable level of risk. Healthcare targets a diversified asset allocation that places a greater emphasis on equity-based investments and bonds to achieve its long-term return objectives within prudent risk constraints.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

	2009		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2009	\$ (1,235,276)	4,528,164	3,292,888
Investment return:			
Investment income	-	80,835	80,835
Net appreciation (realized and unrealized)	-	602,282	602,282
Other	<u>683,117</u>	<u>(683,117)</u>	<u>-</u>
Endowment net assets, December 31, 2009	\$ <u>(552,159)</u>	<u>4,528,164</u>	<u>3,976,005</u>

(m) Net Patient Service Revenue and Patient Accounts Receivable

Healthcare has agreements with third-party payors that provide for payments to the various organizations within its healthcare delivery system at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge, cost-based reimbursement, discounted charges, per diem payments and fee-for-service payments. Net patient service revenue and the related patient accounts receivable are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. Retroactive adjustments are included in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations.

An allowance for doubtful accounts receivable is estimated by management based on periodic reviews of the collectibility of accounts receivable considering historical experience and prevailing economic conditions.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(m) Net Patient Service Revenue and Patient Accounts Receivable, Continued

Revenue from the Medicare and Medicaid programs accounted for approximately 52% and 51% of Healthcare's net patient service revenue for 2010 and 2009, respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Patient service revenue decreased by approximately \$275,000 in 2010 and decreased by approximately \$690,000 in 2009 related to either settlement of prior year issues or changes in estimates associated with third-party issues.

Healthcare grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2010</u>	<u>2009</u>
Medicare	27%	28%
Medicaid	14%	16%
Private payors	16%	16%
Insurance and all others	<u>43%</u>	<u>40%</u>
	<u>100%</u>	<u>100%</u>

(n) Charity Care

Healthcare provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Healthcare does not pursue collection of such amounts, they are not reported as net patient service revenue. Charity care charges foregone, based on established rates, were approximately \$1,690,000 and \$1,399,000 for 2010 and 2009, respectively.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Contributions

Unconditional promises to give cash and other assets 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. Contributions 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 statements of operations and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated statements of operations and changes in net assets.

(p) Excess (Deficiency) of Revenues over Expenses

The consolidated statements of operations and changes in net assets include excess (deficiency) of revenues over expenses. Changes in unrestricted net assets which are excluded from excess (deficiency) of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

(q) Income Taxes

Healthcare and the Foundation are not-for-profit corporations and have been recognized as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code. Leasing is a for-profit limited liability corporation.

The standards for accounting for uncertainty in income taxes establish a recognition threshold and measurement for income tax positions recognized in a Hospital's financial statements. These standards had no impact on the accompanying consolidated financial statements.

The tax years open to examination by federal and state taxing authorities are 2007 through 2010.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(r) Concentration of Credit Risk

Healthcare invests cash and cash equivalents with financial institutions, and has determined that the amount of credit exposure at any one financial institution is immaterial to Healthcare's financial position.

(s) Reclassifications

Certain 2009 amounts have been reclassified to conform with the 2010 financial statement presentation.

(t) Subsequent Events

Subsequent events have been evaluated through June 29, 2011, which is the date financial statements were issued.

(2) Prior Period Restatement

Prior to 2010, Healthcare recorded employee extended sick leave time on the cash basis when benefits were paid out to retiring employees who had met all the required eligibility criteria. The accompanying consolidated financial statements for 2009 have been restated to reflect an accrued estimated liability for these benefits from their effective date as such benefits accumulate. The approximate effect of the adjustment required was to decrease unrestricted net assets at December 31, 2008 by approximately \$8,007,000 and to decrease the excess of revenues over expenses by approximately \$1,495,000 in 2009.

(3) Discontinued Operations

On December 9, 2009, Healthcare sold its wholly owned, for-profit subsidiary, Faxchil Realty, Inc. (Faxchil), including Faxchil's wholly owned, for-profit subsidiary, Centrex Clinical Laboratories, Inc. (Centrex), to Laboratory Corporation of America Holdings for \$42,000,000 with certain assets and liabilities assumed by Healthcare, plus an additional earn-out opportunity not to exceed \$5,000,000 if certain revenue targets are achieved during two separate one year earn-out periods. Healthcare has been notified that these revenue targets were not achieved for the first earn-out period and have not recorded any amount at December 31, 2010 for the second earn-out period. Healthcare recorded a gain in connection with the sale of approximately \$30,762,000 in 2009 and \$792,000 in 2010. The 2010 gain consists of the removal of a \$1,200,000 reserve on funds held in escrow offset by additional expenses related to the sale.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) Discontinued Operations, Continued

Faxchil was a holding company that managed real property prior to 2009 and Centrex provided clinical laboratory services to health care providers. In connection with the disposal of this business, Healthcare has classified the results of operations for this business as discontinued operations in the accompanying financial statements.

The operating results of Faxchil and Centrex classified as discontinued operations at December 31, 2009 are as follows:

Sales	\$ 42,885,179
Income before taxes	2,846,055
Income tax provision	1,138,422
Income from operations of discontinued operations, net of tax	1,707,633

(4) Investments

Assets Limited as to Use

At December 31, assets limited as to use, at fair value, are comprised of and are to be used for the following purposes:

	<u>2010</u>	<u>2009</u>
Cash and cash equivalents	\$ 2,395,675	2,367,451
Cash equivalents - in escrow (a)	4,202,964	3,000,000
Guaranteed Investments Contracts	2,750,415	2,787,914
Mutual funds	253,492	441,601
	9,602,546	8,596,966
Classified as current assets	4,494,491	3,452,108
Classified as non-current assets	\$ 5,108,055	5,144,858
Debt service and debt service reserve funds	5,108,055	5,144,858
Amounts held in escrow	4,202,964	3,010,177
Amounts held for other purposes	291,527	441,931
	\$ 9,602,546	8,596,966

(a) Cash equivalents in escrow are primarily invested in short-term U.S. Treasury and government agency securities. The cash equivalents held in escrow will be released no later than July 1, 2011, as described in the escrow agreement related to the sale of Faxchil.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Investments, Continued

Investments

At December 31, investments, at fair value, are comprised of the following:

	<u>2010</u>	<u>2009</u>
Cash and cash equivalents	\$ 523,017	35,185,923
Mutual funds	30,873,777	11,155,742
Common stock	3,513,081	2,963,449
Corporate obligations	27,018,813	7,327,049
Real estate investment trust	485,484	536,920
	<u>\$ 62,414,172</u>	<u>57,169,083</u>

The above amounts are included in the accompanying financial statements as follows:

	<u>2010</u>	<u>2009</u>
Investments - current assets	\$ 57,388,822	17,473,296
Cash and cash equivalents	497,186	35,167,623
Long-term investments	4,528,164	4,528,164
	<u>\$ 62,414,172</u>	<u>57,169,083</u>

Investment income and gains (losses) on unrestricted investments are comprised of the following for the years ended December 31:

	<u>2010</u>	<u>2009</u>
Investment income:		
Interest income and dividends, net of fees	\$ 1,192,335	623,265
Realized gains (losses)	253,786	(306,431)
	1,446,121	316,834
Change in net unrealized gains and losses on investments	3,409,058	3,569,818
	<u>\$ 4,855,179</u>	<u>3,886,652</u>

Healthcare continually reviews investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. In the evaluation of whether an impairment is other-than-temporary, Healthcare considers the reasons for the impairment, its ability and intent to hold the investment until the market price recovers or the investment matures, compliance with its investment policy, the severity and duration of the impairment, and expected future performance.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Investments, Continued

Healthcare's investments in marketable equity securities and mutual funds consist of investments diversified in several different industries. Healthcare evaluated the near-term prospects of the issuer in relation to the severity and duration of impairment. Based upon the evaluation and Healthcare's ability and intent to hold the securities for a reasonable period of time sufficient for a forecasted recovery of fair value, Healthcare does not consider the securities in an unrealized loss position to be other-than-temporarily impaired at December 31, 2010 and 2009.

Healthcare and the Foundation have a commingled investment portfolio. The following table presents the gross unrealized losses and fair value of the commingled investment portfolio with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2010 and 2009:

<u>Securities</u>	2010					
	<u>Less than Twelve Months</u>		<u>Twelve Months or Greater</u>		<u>Total</u>	
	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>
Mutual funds	\$ 863,395	(36,605)	3,859,556	(1,074,145)	4,722,951	(1,110,750)
Common stocks	152,401	(11,621)	193,122	(40,731)	345,523	(52,352)
Real estate investment trust	-	-	569,366	(277,611)	569,366	(277,611)
	\$ 1,015,796	(48,226)	4,622,044	(1,392,487)	5,637,840	(1,440,713)

<u>Securities</u>	2009					
	<u>Less than Twelve Months</u>		<u>Twelve Months or Greater</u>		<u>Total</u>	
	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>	<u>Fair value</u>	<u>Unrealized losses</u>
Mutual funds	\$ 1,359,034	(18,383)	5,479,038	(1,539,807)	6,838,072	(1,558,190)
Common stocks	180,780	(12,713)	757,897	(157,401)	938,677	(170,114)
Real estate investment trust	-	-	635,257	(455,827)	635,257	(455,827)
	\$ 1,539,814	(31,096)	6,872,192	(2,153,035)	8,412,006	(2,184,131)

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(5) Property and Equipment

Property and equipment is comprised of the following at December 31:

	<u>2010</u>	<u>2009</u>
Land and land improvements	\$ 5,890,704	5,651,010
Buildings	109,696,683	104,239,844
Fixed equipment	35,503,948	34,781,275
Movable equipment	73,826,905	70,920,414
Property and equipment under capitalized leases	<u>25,103,273</u>	<u>20,484,641</u>
	250,021,513	236,077,184
Less accumulated depreciation	<u>158,684,058</u>	<u>145,477,503</u>
	91,337,455	90,599,681
Construction-in-progress	<u>9,086,109</u>	<u>6,252,212</u>
Property and equipment, net	<u>\$ 100,423,564</u>	<u>96,851,893</u>

Depreciation expense amounted to approximately \$14.5 million and \$13.0 million for the years ended December 31, 2010 and 2009, respectively. At December 31, 2010, the balance remaining on construction contract commitments approximated \$2.3 million.

(6) Direct Financing Lease

In 2001, Healthcare completed construction of a medical office building with a cost of approximately \$5 million on land owned by an affiliate of Slocum-Dickson Medical Group, P.C. (SDMG). The building is leased to SDMG under a direct financing lease for minimum lease payments of \$45,393 per month through 2022. Healthcare financed 80% of the building cost with a mortgage described in note 10.

The balance sheet presentation of the direct financing lease at December 31 is as follows:

	<u>2010</u>	<u>2009</u>
Minimum lease payments receivable	\$ 5,953,711	6,500,827
Unearned lease income	<u>(1,863,357)</u>	<u>(2,173,776)</u>
Net investment in direct financing lease	4,090,354	4,327,051
Less current portion	<u>547,116</u>	<u>547,116</u>
Long-term net investment in direct financing lease	<u>\$ 3,543,238</u>	<u>3,779,935</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(7) Line of Credit

At December 31, 2010 and 2009, Healthcare had a \$17,500,000 line of credit with a bank, collateralized by substantially all of Healthcare's investments. The line of credit on short-term borrowing bears a daily interest rate at prime (3.25% at December 31, 2010). The line of credit on long-term borrowings bears a monthly interest rate at LIBOR (1.21% at December 31, 2010). The line of credit is available through July 2011. At December 31, 2010, a portion of the line was reserved for four letters of credit totaling approximately \$5,069,000 related to self-insured liabilities. The line contains financial covenants including a debt service coverage ratio requirement, a day's cash on hand requirement and a minimum unrestricted liquidity to funded debt ratio. At December 31, 2010, Healthcare was not in compliance with the debt service coverage ratio for which it obtained a waiver. At December 31, 2010, the amount outstanding was \$4,200,000. At December 31, 2009, the amount outstanding was \$2,030,000.

(8) Extended Sick Leave

Healthcare employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. Healthcare accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. Healthcare has accrued an estimated liability of approximately \$10,040,000 and \$9,727,000 at December 31, 2010 and 2009, respectively, for these anticipated termination payments.

Amounts are included in the accompanying consolidated financial statements as follows at December 31:

	<u>2010</u>	<u>2009</u>
Accrued payroll, payroll taxes and benefits	\$ 1,220,000	341,000
Other liabilities	<u>8,820,000</u>	<u>9,386,000</u>
	<u>\$ 10,040,000</u>	<u>9,727,000</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations

Long-term debt consists of the following at December 31:

	<u>2010</u>	<u>2009</u>
Variable rate demand 2006 Civic Facility Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton-St. Luke's Healthcare)	\$ 18,295,000	18,725,000
Civic Facility 1998 and 1999 Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton Hospital Facility)	10,515,000	12,555,000
Civic Facility 1998 and 1999 Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; St. Luke's-Memorial Hospital Center Facility)	7,615,000	9,915,000
Notes payable in varying monthly installments maturing from January 2013 through January 2016 at interest rates ranging from 5% to 6%	7,277,314	-
Note payable in monthly installments of \$116,667 at a fixed rate of 5.3%, maturing June 2015 and collateralized by Healthcare's gross receipts (a)	6,416,666	-
Mortgage note payable in varying installments at interest rates ranging from 5% to 8% with a balloon payment estimated at \$2.5 million due January 2012, secured by property under direct financing lease (note 6)	2,748,010	2,930,150
Unamortized premium on Civic Facility Revenue Bonds	91,571	116,481
Note payable to SLM at a fixed interest rate of 3.65% with a balloon payment for the remaining amount due December 2016	1,551,049	1,626,048

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

	<u>2010</u>	<u>2009</u>
Mortgage payable in monthly installments of \$44,248 at a fixed rate of 6.5%, maturing January 2020 (a)	3,587,948	3,872,211
Note payable in varying monthly installments at LIBOR plus 2.15%, with a cap between 6% to 9% (6.0% at December 31, 2010) with a balloon payment estimated at \$1,947,000 due January 2020, collateralized by certain property	2,950,580	3,030,850
Note payable in varying monthly installments at interest rates of prime minus .5%, maturing April 2020, collateralized by certain property (2.75% at December 31, 2010) with a balloon payment estimated at \$279,000	470,934	488,675
Notes payable in varying monthly installments maturing from November 2011 through November 2012 (interest rates ranging from 6.25% to 7.25%)	293,655	507,360
Capital lease obligations (interest rates ranging from 3.12% to 8.51%)	<u>13,999,296</u>	<u>12,500,366</u>
	75,812,023	66,267,141
Less current portion:		
Debt	(8,971,732)	(5,583,224)
Capital lease obligations	<u>(4,549,596)</u>	<u>(3,756,113)</u>
Long-term debt, net of current portion	<u>\$ 62,290,695</u>	<u>56,927,804</u>

- (a) The note due 2015 and the mortgage payable due 2020 contain certain financial covenants. At December 31, 2010, Healthcare was not in compliance with the debt service coverage ratio. The lending institutions have waived the events of noncompliance through June 30, 2011. The Hospital anticipates continuing to require waivers for this covenant for the remainder of 2011 and believes that such waivers will be granted. Such indebtedness has been classified as long-term because the respective banks have granted waivers to date and because reclassification of such indebtedness is considered immaterial to Healthcare's financial position at December 31, 2010.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

Healthcare, through the Oneida County Industrial Development Agency (OCIDA), has issued serial and term Civic Facility Revenue Bonds as follows:

<u>Series</u>	<u>Term</u>	<u>Principal/Mandatory Sinking Fund Payments</u>	<u>Rate</u>
Faxton-St. Luke's Healthcare:			
2006E - tax-exempt	2031	\$ 195,000 - 525,000	4.873 - 4.995%
2006F - taxable	2031	260,000 - 955,000	4.873 - 4.995%
Faxton Hospital Facility:			
1998A - tax-exempt	2013	\$ 610,000 - 675,000	5.000%
1998B - taxable	2013	175,000 - 200,000	6.250%
1999C - tax-exempt	2015	800,000 - 1,035,000	6.625%
1999D - taxable	2015	585,000 - 805,000	8.375%
St. Luke's-Memorial Hospital Center Facility:			
1998A - tax-exempt	2013	\$ 1,170,000 - 1,295,000	5.20%
1998B - tax-exempt	2013	1,145,000 - 1,260,000	5.00%
1998C - taxable	2013	100,000 - 110,000	6.25%

Healthcare may, at its option, redeem certain of the term bonds maturing after February 1, 2010 at the par value of the bond face amount.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

All of the bonds are insured and are collateralized by Healthcare's gross receipts (as defined), including all rights to receive such receipts whether in the form of accounts receivable, contract rights or other rights. Healthcare entered into a lease agreement with OCIDA, which also acts as security for payment of the revenue bonds. Additional security is provided by a Master Trust Indenture under which the initial Members of the Obligated Group (Healthcare and MVN) are jointly and severally responsible for payment of the Bonds. The total debt outstanding for the Master Indenture Bonds at December 31, 2010 was \$36,425,000.

The variable rate demand bonds bear interest based on one of three modes - the weekly rate, the term rate, or the fixed rate - for periods selected by the Company. The interest rate for each mode will be the current market interest rate as determined by the remarketing agent of the bonds. The Company used the weekly rate during 2010 and 2009. At December 31, 2010, the bonds carried interest at rates of .35% and .33%. At December 31, 2009 the bonds carried interest at rates of .35% and .23%.

The variable rate demand bonds are remarketed by a remarketing agent in accordance with the terms of a remarketing agreement. The bonds will be remarketed whenever a new interest rate is in effect. If the bonds cannot be remarketed, they would be due and payable under the terms of the remarketing agreement; however, the 2006 Civic Facility Revenue Bonds are credit-enhanced by an irrevocable Bank of America letter of credit, which is set to expire June 25, 2013.

Various agreements relating to the revenue bonds establish covenants with which Healthcare has agreed to comply, including the following, among others. In any year, Healthcare will not dispose of operating assets exceeding 2.5% of the total book value of operating assets or accounts receivable with recourse having a book value in excess of 50% of the total book value of accounts receivable. The Obligated Group may not merge or consolidate with another entity unless certain conditions are met. Additional indebtedness is limited to certain provisions including borrowings not to exceed 15% of total operating revenue. The Obligated Group agreed to maintain a minimum debt service coverage ratio, as defined, of 120% annually or employ a management consultant. The Obligated Group did not achieve the required debt service coverage ratio for the year ended December 31, 2010 and has retained a consultant.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

As a result of the aforementioned bond issuances, Healthcare has entered into two interest rate swap contracts to reduce its risk of exposure to changes in interest rates. The interest rate swaps effectively convert the variable rates of the 2006 bonds to fixed rates of 5.938% and 4.216% through June 2031. The swaps have been designated as cash flow hedges of the variable interest rates and are recorded at fair value as a liability of \$3,967,565 on the accompanying consolidated balance sheet as of December 31, 2010. The swaps have effective dates of June 26, 2006 and termination dates of June 1, 2031. The amounts exchanged are based on the notional amounts whereby Healthcare pays the swap counter-party interest at a fixed rate (4.216% - tax-exempt, 5.938% - taxable) and the swap counter-party pays Healthcare a variable rate (based on 70% of 1 month LIBOR tax-exempt, BMA Rate - taxable). The notional amounts and fair values based on quoted market prices, of Healthcare's interest rate swaps are as follows at December 31, 2010:

	<u>Notional amount</u>	<u>Liability market value</u>
Healthcare - Series E	\$ 6,980,000	1,208,209
Healthcare - Series F	11,315,000	<u>2,759,356</u>
		<u>\$ 3,967,565</u>

The mark-to-market adjustments resulted in a decrease in unrestricted net assets of \$809,818 for the year ended December 31, 2010. Changes in value of the swaps determined to arise from ineffectiveness of the instruments, as determined through the hypothetical derivative method, are recorded as a component of interest expense in the consolidated statements of operations and changes in net assets. For the year ended December 31, 2010, there was no significant ineffectiveness. Healthcare expects that the loss existing in unrestricted net assets to be reclassified into income from operations within the next 12 months will not be significant.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

Healthcare leases certain equipment under capital leases. Healthcare also leases equipment and facilities under non-cancelable operating leases, including leases with affiliates. The net book value of the equipment capitalized under lease agreements at December 31, 2010 and 2009 amounted to approximately \$15,826,000 and \$16,200,000, respectively.

Scheduled principal payments on long-term debt and payments under non-cancelable operating leases and the present value of future minimum capital lease payments at December 31, 2010 are:

Years ended December 31:	Long-term <u>debt</u>	Capital <u>leases</u>	<u>Operating leases</u>	
			<u>Affiliates</u>	<u>Other</u>
2011	\$ 8,971,732	5,102,222	240,650	624,018
2012	11,791,619	3,481,009	170,786	534,089
2013	8,814,697	3,117,707	170,786	518,294
2014	5,442,592	1,722,310	78,248	433,613
2015	5,075,046	963,493	76,701	98,004
Thereafter	<u>21,717,041</u>	<u>1,262,082</u>		
Total payments	61,812,727	15,648,823		
Less amounts representing interest		<u>1,649,527</u>		
Present value of capital lease obligations		13,999,296		
Less current portion		<u>4,549,596</u>		
Capital lease obligations, net of current portion		<u>\$ 9,449,700</u>		

Rent expense under operating leases amounted to approximately \$1,585,000 in 2010 and \$1,409,000 in 2009.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2010</u>	<u>2009</u>
Funds held in trust by others (for capital)	\$ 2,032,000	-
Children's Miracle Network	991,461	951,271
Continuous Learning Center	212,655	302,477
Scholarship assistance	31,104	30,359
Programs	188,617	91,661
Renovations	<u>1,114,944</u>	<u>1,116,502</u>
	<u>\$ 4,570,781</u>	<u>2,492,270</u>

Permanently restricted net assets at December 31 are restricted to:

	<u>2010</u>	<u>2009</u>
Investments to be held in perpetuity, the income from which is to support charity care, health care services, scholarships and facility maintenance	<u>\$ 4,528,164</u>	<u>4,528,164</u>

During 2010, the Foundation recognized at the present value \$2,032,000 in funds held in trust by others for specific use by Healthcare.

(11) Pension Plans

Healthcare sponsors a 401(k) plan that covers substantially all full-time non-union employees. Healthcare contributes 5% of eligible compensation to the plan (4% for employees hired after December 1, 2001). Healthcare also makes a matching contribution up to 100% of the first 4% of employee contributions to the 401(k) plan. Healthcare also sponsors a 403(b) plan that covers union and certain other employees. Healthcare contributes 5% to 7% of eligible compensation to the 403(b) plan.

Pension expense under all plans aggregated approximately \$6,410,000 in 2010 and approximately \$6,153,000 in 2009.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(12) Other Revenue

Other revenue consists of the following for the years ended December 31:

	<u>2010</u>	<u>2009</u>
Rent	\$ 759,702	878,097
Affiliate sold services	488,525	613,909
Other interest income	323,854	371,319
Mohawk Valley Heart Institute	(168,751)	1,781,149
Equity in earnings of investees	242,079	186,475
New Hartford Scanner	1,154,334	743,092
Grant revenue	508,028	567,620
EMS education classes	584,687	489,161
CMIC Partnership income	154,413	191,737
School of Radiology tuition	232,059	230,119
VHA partnership equity earnings	274,384	301,975
Managed care incentive income	203,759	348,251
Other	124,142	247,900
	<u>\$ 4,881,215</u>	<u>6,950,804</u>

(13) Estimated Medical Malpractice and General Liability Costs

Effective March 15, 2004, Healthcare is insured for medical malpractice risks through claims-made professional liability insurance. Should the annual claims-made policy not be renewed or replaced with equivalent insurance, claims based on incidents during its term, but reported subsequently, will be uninsured. Prior to that date, Healthcare maintained occurrence-based medical malpractice and general liability insurance coverage.

Healthcare is a defendant in various malpractice and general liability claims. The ultimate outcome of such litigation cannot be determined at this time. However, management believes the final disposition of these claims will not have a material effect on the financial position or results of operations of Healthcare.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Estimated Medical Malpractice and General Liability Costs, Continued

Healthcare and certain of its affiliates were primarily self-insured for employee workers' compensation and disability claims through December 31, 2007. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, Healthcare has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. Each affiliate is jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2010 and 2009. Effective January 1, 2010, Healthcare and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of Healthcare and affiliates.

Effective January 1, 2009, Healthcare became self-insured for healthcare claims. Healthcare has obtained a stop loss coverage policy for healthcare costs to supplement its self-insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

(14) Affiliated Entities

The following represents summarized financial information from the financial statements of Healthcare's affiliates that are included in the accompanying financial statements on the equity method of accounting.

<u>2010</u>	<u>Foundation</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 9,307,849	6,797,705	125,455
Total liabilities	<u>343,494</u>	<u>6,292,608</u>	<u>205,590</u>
Net assets	<u>\$ 8,964,355</u>	<u>505,097</u>	<u>(80,135)</u>
Total revenue	2,103,999	1,264,020	2,069,134
Total expenses	<u>(1,817,846)</u>	<u>(1,196,187)</u>	<u>(2,120,505)</u>
Excess (deficiency) of revenue over expenses and changes in net assets	<u>\$ 286,153</u>	<u>67,833</u>	<u>(51,371)</u>
Change in fair value of interest rate swap	<u>-</u>	<u>225,617</u>	<u>-</u>
Increase (decrease) in unrestricted net assets	<u>\$ 286,153</u>	<u>293,450</u>	<u>(51,371)</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities, Continued

<u>2009</u>	<u>Foundation</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 6,933,446	6,239,775	75,844
Total liabilities	<u>333,010</u>	<u>6,028,128</u>	<u>(104,608)</u>
Net assets (deficiency)	\$ <u>6,600,436</u>	<u>211,647</u>	<u>(28,764)</u>
Total revenue	2,103,434	1,266,235	108,914
Total expenses	<u>(1,909,154)</u>	<u>(1,209,222)</u>	<u>(137,678)</u>
Excess (deficiency) of revenue over expenses and changes in net assets	\$ <u>194,280</u>	<u>57,013</u>	<u>(28,764)</u>
Change in fair value of interest rate swap	<u>-</u>	<u>158,226</u>	<u>-</u>
Increase (decrease) in unrestricted net assets	\$ <u>194,280</u>	<u>215,239</u>	<u>(28,764)</u>

The following are approximate dollar amounts of significant transactions and balances with affiliated entities.

Contributions from the Foundation to Healthcare amounted to approximately \$1,002,000 and \$1,092,000 in 2010 and 2009, respectively.

Healthcare rents space from SLM and provides utilities, maintenance and accounting services to SLM. Rent totaled approximately \$77,000 for 2010 and 2009 and utilities and maintenance services sold totaled approximately \$468,000 and \$554,000 in 2010 and 2009, respectively.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities, Continued

Net receivables (payables) at December 31 from the following affiliates were approximately:

	<u>2010</u>	<u>2009</u>
Home	\$ 1,194,000	930,000
MVN	1,035,000	1,818,000
New Hartford Scanner Associates	676,000	644,000
Foundation	201,000	259,000
VNA	61,000	183,000
SLM	(82,000)	138,000
Paraffin	27,000	33,000
Other	19,000	189,000
	<u>\$ 3,131,000</u>	<u>4,194,000</u>

New Hartford Scanner Associates (NHSA) is a joint venture between Healthcare and several radiologists to provide CT scan services. Healthcare receives income from NHSA, which amounted to approximately \$878,000 and \$587,000 in 2010 and 2009, respectively. Healthcare also provides payroll services and leased equipment to NHSA, which amounted to approximately \$276,000 and \$156,000 in 2010 and 2009, respectively.

In addition to the foregoing, Healthcare, through its affiliation with MVN, is affiliated with several other entities all of which are independent from Healthcare and are engaged in serving the Mohawk Valley area as providers of various healthcare related services.

(15) Statements of Cash Flows - Supplemental Disclosures

Healthcare's non-cash investing and financing activity and cash payments for interest for the years ended December 31 were as follows:

	<u>2010</u>	<u>2009</u>
Non-cash investing and financing activity:		
Capital lease obligations issued for property and equipment	\$ 5,499,994	4,355,391
Long-term debt transferred - Faxchil	-	3,605,264
Cash paid for interest	4,091,499	4,128,249

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(16) Functional Expenses

Healthcare provides general health care services to residents of the Greater Utica area. Expenses related to providing these services are as follows:

	<u>2010</u>	<u>2009</u>
Health care services	\$ 243,066,004	234,849,112
General and administrative	<u>39,694,779</u>	<u>35,599,619</u>
	<u>\$ 282,760,783</u>	<u>270,448,731</u>

(17) Fair Value of Financial Instruments

The Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

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

Cash and Cash Equivalents: The amount reported on the balance sheet for cash and cash equivalents approximates fair value.

Investments including Assets Limited as to Use: The fair values, which are the amounts reported on the balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Estimated Third-Party Payor Settlements: The amount reported on the balance sheet for estimated third-party payor settlements approximates its fair value.

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

Long-Term Debt: The fair value of fixed rate issues was determined by price quotes from an investment banker or estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements. The fair value of variable rate debt approximates its reported value on the balance sheet. Fixed rate long-term debt is the only financial instrument with a difference between recorded and fair value. The recorded value of fixed rate long-term debt on the balance sheet at December 31, 2010 was approximately \$42,955,000 and the estimated fair value was approximately \$45,028,000.

The following tables present information about assets and liabilities that are measured at fair value on a recurring basis as of December 31 and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. Healthcare considers a security that trades at least weekly to have an active market. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability.

	Carrying amount at December 31, 2010	<u>Fair value measurements at December 31, 2010</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Assets:				
Cash equivalents	\$ 497,186	497,186	-	-
Investments	61,916,986	61,431,502	-	485,484
Assets limited as to use	<u>9,602,546</u>	<u>6,852,131</u>	<u>2,750,415</u>	<u>-</u>
Total	<u>\$ 72,016,718</u>	<u>68,780,819</u>	<u>2,750,415</u>	<u>485,484</u>
Liabilities:				
Interest rate swaps	<u>(3,967,565)</u>	<u>-</u>	<u>(3,967,565)</u>	<u>-</u>
Total	<u>\$ (3,967,565)</u>	<u>-</u>	<u>(3,967,565)</u>	<u>-</u>

FAXTON-ST. LUKE'S HEALTHCARE AND CONSOLIDATED SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, <u>2009</u>	<u>Fair value measurements at December 31, 2009</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Assets:				
Cash equivalents	\$ 35,167,623	35,167,623	-	-
Investments	22,001,460	21,464,540	-	536,920
Assets limited as to use	<u>8,596,966</u>	<u>5,809,052</u>	<u>2,787,914</u>	<u>-</u>
Total	\$ <u>65,766,049</u>	<u>62,441,215</u>	<u>2,787,914</u>	<u>536,920</u>
Liabilities:				
Interest rate swaps	<u>(3,157,747)</u>	<u>-</u>	<u>(3,157,747)</u>	<u>-</u>
Total	\$ <u>(3,157,747)</u>	<u>-</u>	<u>(3,157,747)</u>	<u>-</u>

The following table sets forth a summary of changes in the fair value of the Healthcare's level 3 assets for the years ended December 31, 2010 and 2009.

	<u>2010</u>	<u>2009</u>
Balance, beginning of year	\$ 536,920	849,618
Interest and dividends, net of investment manager fees	25,260	33,139
Net realized gains (losses) on sale of investments	6,492	(93,452)
Change in net unrealized gains and losses on investments	37,394	(120,719)
Purchases, sales, issuances and settlements, net	<u>(120,582)</u>	<u>(131,666)</u>
Balance, end of year	\$ <u>485,484</u>	<u>536,920</u>

FAXTON-ST. LUKE'S HEALTHCARE

Financial Statements
(Governmental Filing Requirements)

December 31, 2012 and 2011

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Faxton-St. Luke's Healthcare:

We have audited the accompanying financial statements of Faxton-St. Luke's Healthcare, which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

(Continued)

The Board of Directors
Page 2 of 2

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Faxton-St. Luke's Healthcare as of December 31, 2012 and 2011, and the results of its operations, changes in net assets and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

The financial statements referred to above were prepared primarily to meet credit analysis and governmental filing requirements. Such financial statements are not intended to be general purpose financial statements (see note to financial statements 1(b)).

Restriction on Use

This report is intended solely for the information and use of the board of directors and management of Faxton-St. Luke's Healthcare, the New York State Department of Health and other Offices and Agencies of the State of New York and selected financial institutions and is not intended to be and should not be used by anyone other than these specified parties.

Fust Charles Chambers LLP

May 29, 2013

FAXTON-ST. LUKE'S HEALTHCARE

Balance Sheets

December 31, 2012 and 2011

<u>Assets</u>	<u>2012</u>	<u>2011</u>
Current assets:		
Cash and cash equivalents	\$ 2,910,193	1,120,275
Investments	59,774,878	48,103,626
Patient accounts receivable, net of reserve for charity care and doubtful accounts of \$10,375,721 in 2012 and \$8,382,207 in 2011	43,268,140	40,666,564
Inventories	5,680,655	5,231,856
Prepaid expenses and other current assets	18,012,307	13,042,408
Due from affiliates, net	2,304,477	1,316,822
Net investment in direct financing lease	547,116	547,116
Estimated third-party payor settlements, net	<u>8,816,308</u>	<u>7,977,712</u>
Total current assets	141,314,074	118,006,379
Interest in Faxton-St. Luke's Healthcare Foundation	6,567,674	7,229,709
Investment in affiliates	137,248	129,203
Due from affiliates, net	423,965	300,000
Investments	4,528,164	4,528,164
Net investment in direct financing lease	3,013,803	3,288,328
Property and equipment, net	93,838,604	96,624,341
Unamortized debt issuance costs	472,689	498,240
Other assets	<u>26,416,499</u>	<u>21,902,974</u>
 Total assets	 <u>\$ 276,712,720</u>	 <u>252,507,338</u>

<u>Liabilities and Net Assets</u>	<u>2012</u>	<u>2011</u>
Current liabilities:		
Revolving note payable	\$ 12,678,000	3,959,000
Current portion of long-term debt	3,597,989	4,582,967
Current portion of capital lease obligations	4,035,695	3,534,395
Accounts payable and accrued expenses	14,160,693	12,364,645
Accrued payroll, payroll taxes and benefits	12,675,359	11,539,608
Current portion of estimated self-insured liabilities	1,732,116	1,671,472
Other current liabilities	<u>10,916,859</u>	<u>8,902,002</u>
Total current liabilities	<u>59,796,711</u>	<u>46,554,089</u>
Long-term debt, net of current portion:		
Notes payable	8,824,057	17,339,959
Civic facility revenue bonds	16,845,000	17,355,000
Capital lease obligations	<u>7,779,365</u>	<u>8,209,973</u>
Total long-term debt, net of current portion	<u>33,448,422</u>	<u>42,904,932</u>
Other liabilities	35,792,783	31,757,765
Unrealized loss on interest rate swaps	6,144,832	6,299,513
Estimated self-insured liabilities, net of current portion	<u>2,670,011</u>	<u>3,071,196</u>
Total liabilities	<u>137,852,759</u>	<u>130,587,495</u>
Net assets:		
Unrestricted	131,290,203	113,859,059
Temporarily restricted	3,041,594	3,532,620
Permanently restricted	<u>4,528,164</u>	<u>4,528,164</u>
Total net assets	<u>138,859,961</u>	<u>121,919,843</u>
Commitments and contingencies (notes 5, 8 and 12)		
Total liabilities and net assets	<u>\$ 276,712,720</u>	<u>252,507,338</u>

See accompanying notes to financial statements.

FAXTON-ST. LUKE'S HEALTHCARE

Statements of Operations and Changes in Net Assets

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted revenues, gains and other support:		
Patient service revenue (net of contractual allowances and discounts)	\$ 278,712,198	273,563,145
Provision for bad debts	<u>(8,931,406)</u>	<u>(8,987,088)</u>
Net patient service revenue less provision for bad debts	269,780,792	264,576,057
Other revenue (note 11)	7,564,835	9,263,962
Investment income, net of fees	2,161,051	603,919
Contributions	<u>1,533,659</u>	<u>557,986</u>
Total unrestricted revenues, gains and other support	<u>281,040,337</u>	<u>275,001,924</u>
Expenses:		
Salaries and wages	124,489,479	117,781,430
Employee benefits	27,225,072	28,481,707
Supplies and other	107,135,317	103,635,185
Depreciation and amortization	16,596,968	16,049,757
Interest	2,695,394	3,943,250
Loss on extinguishment of debt	-	871,935
NYS gross receipts taxes	<u>1,133,677</u>	<u>995,149</u>
Total expenses	<u>279,275,907</u>	<u>271,758,413</u>
Net income from continuing operations	1,764,430	3,243,511
Discontinued operations	<u>2,354,183</u>	<u>(235,825)</u>
Excess of revenues over expenses	<u>\$ 4,118,613</u>	<u>3,007,686</u>

FAXTON-ST. LUKE'S HEALTHCARE

Statements of Operations and Changes in Net Assets, Continued

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 4,118,613	3,007,686
Change in fair value of interest rate swaps	154,681	(2,331,948)
Change in interest in unrestricted net assets of Foundation	(170,679)	(696,720)
Contributions used for capital acquisitions	1,534,957	1,525,621
Change in net unrealized gains and losses on investments	5,108,072	(2,016,122)
Contributions from HEAL grant	6,685,500	-
Cumulative effect of change in accounting principle	-	(5,000,000)
Other	-	(72,533)
	<u>17,431,144</u>	<u>(5,584,016)</u>
Increase (decrease) in unrestricted net assets		
Temporarily restricted net assets:		
Income on investments	1,669	104
Change in interest in temporarily restricted net assets of Foundation	(491,356)	(1,037,926)
Net assets released from restrictions	(1,339)	(339)
	<u>(491,026)</u>	<u>(1,038,161)</u>
Decrease in temporarily restricted net assets		
Total increase (decrease) in net assets	16,940,118	(6,622,177)
Net assets at beginning of year	<u>121,919,843</u>	<u>128,542,020</u>
Net assets at end of year	<u>\$ 138,859,961</u>	<u>121,919,843</u>

See accompanying notes to financial statements.

FAXTON-ST. LUKE'S HEALTHCARE

Statements of Cash Flows

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Change in net assets	\$ 16,940,118	(6,622,177)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	16,596,968	16,049,757
Provision for bad debts	8,931,406	8,987,088
Loss on extinguishment of debt	-	364,939
Cumulative effect of change in accounting principle	-	5,000,000
Contributions from HEAL grant	(6,685,500)	-
Change in interest in net assets of Faxton-St. Luke's Healthcare Foundation	662,035	1,734,646
Change in net unrealized gains and losses on investments	(5,108,072)	2,016,122
Change in fair value of interest rate swaps	(154,681)	2,331,948
Other	-	72,533
Amortization of unearned lease income	(272,591)	(292,206)
Net realized (gain) loss on sale of investments	(1,029,973)	508,984
(Gain) loss on disposition of property and equipment	398,197	(4,636)
(Gain) loss in earnings of investees	(8,045)	295,759
Loss on discontinued component	(2,354,183)	235,825
Contributions for capital acquisitions	(1,534,957)	(1,525,621)
Changes in operating assets and liabilities:		
Patient accounts receivable	(11,532,982)	(9,153,695)
Inventories, prepaid expenses and other current assets	(3,442,682)	(625,647)
Due from affiliates, net	(1,111,620)	1,402,779
Accounts payable, accrued expenses and other liabilities	2,121,179	1,503,605
Estimated self-insured liabilities	(340,541)	(151,702)
Estimated third-party payor settlements	(838,596)	(4,784,504)
Net cash provided by operating activities	<u>11,235,480</u>	<u>17,343,797</u>
Cash flows from investing activities:		
Purchases of property and equipment	(8,667,012)	(9,016,156)
Proceeds from sale of property and equipment	487,010	14,838
Proceeds from sale (purchases) of investments, net	(5,533,207)	6,743,975
Discontinued operations	2,354,183	(235,825)
Increase in other assets	(648,179)	(269,900)
Net (increase) decrease in assets limited as to use	-	9,618,661
Net cash provided by (used in) investing activities	<u>(12,007,205)</u>	<u>6,855,593</u>
Cash flows from financing activities:		
Proceeds (payments) on revolving note payable, net	8,719,000	(241,000)
Proceeds from long-term debt	1,400,000	72,827
Principal payments on long-term debt and capitalized lease obligations	(9,639,430)	(27,213,418)
Minimum direct financing lease payments received	547,116	547,116
Contributions for capital acquisitions	1,534,957	1,525,621
Net cash provided by (used in) financing activities	<u>2,561,643</u>	<u>(25,308,854)</u>
Increase (decrease) in cash and cash equivalents	1,789,918	(1,109,464)
Cash and cash equivalents at beginning of year	1,120,275	2,229,739
Cash and cash equivalents at end of year	<u>\$ 2,910,193</u>	<u>1,120,275</u>

See accompanying notes to financial statements.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

December 31, 2012 and 2011

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

Faxton-St. Luke's Healthcare (Healthcare), located in Utica, New York, is a not-for-profit healthcare delivery system providing inpatient, outpatient, emergency care, cancer treatment, rehabilitation, dialysis, maternity, child care, long term care, surgical, psychiatric and community services to residents of the Mohawk Valley Region. Admitting physicians are primarily practitioners in the local area. Mohawk Valley Network, Inc. (MVN), a not-for-profit corporation, is the sole corporate member of Healthcare and various other organizations involved in providing health care services to the Mohawk Valley Region.

(b) Basis of Accounting

The accompanying financial statements were prepared primarily to meet credit analysis and governmental filing requirements, and are not intended to be general purpose financial statements of a primary reporting entity. Accordingly, such statements do not include the assets, liabilities or results of operations of all subsidiaries or controlled corporations as such terms are defined under generally accepted accounting principles for consolidated financial statements. Healthcare separately issues consolidated primary reporting entity financial statements.

Faxton-St. Luke's Healthcare Foundation (Foundation), of which Healthcare is the sole member, SLM Corporation (SLM), whose stock is owned by a trust, of which Healthcare is the sole beneficiary, and Paraffin, LLC (Paraffin), of which Healthcare is the sole member, are included on the equity method of accounting. St. Luke's Home Residential Health Care Facility, Inc. (Home), in which Healthcare has a sole financial interest at dissolution, is excluded from these financial statements.

The Foundation is a not-for-profit, tax-exempt corporation that carries out fund raising activities which benefit Healthcare and the Home. Paraffin is a not-for-profit limited liability company that provides laboratory services to a local hospital.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(c) Adoption of Accounting Pronouncement

In July 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2011-07 requires health care entities that recognize significant amounts of patient service revenue at the time of service, even though they do not assess the patient's ability to pay, to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue on the statement of operations and changes in net assets. In addition, enhanced disclosure about the entity's policies for recognizing revenue and assessing bad debts, including disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts is required. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011. Healthcare adopted this guidance as of and for the year ended December 31, 2012, with retrospective application to all periods presented for the amendments relating to the presentation of the provision for bad debts related to patient service revenue; however, the enhanced disclosures required by the amendments are provided for the period of adoption and subsequent reporting periods. The adoption of ASU 2011-07 had the effect of reducing net patient service revenue by \$8,987,088, with an offsetting reduction in operating expenses for the year ended December 31, 2011, on the statements of operations and changes in net assets, and no effect on excess of revenues over expenses.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(e) Collective Bargaining Agreements

At December 31, 2012, Healthcare has approximately 30% of its employees working under collective bargaining agreements.

(f) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturity of three months or less, excluding temporary investments included in investments.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(g) Investments

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value which is determined utilizing quoted market prices. Investments in insurance group fixed annuity contracts (Guaranteed Investment Contracts) are valued at contract value, which is considered the best representation of fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses since none of the investments are classified as trading securities.

Certain investments that do not have readily determinable fair values are valued by using the net asset value (NAV) per share (or its equivalent), as a practical expedient permitted under the Fair Value Measurement Topic of the FASB Accounting Standards Codification.

Healthcare invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect Healthcare's net assets.

(h) Inventories

Inventories are stated at the lower of average cost or market.

(i) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is calculated over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years using the straight-line method. Property and equipment under capital leases and leasehold improvements are amortized on the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Amortization of equipment under capital leases and leasehold improvements is included in depreciation and amortization expense.

Interest cost incurred on borrowed funds during the construction of capital assets is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized amounted to approximately \$116,000 in 2012 and \$121,000 in 2011.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(i) Property and Equipment, Continued

Gifts of long-lived assets, such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(j) Unamortized Debt Issuance Costs

Debt issuance costs are amortized using the straight-line method, which approximates the effective interest method, over the terms of the related debt.

(k) Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

(l) Permanently Restricted Net Assets (Endowment Funds)

Healthcare maintains various donor-restricted and board-designated funds whose purpose is to provide long-term support for its charitable programs. In classifying such funds for financial statement purposes as either permanently restricted, temporarily restricted or unrestricted net assets, the Board of Directors looks to the explicit directions of the donor where applicable and the provisions of the laws of the State of New York. To constitute an endowment under New York State law, the restriction must arise from a clearly expressed donor limitation, not a limitation from within the beneficiary organization. The Board has determined that, absent donor stipulations to the contrary, the provisions of New York State law do not impose either a permanent or temporary restriction on the income or capital appreciation derived from the original gift. Therefore, all income and appreciation derived from the original gift are transferred to unrestricted net assets absent any restrictions on the use made by the donor. Permanently restricted net assets consist of endowment funds of \$4,528,164 at December 31, 2012 and 2011, and are included in long-term investments in the balance sheets.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

Healthcare utilizes an investment strategy that emphasizes preservation of principal and total return consistent with prudent levels of risk. Investments are allocated over a diversified portfolio of multiple asset classes of domestic and international equities and bonds.

Interpretation of Relevant Law

Previous to September 17, 2010, New York State law required the preservation of an endowment fund's historic dollar value. Historic dollar value is defined as the aggregate fair value in dollars of an endowment fund at the time it becomes an endowment fund, each subsequent donation to the fund at the time it is made and each accumulation made pursuant to a direction in applicable gift instrument at the time an accumulation is added to the fund. The law permitted an organization to spend the income earned by an endowment fund (i.e. interest, dividends), as well as the net appreciation (realized with respect to all assets and unrealized with respect to readily marketable assets) of such fund.

On September 17, 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) was signed into New York State law. The most prominent feature of NYPMIFA is the elimination of the requirement to preserve an endowment fund's historic dollar value which allows an organization to spend from an endowment whose market value has dropped below the historic dollar value, as long as it is deemed prudent under the organization's policies. In accordance with NYPMIFA, an organization must consider the following factors in exercising a standard of prudence:

1. The duration and preservation of the endowment fund
2. The purposes of the organization and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the organization
7. The investment policies of the organization
8. Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization

NYPMIFA requires compliance with donor intent when making investment or spending decisions with respect to an endowment fund. In addition, NYPMIFA creates a restriction on the portion of an endowment fund that is not classified as permanently restricted net assets, even in the absence of a donor restriction. Such portion is classified as temporarily restricted net assets until appropriated for expenditure by the organization.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

Interpretation of Relevant Law, Continued

As of December 31, 2012, the Board of Directors of Healthcare has not adopted and is currently evaluating the provisions of NYPMIFA. As a result, Healthcare continues to classify permanently restricted net assets at the historic dollar value of the fund in accordance with donor instructions.

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or NYPMIFA requires Healthcare to retain as a fund of perpetual duration. If the situation were to occur, the deficiency would be recorded in Healthcare's unrestricted net assets. The deficiency recorded in unrestricted net assets at December 31, 2011 was approximately \$141,000. There was not a deficiency at December 31, 2012.

Return Objectives, Strategies, Spending Policy and Investment Objectives

Healthcare has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in a well diversified asset mix that can be expected to generate acceptable long-term returns at an acceptable level of risk. Healthcare targets a diversified asset allocation that places a greater emphasis on equity-based investments and bonds to achieve its long-term return objectives within prudent risk constraints.

Changes in Endowment Net Assets

	2012		
	Unrestricted	Permanently restricted	Total
Endowment net assets, January 1, 2012	\$ (140,961)	4,528,164	4,387,203
Investment return:			
Investment income	-	95,620	95,620
Net appreciation (realized and unrealized)	-	435,114	435,114
Other	530,734	(530,734)	-
Endowment net assets, December 31, 2012	\$ 389,773	4,528,164	4,917,937

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Permanently Restricted Net Assets (Endowment Funds), Continued

	2011		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2011	\$ (107,940)	4,528,164	4,420,224
Investment return:			
Investment income	-	91,367	91,367
Net depreciation (realized and unrealized)	-	(124,388)	(124,388)
Other	(33,021)	33,021	-
Endowment net assets, December 31, 2011	\$ (140,961)	4,528,164	4,387,203

(m) Net Patient Service Revenue and Patient Accounts Receivable

Healthcare has agreements with third-party payors that provide for payments to the various organizations within its healthcare delivery system at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge or visit, cost-based reimbursement, discounted charges, per diem payments and fee-for-service payments. Healthcare recognizes patient service revenue associated with services provided to patients who have third-party coverage on the basis of contractual rates for the services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. Retroactive adjustments are included in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. For uninsured patients that do not qualify for charity care, Healthcare recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of Healthcare's uninsured patients will be unable or unwilling to pay for the services provided. Thus, Healthcare records a provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts) from these major payor sources, is as follows for the year ended December 31, 2012:

	<u>Government payors</u>	<u>Commercial insurance and others</u>	<u>Self-pay</u>	<u>Total</u>
Patient service revenue (net of contractual allowances and discounts)	\$ 150,476,268	120,422,261	7,813,669	278,712,198

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(m) Net Patient Service Revenue and Patient Accounts Receivable, Continued

Revenue from the Medicare and Medicaid programs accounted for approximately 53% of Healthcare's patient service revenue, net of contract allowances and discounts (but before the provision for bad debts) for 2012 and 2011. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Patient service revenue increased by approximately \$40,000 and \$1,200,000 in 2012 and 2011, respectively, related to either settlement of prior year issues or changes in estimates associated with third-party issues.

Healthcare grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2012</u>	<u>2011</u>
Medicare	26%	23%
Medicaid	19%	18%
Private payors	11%	10%
Insurance and all others	<u>44%</u>	<u>49%</u>
	<u>100%</u>	<u>100%</u>

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(m) Net Patient Service Revenue and Patient Accounts Receivable, Continued

Patient accounts receivable are reduced by a reserve for doubtful accounts. In evaluating the collectibility of patient accounts receivable, Healthcare analyzes past payment history and identifies trends for each of its major payor sources of revenue to estimate the appropriate reserve for doubtful accounts and provision for bad debts. For receivables associated with patients who have third-party coverage, Healthcare analyzes contractually due amounts and provides a reserve for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), Healthcare records a reserve for doubtful accounts and a provision for bad debts in the period of service based on 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 standards rates (or the discounted rates if negotiated) and the amount actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

Healthcare's reserve for doubtful accounts for self-pay patients increased from 59% of self-pay accounts receivable at December 31, 2011 to 64% of self-pay accounts receivable at December 31, 2012. The increase relates to negative trends experienced in the collection of amounts from self-pay patients in recent years as a result of unstable economic conditions. In addition, Healthcare's self-pay write offs decreased \$2,491,544 from \$9,752,198 for fiscal year 2011 to \$7,260,654 for fiscal year 2012.

(n) Charity Care

Healthcare provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Healthcare does not pursue collection of such amounts, they are not reported as net patient service revenue. During 2012 and 2011, costs incurred by Healthcare in the provision of charity care were based on the ratio of Healthcare's costs to gross charges and approximated \$340,000 and \$657,000, respectively.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Contributions

Unconditional promises to give cash and other assets 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. Contributions 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 statements of operations and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the statements of operations and changes in net assets.

(p) Excess of Revenues over Expenses

The statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, the effective portion of gains and losses on derivative instruments, changes in interest in the Foundation, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

(q) Income Taxes

Healthcare is a not-for-profit corporation and has been recognized as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

As of December 31, 2012 and 2011, Healthcare did not have any unrecognized tax benefits or any related accrued interest or penalties.

The tax years open to examination by federal and state taxing authorities are 2009 through 2012.

(r) Concentration of Credit Risk

Healthcare invests cash and cash equivalents with financial institutions, and has determined that the amount of credit exposure at any one financial institution is immaterial to Healthcare's financial position.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(s) Reclassifications

Certain 2011 amounts have been reclassified to conform with the 2012 financial statement presentation.

(t) Subsequent Events

Subsequent events have been evaluated through May 29, 2013, which is the date financial statements were issued.

(2) Discontinued Operations

In 2009, Healthcare sold its wholly owned, for-profit subsidiary, Faxchil Realty, Inc. (Faxchil), including Faxchil's wholly owned, for-profit subsidiary, Centrex Clinical Laboratories, Inc. (Centrex). The sale included an earn-out opportunity not to exceed \$5,000,000 if certain revenue targets were achieved during two separate one year earn-out periods ending December 31, 2010 and 2011. These revenue targets were not achieved for the first two earn-out periods. During 2012, the earn-out period was extended for two additional one-year periods. For the year ended December 31, 2012, an earn-out of approximately \$2,354,000 was earned and recorded by Healthcare. During 2011, Healthcare recorded a loss of approximately \$236,000 related to covenant not to compete agreements, changes in accounts receivable and outstanding liabilities. It is expected that all other significant transactions related to the sale of Faxchil Realty, other than the final earn-out, have been recorded.

(3) HEAL Grant

During 2012, Healthcare was approved for a grant award of \$7,135,500 as part of the New York State HEAL grant program. The grant award is primarily to be used for restructuring initiatives in Medicaid redesign. The award included \$6,685,500 for the discharge of debt and \$450,000 for facility integration with St. Elizabeth Medical Center.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(4) Investments

At December 31, investments, at fair value, are comprised of the following:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 2,397,514	1,059,805
Mutual funds	32,339,496	23,661,365
Common stock	3,589,957	3,187,051
Pooled investment funds	<u>28,330,573</u>	<u>25,639,216</u>
	<u>\$ 66,657,540</u>	<u>53,547,437</u>

The above amounts are included in the accompanying financial statements as follows:

	<u>2012</u>	<u>2011</u>
Investments - current assets	\$ 59,774,878	48,103,626
Cash and cash equivalents	2,354,498	915,647
Long-term investments	<u>4,528,164</u>	<u>4,528,164</u>
	<u>\$ 66,657,540</u>	<u>53,547,437</u>

Investment income and gains (losses) on investments are comprised of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Investment income:		
Interest income and dividends, net of fees	\$ 1,131,078	1,112,903
Realized gains (losses)	<u>1,029,973</u>	<u>(508,984)</u>
	2,161,051	603,919
Change in net unrealized gains and losses on investments	<u>5,108,072</u>	<u>(2,016,122)</u>
	<u>\$ 7,269,123</u>	<u>(1,412,203)</u>

Healthcare continually reviews investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. In the evaluation of whether an impairment is other-than-temporary, Healthcare considers the reasons for the impairment, its ability and intent to hold the investment until the market price recovers or the investment matures, compliance with its investment policy, the severity and duration of the impairment, and expected future performance.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(4) Investments, Continued

Healthcare's investments in common stocks and mutual funds consist of investments diversified in several different industries. Healthcare evaluated the near-term prospects of the issuer in relation to the severity and duration of impairment. Based upon the evaluation and Healthcare's ability and intent to hold the securities for a reasonable period of time sufficient for a forecasted recovery of fair value, Healthcare does not consider the securities in an unrealized loss position to be other-than-temporarily impaired at December 31, 2012 and 2011.

(5) Property and Equipment

Property and equipment is comprised of the following at December 31:

	<u>2012</u>	<u>2011</u>
Land and land improvements	\$ 6,192,615	5,955,732
Buildings	115,819,244	110,562,837
Fixed equipment	39,018,130	34,934,873
Movable equipment	96,684,886	93,437,080
Property and equipment under capitalized leases	<u>20,899,600</u>	<u>20,247,109</u>
	278,614,475	265,137,631
Less accumulated depreciation	<u>187,271,205</u>	<u>172,366,589</u>
	91,343,270	92,771,042
Construction-in-progress	<u>2,495,334</u>	<u>3,853,299</u>
Property and equipment, net	<u>\$ 93,838,604</u>	<u>96,624,341</u>

Depreciation expense amounted to approximately \$16.6 million and \$15.8 million for the years ended December 31, 2012 and 2011, respectively. At December 31, 2012, commitments to purchase in association with ongoing projects totalled approximately \$4.9 million.

(6) Direct Financing Lease

In 2001, Healthcare completed construction of a medical office building with a cost of approximately \$5 million on land owned by an affiliate of Slocum-Dickson Medical Group, P.C. (SDMG). The building is leased to SDMG under a direct financing lease for minimum lease payments of \$45,393 per month through 2022. Healthcare financed 80% of the building cost with a mortgage described in note 8 which was paid off in 2012.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(6) Direct Financing Lease, Continued

The balance sheet presentation of the direct financing lease at December 31 is as follows:

	<u>2012</u>	<u>2011</u>
Minimum lease payments receivable	\$ 4,859,479	5,406,595
Unearned lease income	<u>(1,298,560)</u>	<u>(1,571,151)</u>
Net investment in direct financing lease	3,560,919	3,835,444
Less current portion	<u>547,116</u>	<u>547,116</u>
Long-term net investment in direct financing lease	<u>\$ 3,013,803</u>	<u>3,288,328</u>

(7) Extended Sick Leave

Healthcare employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. Healthcare accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. Healthcare has accrued an estimated liability of approximately \$10,733,000 and \$9,869,000 at December 31, 2012 and 2011, respectively, for these anticipated termination payments.

Amounts are included in the accompanying financial statements as follows at December 31:

	<u>2012</u>	<u>2011</u>
Accrued payroll, payroll taxes and benefits	\$ 536,000	536,000
Other liabilities	<u>10,197,000</u>	<u>9,333,000</u>
	<u>\$ 10,733,000</u>	<u>9,869,000</u>

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(8) Long-Term Debt and Lease Obligations

Long-term debt consists of the following at December 31:

	<u>2012</u>	<u>2011</u>
Variable rate demand 2006 Civic Facility Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton-St. Luke's Healthcare) (a)	\$ 17,355,000	17,840,000
Revolving note payable (b)	12,678,000	3,959,000
Unsecured notes payable in varying monthly installments maturing from January 2013 through January 2016 at interest rates ranging from 5% to 6% (c)	3,262,988	5,690,632
Note payable in monthly installments of \$116,667 at a fixed rate of 5.3%, maturing June 2015 and collateralized by Healthcare's gross receipts	3,616,667	5,016,667
Mortgage note payable in monthly installments of \$26,230 at a fixed rate of 4.0%, secured by property under direct financing lease (note 6) (c)	-	2,583,712
Note payable in monthly installments of \$15,249 at a fixed rate of 5.5% through March 2017 (c)	687,457	-
Note payable to SLM at a fixed interest rate of 3.65% with a balloon payment for the remaining amount due December 2016	1,400,305	1,475,676
Mortgage payable in monthly installments of \$44,248 at a fixed rate of 6.5%, maturing January 2020 and collateralized by the related building	2,944,629	3,284,603
Notes payable in varying monthly installments at interest rates of 3.0% to 6.0%, collateralized by certain property (c)	-	3,317,985
Notes payable in varying monthly installments maturing November 2012 (interest rates ranging from 6.25% to 6.75%)	-	68,651

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(8) Long-Term Debt and Lease Obligations, Continued

	<u>2012</u>	<u>2011</u>
Capital lease obligations (interest rates ranging from 2.9% to 8.5%)	11,815,060	11,744,368
	53,760,106	54,981,294
Less current portion:		
Revolving note payable	(12,678,000)	(3,959,000)
Debt	(3,597,989)	(4,582,967)
Capital lease obligations	(4,035,695)	(3,534,395)
Long-term debt, net of current portion	\$ 33,448,422	42,904,932

(a) Healthcare, through the Oneida County Industrial Development Agency (OCIDA), has issued serial and term Civic Facility Revenue Bonds as follows:

<u>Series</u>	<u>Term</u>	<u>Principal Payments</u>	<u>Rate</u>
Faxton-St. Luke's Healthcare:			
2006E - tax-exempt	2031	\$ 210,000 - 525,000	4.903 - 4.995%
2006F - taxable	2031	300,000 - 955,000	4.903 - 4.995%

The bonds are insured and are collateralized by Healthcare's gross receipts (as defined), including all rights to receive such receipts whether in the form of accounts receivable, contract rights or other rights. Healthcare entered into a lease agreement with OCIDA, which also acts as security for payment of the revenue bonds. Additional security is provided by a Master Trust Indenture under which the initial Members of the Obligated Group (Healthcare and MVN) are jointly and severally responsible for payment of the bonds.

The bonds bear interest based on one of three modes - the weekly rate, the term rate, or the fixed rate - for periods selected by Healthcare. The interest rate for each mode will be the current market interest rate as determined by the remarketing agent of the bonds. Healthcare used the weekly rate during 2012 and 2011. At December 31, 2012, the bonds carried interest at rates of .52% and .19%. At December 31, 2011 the bonds carried interest at rates of .40% and .18%.

The bonds are remarketed by a remarketing agent in accordance with the terms of a remarketing agreement. The bonds will be remarketed whenever a new interest rate is in effect. If the bonds cannot be remarketed, they would be due and payable under the terms of the remarketing agreement; however, the bonds are credit-enhanced by an irrevocable Bank of America letter of credit, which is set to expire June 25, 2016. In the event that the remarketing agent is unable to remarket the bonds, the bond trustee will make a draw on the letter of credit and the tendered variable rate bonds will become bank bonds.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(8) Long-Term Debt and Lease Obligations, Continued

Various agreements relating to the bonds establish covenants with which Healthcare has agreed to comply, including the following, among others. In any year, Healthcare will not dispose of operating assets exceeding 2.5% of the total book value of operating assets or accounts receivable with recourse having a book value in excess of 50% of the total book value of accounts receivable. The Obligated Group may not merge or consolidate with another entity unless certain conditions are met. Additional indebtedness is limited to certain provisions including borrowings not to exceed 15% of total operating revenue. The Obligated Group agreed to maintain a minimum debt service coverage ratio, as defined, of 120% annually or employ a management consultant. At December 31, 2012 and 2011, the Obligated Group was in compliance with the covenants that are considered events of default.

As a result of the aforementioned 2006 bond issuances, Healthcare has entered into two interest rate swap contracts to reduce its risk of exposure to changes in interest rates. The interest rate swaps effectively convert the variable rates of the 2006 bonds to fixed rates of 5.938% and 4.216% through June 2031. The swaps have been designated as cash flow hedges of the variable interest rates and are recorded at fair value as a liability of \$6,144,832 on the accompanying balance sheet as of December 31, 2012. The swaps have effective dates in June 2006 and termination dates of June 2031. The amounts exchanged are based on the notional amounts whereby Healthcare pays the swap counter-party interest at a fixed rate (4.216% - tax-exempt, 5.938% - taxable) and the swap counter-party pays Healthcare a variable rate (based on 70% of 1 month LIBOR tax-exempt, BMA Rate - taxable). The notional amounts and fair values based on quoted market prices, of Healthcare's interest rate swaps are as follows at December 31, 2012:

	<u>Notional amount</u>	<u>Liability market value</u>
Healthcare - Series E	\$ 10,775,000	4,311,511
Healthcare - Series F	<u>6,580,000</u>	<u>1,833,321</u>
	<u>\$ 17,355,000</u>	<u>6,144,832</u>

The mark-to-market adjustments resulted in an increase of \$154,681 and a decrease of \$2,331,948 in unrestricted net assets for the years ended December 31, 2012 and 2011, respectively. Changes in value of the swaps determined to arise from ineffectiveness of the instruments, as determined through the hypothetical derivative method, are recorded as a component of interest expense in the statements of operations and changes in net assets. For the years ended December 31, 2012 and 2011, there was no significant ineffectiveness. Healthcare expects that the loss existing in unrestricted net assets to be reclassified into income from operations within the next 12 months will not be significant.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(8) Long-Term Debt and Lease Obligations, Continued

- (b) At December 31, 2012 and 2011, Healthcare had a \$19,500,000 revolving note payable with a bank, collateralized by substantially all of Healthcare's investments. The revolving note payable on short-term borrowings bears a daily interest rate at prime (3.25% at December 31, 2012). The revolving note payable on long-term borrowings bears a monthly interest rate at LIBOR plus 95 basis points (1.16% at December 31, 2012). The revolving note payable is available through July 2013. At December 31, 2012, a portion of the revolving note payable was reserved for three letters of credit totaling approximately \$4,357,000 related to self-insured liabilities. At December 31, 2012 and 2011, Healthcare had \$3,678,000 and \$959,000 outstanding on the short-term borrowings, respectively. At December 31, 2012 and 2011, Healthcare had \$9,000,000 and \$3,000,000 outstanding on the long-term borrowings, respectively. The revolving note payable contains financial covenants including a debt service coverage ratio requirement, a day's cash on hand requirement and a minimum unrestricted liquidity to funded debt ratio. At December 31, 2012 and 2011, Healthcare was in compliance with the covenants that are considered events of default.
- (c) Healthcare utilized funds as awarded by New York State through the HEAL grant of \$6,685,500 for the discharge of debt, which was used to pay off or pay down this debt. The HEAL grant is further described in note 3.

Healthcare leases certain equipment under capital leases. Healthcare also leases equipment and facilities under non-cancelable operating leases, including leases with affiliates. The net book value of the equipment capitalized under lease agreements at December 31, 2012 and 2011 amounted to approximately \$13,312,000 and \$13,129,000, respectively.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(8) Long-Term Debt and Lease Obligations, Continued

Scheduled principal payments on long-term debt and payments under non-cancelable operating leases and the present value of future minimum capital lease payments at December 31, 2012 are:

Years ended December 31:	Revolving note <u>payable</u>	Long-term <u>debt</u>	Capital <u>leases</u>	<u>Operating leases</u>	
				<u>Affiliates</u>	<u>Other</u>
2013	\$ 12,678,000	3,597,989	4,446,951	792,763	2,458,616
2014	-	3,611,816	3,134,274	792,763	2,278,747
2015	-	4,301,607	2,376,501	792,763	1,859,220
2016	-	16,349,808	1,436,603	792,763	1,790,673
2017	-	471,800	848,409	792,763	1,705,624
Thereafter	-	934,026	719,339		
		<hr/>	<hr/>		
Total payments	12,678,000	29,267,046	12,962,077		
Less amounts representing interest			<hr/>		
			1,147,017		
Present value of capital lease obligations			11,815,060		
Less current portion			<hr/>		
			4,035,695		
Capital lease obligations, net of current portion			<hr/>		
			\$ 7,779,365		

Rent expense under operating leases amounted to approximately \$5,077,000 in 2012 and \$3,177,000 in 2011.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(9) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2012</u>	<u>2011</u>
Funds held in trust by others (for capital)	\$ 1,247,000	2,005,000
Children's Miracle Network	665,282	646,182
Continuous Learning Center	239,738	248,957
Scholarship assistance	31,199	30,869
Programs	530,051	355,605
Renovations	<u>328,324</u>	<u>246,007</u>
	<u>\$ 3,041,594</u>	<u>3,532,620</u>

Permanently restricted net assets at December 31 are restricted to:

	<u>2012</u>	<u>2011</u>
Investments to be held in perpetuity, the income from which is to support charity care, health care services, scholarships and facility maintenance	<u>\$ 4,528,164</u>	<u>4,528,164</u>

(10) Pension Plans

Healthcare sponsors a 401(k) plan that covers substantially all full-time non-union employees. Healthcare contributes 4% of eligible compensation to the plan (5% for employees hired before December 1, 2001). Healthcare also makes a matching contribution up to 100% of the first 4% of employee contributions to the 401(k) plan. Healthcare also sponsors a 403(b) plan that covers union and certain other employees. Healthcare contributes 5% to 7% of eligible compensation to the 403(b) plan.

Pension expense under all plans aggregated approximately \$6,914,000 in 2012 and approximately \$6,830,000 in 2011.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(11) Other Revenue

Other revenue consists of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Rent	\$ 797,434	868,983
Affiliate sold services	689,526	415,285
Other interest income	292,550	350,086
Mohawk Valley Heart Institute	(966,681)	(373,765)
Equity (deficit) in earnings of investees	8,045	(295,759)
New Hartford Scanner	845,776	875,379
Grant revenue	551,584	491,142
EMS education classes	520,900	546,435
CMIC Partnership income	197,886	191,178
School of Radiology tuition	231,170	224,241
VHA partnership equity earnings	225,704	237,321
Managed care incentive income	530,544	468,780
Medicare and Medicaid health information technology income	3,089,004	4,880,080
Net assets released from restrictions used for operations	1,339	339
Other	550,054	384,237
	<u>\$ 7,564,835</u>	<u>9,263,962</u>

The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 included provisions for implementing health information technology under the Health Information Technology for Economic and Clinical Health Act (HITECH). The provisions were designed to increase the use of electronic health record (EHR) technology and to establish the requirements for a Medicare and Medicaid incentive payment program beginning in 2011 for eligible providers that adopt and meaningfully use certified EHR technology. Eligibility for annual Medicare incentive payments is dependent on providers demonstrating meaningful use of EHR technology in each period over a four-year period. Initial Medicaid payments are available to providers that adopt, implement or upgrade certified EHR technology. Providers must demonstrate meaningful use of such technology in subsequent years to qualify for additional Medicaid incentive payments.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(11) Other Revenue, Continued

The American Recovery and Reinvestment Act of 2009, Continued

Healthcare recognizes HITECH incentive payments as revenue when it is reasonably assured that the meaningful use objectives have been achieved. Healthcare recognized Medicare and Medicaid incentive payments totaling approximately \$3,089,000 and \$4,880,000 for the years ended December 31, 2012 and 2011, respectively, as other operating revenue in the accompanying statements of operations and changes in net assets. Healthcare's compliance with the meaningful use criteria is subject to audit by the federal and New York State governments.

(12) Contingencies

General and malpractice insurance coverage is provided under a claims-made based policy, which provide for \$1,000,000 coverage for each claim, not to exceed \$3,000,000 in aggregate annual coverage. In addition, Healthcare has purchased an excess insurance policy. Claims alleging malpractice have been asserted against Healthcare and are currently in various stages of litigation. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted relating to services provided to patients. Accrued malpractice losses in management's opinion provide an adequate reserve for loss contingencies. Healthcare has accrued a liability included in other liabilities of approximately \$25,849,000 and \$25,952,000 at December 31, 2012 and 2011, respectively.

Healthcare and its affiliates are self-insured for employee healthcare costs. The group has obtained a stop loss coverage policy for healthcare costs to supplement its self insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

Healthcare is primarily self-insured for employee workers' compensation and disability claims along with certain of its affiliates for the years 2007 and prior. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, Healthcare has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. Each affiliate is jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2012 and 2011. Effective 2010, Healthcare and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of Healthcare and its affiliates.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(12) Contingencies, Continued

Health Care Reform

The Affordable Care Act was signed into law, in two parts, on March 23, 2010 and March 30, 2010. The Affordable Care Act dramatically alters the healthcare system and is intended to decrease the number of uninsured individuals and reduce the overall cost of healthcare. The Affordable Care Act attempts to achieve these goals by, among other things, requiring most individuals to obtain health insurance, expanding Medicare and Medicaid eligibility, reducing Medicare payments and Medicaid DSH payments to providers, expanding the Medicare program's use of value-based purchasing programs, tying hospital payments to the satisfaction of certain quality criteria, bundling payments to hospitals and other providers, and instituting certain private health insurance reforms. Although a majority of the measures contained in the Affordable Care Act do not take effect until 2013 and 2014, certain of the reductions in Medicare spending, such as negative adjustments to the Medicare hospital inpatient and outpatient prospective payment system market basket updates and the incorporation of productivity adjustments to the Medicare program's annual inflation updates, became effective in 2010, 2011 and 2012.

On June 28, 2012, the U.S. Supreme Court upheld the "individual mandate" provision of the Affordable Care Act that generally requires all individuals to obtain healthcare insurance or pay a penalty. However, the U.S. Supreme Court also held that the provision of the Affordable Care Act that authorized the Secretary of the Department of Health and Human Services (HHS) to penalize states that choose not to participate in the expansion of the Medicaid program by removing all of their existing Medicaid funding was unconstitutional. In response to the ruling, a number of states have already indicated that they will not expand their Medicaid programs, which would result in the Affordable Care Act not providing coverage to some low-income persons in those states. In addition, several bills have been and may continue to be introduced in Congress to repeal or amend all or significant provisions of the Affordable Care Act. It is difficult to predict the full impact of the Affordable Care Act on Healthcare's revenue and results of operations due to its complexity, lack of implementing regulations and interpretive guidance, gradual and potentially delayed implementation, potential future legal challenges, possible repeal and/or amendment and how individuals and businesses will respond to the choices afforded them by the Affordable Care Act.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(13) Affiliated Entities

The following represents summarized financial information from the financial statements of Healthcare's affiliates that are included in the accompanying financial statements on the equity method of accounting.

<u>2012</u>	<u>Foundation</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 7,027,015	5,202,961	148,893
Total liabilities	<u>459,341</u>	<u>4,757,631</u>	<u>456,975</u>
Net assets (deficit)	<u>\$ 6,567,674</u>	<u>445,330</u>	<u>(308,082)</u>
Total revenue	2,303,614	1,455,963	1,842,269
Total expenses	<u>(2,474,293)</u>	<u>(1,384,671)</u>	<u>(1,905,516)</u>
Excess (deficiency) of revenue over expenses	<u>\$ (170,679)</u>	<u>71,292</u>	<u>(63,247)</u>
 <u>2011</u>	 <u>Foundation</u>	 <u>SLM</u>	 <u>Paraffin</u>
Total assets	\$ 7,904,192	5,435,916	132,103
Total liabilities	<u>674,483</u>	<u>5,061,878</u>	<u>376,938</u>
Net assets (deficit)	<u>\$ 7,229,709</u>	<u>374,038</u>	<u>(244,835)</u>
Total revenue	2,413,980	1,247,565	1,918,632
Total expenses	<u>(3,110,700)</u>	<u>(1,378,624)</u>	<u>(2,083,332)</u>
Deficiency of revenue over expenses	<u>\$ (696,720)</u>	<u>(131,059)</u>	<u>(164,700)</u>

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(13) Affiliated Entities, Continued

The following are approximate dollar amounts of significant transactions and balances with affiliated entities.

Contributions from the Foundation to Healthcare, primarily for capital acquisitions and programs, amounted to approximately \$1,607,000 and \$2,075,000 in 2012 and 2011, respectively.

Healthcare rents space from SLM and provides utilities, maintenance and accounting services to SLM. Rent totalled approximately \$124,000 and \$116,000 in 2012 and 2011 and utilities and maintenance services sold totalled approximately \$773,000 and \$513,000 in 2012 and 2011, respectively.

Net receivables (payables) at December 31 from the following affiliates were approximately:

	<u>2012</u>	<u>2011</u>
Home	\$ 525,000	(60,000)
MVN	499,000	568,000
New Hartford Scanner Associates	355,000	460,000
Foundation	306,000	574,000
VNA	324,000	120,000
SLM	186,000	17,000
Paraffin	328,000	157,000
Heart Institute	160,000	(260,000)
Other	45,000	41,000
	<u>\$ 2,728,000</u>	<u>1,617,000</u>

New Hartford Scanner Associates (NHSA) is a joint venture between Healthcare and several radiologists to provide CT scan services. Healthcare receives income from NHSA, which amounted to approximately \$685,000 and \$715,000 in 2012 and 2011, respectively. Healthcare also provides leased equipment to NHSA, which amounted to approximately \$161,000 in 2012 and 2011.

In addition to the foregoing, Healthcare, through its affiliation with MVN, is affiliated with several other entities all of which are independent from Healthcare and are engaged in serving the Mohawk Valley Region as providers of various healthcare related services.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(14) Statements of Cash Flows - Supplemental Disclosures

Healthcare's non-cash investing and financing activity and cash payments for interest for the years ended December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Capital lease obligations issued for property and equipment	\$ 4,984,742	2,350,862
Purchases of property and equipment financed through accounts payable	340,960	678,173
Cash paid for interest, net of capitalized interest	2,812,517	4,471,619

(15) Functional Expenses

Healthcare provides general health care services to residents of the Mohawk Valley Region. Expenses related to providing these services are as follows:

	<u>2012</u>	<u>2011</u>
Health care services	\$ 237,541,121	234,666,168
General and administrative	<u>41,734,786</u>	<u>37,092,245</u>
	<u>\$ 279,275,907</u>	<u>271,758,413</u>

(16) Fair Value of Financial Instruments

The Fair Value Measurement Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(16) Fair Value of Financial Instruments, Continued

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

Cash and Cash Equivalents: The amount reported on the balance sheet for cash and cash equivalents approximates fair value.

Mutual Funds and Common Stock: The fair values, which are the amounts reported on the balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pooled Investment Hedge Funds and Real Estate Funds: Fair values are based on NAV per share as determined by the fund's investment manager or general partner.

Estimated Third-Party Payor Settlements: The amount reported on the balance sheet for estimated third-party payor settlements approximates its fair value.

Long-Term Debt: The fair value of fixed rate issues was determined by price quotes from an investment banker or estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements (considered a Level 2 input). The fair value of variable rate debt approximates its reported value on the balance sheet. Fixed rate long-term debt is the only financial instrument with a difference between recorded and fair value. The recorded value of fixed rate long-term debt on the balance sheet at December 31, 2012 approximates its fair value.

The following tables present information about assets and liabilities that are measured at fair value on a recurring basis as of December 31 and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. Healthcare considers a security that trades at least weekly to have an active market. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Investments valued using NAV as a practical expedient are classified as Level 2 if the investment is redeemable at NAV (as adjusted for subsequent gains or losses through the effective date of redemption) in the near-term (generally within a 3-month period) without significant restrictions on redemption. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Investments valued using NAV as a practical expedient are classified as Level 3 if the investment is not redeemable in the near-term or has significant restrictions.

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(16) Fair Value of Financial Instruments, Continued

	Total	Fair value measurements at December 31, 2012		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 2,354,498	2,354,498	-	-
Investments:				
Cash and cash equivalents	43,016	43,016	-	-
Mutual funds:				
U.S. large cap	8,213,167	8,213,167	-	-
U.S. mid cap	2,753,666	2,753,666	-	-
U.S. small cap	154,578	154,578	-	-
International developed	7,732,790	7,732,790	-	-
Emerging markets	3,119,298	3,119,298	-	-
Fixed income funds	8,101,747	8,101,747	-	-
Other	2,264,250	2,264,250	-	-
	<u>32,339,496</u>	<u>32,339,496</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	883,498	883,498	-	-
Energy	427,336	427,336	-	-
Financial	207,767	207,767	-	-
Healthcare	455,136	455,136	-	-
Industrial	527,150	527,150	-	-
Information technology	897,652	897,652	-	-
Materials	191,418	191,418	-	-
	<u>3,589,957</u>	<u>3,589,957</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	14,937,845	-	14,937,845	-
Real estate funds	3,218,996	-	3,218,996	-
Bond funds	3,688,542	-	3,688,542	-
Foreign equity funds	6,485,190	-	6,485,190	-
	<u>28,330,573</u>	<u>-</u>	<u>28,330,573</u>	<u>-</u>
Total assets at fair value	\$ <u>66,657,540</u>	<u>38,326,967</u>	<u>28,330,573</u>	<u>-</u>
Cash and cash equivalents				
Cash and cash equivalents	2,354,498	2,354,498	-	-
Investments				
Investments	64,303,042	35,972,469	28,330,573	-
	\$ <u>66,657,540</u>	<u>38,326,967</u>	<u>28,330,573</u>	<u>-</u>
Liabilities:				
Interest rate swaps	6,144,832	-	6,144,832	-
Total	\$ <u>6,144,832</u>	<u>-</u>	<u>6,144,832</u>	<u>-</u>

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(16) Fair Value of Financial Instruments, Continued

	Total	Fair value measurements at December 31, 2011		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 915,647	915,647	-	-
Investments:				
Cash and cash equivalents	144,158	144,158	-	-
Mutual funds:				
U.S. large cap	5,052,704	5,052,704	-	-
U.S. mid cap	2,256,065	2,256,065	-	-
U.S. small cap	853,385	853,385	-	-
International developed	5,041,908	5,041,908	-	-
Emerging markets	2,107,319	2,107,319	-	-
Fixed income funds	7,382,237	7,382,237	-	-
Other	967,747	967,747	-	-
	<u>23,661,365</u>	<u>23,661,365</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	833,125	833,125	-	-
Energy	276,411	276,411	-	-
Financial	336,363	336,363	-	-
Healthcare	422,254	422,254	-	-
Industrial	468,071	468,071	-	-
Information technology	723,387	723,387	-	-
Materials	127,440	127,440	-	-
	<u>3,187,051</u>	<u>3,187,051</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	14,583,412	-	14,583,412	-
Real estate funds	2,305,759	-	2,171,851	133,908
Bond funds	3,389,669	-	3,389,669	-
Foreign equity funds	5,360,376	-	5,360,376	-
	<u>25,639,216</u>	<u>-</u>	<u>25,505,308</u>	<u>133,908</u>
Total assets at fair value	<u>\$ 53,547,437</u>	<u>27,908,221</u>	<u>25,505,308</u>	<u>133,908</u>
Cash and cash equivalents	915,647	915,647	-	-
Investments	52,631,790	26,992,574	25,505,308	133,908
	<u>\$ 53,547,437</u>	<u>27,908,221</u>	<u>25,505,308</u>	<u>133,908</u>
Liabilities:				
Interest rate swaps	6,299,513	-	6,299,513	-
Total	<u>\$ 6,299,513</u>	<u>-</u>	<u>6,299,513</u>	<u>-</u>

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(16) Fair Value of Financial Instruments, Continued

The following table sets forth a summary of changes in the fair value of Healthcare's level 3 assets for the years ended December 31, 2012 and 2011.

	<u>2012</u>	<u>2011</u>
Balance, beginning of year	\$ 133,908	485,484
Interest and dividends, net of investment manager fees	172	9,229
Net realized gains (losses) on sale of investments	441	(8,242)
Change in net unrealized gains and losses on investments	-	40,722
Sales	<u>(134,521)</u>	<u>(393,285)</u>
Balance, end of year	<u>\$ -</u>	<u>133,908</u>

The following is a summary of the investments whose NAV approximates fair value and the related redemption restrictions associated with each major category at December 31, 2012 and 2011.

	<u>2012</u>		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
<u>Pooled investment fund</u>			
Hedge funds	\$ 14,937,845	Monthly	90 days
Real estate funds	3,218,996	Monthly	None
Bond funds	3,688,542	Monthly	10 days
Foreign equity funds	<u>6,485,190</u>	Monthly	10 days
	<u>\$ 28,330,573</u>		

	<u>2011</u>		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
<u>Pooled investment fund</u>			
Hedge funds	\$ 14,583,412	Monthly	90 days
Real estate funds	2,171,851	Monthly	None
Real estate funds	133,908	Restricted	Upon approval
Bond funds	3,389,669	Monthly	10 days
Foreign equity funds	<u>5,360,376</u>	Monthly	10 days
	<u>\$ 25,639,216</u>		

FAXTON-ST. LUKE'S HEALTHCARE

Notes to Financial Statements

(16) Fair Value of Financial Instruments, Continued

Hedge Funds

Hedge fund strategies involve funds with investment managers who have the authority to invest in various asset classes at their discretion and who have the ability to employ multiple investments strategies within their respective portfolios. Investment strategies may include the following categories: merger arbitrage, distressed, long/short credit, fixed income arbitrage and convertible arbitrage. These funds attempt to reduce individual manager risk by allocating capital among multiple investment managers. Funds with hedged strategies generally hold securities or other financial instruments for which a ready market exists and may include stocks, bonds, put or call options, swaps, currency hedges, and other instruments, and are valued accordingly.

Real Estate Funds

Real estate funds hold interests in publicly traded equity securities issued by real estate investment trusts ("REIT"), private real estate partnerships, and privately held REIT's. Strategies of these funds often require the estimation of fair values by the fund managers in the absence of readily determinable market values. Because of the inherent uncertainties of valuation, these estimated fair values may differ significantly from values that would have been used had a ready market existed, and the differences could be material. Such valuations are determined by fund managers and generally consider variables such as operating results, comparable earnings multiples, projected cash flows, recent sales prices, and other pertinent information, and may reflect discounts for the illiquid nature of certain investments held. Moreover, the fair values of Healthcare's interests in shares or units of these funds, because of the liquidity and capital commitment terms that vary depending on the specific fund or partnership agreement, may differ from the fair value of the funds' underlying net assets.

Bond Funds

Bond funds are invested in a globally diversified portfolio of primarily debt and debt-like securities. The funds are controlled by an investment manager. The investment manager generally will acquire positions in debt securities and currencies that are rated investment grade by Standard & Poor's Credit Market Services, or if unrated, an equivalent rating determined by the investment manager at its sole discretion.

Foreign Equity Funds

Foreign equity funds are invested in a diversified portfolio of equity securities of companies ordinarily located in any country other than the United States and Canada. The funds are controlled by an investment manager.

**MOHAWK VALLEY NETWORK, INC.
AND SUBSIDIARIES**

Consolidated Financial Statements

December 31, 2012 and 2011

INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Mohawk Valley Network, Inc. and Subsidiaries:

We have audited the accompanying consolidated financial statements of Mohawk Valley Network, Inc. and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

(Continued)

The Board of Directors
Page 2 of 2

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mohawk Valley Network, Inc. and Subsidiaries as of December 31, 2012 and 2011, and the results of their operations, changes in net assets and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Fust Charles Chambers LLP

July 3, 2013

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

December 31, 2012 and 2011

<u>Assets</u>	<u>2012</u>	<u>2011</u>
Current assets:		
Cash and cash equivalents	\$ 4,957,148	3,282,222
Assets limited as to use	365,153	384,829
Investments	65,378,129	53,271,796
Patient accounts receivable, net of reserve for doubtful accounts of \$10,705,466 in 2012 and \$8,807,842 in 2011	47,343,149	45,044,954
Pledges receivable	135,446	130,702
Inventories	5,694,209	5,245,890
Prepaid expenses and other current assets	18,775,281	13,836,110
Due from affiliates, net	1,077,770	437,072
Net investment in direct financing lease	547,116	547,116
Estimated third-party payor settlements, net	<u>9,567,612</u>	<u>8,459,560</u>
Total current assets	153,841,013	130,640,251
Investment in affiliates	137,248	129,203
Investments	4,528,164	4,528,164
Other receivables	4,871,330	15,089,675
Beneficial interest in charitable trusts	1,247,000	2,005,000
Residents' funds held in trust	90,429	72,091
Net investment in direct financing lease	3,013,803	3,288,328
Property and equipment, net	115,602,518	108,024,829
Unamortized debt issuance costs	472,689	498,240
Other assets	<u>30,651,737</u>	<u>24,947,260</u>
Total assets	<u>\$ 314,455,931</u>	<u>289,223,041</u>

<u>Liabilities and Net Assets</u>	<u>2012</u>	<u>2011</u>
Current liabilities:		
Bank overdraft	\$ -	158,431
Short-term borrowings	3,000,000	-
Revolving note payable	12,678,000	3,959,000
Current portion of long-term debt	3,597,989	4,582,967
Current portion of capital lease obligations	4,035,695	3,534,395
Accounts payable and accrued expenses	15,791,249	13,926,917
Accrued payroll, payroll taxes and benefits	13,921,345	12,562,609
Current portion of estimated self-insured liabilities	2,068,674	1,904,703
Other current liabilities	12,196,681	10,070,520
	<u>67,289,633</u>	<u>50,699,542</u>
Total current liabilities		
Long-term debt, net of current portion:		
Notes payable	8,824,057	17,339,959
Civic facility revenue bonds	16,845,000	17,355,000
Capital lease obligations	7,779,365	8,209,973
	<u>33,448,422</u>	<u>42,904,932</u>
Total long-term debt, net of current portion		
Estimated self-insured liabilities, net of current portion	2,927,462	3,584,985
Unrealized loss on interest rate swaps	6,144,832	6,299,513
Residents' funds held in trust	90,429	72,091
Other liabilities	40,029,086	34,809,192
	<u>149,929,864</u>	<u>138,370,255</u>
Total liabilities		
Net assets:		
Unrestricted	156,188,035	130,299,021
Temporarily restricted	3,809,868	16,025,601
Permanently restricted	4,528,164	4,528,164
	<u>164,526,067</u>	<u>150,852,786</u>
Total net assets		
Commitments and contingencies (notes 5, 9 and 13)		
Total liabilities and net assets	<u>\$ 314,455,931</u>	<u>289,223,041</u>

See accompanying notes to consolidated financial statements.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted revenues, gains and other support:		
Patient service revenue (net of contractual allowances and discounts)	\$ 303,554,077	301,227,950
Provision for bad debts	<u>(9,163,250)</u>	<u>(9,246,568)</u>
Net patient service revenue less provision for bad debts	294,390,827	291,981,382
Premium revenue	7,867,172	7,675,173
Other revenue (note 12)	9,690,504	10,989,959
Investment income, net of fees	<u>2,468,870</u>	<u>674,328</u>
Total unrestricted revenues, gains and other support	<u>314,417,373</u>	<u>311,320,842</u>
Expenses:		
Salaries and wages	142,930,466	136,726,899
Employee benefits	32,573,500	34,510,465
Supplies and other	117,559,766	114,366,102
Depreciation and amortization	18,071,785	17,560,722
Interest	2,695,700	4,795,783
New York State gross receipts taxes	1,926,098	1,813,279
Loss on extinguishment of debt	<u>62,626</u>	<u>871,935</u>
Total expenses	<u>315,819,941</u>	<u>310,645,185</u>
Net income (loss) from continuing operations	<u>(1,402,568)</u>	<u>675,657</u>
Discontinued operations	<u>2,354,183</u>	<u>(235,825)</u>
Excess of revenues over expenses	<u>\$ 951,615</u>	<u>439,832</u>

See accompanying notes to consolidated financial statements.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Consolidated Statements of Operations and Changes in Net Assets, Continued

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Unrestricted net assets:		
Excess of revenues over expenses	\$ 951,615	439,832
Change in fair value of interest rate swaps	154,681	(2,331,948)
Change in net unrealized gains and losses on investments	5,312,634	(1,983,904)
Net assets released for capital acquisitions	12,787,932	1,606,721
Contributions from HEAL grant, net	6,685,500	16,821,922
Cumulative effect of change in accounting principle	-	(5,000,000)
Other	(3,348)	(72,533)
	<u>25,889,014</u>	<u>9,480,090</u>
Increase in unrestricted net assets		
Temporarily restricted net assets:		
Contributions and grants	1,265,409	1,331,110
Contributions from HEAL grant	-	12,468,581
Income on investments	1,669	104
Change in value of charitable trusts	142,000	(27,000)
Net assets released from restrictions	(13,624,811)	(2,423,475)
	<u>(12,215,733)</u>	<u>11,349,320</u>
Increase (decrease) in temporarily restricted net assets		
Total increase in net assets	13,673,281	20,829,410
Net assets at beginning of year	<u>150,852,786</u>	<u>130,023,376</u>
Net assets at end of year	<u>\$ 164,526,067</u>	<u>150,852,786</u>

See accompanying notes to consolidated financial statements.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Change in net assets	\$ 13,673,281	20,829,410
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation and amortization	18,071,785	17,560,722
Provision for bad debts	9,163,250	9,246,568
Loss on extinguishment of debt	-	1,621,287
Contributions from HEAL grant, net	(6,685,500)	(30,620,671)
Cumulative effect of change in accounting principle	-	5,000,000
Change in net unrealized gains and losses on investments	(5,312,634)	1,983,904
Change in fair value of interest rate swaps	(154,681)	2,331,948
Other	-	72,533
Amortization of unearned lease income	(272,591)	(292,206)
Net realized (gain) loss on sale of investments	(1,174,399)	588,383
(Gain) loss on disposition of property and equipment	460,573	(818)
(Gain) loss on discontinued component	(2,354,183)	235,825
Contributions for capital acquisitions	(110,000)	(166,934)
Change in value of charitable trusts	(142,000)	-
Changes in operating assets and liabilities:		
Bank overdraft	(158,431)	158,431
Receivables	(11,461,187)	(10,170,803)
Beneficial interest in charitable trusts	900,000	27,000
Due from affiliates, net	1,397	(497,237)
Inventories, prepaid expenses and other current assets	(1,127,916)	(726,629)
Accounts payable, accrued expenses and other liabilities	2,948,186	1,829,824
Estimated self-insured liabilities	(858,438)	9,234
Estimated third-party payor settlements	(1,108,052)	(4,537,448)
Net cash provided by operating activities	<u>14,298,460</u>	<u>14,482,323</u>
Cash flows from investing activities:		
Purchases of property and equipment	(20,567,881)	(11,100,052)
Proceeds from sale of property and equipment	487,260	19,432
Proceeds from sale (purchases) of investments, net	(5,618,924)	6,864,684
Purchase of certificates of deposit	(376)	(967)
Net decrease in assets limited as to use	-	9,363,861
Discontinued operations	-	(235,825)
Use of project escrow funds	19,676	4,706,944
Net (increase) decrease in other assets	(656,224)	25,859
Net cash provided by (used in) investing activities	<u>(26,336,469)</u>	<u>9,643,936</u>

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from financing activities:		
Proceeds from short-term borrowing	3,000,000	-
Proceeds (payments) on revolving note payable, net	8,719,000	(241,000)
Proceeds from long-term debt	1,400,000	72,827
Prepayment penalty on debt extinguishment	-	(621,667)
Contributions from HEAL grant, net	9,576,249	16,237,143
Principal payments on long-term debt and capitalized lease obligations	(9,639,430)	(43,253,990)
Minimum direct financing lease payments received	547,116	547,116
Contributions for capital acquisitions	110,000	166,934
	<u>13,712,935</u>	<u>(27,092,637)</u>
Net cash provided by (used in) financing activities		
	1,674,926	(2,966,378)
Increase (decrease) in cash and cash equivalents		
Cash and cash equivalents at beginning of year	<u>3,282,222</u>	<u>6,248,600</u>
Cash and cash equivalents at end of year	<u>\$ 4,957,148</u>	<u>3,282,222</u>

See accompanying notes to consolidated financial statements.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

December 31, 2012 and 2011

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization and Principles of Consolidation

The consolidated financial statements include the accounts of Mohawk Valley Network, Inc. (MVN) and each of its subsidiaries (the Corporation). The Corporation is a health care delivery system providing inpatient, outpatient, emergency care, cancer treatment, rehabilitation, laboratory, dialysis, maternity, childcare, long term care, home care, surgical, psychiatric and community services to residents of the Mohawk Valley Region.

MVN is a not-for-profit corporation and is the sole corporate member of Faxton-St. Luke's Healthcare (Healthcare), Visiting Nurse Association of Utica and Oneida County, Inc. (VNA), Mohawk Valley Home Care, LLC (MVHC) and Senior Network Health, LLC (SNH). The Corporation is governed by a self-perpetuating Board of Directors.

Healthcare includes the accounts of the following affiliated entities: Faxton-St. Luke's Healthcare Foundation (Foundation), of which Healthcare is the sole member and St. Luke's Home Residential Health Care Facility, Inc. (Home), in which Healthcare has a sole financial interest at dissolution. Affiliates not considered material to the consolidated financial statements and included on the equity method of accounting are SLM Corporation (SLM), whose stock is owned by a trust, of which Healthcare is the sole beneficiary, and Paraffin, LLC (Paraffin), of which Healthcare is the sole member. All significant intercompany transactions and balances have been eliminated in consolidation.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(b) Adoption of Accounting Pronouncement

In July 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-07, *Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities*. ASU 2011-07 requires health care entities that recognize significant amounts of patient service revenue at the time of service, even though they do not assess the patient's ability to pay, to present the provision for bad debts related to patient service revenue as a deduction from patient service revenue on the statement of operations and changes in net assets. In addition, enhanced disclosure about the entity's policies for recognizing revenue and assessing bad debts, including disclosures of patient service revenue (net of contractual allowances and discounts) as well as qualitative and quantitative information about changes in the allowance for doubtful accounts is required. This new guidance is effective for fiscal years and interim periods within those fiscal years beginning after December 15, 2011. The Corporation adopted this guidance as of and for the year ended December 31, 2012, with retrospective application to all periods presented for the amendments relating to the presentation of the provision for bad debts related to patient service revenue; however, the enhanced disclosures required by the amendments are provided for the period of adoption and subsequent reporting periods. The adoption of ASU 2011-07 had the effect of reducing net patient service revenue by \$9,246,568, with an offsetting reduction in operating expenses for the year ended December 31, 2011, on the consolidated statements of operations and changes in net assets, and no effect on excess of revenues over expenses.

(c) Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(d) Collective Bargaining Agreement

At December 31, 2012, the Corporation has approximately 30% of its employees working under collective bargaining agreements.

(e) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with original maturities of three months or less, excluding temporary investments included in assets limited as to use and long-term investments.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(f) Assets Limited as to Use and Investments

SNH is required by the New York State Insurance Department to maintain an escrow deposit equal to the greater of five percent of the current year's projected medical expenses or \$100,000. SNH must also maintain positive net worth (member's equity) equal to or in excess of at least seven and one quarter percent of net premium revenue in 2012 and 2011. At December 31, 2012 and 2011, SNH was in compliance with both requirements. At December 31, 2012 and 2011, the cash equivalents in escrow and primarily invested in short-term U.S. Treasury, money markets and government agency securities.

Investments in equity securities with readily determinable fair values and all investments in debt securities are measured at fair value which is determined utilizing quoted market prices. Investments in insurance group fixed annuity contracts (Guaranteed Investment Contracts) are valued at contract value, which is considered the best representation of fair value. Investment income or loss (including realized gains and losses on investments, interest and dividends) is included in the excess of revenues over expenses unless the income or loss is restricted by donor or law. Unrealized gains and losses on investments are excluded from the excess of revenues over expenses since none of the investments are classified as trading securities.

Certain investments that do not have readily determinable fair values are valued by using the net asset value (NAV) per share (or its equivalent), as a practical expedient permitted under the Fair Value Measurements Topic of the FASB Accounting Standards Codification.

The Corporation invests in various investment securities. Investment securities are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and such changes could materially affect the Corporation's net assets.

(g) Beneficial Interest in Charitable Trusts

The Corporation has beneficial interests in various irrevocable split-interest agreements that are administered by independent trustees which consist of charitable remainder unitrusts (CRUT). The Corporation's interest in these trusts is recorded at the present value of the estimated future cash flows from the trust's assets using a discount rate that reflects current market conditions and is included in temporarily restricted net assets for renovations and equipment. The Corporation used a discount rate of 1.2% and 1.6% at December 31, 2012 and 2011, respectively. Changes in the fair value of the beneficial interest are reflected as a change in value of charitable trusts in the consolidated statement of operations and changes in net assets.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(h) Residents' Funds Held in Trust

Residents' funds represent amounts deposited with the Home on behalf of residents for their discretionary use. These funds are administered by the Home with the corresponding liability to the residents reflected on the consolidated balance sheet.

(i) Inventories

Inventories are stated at the lower of average cost or market.

(j) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is calculated over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years using the straight-line method. Property and equipment under capital leases and leasehold improvements are amortized on the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Amortization of equipment under capital leases and leasehold improvements is included in depreciation and amortization expense.

Interest cost incurred on borrowed funds during the construction of capital assets is capitalized as a component of the cost of acquiring those assets. Net interest cost capitalized amounted to approximately \$163,000 in 2012 and \$121,000 in 2011.

Gifts of long-lived assets, such as land, buildings or equipment are reported as unrestricted support and are excluded from the excess of revenues over expenses, unless explicit donor stipulations specify how the donated asset must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(k) Unamortized Debt Issuance Costs

Debt issuance costs are amortized using the straight-line method, which approximates the effective interest method, over the terms of the related debt.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(l) Contributions and Pledges Receivable

Unconditional promises to give cash and other assets 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. Contributions 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 and changes in net assets as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the consolidated statements of operations and changes in net assets.

Pledges receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a provision for bad debts and an adjustment to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to pledges receivable. At December 31, 2012 and 2011, no allowance was recorded. The original pledge amount at December 31, 2012 and 2011 approximates the net present value.

(m) Temporarily Restricted Net Assets

Temporarily restricted net assets are those whose use has been limited by donors to a specific time period or purpose.

(n) Permanently Restricted Net Assets (Endowment Funds)

The Corporation maintains various donor-restricted and board-designated funds whose purpose is to provide long-term support for its charitable programs. In classifying such funds for financial statement purposes as either permanently restricted, temporarily restricted or unrestricted net assets, the Board of Directors looks to the explicit directions of the donor where applicable and the provisions of the laws of the State of New York. To constitute an endowment under New York State law, the restriction must arise from a clearly expressed donor limitation, not a limitation from within the beneficiary organization. The Board has determined that, absent donor stipulations to the contrary, the provisions of New York State law do not impose either a permanent or temporary restriction on the income or capital appreciation derived from the original gift. Therefore, all income and appreciation derived from the original gift are transferred to unrestricted net assets absent any restrictions on the use made by the donor. Permanently restricted net assets consist of endowment funds of \$4,528,164 at December 31, 2012 and 2011, respectively, and are included in long-term investments in the consolidated balance sheets.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds), Continued

The Corporation utilizes an investment strategy that emphasizes preservation of principal and total return consistent with prudent levels of risk. Investments are allocated over a diversified portfolio of multiple asset classes of domestic and international equities and bonds.

Interpretation of Relevant Law

Previous to September 17, 2010, New York State law required the preservation of an endowment fund's historic dollar value. Historic dollar value is defined as the aggregate fair value in dollars of an endowment fund at the time it becomes an endowment fund, each subsequent donation to the fund at the time it is made and each accumulation made pursuant to a direction in applicable gift instrument at the time an accumulation is added to the fund. The law permitted an organization to spend the income earned by an endowment fund (i.e. interest, dividends), as well as the net appreciation (realized with respect to all assets and unrealized with respect to readily marketable assets) of such fund.

On September 17, 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) was signed into New York State law. The most prominent feature of NYPMIFA is the elimination of the requirement to preserve an endowment fund's historic dollar value which allows an organization to spend from an endowment whose market value has dropped below the historic dollar value, as long as it is deemed prudent under the organization's policies. In accordance with NYPMIFA, an organization must consider the following factors in exercising a standard of prudence:

1. The duration and preservation of the endowment fund
2. The purposes of the organization and the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation and deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the organization
7. The investment policies of the organization
8. Where appropriate, alternatives to spending from the endowment fund and the possible effects of those alternatives on the organization

NYPMIFA requires compliance with donor intent when making investment or spending decisions with respect to an endowment fund. In addition, NYPMIFA creates a restriction on the portion of an endowment fund that is not classified as permanently restricted net assets, even in the absence of a donor restriction. Such portion is classified as temporarily restricted net assets until appropriated for expenditure by the organization.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds), Continued

Interpretation of Relevant Law, Continued

As of December 31, 2011, the Board of Directors has not adopted and is currently evaluating the provisions of NYPMIFA. As a result, the Corporation continues to classify permanently restricted net assets at the historic dollar value of the fund in accordance with donor instructions.

Funds with Deficiencies

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or NYPMIFA requires the Corporation to retain as a fund of perpetual duration. If the situation were to occur, the deficiency would be recorded in the Corporation's unrestricted net assets. The deficiency recorded in unrestricted net assets at December 31, 2011 was approximately \$141,000. There was not a deficiency at December 31, 2012.

The Corporation has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs supported by its endowment. Under this policy, as approved by the Board of Directors, the endowment assets are to be invested in a well diversified asset mix that can be expected to generate acceptable long-term returns at an acceptable level of risk. The Corporation targets a diversified asset allocation that places a greater emphasis on equity-based investments and bonds to achieve its long-term return objectives within prudent risk constraints.

Changes in Endowment Net Assets

	2012		
	Unrestricted	Permanently restricted	Total
Endowment net assets, January 1, 2012	\$ (140,961)	4,528,164	4,387,203
Investment return:			
Investment income	-	95,620	95,620
Net appreciation (realized and unrealized)	-	435,114	435,114
Other	530,734	(530,734)	-
Endowment net assets, December 31, 2012	\$ 389,773	4,528,164	4,917,937

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(n) Permanently Restricted Net Assets (Endowment Funds), Continued

Changes in Endowment Net Assets, Continued

	2011		
	<u>Unrestricted</u>	<u>Permanently restricted</u>	<u>Total</u>
Endowment net assets, January 1, 2011	\$ (107,940)	4,528,164	4,420,224
Investment return:			
Investment income	-	91,367	91,367
Net appreciation (realized and unrealized)	-	(124,388)	(124,388)
Other	(33,021)	33,021	-
Endowment net assets, December 31, 2011	\$ (140,961)	4,528,164	4,387,203

(o) Net Patient Service Revenue and Patient Accounts Receivable

The Corporation has agreements with third-party payors that provide for payments to the various organizations within its healthcare delivery system at amounts different from their established rates. Payment arrangements include prospectively determined rates per discharge or visit, cost-based reimbursement, discounted charges, per diem payments and fee-for-service payments. The Corporation recognizes patient service revenue associated with services provided to patients who have third-party coverage on the basis of contractual rates for the services rendered, including estimated retroactive adjustments due to future audits, reviews and investigations. Retroactive adjustments are included in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations. For uninsured patients that do not qualify for charity care, the Corporation recognizes revenue on the basis of its standard rates for services provided. On the basis of historical experience, a significant portion of the Corporation's uninsured patients will be unable or unwilling to pay for the services provided. Thus, the Corporation records a provision for bad debts related to uninsured patients in the period the services are provided. Patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts) from these major payor sources, is as follows for the year ended December 31, 2012:

	<u>Government payors</u>	<u>Commercial insurance and others</u>	<u>Self-pay</u>	<u>Total</u>
Patient service revenue (net of contractual allowances and discounts)	\$ 171,671,085	123,000,384	8,882,608	303,554,077
	\$ 171,671,085	123,000,384	8,882,608	303,554,077

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

- (1) Description of Organization and Summary of Significant Accounting Policies, Continued
- (o) Net Patient Service Revenue and Patient Accounts Receivable, Continued

Revenue from the Medicare and Medicaid programs accounted for approximately 57% and 55% of the Corporation's patient service revenue, net of contractual allowances and discounts (but before the provision for bad debts) for 2012 and 2011, respectively. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. Patient service revenue increased by approximately \$47,000 and \$1,080,000 in 2012 and 2011, respectively, related to either settlement of prior year issues or changes in estimates associated with third-party issues.

The Corporation grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2012</u>	<u>2011</u>
Medicare	27%	23%
Medicaid	21%	20%
Private payors	12%	12%
Insurance and all others	<u>40%</u>	<u>45%</u>
	<u>100%</u>	<u>100%</u>

Patient accounts receivable are reduced by a reserve for doubtful accounts. In evaluating the collectibility of patient accounts receivable, the Corporation analyzes past payment history and identifies trends for each of its major payor sources of revenue to estimate the appropriate reserve for doubtful accounts and provision for bad debts. For receivables associated with patients who have third-party coverage, the Corporation analyzes contractually due amounts and provides a reserve for doubtful accounts and a provision for bad debts, if necessary (for example, for expected uncollectible deductibles and copayments, or for payors who are known to be having financial difficulties that make the realization of amounts due unlikely). For receivables associated with self-pay patients (which includes both patients without insurance and patients with deductible and copayment balances due for which third-party coverage exists for part of the bill), the Corporation records a reserve for doubtful accounts and a provision for bad debts in the period of service based on 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 standards rates (or the discounted rates if negotiated) and the amount actually collected after all reasonable collection efforts have been exhausted is charged off against the allowance for doubtful accounts.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(o) Net Patient Service Revenue and Patient Accounts Receivable, Continued

The Corporation's reserve for doubtful accounts for self-pay patients increased from 57% of self-pay accounts receivable at December 31, 2011 to 62% of self-pay accounts receivable at December 31, 2012. The increase relates to negative trends experienced in the collection of amounts from self-pay patients in recent years as a result of unstable economic conditions. In addition, the Corporation's self-pay write offs decreased \$2,339,854 from \$9,898,546 for fiscal year 2011 to \$7,558,692 for fiscal year 2012.

(p) Premium Revenue

SNH administers an agreement with New York State to provide a long-term care services benefit package to dually-eligible Medicare/Medicaid recipients under a partial risk contract. Under this agreement, SNH receives monthly capitation payments based on the number of enrollees, regardless of services actually performed. The agreement allows for retroactive adjustments to the monthly capitation rate.

Medicaid excess revenue represents the monthly amount billed to individuals participating in the Medicaid managed care program. This monthly contribution is determined by the local county's Department of Social Services.

(q) Charity Care

Healthcare provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because Healthcare does not pursue collection of such amounts, they are not reported as patient service revenue. During 2012 and 2011, costs incurred by Healthcare in the provision of charity care were based on the ratio of Healthcare's costs to gross charges and approximated \$340,000 and \$657,000, respectively.

(r) Excess of Revenues over Expenses

The consolidated statements of operations and changes in net assets include excess of revenues over expenses. Changes in unrestricted net assets which are excluded from excess of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, the effective portion of gains and losses on derivative instruments, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(s) Income Taxes

Healthcare, Foundation, Home, VNA and MVN are not-for-profit corporations and have been recognized as tax-exempt pursuant to Section 501(c)(3) of the Internal Revenue Code.

MVHC and SNH are sole member New York limited liability companies. Accordingly, they are treated as disregarded entities for tax purposes and taxable income, if any, is attributed to MVN. Additionally, MVHC and SNH, disregarded entities, are considered divisions of MVN for tax purposes and, accordingly, share in MVN's 501(c)(3) not-for-profit tax status.

As of December 31, 2012, Healthcare, Foundation, Home, VNA and MVN did not have any unrecognized tax benefits or any related accrued interest or penalties. The tax years open to examination by federal and New York State taxing authorities are 2009 through 2012.

(t) Concentration of Credit Risk

The Corporation invests cash and cash equivalents with financial institutions, and has determined that the amount of credit exposure at any one financial institution is immaterial to the Corporation's financial position.

(u) Reclassifications

Certain 2011 amounts have been reclassified to conform with the 2012 financial statement presentation.

(v) Subsequent Events

Subsequent events have been evaluated through July 3, 2013 which is the date financial statements were issued.

(2) Discontinued Operations

In 2009, the Corporation sold its wholly owned, for-profit subsidiary, Faxchil Realty, Inc. (Faxchil), including Faxchil's wholly owned, for-profit subsidiary, Centrex Clinical Laboratories, Inc. (Centrex). The sale included an earn-out opportunity not to exceed \$5,000,000 if certain revenue targets were achieved during two separate one year earn-out periods ending December 31, 2010 and 2011. These revenue targets were not achieved for the first two earn-out periods. During 2012, the earn-out period was extended for two additional one-year periods. For the year ended December 31, 2012, an earn-out of approximately \$2,354,000 was earned and recorded by the Corporation. During 2011, the Corporation recorded a loss of approximately \$236,000 related to covenant not to compete agreements, changes in accounts receivable and outstanding liabilities. It is expected that all other significant transactions related to the sale of Faxchil Realty, other than the final earn-out, have been recorded.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(3) HEAL Grant

During 2012, Healthcare was approved for a grant award of \$7,135,500 as part of the New York State HEAL grant program. The grant award is primarily to be used for restructuring initiatives in Medicaid redesign. The award included \$6,685,500 for the discharge of debt and \$450,000 for facility integration with St. Elizabeth Medical Center.

During 2011, MVN was approved for a grant award of \$31,329,508 as part of the New York State HEAL grant program. The grant award is primarily to be used to construct new and renovate existing portions of the Home's facility in order to centralize and expand long-term care services; to pay off the outstanding HUD mortgages at the Home; and for capital acquisitions for certain affiliates. In 2011, the Home applied to decertify 40 of its RHCF beds and closed one of its nursing wings to make space for these renovations. The beds were decertified as of January 13, 2012.

For accounting purposes, MVN is being treated as a pass-through entity for the grant as these funds are primarily being utilized by the Home in accordance with the Revenue Recognition Topic of the FASB Accounting Standards Codification. As such, the activity is recorded through the net assets of the Home. At December 31, 2012 and 2011, the Home had a receivable due from MVN of approximately \$4,871,000 and \$15,090,000, respectively, related to the HEAL grant (refer to note 14).

During 2011, the Home recorded approximately \$18,861,000 of contributions from HEAL grant as unrestricted contributions. The funds were utilized as follows:

Payment of HUD guaranteed mortgages including penalties	\$ 17,211,000
Renovations and construction at St. Luke's Home	1,489,000
Reimbursement of costs for wing closure at St. Luke's Home	87,000
Capital acquisitions for VNA	<u>74,000</u>
	\$ <u>18,861,000</u>

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Investments

At December 31, investments, at fair value, are comprised of the following:

	<u>2012</u>	<u>2011</u>
Cash and cash equivalents	\$ 2,474,152	1,287,040
Certificates of deposit	102,028	101,652
Mutual funds	35,953,680	26,953,000
Common stock	4,158,057	3,716,436
Pooled investment funds	29,291,303	26,469,976
Government agency obligations	<u>321,514</u>	<u>328,013</u>
	<u>\$ 72,300,734</u>	<u>58,856,117</u>

The above amounts are included in the accompanying consolidated financial statements as follows:

	<u>2012</u>	<u>2011</u>
Investments - current assets	\$ 65,378,129	53,271,796
Cash and cash equivalents	2,394,441	1,056,157
Long-term investments	<u>4,528,164</u>	<u>4,528,164</u>
	<u>\$ 72,300,734</u>	<u>58,856,117</u>

Investment income and gains (losses) on unrestricted assets limited as to use, cash equivalents and investments are comprised of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Investment income:		
Interest income and dividends, net of fees	\$ 1,294,471	1,262,711
Realized gains (losses)	<u>1,174,399</u>	<u>(588,383)</u>
	2,468,870	674,328
Change in net unrealized gains and losses on investments	<u>5,312,634</u>	<u>(1,983,904)</u>
	<u>\$ 7,781,504</u>	<u>(1,309,576)</u>

The Corporation continually reviews investments for other-than-temporary impairment whenever the fair value of an investment is less than amortized cost and evidence indicates that an investment's carrying amount is not recoverable within a reasonable period of time. In the evaluation of whether an impairment is other-than-temporary, the Corporation considers the reasons for the impairment, its ability and intent to hold the investment until the market price recovers or the investment matures, compliance with its investment policy, the severity and duration of the impairment, and expected future performance.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(4) Investments, Continued

The Corporation's investments in common stocks and mutual funds consist of investments diversified in several different industries. The Corporation evaluated the near-term prospects of the issuer in relation to the severity and duration of impairment. Based upon the evaluation and the Corporation's ability and intent to hold the securities for a reasonable period of time sufficient for a forecasted recovery of fair value, the Corporation does not consider the securities in an unrealized loss position to be other-than-temporarily impaired at December 31, 2012 and 2011.

(5) Property and Equipment

Property and equipment is comprised of the following at December 31:

	<u>2012</u>	<u>2011</u>
Land and land improvements	\$ 10,281,040	8,450,706
Buildings	137,020,816	130,656,933
Fixed equipment	40,309,297	35,349,782
Movable equipment	102,229,690	99,734,448
Property and equipment under capitalized leases	20,899,600	20,247,109
	<u>310,740,443</u>	<u>294,438,978</u>
Less accumulated depreciation	206,488,477	191,769,507
	<u>104,251,966</u>	<u>102,669,471</u>
Construction-in-progress	11,350,552	5,355,358
	<u>115,602,518</u>	<u>108,024,829</u>
Property and equipment, net	\$ 115,602,518	108,024,829

Depreciation expense amounted to approximately \$18,046,000 and \$17,308,000 for the years ended December 31, 2012 and 2011, respectively. At December 31, 2012, commitments to purchase in association with ongoing projects totalled approximately \$5.6 million.

(6) Direct Financing Lease

In 2001, Healthcare completed construction of a medical office building with a cost of approximately \$5 million on land owned by an affiliate of Slocum-Dickson Medical Group, P.C. (SDMG). The building is leased to SDMG under a direct financing lease for minimum lease payments of \$45,393 per month through 2022. Healthcare financed 80% of the building cost with a mortgage described in detail in note 9 which was paid off in 2012.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(6) Direct Financing Lease, Continued

The balance sheet presentation of the direct financing lease at December 31 is as follows:

	<u>2012</u>	<u>2011</u>
Minimum lease payments receivable	\$ 4,859,479	5,406,595
Unearned lease income	<u>(1,298,560)</u>	<u>(1,571,151)</u>
Net investment in direct financing lease	3,560,919	3,835,444
Less current portion	<u>547,116</u>	<u>547,116</u>
Long-term net investment in direct financing lease	<u>\$ 3,013,803</u>	<u>3,288,328</u>

(7) Extended Sick Leave

The Corporation's employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. The Corporation accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. The Corporation has accrued an estimated liability of approximately \$11,179,000 and \$10,308,000 at December 31, 2012 and 2011, respectively, for these anticipated termination payments.

Amounts are included in the accompanying consolidated financial statements as follows at December 31:

	<u>2012</u>	<u>2011</u>
Accrued payroll, payroll taxes and benefits	\$ 691,000	677,000
Other liabilities	<u>10,488,000</u>	<u>9,631,000</u>
	<u>\$ 11,179,000</u>	<u>10,308,000</u>

(8) Short-Term Borrowings

VNA has a line of credit with a bank which provides for borrowings up to \$500,000, at an interest rate equal to the bank's prime rate (3.25% at December 31, 2011) less 50 basis points or a minimum of 3%. All assets are pledged as collateral. The line expires June 30, 2013. There was no outstanding balance on the line at December 31, 2012 and 2011.

The Home has a line of credit with an available and outstanding balance of \$3,000,000 through a bank. The Foundation acts as a guarantor on this line of credit. Interest is calculated at the thirty-day LIBOR rate (0.21% at December 31, 2012) plus 2.25%.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations

Long-term debt consists of the following at December 31:

	<u>2012</u>	<u>2011</u>
Variable rate demand 2006 Civic Facility Revenue Bonds (Mohawk Valley Network, Inc. Obligated Group; Faxton-St. Luke's Healthcare) (a)	\$ 17,355,000	17,840,000
Revolving note payable (b)	12,678,000	3,959,000
Unsecured notes payable in varying monthly installments maturing from January 2013 through January 2016 at interest rates ranging from 5% to 6% (c)	3,262,988	5,690,632
Note payable in monthly installments of \$116,667 at a fixed rate of 5.3%, maturing June 2015 and collateralized by Healthcare's gross receipts	3,616,667	5,016,667
Note payable in monthly installments of \$15,249 at a fixed rate of 5.5% through March 2017 (c)	687,457	-
Mortgage note payable in monthly installments of \$26,230 at a fixed rate of 4.0%, secured by property under direct financing lease (note 6) (c)	-	2,583,712
Note payable to SLM at a fixed interest rate of 3.65% with a balloon payment for the remaining amount due December 2016	1,400,305	1,475,676
Mortgage payable in monthly installments of \$44,248 at a fixed rate of 6.5%, maturing January 2020 and collateralized by the related building	2,944,629	3,284,603
Notes payable in varying monthly installments at interest rates of 3.0% to 6.0%, collateralized by certain property (c)	-	3,317,985

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

	<u>2012</u>	<u>2011</u>
Notes payable in varying monthly installments maturing November 2012 (interest rates ranging from 2.5% to 6.75%)	-	68,651
Capital lease obligations (interest rates ranging from 2.9% to 8.5%)	<u>11,815,060</u>	<u>11,744,368</u>
	53,760,106	54,981,294
Less current portion:		
Revolving note payable	(12,678,000)	(3,959,000)
Debt	(3,597,989)	(4,582,967)
Capital lease obligations	<u>(4,035,695)</u>	<u>(3,534,395)</u>
Long-term debt, net of current portion	<u>\$ 33,448,422</u>	<u>42,904,932</u>

(a) Healthcare, through the Oneida County Industrial Development Agency (OCIDA), has issued serial and term Civic Facility Revenue Bonds as follows:

<u>Series</u>	<u>Term</u>	<u>Principal Payments</u>	<u>Rate</u>
Faxton-St. Luke's Healthcare:			
2006E - tax-exempt	2031	\$ 210,000 - 525,000	4.903 - 4.995%
2006F - taxable	2031	300,000 - 955,000	4.903 - 4.995%

The bonds are insured and are collateralized by Healthcare's gross receipts (as defined), including all rights to receive such receipts whether in the form of accounts receivable, contract rights or other rights. Healthcare entered into a lease agreement with OCIDA, which also acts as security for payment of the revenue bonds. Additional security is provided by a Master Trust Indenture under which the initial Members of the Obligated Group (Healthcare and MVN) are jointly and severally responsible for payment of the bonds.

The bonds bear interest based on one of three modes - the weekly rate, the term rate, or the fixed rate - for periods selected by Healthcare. The interest rate for each mode will be the current market interest rate as determined by the remarketing agent of the bonds. Healthcare used the weekly rate during 2012 and 2011. At December 31, 2012, the bonds carried interest at rates of .52% and .19%. At December 31, 2011 the bonds carried interest at rates of .40% and .18%.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

The bonds are remarketed by a remarketing agent in accordance with the terms of a remarketing agreement. The bonds will be remarketed whenever a new interest rate is in effect. If the bonds cannot be remarketed, they would be due and payable under the terms of the remarketing agreement; however, the bonds are credit-enhanced by an irrevocable Bank of America letter of credit, which is set to expire June 25, 2016. In the event that the remarketing agent is unable to remarket the bonds, the bond trustee will make a draw on the letter of credit and the tendered variable rate bonds will become bank bonds.

Various agreements relating to the bonds establish covenants with which Healthcare has agreed to comply, including the following, among others. In any year, Healthcare will not dispose of operating assets exceeding 2.5% of the total book value of operating assets or accounts receivable with recourse having a book value in excess of 50% of the total book value of accounts receivable. The Obligated Group may not merge or consolidate with another entity unless certain conditions are met. Additional indebtedness is limited to certain provisions including borrowings not to exceed 15% of total operating revenue. The Obligated Group agreed to maintain a minimum debt service coverage ratio, as defined, of 120% annually or employ a management consultant. At December 31, 2012 and 2011, the Obligated Group was in compliance with the covenants that are considered events of default.

As a result of the aforementioned 2006 bond issuances, the Healthcare has entered into two interest rate swap contracts to reduce its risk of exposure to changes in interest rates. The interest rate swaps effectively convert the variable rates of the 2006 bonds to fixed rates of 5.938% and 4.216% through June 2031. The swaps have been designated as cash flow hedges of the variable interest rates and are recorded at fair value as a liability of \$6,144,832 on the accompanying consolidated balance sheet as of December 31, 2012. The swaps have effective dates in June 2006 and termination dates of June 2031. The amounts exchanged are based on the notional amounts whereby Healthcare pays the swap counter-party interest at a fixed rate (4.216% - tax-exempt, 5.938% - taxable) and the swap counter-party pays Healthcare a variable rate (based on 70% of 1 month LIBOR tax-exempt, BMA Rate - taxable). The notional amounts and fair values based on quoted market prices of Healthcare's interest rate swaps are as follows at December 31, 2012:

	<u>Notional amount</u>	<u>Liability market value</u>
Healthcare - Series E	\$ 10,775,000	4,311,511
Healthcare - Series F	6,580,000	1,833,321
	<u>\$ 17,355,000</u>	<u>6,144,832</u>

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

The mark-to-market adjustments resulted in an increase of \$154,681 and a decrease of \$2,331,948 in unrestricted net assets for the years ended December 31, 2012 and 2011, respectively. Changes in value of the swaps determined to arise from ineffectiveness of the instruments, as determined through the hypothetical derivative method, are recorded as a component of interest expense in the consolidated statements of operations and changes in net assets. For the years ended December 31, 2012 and 2011, there was no significant ineffectiveness. Healthcare expects that the loss existing in unrestricted net assets to be reclassified into net income (loss) from continuing operations within the next 12 months will not be significant.

- (b) At December 31, 2012 and 2011, Healthcare had a \$19,500,000 revolving note payable with a bank, collateralized by substantially all of Healthcare's investments. The revolving note payable on short-term borrowings bears a daily interest rate at prime (3.25% at December 31, 2012). The revolving note payable on long-term borrowings bears a monthly interest rate at LIBOR (1.16% at December 31, 2012). The revolving note payable is available through July 2013. At December 31, 2012, a portion of the revolving note payable was reserved for three letters of credit totaling approximately \$4,357,000 related to self-insured liabilities. At December 31, 2012 and 2011, Healthcare had \$3,678,000 and \$959,000 outstanding on the short-term borrowings, respectively. At December 31, 2012 and 2011, Healthcare had \$9,000,000 and \$3,000,000 outstanding on the long-term borrowings, respectively. The revolving note payable contains financial covenants including a debt service coverage ratio requirement, a day's cash on hand requirement and a minimum unrestricted liquidity to funded debt ratio. At December 31, 2012 and 2011, Healthcare was in compliance with the covenants that are considered events of default.
- (c) Healthcare utilized funds as awarded by New York State through the HEAL grant of \$6,685,500 for the discharge of debt, which was used to pay off or pay down this debt. The HEAL grant is further described in note 3.

Healthcare leases certain equipment under capital leases. Healthcare also leases equipment and facilities under non-cancelable operating leases, including leases with affiliates. The net book value of the equipment capitalized under lease agreements at December 31, 2012 and 2011 amounted to approximately \$13,312,000 and \$13,129,000, respectively.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(9) Long-Term Debt and Lease Obligations, Continued

Scheduled principal payments on long-term debt and payments under non-cancelable operating leases and the present value of future minimum capital lease payments at December 31, 2012 are:

Years ended December 31:	Revolving note payable	Long-term debt	Capital leases	<u>Operating leases</u>	
				<u>Affiliates</u>	<u>Other</u>
2013	\$12,678,000	3,597,989	4,446,951	154,867	2,458,616
2014	-	3,611,816	3,134,274	154,867	2,278,747
2015	-	4,301,607	2,376,501	154,867	1,859,220
2016	-	16,349,808	1,436,603	154,867	1,790,673
2017	-	471,800	848,409	154,867	1,705,624
Thereafter	-	934,026	719,339		
Total payments	12,678,000	29,267,046	12,962,077		
Less amounts representing interest			<u>1,147,017</u>		
Present value of capital lease obligations			11,815,060		
Less current portion			<u>4,035,695</u>		
Capital lease obligations, net of current portion			<u>\$ 7,779,365</u>		

Rent expense under operating leases amounted to approximately \$4,439,000 in 2012 and \$3,177,000 in 2011.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(10) Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2012</u>	<u>2011</u>
Funds held in trust by others (for capital)	\$ 1,247,000	2,005,000
Children's Miracle Network	665,282	646,182
Continuous Learning Center	239,738	248,957
Scholarship assistance	31,699	31,369
Programs	530,051	354,021
Capital renovations	333,324	271,491
HEAL Grant - capital purchases	<u>762,774</u>	<u>12,468,581</u>
	<u>\$ 3,809,868</u>	<u>16,025,601</u>

Permanently restricted net assets at December 31 are restricted to:

Investments to be held in perpetuity, the income from which is to support charity care, health care services, scholarships and facility maintenance	\$ <u>4,528,164</u>	<u>4,528,164</u>
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(11) Pension Plans

Healthcare and the Home sponsor a 401(k) plan that covers substantially all full-time non-union employees. Each sponsor contributes 4% of eligible compensation to the plan (5% for employees hired before December 1, 2001). Each sponsor also makes a matching contribution up to 100% of the first 4% of employee contributions to the 401(k) plan. Healthcare also sponsors a 403(b) plan that covers union and certain other employees. Healthcare contributes 5% to 7% of eligible compensation to the 403(b) plan.

The VNA sponsors two defined contribution pension plans covering substantially all employees. VNA matches employee contributions up to specified limits.

Pension expense under all plans aggregated approximately \$7,580,000 in 2012 and approximately \$7,508,000 in 2011.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(12) Other Revenue

Other revenue consists of the following for the years ended December 31:

	<u>2012</u>	<u>2011</u>
Rent	\$ 806,126	837,271
Mohawk Valley Heart Institute	(966,681)	(373,765)
New Hartford Scanner	845,776	1,009,764
Grant revenue and contributions	2,085,243	491,142
Medicare and Medicaid health information technology income	3,089,004	4,880,080
CMIC Partnership income	230,100	222,300
VHA Partnership equity earnings	229,336	239,099
Net assets released for operations	817,979	816,754
Other	<u>2,553,621</u>	<u>2,867,314</u>
	<u>\$ 9,690,504</u>	<u>10,989,959</u>

The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 included provisions for implementing health information technology under the Health Information Technology for Economic and Clinical Health Act (HITECH). The provisions were designed to increase the use of electronic health record (EHR) technology and to establish the requirements for a Medicare and Medicaid incentive payment program beginning in 2011 for eligible providers that adopt and meaningfully use certified EHR technology. Eligibility for annual Medicare incentive payments is dependent on providers demonstrating meaningful use of EHR technology in each period over a four-year period. Initial Medicaid payments are available to providers that adopt, implement or upgrade certified EHR technology. Providers must demonstrate meaningful use of such technology in subsequent years to qualify for additional Medicaid incentive payments.

The Company recognizes HITECH incentive payments as revenue when it is reasonably assured that the meaningful use objectives have been achieved. The Company recognized Medicare and Medicaid incentive payments totalling approximately \$3,089,000 and \$4,880,000 for the years ended December 31, 2012 and 2011, respectively, as other operating revenue in the accompanying statements of operations and changes in net assets. The Company's compliance with the meaningful use criteria is subject to audit by the federal and New York State governments.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Contingencies

General and malpractice insurance coverage is provided under a claims-made based policy for Healthcare and an occurrence-based policy for the Home, VNA and SNH, which provide for \$1,000,000 coverage for each claim, not to exceed \$3,000,000 in aggregate annual coverage. In addition, the Corporation has purchased an excess insurance policy. Claims alleging malpractice have been asserted against the Corporation and are currently in various stages of litigation. There are known claims and incidents that may result in the assertion of additional claims, as well as claims from unknown incidents that may be asserted relating to services provided to patients. Accrued malpractice losses in management's opinion provide an adequate reserve for loss contingencies. The Corporation has accrued a liability included in other liabilities of approximately \$27,344,000 and \$27,305,000 at December 31, 2012 and 2011, respectively.

The Corporation and its affiliates are self-insured for employee healthcare costs. The group has obtained a stop loss coverage policy for healthcare costs to supplement its self insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

The Corporation is primarily self-insured for employee workers' compensation and disability claims along with certain of its affiliates for the years 2007 and prior. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, the Corporation has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. The Corporation and certain of its affiliates are jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2012 and 2011. Effective 2010, the Corporation and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of the Corporation and its affiliates.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(13) Contingencies, Continued

Health Care Reform

The Affordable Care Act was signed into law, in two parts, on March 23, 2010 and March 30, 2010. The Affordable Care Act dramatically alters the U.S. healthcare system and is intended to decrease the number of uninsured Americans and reduce the overall cost of healthcare. The Affordable Care Act attempts to achieve these goals by, among other things, requiring most Americans to obtain health insurance, expanding Medicare and Medicaid eligibility, reducing Medicare payments and Medicaid DSH payments to providers, expanding the Medicare program's use of value-based purchasing programs, tying hospital payments to the satisfaction of certain quality criteria, bundling payments to hospitals and other providers, and instituting certain private health insurance reforms. Although a majority of the measures contained in the Affordable Care Act do not take effect until 2013 and 2014, certain of the reductions in Medicare spending, such as negative adjustments to the Medicare hospital inpatient and outpatient prospective payment system market basket updates and the incorporation of productivity adjustments to the Medicare program's annual inflation updates, became effective in 2010, 2011 and 2012.

On June 28, 2012, the U.S. Supreme Court upheld the "individual mandate" provision of the Affordable Care Act that generally requires all individuals to obtain healthcare insurance or pay a penalty. However, the U.S. Supreme Court also held that the provision of the Affordable Care Act that authorized the Secretary of the Department of Health and Human Services (HHS) to penalize states that choose not to participate in the expansion of the Medicaid program by removing all of their existing Medicaid funding was unconstitutional. In response to the ruling, a number of states have already indicated that they will not expand their Medicaid programs, which would result in the Affordable Care Act not providing coverage to some low-income persons in those states. In addition, several bills have been and may continue to be introduced in Congress to repeal or amend all or significant provisions of the Affordable Care Act. It is difficult to predict the full impact of the Affordable Care Act on our revenue and results of operations due to its complexity, lack of implementing regulations and interpretive guidance, gradual and potentially delayed implementation, potential future legal challenges, possible repeal and/or amendment and how individuals and businesses will respond to the choices afforded them by the Affordable Care Act.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities

The following represents summarized financial information from the financial statements of Healthcare's affiliates that are included in the accompanying consolidated financial statements on the equity method of accounting.

<u>2012</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 5,202,961	148,893
Total liabilities	<u>4,757,631</u>	<u>456,975</u>
Net assets (deficit)	<u>\$ 445,330</u>	<u>(308,082)</u>
Total revenues	1,455,963	1,842,269
Total expenses	<u>(1,384,671)</u>	<u>(1,905,516)</u>
Excess (deficiency) of revenues over expenses	<u>\$ 71,292</u>	<u>(63,247)</u>
<u>2011</u>	<u>SLM</u>	<u>Paraffin</u>
Total assets	\$ 5,435,916	132,103
Total liabilities	<u>5,061,878</u>	<u>376,938</u>
Net assets (deficit)	<u>\$ 374,038</u>	<u>(244,835)</u>
Total revenues	1,247,565	1,918,632
Total expenses	<u>(1,378,624)</u>	<u>(2,083,332)</u>
Deficiency of revenues over expenses	<u>\$ (131,059)</u>	<u>(164,700)</u>

The following are approximate dollar amounts of significant transactions and balances with affiliated entities.

Healthcare rents space from SLM and provides utilities, maintenance and accounting services to SLM. Rent totalled approximately \$124,000 and \$116,000 for 2012 and 2011 and utilities, maintenance and accounting services sold totalled approximately \$773,000 and \$513,000 and in 2012 and 2011, respectively.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(14) Affiliated Entities, Continued

Net receivables (payables) at December 31 from the following affiliates approximated:

	<u>2012</u>	<u>2011</u>
New Hartford Scanner Associates	\$ 355,000	460,000
Others	<u>723,000</u>	<u>(23,000)</u>
	<u>\$ 1,078,000</u>	<u>437,000</u>

New Hartford Scanner Associates (NHSA) is a joint venture between Healthcare and several radiologists to provide CT scan services. Healthcare receives income from NHSA, which amounted to approximately \$685,000 and \$715,000 in 2012 and 2011, respectively. Healthcare also leased equipment to NHSA, which amounted to approximately \$161,000 in 2012 and 2011, respectively.

SLM Medical Office Building, which is included on the equity method, is a for-profit rental real estate corporation whose stock is owned by a trust, of which Healthcare is the sole beneficiary.

(15) Consolidated Statements of Cash Flows - Supplemental Disclosures

The Corporation's non-cash investing and financing activities and cash payments for interest for the years ended December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Capital lease obligations issued for property and equipment	\$ 4,984,742	2,350,862
Purchases of property and equipment financed through accounts payable	340,960	678,173
Cash paid for interest, net of capitalized interest	2,852,779	5,403,102

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(16) Functional Expenses

The Corporation provides general health care services to residents of the Mohawk Valley Region. Expenses related to providing these services are as follows:

	<u>2012</u>	<u>2011</u>
Health care services	\$ 267,053,996	266,698,558
General and administrative	47,942,826	43,072,954
Fund raising	<u>823,119</u>	<u>873,673</u>
	<u>\$ 315,819,941</u>	<u>310,645,185</u>

(17) Fair Value of Financial Instruments

The Fair Value Measurement Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

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

Cash and Cash Equivalents: The amount reported on the consolidated balance sheets for cash and cash equivalents approximates fair value.

Mutual Funds and Common Stock: The fair values, which are the amounts reported on the consolidated balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.

Pooled Investment, Hedge Funds and Real Estate Funds: Fair values are based on net asset value (NAV) per share as determined by the fund's investment manager or general partner.

Estimated Third-Party Payor Settlements: The amount reported on the consolidated balance sheets for estimated third-party payor settlements approximates its fair value.

Beneficial Interest in Charitable Trusts: Valued at the present value of the estimated future cash flows from the trust's assets using the Section 7520 interest rate as published by the Internal Revenue Services.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

Long-Term Debt: The fair value of fixed rate issues was determined by price quotes from an investment banker or estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements (considered a Level 2 input). The fair value of variable rate debt approximates its reported value on the consolidated balance sheet. Fixed rate long-term debt is the only financial instrument with a difference between recorded and fair value. The recorded value of fixed rate long-term debt on the consolidated balance sheet at December 31, 2012 approximates its fair value.

The following tables present information about assets and liabilities and are measured at fair value on a recurring basis as of December 31 and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value. In general, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. The Corporation considers a security that trades at least weekly to have an active market. Fair values determined by Level 2 inputs utilize data points that are observable, such as quoted prices, interest rates and yield curves. Investments valued using NAV as a practical expedient are classified as Level 2 if the investment is redeemable at NAV (as adjusted for subsequent gains or losses through the effective date of redemption) in the near-term (generally within a 3-month period) without significant restrictions on redemption. Fair values determined by Level 3 inputs are unobservable data points for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. Investments valued using NAV as a practical expedient are classified as Level 3 if the investment is not redeemable in the near-term or has significant restrictions.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2012	Fair value measurements at December 31, 2012		
		Level 1	Level 2	Level 3
Assets:				
Cash and cash equivalents	\$ 2,394,441	2,394,441	-	-
Investments:				
Cash and cash equivalents	181,739	79,711	102,028	-
Mutual funds:				
U.S. large cap	8,792,411	8,792,411	-	-
U.S. mid cap	3,026,320	3,026,320	-	-
U.S. small cap	179,040	179,040	-	-
Internationally developed	7,760,066	7,760,066	-	-
Emerging markets	3,335,237	3,335,237	-	-
Fixed income funds	10,432,158	10,432,158	-	-
Other	2,428,448	2,428,448	-	-
	<u>35,953,680</u>	<u>35,953,680</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	1,023,309	1,023,309	-	-
Energy	494,961	494,961	-	-
Financial	240,645	240,645	-	-
Healthcare	527,160	527,160	-	-
Industrial	610,570	610,570	-	-
Information technology	1,039,703	1,039,703	-	-
Materials	221,709	221,709	-	-
	<u>4,158,057</u>	<u>4,158,057</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	15,573,023	-	15,573,023	-
Real estate funds	3,544,548	2,943	3,541,605	-
Bond funds	3,688,542	-	3,688,542	-
Foreign equity funds	6,485,190	-	6,485,190	-
	<u>29,291,303</u>	<u>2,943</u>	<u>29,288,360</u>	<u>-</u>
US governmental bonds	220,526	220,526	-	-
US treasury securities	100,988	100,988	-	-
Assets limited as to use - fixed income mutual funds	365,153	365,153	-	-
Beneficial interest in charitable trusts	1,247,000	-	-	1,247,000
Total	\$ <u>73,912,887</u>	<u>43,275,499</u>	<u>29,390,388</u>	<u>1,247,000</u>
Liabilities:				
Interest rate swaps	6,144,832	-	6,144,832	-
Total	\$ <u>6,144,832</u>	<u>-</u>	<u>6,144,832</u>	<u>-</u>

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

	Carrying amount at December 31, 2011	<u>Fair value measurements at December 31, 2011</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Assets:				
Cash and cash equivalents	\$ 1,056,157	1,056,157	-	-
Investments:				
Cash and cash equivalents	332,535	230,883	101,652	-
Mutual funds:				
U.S. large cap	5,610,039	5,610,039	-	-
U.S. mid cap	2,481,156	2,481,156	-	-
U.S. small cap	893,655	893,655	-	-
Internationally developed	5,066,565	5,066,565	-	-
Emerging markets	2,298,715	2,298,715	-	-
Fixed income funds	9,629,021	9,629,021	-	-
Other	973,849	973,849	-	-
	<u>26,953,000</u>	<u>26,953,000</u>	<u>-</u>	<u>-</u>
Common stock:				
Consumer	971,511	971,511	-	-
Energy	322,324	322,324	-	-
Financial	392,234	392,234	-	-
Healthcare	492,393	492,393	-	-
Industrial	545,820	545,820	-	-
Information technology	843,545	843,545	-	-
Materials	148,609	148,609	-	-
	<u>3,716,436</u>	<u>3,716,436</u>	<u>-</u>	<u>-</u>
Pooled investment funds:				
Hedge funds	15,189,176	-	15,189,176	-
Real estate funds	2,530,755	-	2,374,604	156,151
Bond funds	3,389,669	-	3,389,669	-
Foreign equity funds	5,360,376	-	5,360,376	-
	<u>26,469,976</u>	<u>-</u>	<u>26,313,825</u>	<u>156,151</u>
US government bonds	224,158	224,158	-	-
US treasury securities	103,855	103,855	-	-
Assets limited as to use - fixed income mutual funds	384,829	384,829	-	-
Beneficial interest in charitable trusts	2,005,000	-	-	2,005,000
Total	<u>\$ 61,245,946</u>	<u>32,669,318</u>	<u>26,415,477</u>	<u>2,161,151</u>
Liabilities:				
Interest rate swaps	6,299,513	-	6,299,513	-
Total	<u>\$ 6,299,513</u>	<u>-</u>	<u>6,299,513</u>	<u>-</u>

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

The following tables set forth a summary of changes in the fair value of the Corporation's level 3 assets for the years ended December 31, 2012 and 2011.

	2012		2011	
	<u>Real estate funds</u>	<u>Beneficial interest in charitable trusts</u>	<u>Real estate funds</u>	<u>Beneficial interest in charitable trusts</u>
Balance, beginning of year	\$ 156,151	2,005,000	569,926	2,032,000
Contribution received	-	(900,000)	-	-
Change in value of charitable trusts	-	142,000	-	(27,000)
Interest and dividends, net of investment manager fees	200	-	10,795	-
Net realized gains (losses) on sale of investments	507	-	(9,595)	-
Change in net unrealized gains on investments	-	-	47,603	-
Sales	<u>(156,858)</u>	<u>-</u>	<u>(462,578)</u>	<u>-</u>
Balance, end of year	<u>\$ -</u>	<u>1,247,000</u>	<u>156,151</u>	<u>2,005,000</u>

The following is a summary of the investments whose NAV approximates fair value and the related redemption restrictions associated with each major category at December 31, 2012 and 2011.

<u>Pooled investment fund</u>	2012		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 15,573,023	Monthly	90 days
Real estate funds	3,541,605	Monthly	None
Bond funds	3,688,542	Monthly	10 days
Foreign equity funds	<u>6,485,190</u>	Monthly	10 days
	<u>\$ 29,288,360</u>		

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

<u>Pooled investment fund</u>	2011		
	<u>Total fair value</u>	<u>Redemption frequency</u>	<u>Redemption notice periods</u>
Hedge funds	\$ 15,189,176	Monthly	90 days
Real estate funds	2,374,604	Monthly	None
Real estate funds	156,151	Restricted	Upon approval
Bond funds	3,389,669	Monthly	10 days
Foreign equity funds	5,360,376	Monthly	10 days
	\$ 26,469,976		

Hedge Funds

Hedge fund strategies involve funds with investment managers who have the authority to invest in various asset classes at their discretion and who have the ability to employ multiple investments strategies within their respective portfolios. Investment strategies may include the following categories: merger arbitrage, distressed, long/short credit, fixed income arbitrage and convertible arbitrage. These funds attempt to reduce individual manager risk by allocating capital among multiple investment managers. Funds with hedged strategies generally hold securities or other financial instruments for which a ready market exists and may include stocks, bonds, put or call options, swaps, currency hedges, and other instruments, and are valued accordingly.

Real Estate Funds

Real estate funds hold interests in publicly traded equity securities issued by real estate investment trusts ("REIT"), private real estate partnerships, and privately held REIT's. Strategies of these funds often require the estimation of fair values by the fund managers in the absence of readily determinable market values. Because of the inherent uncertainties of valuation, these estimated fair values may differ significantly from values that would have been used had a ready market existed, and the differences could be material. Such valuations are determined by fund managers and generally consider variables such as operating results, comparable earnings multiples, projected cash flows, recent sales prices, and other pertinent information, and may reflect discounts for the illiquid nature of certain investments held. Moreover, the fair values of the Corporation's interests in shares or units of these funds, because of the liquidity and capital commitment terms that vary depending on the specific fund or partnership agreement, may differ from the fair value of the funds' underlying net assets.

MOHAWK VALLEY NETWORK, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(17) Fair Value of Financial Instruments, Continued

Bond Funds

Bond funds are invested in a globally diversified portfolio of primarily debt and debt-like securities. The funds are controlled by an investment manager. The investment manager generally will acquire positions in debt securities and currencies that are rated investment grade by Standard & Poor's Credit Market Services, or if unrated, an equivalent rating determined by the investment manager at its sole discretion.

Foreign Equity Funds

Foreign equity funds are invested in a diversified portfolio of equity securities of companies ordinarily located in any country other than the United States and Canada. The funds are controlled by an investment manager.

**ST. LUKE'S HOME
RESIDENTIAL HEALTH CARE FACILITY, INC.**

Financial Statements

December 31, 2010 and 2009

INDEPENDENT AUDITOR'S REPORT

The Board of Trustees
St. Luke's Home Residential Health Care Facility, Inc.:

We have audited the accompanying balance sheets of St. Luke's Home Residential Health Care Facility, Inc. as of December 31, 2010 and 2009, and the related statements of operations and changes in net deficit and cash flows for the years then ended. These financial statements are the responsibility of the Home's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of St. Luke's Home Residential Health Care Facility, Inc. as of December 31, 2010 and 2009, and the results of its operations, changes in net deficit and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Fust Charles Chambers LLP

May 18, 2011

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Balance Sheets

December 31, 2010 and 2009

<u>Assets</u>	<u>2010</u>	<u>2009</u>
Current assets:		
Cash and cash equivalents	\$ 205,085	294,198
Patient accounts receivable, net of allowance for doubtful accounts of approximately \$333,000 in 2010 and \$173,000 in 2009	2,457,993	2,843,023
Prepaid expenses and other assets	124,996	115,332
Estimated third-party payor settlements, net	<u>886,306</u>	<u>1,012,460</u>
Total current assets	<u>3,674,380</u>	<u>4,265,013</u>
Residents' funds held in trust	<u>86,804</u>	<u>100,550</u>
Assets limited as to use:		
Operating escrows	71,510	65,494
Reserve for replacement	1,079,779	1,256,532
Debt service reserve	3,179,808	3,171,865
Residual receipts	<u>105,424</u>	<u>105,161</u>
	4,436,521	4,599,052
Property and equipment, net	7,905,766	8,576,046
Debt issuance costs, net	<u>670,941</u>	<u>714,519</u>
Total assets	<u>\$ 16,774,412</u>	<u>18,255,180</u>

<u>Liabilities and Net Deficit</u>	<u>2010</u>	<u>2009</u>
Current liabilities:		
Current maturities of long-term debt	\$ 601,673	567,242
Accounts payable, vacation and accrued expenses	989,750	1,008,318
Accrued payroll and payroll taxes	254,521	256,936
Current portion of self insurance liability	84,863	215,380
Due to affiliated entities, net	989,673	1,004,274
Other liabilities	45,872	44,404
	<u>2,966,352</u>	<u>3,096,554</u>
Total current liabilities		
Residents' funds held in trust	86,804	100,550
Long-term portion of self insurance liability	724,011	708,386
Long-term debt, net of current maturities	15,438,899	16,040,571
Other liabilities	161,695	131,288
	<u>19,377,761</u>	<u>20,077,349</u>
Total liabilities		
Net deficit:		
Unrestricted	<u>(2,603,349)</u>	<u>(1,822,169)</u>
Total net deficit	<u>(2,603,349)</u>	<u>(1,822,169)</u>
Contingent liabilities (note 11)		
Total liabilities and net deficit	<u>\$ 16,774,412</u>	<u>18,255,180</u>

See accompanying notes to financial statements.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Statements of Operations and Changes in Net Deficit

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Unrestricted net deficit:		
Revenues, gains and other support:		
Net patient service revenue	\$ 19,472,789	20,971,413
Investment income	11,336	11,170
Other revenue	<u>386,707</u>	<u>552,925</u>
Total revenues, gains and other support	<u>19,870,832</u>	<u>21,535,508</u>
Expenses:		
Salaries and wages	10,351,414	10,421,183
Fringe benefits	2,784,281	2,665,468
Supplies and other expenses	5,238,891	5,289,596
Depreciation and amortization	1,195,805	1,442,846
Interest	963,121	995,741
New York State gross receipts tax	-	663,057
Provision for bad debts	<u>118,500</u>	<u>9,973</u>
Total expenses	<u>20,652,012</u>	<u>21,487,864</u>
Excess (deficiency) of revenue over expenses and change in net deficit	(781,180)	47,644
Net deficit at beginning of year	<u>(1,822,169)</u>	<u>(1,869,813)</u>
Net deficit at end of year	\$ <u><u>(2,603,349)</u></u>	\$ <u><u>(1,822,169)</u></u>

See accompanying notes to financial statements.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Statements of Cash Flows

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Change in net deficit	\$ (781,180)	47,644
Adjustments to reconcile changes in net deficit to net cash provided by operating activities:		
Depreciation and amortization	1,195,805	1,442,846
Provision for bad debts	118,500	9,973
Change in operating assets and liabilities:		
Patient accounts receivable	266,530	(303,284)
Prepaid expenses and other assets	(9,664)	46,867
Estimated third-party payor settlements, net	126,154	(299,380)
Accounts payable, vacation and accrued expenses	(18,568)	(134,859)
Accrued payroll, payroll taxes and self-insurance liability	(117,307)	(234,796)
Due to affiliated entities, net	(14,601)	222,652
Other liabilities	31,875	36,768
	<u>797,544</u>	<u>834,431</u>
Cash flows from investing activities:		
Purchase of property and equipment	(481,947)	(460,412)
Cash invested in assets limited as to use	(316,700)	(392,999)
Use of project escrow funds	479,231	530,369
	<u>(319,416)</u>	<u>(323,042)</u>
Cash flows from financing activities:		
Payments on long-term debt	(567,241)	(534,782)
	<u>(567,241)</u>	<u>(534,782)</u>
Net decrease in cash and cash equivalents	(89,113)	(23,393)
Cash and cash equivalents at beginning of year	<u>294,198</u>	<u>317,591</u>
Cash and cash equivalents at end of year	\$ <u><u>205,085</u></u>	\$ <u><u>294,198</u></u>

See accompanying notes to financial statements.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

December 31, 2010 and 2009

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

St. Luke's Home Residential Health Care Facility, Inc. (Home), located in New Hartford, New York, operates a 242-bed residential health care facility to provide nursing home accommodations for the sick, invalid, infirmed and disabled of the Greater Utica area.

The Home is governed by the Board of Directors of Faxton-St. Luke's Healthcare (Healthcare). In the event of dissolution, all of the remaining assets and property of the Home shall be distributed to Healthcare.

(b) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Cash and Cash Equivalents

Cash and cash equivalents include certain investments in highly liquid debt instruments with an original maturity of three months or less, excluding assets limited as to use.

(d) Inventories

Inventories (included in prepaid expenses and other assets) are stated at the lower of cost, (first-in, first-out) method or market.

(e) Residents' Funds Held in Trust

Residents' funds represent amounts deposited with the Home on behalf of residents for their discretionary use. These funds are administered by the Home with the corresponding liability to the residents reflected on the balance sheet.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(f) Assets Limited as to Use

Assets limited as to use at December 31, 2010 and 2009 include assets held in operating escrows, replacement reserves, funded depreciation reserve, residual receipts and debt service reserves established in connection with the Home's HUD-insured mortgages. These funds are presently invested in cash and cash equivalents.

Investment income or loss (including realized gains and losses on investments, interest and dividends) on assets limited as to use is included in operations unless the income or loss is restricted by donor or law.

(g) Property and Equipment

Property and equipment acquisitions are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset ranging from 3 - 40 years and is computed using the straight-line method. Gifts of long-lived assets such as land, buildings or equipment are reported as unrestricted support and are excluded from the operating loss, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash and other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated or acquired long-lived assets are placed in service.

(h) Debt Issuance Costs

Debt issuance costs associated with obtaining mortgage financings are being amortized on a straight-line basis over the term of the mortgages which is not materially different from the effective interest method. Accumulated amortization was approximately \$479,000 and \$436,000 at December 31, 2010 and 2009, respectively. Amortization expense for the period was \$43,578. Amortization expense is estimated to be \$43,578 for each of the next five years.

(i) Net Patient Service Revenue and Related Receivables

Net patient service revenue and the related receivables are reported at the estimated net realizable amounts from residents, third-party payors and others for services rendered.

Revenue under third party payor agreements is subject to audit and retroactive adjustment. Provisions for estimated third-party payor settlements are provided in the period the related services are rendered. Differences between the estimated amounts accrued and interim and final settlements are reported in operations in the year of settlement.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(i) Net Patient Service Revenue and Related Receivables, Continued

The allowance for doubtful accounts is established as losses are estimated to have occurred through a provision for doubtful accounts charged to earnings. Doubtful accounts are charged against the allowance when management believes the uncollectibility of a receivable balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for doubtful accounts is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the receivables in light of historical experience, the nature and volume of the receivables, adverse situations that may affect the resident's ability to repay and prevailing economic conditions.

(j) Contributions

Unconditional promises to give cash and other assets to the Home are reported at fair value at the date the promise is received. The contributions 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 statement of operations as net assets released from restrictions. Donor restricted contributions whose restrictions are met within the same year as received are reported as unrestricted contributions in the statements of operations and changes in net deficit.

(k) Income Taxes

The Home has been recognized by the Internal Revenue Service as a not-for-profit corporation as described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes pursuant to Section 501(a) of the Code.

As of December 31, 2010, the Home did not have any unrecognized tax benefits or any related accrued interest or penalties. The tax years open to examination by federal and New York State taxing authorities are 2007 through 2010.

(l) Credit and Risk Concentration

The Home grants credit without collateral to individual patients primarily residing in the Greater Utica Area and to insurance carriers and to Federal and New York State agencies.

At December 31, 2010 and 2009, the Home has cash and cash equivalents in major financial institutions which exceed Federal Depository Insurance limits. These financial institutions have strong credit ratings and management believes that credit risk related to these deposits is minimal.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(m) Excess (Deficiency) of Revenues over Expenses

The statements of operations and changes in net deficit include excess (deficiency) of revenues over expenses. Changes in unrestricted net deficit which are excluded from excess (deficiency) of revenues over expenses, consistent with industry practice, include changes in unrealized gains and losses on investments other than trading securities, permanent transfers of assets to and from affiliates for other than goods and services and contributions of long-lived assets (including assets acquired using contributions which by donor restriction were to be used for the purpose of acquiring such assets).

(n) Reclassifications

Certain 2009 amounts have been reclassified to conform with the 2010 financial statement presentation.

(o) Subsequent Events

Subsequent events have been evaluated through May 18, 2011, which is the date the financial statements were issued.

(2) Revision of 2009 Financial Statements

During 2010, the Home became aware of certain revisions that it needed to make to the previously issued 2009 financial statements. The revisions were the result of an adjustment to record employee extended sick leave time for retiring employees who had met all the required eligibility criteria. These amounts were previously recorded on the cash basis. The financial statements have been revised to reflect an estimate for these benefits. The effect of the adjustment from amounts previously reported was to increase unrestricted net deficit at December 31, 2008 by approximately \$139,000 and to decrease the excess of revenues over expenses by approximately \$37,000 in 2009.

(3) Third-Party Reimbursement

The Home has agreements with third-party payors which provide for reimbursement at amounts different from its established charges. A summary of the basis of reimbursement with significant third-party payors follows:

- Medicaid - The New York State Medicaid program provides for per diem reimbursement to nursing homes on a prospective basis with certain provisions for retroactive adjustment due to changes in the intensity of care provided to residents, as well as for adjustments resulting from audits by the third-party agency.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(3) Third-Party Reimbursement, Continued

- Medicare - The Medicare program provides for per diem reimbursement to nursing homes on a prospective basis based on the federal rate for services rendered to residents. The per diem rate is modified for intensity of care provided to residents.

Net patient service revenues from Medicaid and Medicare patients amounted to approximately 79% and 80%, respectively, of total net patient service revenue for the years ended 2010 and 2009. Laws and regulations governing Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. In 2010 and 2009, net patient service revenue decreased by approximately \$138,000 and increased by approximately \$61,000, respectively, related to either settlement of prior year issues or changes in estimates associated with third-party issues.

In January 2010 and updated in September 2010, the Home was notified that the Medicaid notice rates provided by the New York State Department of Health (DOH) in 2009 for periods beginning April 1, 2009 had been revised to incorporate changes and corrections necessary to the reimbursement methodology. These new notice rates utilized the rebasing methodology enacted in 2006 by New York State and incorporated the change to a Medicaid-only case mix index based on RUG-III scores measured twice a year and a scale back adjustment used to constrain the overall rate change under the new system to \$210 million statewide. These Medicaid rates have not been approved by the DOH at April 26, 2011 and do not incorporate updated case mix rate adjustments effective for the measurement periods of July 2009, January 2010 and July 2010. Further, the DOH have indicated that the effect of the adoption of these new Medicaid rates would increase the amount of Medicaid spending beyond the approved \$210 million statewide increase and therefore will necessitate that the scale back adjustment included in the Medicaid notice rates be increased from the amount published to a significantly higher adjustment. In 2010 and 2009, the Facility continued to be reimbursed under the New York State Medicaid program based on the reimbursement methodologies approved under the prior law. The Home has recorded an estimate resulting from the difference between the prior Medicaid rates paid and the estimated rates under the new rebasing methodology in estimated third party payor settlements at December 31, 2010 and 2009.

At December 31, 2010 and 2009, estimated third-party payor settlements, net was comprised of estimated Medicaid initial base year settlement liabilities prior to 2009, reserves established for liabilities relating to the new base-year methodology, trend factor reductions after year end, potential capital rate recoveries based on ongoing New York State capital audits, cash receipt assessments and general reimbursement reserves for other issues.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(3) Third-Party Reimbursement, Continued

The Home grants credit without collateral to its residents, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2010</u>	<u>2009</u>
Medicare	35%	15%
Medicaid	33%	52%
Private and other payors	<u>32%</u>	<u>33%</u>
	<u>100%</u>	<u>100%</u>

(4) Property and Equipment

Property and equipment by major category at December 31 is as follows:

	<u>2010</u>	<u>2009</u>
Land	\$ 292,658	292,658
Land improvements	1,064,518	1,064,518
Building and building improvements	18,874,862	18,727,482
Furniture, fixtures and equipment	3,597,645	3,267,021
Construction in progress	9,015	5,073
	<u>23,838,698</u>	<u>23,356,752</u>
Less accumulated depreciation	<u>(15,932,932)</u>	<u>(14,780,706)</u>
	<u>\$ 7,905,766</u>	<u>8,576,046</u>

Depreciation expense amounted to approximately \$1,152,000 and \$1,398,000 for the years ended December 31, 2010 and 2009, respectively.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(5) Long-Term Debt

Long-term debt consists of the following at December 31:

	<u>2010</u>	<u>2009</u>
Section 232 HUD-insured mortgage loan payable, at 5.875%, to Century Health Capital, Inc. payable in monthly principal and interest installments of \$88,000 due April 1, 2027, collateralized by a mortgage on certain property and equipment and insured by the Federal Housing Administration (FHA)	\$ 11,073,111	11,465,947
Section 241 HUD-insured mortgage loan payable, at 5.98%, to Century Health Capital, Inc. payable in monthly principal and interest installments of \$39,763 due April 1, 2027, collateralized by a mortgage on certain property and equipment and insured by the FHA	<u>4,967,461</u>	<u>5,141,866</u>
	<u>16,040,572</u>	<u>16,607,813</u>
Less current maturities	<u>601,673</u>	<u>567,242</u>
	<u>\$ 15,438,899</u>	<u>16,040,571</u>

In connection with the mortgage loan agreements and in consideration of the endorsement for insurance by the FHA, the Home entered into regulatory agreements with the Department of Housing and Urban Development (HUD). The regulatory agreements require the Home to, among other provisions, maintain debt service, operating escrow, residual receipts and replacement reserve funds. As of December 31, 2010 and 2009, these funds aggregated \$4,436,521 and \$4,599,052, respectively, and are included in assets limited as to use in the accompanying financial statements. Contributions to the debt service and replacement reserve funds, calculated on a gross basis without reduction for possible future investment income allocations, required over the next five years will amount to approximately \$202,000 per year.

Future maturities of long-term debt as of December 31, 2010 are as follows:

2011	\$ 601,673
2012	638,193
2013	676,931
2014	718,021
2015	761,605
Thereafter	<u>12,644,149</u>
	<u>\$ 16,040,572</u>

Cash paid for interest amounted to \$965,913 and \$998,374 in 2010 and 2009, respectively.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(6) Extended Sick Leave

The Home employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. The Home accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment or receive sick leave credits to pay for post-employment health insurance payments based upon the formula in place. The Home has accrued an estimated liability of approximately \$208,000 and \$176,000 at December 31, 2010 and 2009, respectively, for these anticipated termination payments.

(7) Affiliated Entities

Significant transactions with affiliated entities are as follows:

Mohawk Valley Network, Inc. (MVN)

MVN is a not-for-profit corporation organized for the benefit of the Home, Faxton-St. Luke's Healthcare, Mohawk Valley Home Care LLC, Senior Network Health and other affiliated entities. The Home was billed its share of allocated costs amounting to approximately \$14,800 and \$10,200 in 2010 and 2009, respectively. The Home has a payable to MVN at December 31, 2010 and 2009 of approximately \$600 and \$500, respectively.

Faxton-St. Luke's Healthcare (Healthcare)

Healthcare is a not-for-profit, tax-exempt acute care hospital. The Home has contracted with Healthcare to provide certain operational services. In 2010 and 2009, the Home purchased services totaling approximately \$491,000 and \$340,000, respectively, from Healthcare. In addition, in 2010 and 2009, the Home billed Healthcare approximately \$227,000 and \$106,000, respectively, for services rendered. The Home has net payables of approximately \$1,082,000 and \$930,000 to Healthcare at December 31, 2010 and 2009, respectively, for services performed and other pass through expenses.

Faxton-St. Luke's Healthcare Foundation (Foundation)

The Foundation is a not-for-profit, tax-exempt corporation which carries out fund raising activities which benefit Healthcare and the Home. Healthcare has a financial interest in and effective control over the Foundation. The Home's revenues as part of fund raising activities amounted to approximately \$23,000 and \$64,000 in 2010 and 2009, respectively. The Home has a receivable due from the Foundation at December 31, 2010 and 2009 of approximately \$21,000 and \$65,000, respectively.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(7) Affiliated Entities, Continued

Mohawk Valley Home Care, LLC (MVHC)

MVHC provides home care services to the Home's patients. Total expenses paid to MVHC by the Home for these services were approximately \$33,000 and \$66,000 in 2010 and 2009, respectively. The Home provides services in relation to MVHC's Meals on Wheels program and other services which amounted to approximately \$121,000 and \$54,000 in 2010 and 2009, respectively. The net receivable from MVHC was approximately \$12,000 at December 31, 2010. The net payable to MVHC was approximately \$33,000 at December 31, 2009.

Senior Network Health (SNH)

SNH is a Medicaid managed care health plan for elderly residents located in Oneida and Herkimer counties. The Home had a net receivable from SNH of approximately \$60,000 at December 31, 2010 and a net payable to SNH of approximately \$121,000 at December 31, 2009 for resident care and expenses paid on SNH's behalf. The total net patient service revenue from SNH amounted to approximately \$673,000 and \$924,000 in 2010 and 2009, respectively.

Visiting Nurse Association of Utica and Oneida County, Inc. (VNA)

VNA provides home health care through professional nurses, therapists and aides primarily in Oneida County. The Home has no amounts due or outstanding with VNA at December 31, 2010. The Home has a receivable from VNA of approximately \$15,000 at December 31, 2009.

(8) Retirement Plan

The Home maintains defined contribution retirement plans which cover all employees who have completed one year of service and are age twenty-one or older. Participants may contribute a percentage of compensation, but not in excess of the maximum allowed under the Internal Revenue Code. The plans provide for matching contributions based on participant contributions at varying percentages of the participant's compensation for the year. In addition, under one plan, the Home will contribute a fixed amount up to 5% of the participant's compensation. The Home's contribution to the plans, net of forfeitures, amounted to approximately \$354,000 in 2010 and \$374,000 in 2009.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(9) Functional Expenses

Expenses related to providing nursing home accommodations for the sick and infirmed of the community are as follows at December 31:

	<u>2010</u>	<u>2009</u>
Residential care	\$ 19,294,439	19,375,175
General and administrative	<u>1,357,573</u>	<u>2,112,689</u>
	<u>\$ 20,652,012</u>	<u>21,487,864</u>

(10) Fair Value of Financial Instruments

The Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification requires disclosures that categorize assets and liabilities measured at fair value based on a fair value hierarchy. The hierarchy prioritizes the inputs into three levels based on the extent to which inputs used in measuring fair value are observable in the market. Each fair value measurement is reported in one of the three levels which is determined by the lowest level input that is significant to the fair value measurement in its entirety.

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

Cash and Cash Equivalents: The carrying amounts reported in the balance sheets for cash and cash equivalents approximate fair value.

Assets Limited as to Use: The fair values, which are the amounts reported in the balance sheets, are based on quoted market prices.

Estimated Third-Party Payor Settlements: The carrying amount reported in the balance sheet for estimated third-party payor settlements approximates its fair value.

Long-Term Debt: The fair value of fixed rate issues was estimated using discounted cash flow analysis, based on the current incremental borrowing rate of similar types of borrowing arrangements. The fair value was estimated to be approximately \$17,685,000 and \$17,297,000 at December 31, 2010 and 2009, respectively.

(11) Contingent Liabilities

The Home has various general liability claims outstanding. The ultimate outcome of such claims cannot be determined at this time. However, management believes that the final disposition of these claims will not have a material adverse effect on the Home's financial position. The Home maintains its malpractice insurance under an occurrence based policy.

ST. LUKE'S HOME RESIDENTIAL HEALTH CARE FACILITY, INC.

Notes to Financial Statements

(11) Contingent Liabilities, Continued

The Home and its affiliates are self-insured for employee healthcare costs. The group has obtained a stop loss coverage policy for healthcare costs to supplement its self insurance coverage. An accrual for healthcare claims, including those incurred but not reported, is included in the current portion of estimated self-insured liabilities.

The Home is primarily self-insured for employee workers' compensation and disability claims along with Healthcare and certain of its other affiliates for the years 2004 through 2007. Self-insured liabilities are based on claims filed and estimates for claims incurred but not reported. As required by the State of New York Workers' Compensation Board, Healthcare has purchased letters of credit to guarantee payment of workers' compensation claims. Stop loss insurance for losses exceeding certain amounts has been purchased for workers' compensation. Each affiliate is jointly and severally liable for the satisfaction of all obligations. These liabilities are recorded at discounted amounts using a 4% interest rate in 2010 and 2009. Effective January 1, 2010, Healthcare and certain of its affiliates became insured in a retrospectively rated workers' compensation and disability policy and premiums are accrued based on the ultimate cost of the experience to date of Healthcare and affiliates.

(12) Subsequent Event

During 2011, the Home is working to finalize a grant award of approximately \$31,330,000 as part of the HEAL NY Grant Program. The grant award is primarily to be used to construct new and renovate portions of the existing facility relating to centralizing and expanding long-term care services and for payoff of the HUD mortgages and for capital acquisitions.

**VISITING NURSE ASSOCIATION
OF UTICA AND ONEIDA COUNTY, INC.**

Financial Statements

December 31, 2010 and 2009

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Visiting Nurse Association of Utica and Oneida County, Inc.:

We have audited the accompanying balance sheets of Visiting Nurse Association of Utica and Oneida County, Inc. as of December 31, 2010 and 2009, and the related statements of operations and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Visiting Nurse Association of Utica and Oneida County, Inc. as of December 31, 2010 and 2009, and the results of its 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.

As discussed in note 2 to the financial statements, the financial statements for 2009 have been restated to reflect a change in accounting for employee extended sick leave time.

Fust Charles Chambers LLP

May 5, 2011

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Balance Sheets

December 31, 2010 and 2009

<u>Assets</u>	<u>2010</u>	<u>2009</u>
Current assets:		
Cash and cash equivalents	\$ 947,285	460,143
Certificates of deposit	100,685	-
Patient accounts receivable, net of allowance for doubtful accounts of \$22,661 in 2010 and \$26,439 in 2009	1,029,046	1,121,600
Due from affiliated entities, net	15,468	-
Prepaid expenses	72,819	104,292
Total current assets	2,165,303	1,686,035
Property and equipment, net	1,582,961	1,820,202
Total assets	\$ 3,748,264	3,506,237
<u>Liabilities and Net Assets</u>		
Current liabilities:		
Short-term borrowings	-	200,000
Accounts payable	102,797	75,349
Accrued salaries, wages and related costs	617,001	572,767
Due to affiliated entities, net	-	124,208
Due to third-party payor	198,354	222,051
Total current liabilities	918,152	1,194,375
Other liabilities	92,097	85,889
Total liabilities	1,010,249	1,280,264
Net assets:		
Unrestricted	2,632,515	2,220,473
Temporarily restricted	105,500	5,500
Total net assets	2,738,015	2,225,973
Commitment (note 12)		
Total liabilities and net assets	\$ 3,748,264	3,506,237

See accompanying notes to financial statements.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Statements of Operations and Changes in Net Assets

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Unrestricted revenues, gains and other support:		
Net patient service revenue	\$ 9,918,449	8,932,057
Other revenue	58,998	27,442
	<hr/>	<hr/>
Total unrestricted revenues, gains and other support	9,977,447	8,959,499
	<hr/>	<hr/>
Expenses:		
Salaries and wages	6,382,767	6,141,763
Contract services	414,493	636,703
Employee benefits	1,244,192	1,275,916
Transportation	407,007	433,474
Supplies and other expenses	186,014	150,914
Occupancy	84,219	85,741
Office and general	845,598	756,266
Interest	1,115	6,437
	<hr/>	<hr/>
Total expenses	9,565,405	9,487,214
	<hr/>	<hr/>
Operating income (loss) and increase (decrease) in unrestricted net assets	412,042	(527,715)
	<hr/>	<hr/>
Temporarily restricted net assets:		
Restricted grant	100,000	-
	<hr/>	<hr/>
Increase in temporarily restricted net assets	100,000	-
	<hr/>	<hr/>
Increase (decrease) in net assets	512,042	(527,715)
	<hr/>	<hr/>
Net assets at beginning of year	2,225,973	2,753,688
	<hr/>	<hr/>
Net assets at end of year	\$ <u>2,738,015</u>	<u>2,225,973</u>

See accompanying notes to financial statements.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Statements of Cash Flows

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Change in net assets	\$ 512,042	(527,715)
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Depreciation	302,043	240,146
Provision for doubtful accounts	18,346	49,772
Changes in operating assets and liabilities:		
Patient accounts receivable, net	74,208	(225,760)
Due to/from affiliated entities, net	(139,676)	216,763
Prepaid expenses	31,473	(2,699)
Accounts payable	27,448	(68,995)
Accrued salaries, wages and related costs and other liabilities	50,442	147,664
Due to/from third-party payor	(23,697)	274,023
Net cash provided by operating activities	<u>852,629</u>	<u>103,199</u>
Cash flows from investing activities:		
Purchase of certificates of deposit	(100,685)	-
Purchase of property and equipment	(64,802)	(277,817)
Net cash used in investing activities	<u>(165,487)</u>	<u>(277,817)</u>
Cash flows from financing activities:		
Proceeds from short-term borrowings	-	200,000
Payments on short-term borrowings	(200,000)	-
Net cash provided by (used in) financing activities	<u>(200,000)</u>	<u>200,000</u>
Net increase in cash and cash equivalents	487,142	25,382
Cash and cash equivalents at beginning of year	<u>460,143</u>	<u>434,761</u>
Cash and cash equivalents at end of year	<u>\$ 947,285</u>	<u>460,143</u>
Supplemental disclosure:		
Cash paid for interest	<u>\$ 1,115</u>	<u>6,437</u>

See accompanying notes to financial statements.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

December 31, 2010 and 2009

(1) Description of Organization and Summary of Significant Accounting Policies

(a) Organization

Visiting Nurse Association of Utica and Oneida County, Inc. (VNA) provides home health care through professional nurses, therapists and aides primarily in Oneida County. VNA is a certified home health agency in New York State and is licensed to sponsor a long-term home health care program.

Mohawk Valley Network, Inc. (MVN) is the sole member of VNA and several other entities. See also note 9.

(b) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The current economic environment has increased the degree of uncertainty inherent in those estimates and assumptions.

(c) Cash and Cash Equivalents

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

At December 31, 2010, VNA had cash and cash equivalent balances in financial institutions that exceeded FDIC insurance limits amounting to approximately \$602,000. These financial institutions have strong credit ratings and management believes that the credit risk related to these deposits is minimal.

(d) Certificates of Deposit

Certificates of deposit in financial institutions with original maturities greater than three months have been recorded at fair value in the balance sheet using Level 2 inputs as defined by the Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(e) Property and Equipment

Property and equipment is stated at cost. Depreciation is calculated by the straight-line method over the estimated useful lives of the related assets ranging from 5 to 40 years.

(f) Net Assets

Unrestricted net assets represent resources that are generally available for support of VNA's activities and exclude any funds temporarily or permanently restricted by a donor except for any donor restricted gifts or grants received and expended within the same year. Temporarily restricted net assets are those whose use by VNA has been limited by donors to a specific time period or purpose.

(g) Net Patient Service Revenue and Related Receivables

VNA has agreements with third-party payors, primarily Medicare and Medicaid, that provide for payments at amounts different from its established rates. Payment arrangements include prospectively determined rates per visit or episode of care, cost-based reimbursement and discounted charges. Net patient service revenue and the related patient accounts receivable are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Unearned Medicare billings are netted against patient accounts receivable. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews and investigations.

Revenue from the Medicare and Medicaid programs accounted for approximately 84% and 85% of net patient service revenue for 2010 and 2009, respectively.

An allowance for doubtful accounts is maintained to record patient accounts receivable at its net realizable value. The allowance for doubtful accounts is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the patient accounts receivable considering historical experience, adverse situations that may affect the patient's ability to repay and prevailing economic conditions. Doubtful accounts are charged against the allowance when management believes the uncollectibility of the receivable balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(1) Description of Organization and Summary of Significant Accounting Policies, Continued

(g) Net Patient Service Revenue and Related Receivables, Continued

VNA grants unsecured credit to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of receivables from patients and third-party payors at December 31 was as follows:

	<u>2010</u>	<u>2009</u>
Medicare	74%	72%
Medicaid	16%	17%
Insurance and all others	9%	10%
Private payors	<u>1%</u>	<u>1%</u>
	<u>100%</u>	<u>100%</u>

(h) Charity Care

VNA has a policy of providing charity care to patients who are unable to pay. Such patients are identified based on financial information obtained from the patient and subsequent analysis. Since payment is not expected, estimated charges for charity care are not included in revenue.

(i) Income Taxes

VNA is a not-for-profit corporation described in Section 501(c)(3) of the Internal Revenue Code and is exempt from federal income taxes pursuant to Section 501(a) of the Code. As of December 31, 2010 and 2009, VNA did not have any unrecognized tax benefits or any related accrued interest or penalties.

The tax years open to examination by federal and New York State authorities are 2007 through 2010. VNA does not anticipate that the total unrecognized tax benefits will change in the next twelve months.

(j) Subsequent Events

Subsequent events have been evaluated through May 5, 2011, which is the date the financial statements were available to be issued.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(2) Prior Period Restatement

The accompanying financial statements for 2009 have been restated to appropriately reflect an estimated liability for employee extended sick leave time on the accrual basis of accounting. The employee extended sick leave time benefit initially became effective during 2009 and was recorded on the cash basis. The approximate effect of the adjustment required was to increase liabilities at December 31, 2009 and operating expenses for the year ended December 31, 2009 by approximately \$167,000.

(3) Property and Equipment

A summary of property and equipment at December 31 follows:

	<u>2010</u>	<u>2009</u>
Land and improvements	\$ 63,105	50,000
Building and improvements	990,997	990,062
Office furniture and equipment	2,027,794	1,977,032
	<u>3,081,896</u>	<u>3,017,094</u>
Less accumulated depreciation	<u>(1,498,935)</u>	<u>(1,196,892)</u>
Property and equipment, net	<u><u>1,582,961</u></u>	<u><u>1,820,202</u></u>

(4) Short-Term Borrowings

VNA has a line of credit with a bank which provides for borrowings up to \$500,000, at an interest rate equal to the bank's prime rate (3.25% at December 31, 2010) less 50 basis points or a minimum of 3%. All assets are pledged as collateral. The line expires June 30, 2011. There was no outstanding balance on the line at December 31, 2010. The amount outstanding on the line at December 31, 2009 was \$200,000.

(5) Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following purposes at December 31:

	<u>2010</u>	<u>2009</u>
Telehealth program	\$ 100,000	-
Facility improvements	5,000	5,000
Scholarships	500	500
	<u>105,500</u>	<u>5,500</u>
	<u><u>\$ 105,500</u></u>	<u><u>5,500</u></u>

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(6) Pension Plans

The VNA sponsors two defined contribution pension plans covering substantially all employees. VNA matches employee contributions up to specified limits. Pension plan contributions for the years ended December 31, 2010 and 2009 amounted to approximately \$222,000 and \$188,000, respectively.

(7) Extended Sick Leave Benefit

VNA employees are permitted to accumulate unused extended sick leave time up to specified maximum amounts. VNA accrues the estimated expense related to extended sick leave based on pay rates currently in effect. Upon retirement, employees who have met certain criteria shall have the option to receive payment for unused sick leave time based upon the formula in place. VNA has accrued an estimated current and long-term liability totalling approximately \$180,000 and \$167,000 at December 31, 2010 and 2009, respectively, for these anticipated termination payments.

(8) Functional Expenses

Functional expenses for the years ended December 31 are as follows:

	<u>2010</u>	<u>2009</u>
Administrative and general	\$ 3,207,754	3,356,677
Program:		
Nursing	3,459,246	3,291,209
Home health aides	1,627,193	1,638,907
Therapy	1,141,518	1,047,175
Other	<u>129,694</u>	<u>153,246</u>
	\$ <u>9,565,405</u>	<u>9,487,214</u>

(9) Transactions with Affiliates

As a member of MVN, VNA is affiliated with and transacts business with other healthcare providers in the MVN network. Senior Network Health, LLC (SNH), a wholly owned subsidiary of MVN, provides Medicaid managed care to seniors. Mohawk Valley Home Care, LLC (MVHC), a wholly owned subsidiary of MVN, provides respiratory infusion and other home care equipment and services. Faxton-St. Luke's Healthcare (FSLH), whose sole member is MVN, is a healthcare delivery system providing various inpatient and outpatient services. St. Luke's Home Residential Health Care Facility (Home), in which FSLH has a sole financial interest at dissolution, is a residential health care facility providing nursing home accommodations.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(9) Transactions with Affiliates, Continued

VNA paid MVN a management fee of \$60,000 during 2010 and 2009. MVN paid VNA a management fee of approximately \$170,000 and \$77,000 during 2010 and 2009, respectively. In addition, as part of the affiliation agreement with MVN, MVN has committed to provide VNA an unsecured line of credit of up to \$300,000 for working capital. There was no balance outstanding at December 31, 2010 and 2009 on the line. There were no amounts due to MVN as of December 31, 2010. VNA had a payable to MVN amounting to approximately \$7,000 at December 31, 2009.

VNA provided home care services to patients of SNH and various administrative services to SNH during 2010 and 2009 generating revenue amounting to approximately \$519,000 and \$501,000, respectively. In addition, VNA purchased various administrative services from SNH during 2010 and 2009 amounting to approximately \$123,000 and \$51,000, respectively. The net receivable from SNH as of December 31, 2010 and 2009 was approximately \$77,000 and \$52,000, respectively. VNA began leasing office space to SNH in 2009 under a lease agreement that expires May 31, 2014 with rent payments based on square footage occupied by SNH. Rental income associated with this lease during 2010 and 2009 was approximately \$24,000 and \$15,000, respectively. Rental income for the next three years is expected to be approximately \$25,000 per year and approximately \$10,000 in 2014.

VNA provided home care services to patients of MVHC and various administrative services to MVHC during 2010 and 2009 generating revenue amounting to approximately \$67,000 and \$52,000, respectively. There were no amounts due from MVHC as of December 31, 2010. The receivable from MVHC as of December 31, 2009 was approximately \$29,000.

VNA purchased various administrative services from FSLH during 2010 and 2009 amounting to approximately \$188,000 and \$173,000, respectively. The payable to FSLH as of December 31, 2010 and 2009 was approximately \$62,000 and \$183,000, respectively. VNA began leasing office and storage space to FSLH in 2009 under a lease agreement that expires May 31, 2014 with rent payments based on square footage occupied by FSLH. Rental income associated with this lease during 2010 and 2009 was approximately \$10,000 and \$6,000, respectively. Rental income for the next three years is expected to be approximately \$11,000 per year and approximately \$5,000 in 2014.

VNA purchased various administrative services from the Home during 2010 and 2009 amounting to approximately \$2,000 and \$62,000, respectively. There were no amounts due to the Home as of December 31, 2010. The payable to Home as of December 31, 2009 was approximately \$15,000.

VISITING NURSE ASSOCIATION OF UTICA AND ONEIDA COUNTY, INC.

Notes to Financial Statements

(10) Professional Liability Insurance

VNA maintains occurrence-based professional liability insurance with \$1,000,000/\$3,000,000 coverage limits. Management does not believe there are any potential claims liabilities in excess of coverage limits.

(11) Self-Insured Risks

VNA participates in a self-insured plan administered by FSLH for employee healthcare costs. FSLH has obtained a stop loss coverage policy for healthcare costs to supplement the self-insurance coverage. FSLH charges VNA a monthly premium based on the plan's overall claims experience. An accrual for additional premiums based on healthcare claims incurred but not reported to the plan is included in the balance sheet within accrued salaries, wages and related costs.

(12) Commitment

VNA entered into an operating lease agreement expiring December 1, 2013 for office space to be used for its operations.

As of December 31, 2010, future minimum lease payments under the operating lease are as follows:

2011	\$ 10,800
2012	10,800
2013	<u>9,900</u>
	\$ <u>31,500</u>

Total rent expense for 2010 and 2009 was approximately \$11,000.