Audited Consolidated Financial Statements and Other Financial Information

Mercy Health Services, Inc. and Subsidiaries

June 30, 2014 and 2013

DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

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Other Financial Information

DIXON HUGHES GOODMAN LLP
Certified Public Accountants and Advisors

Report of Independent Auditors

The Board of Trustees
Mercy Health Services, Inc. and Subsidiaries
Baltimore, MD

We have audited the accompanying financial statements of Mercy Health Services, Inc. and Subsidiaries, which comprise the balance sheet as of June 30, 2014, and the related consolidated statements of operations and changes in net assets and cash flows for the year then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the 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 audit. We did not audit the financial statements of Greenleaf Insurance Company, Ltd., a wholly-owned subsidiary, which statements reflect total assets of $64,012,224 and $63,487,208 as of June 30, 2014 and 2013, respectively, and total revenues of $20,897,069 and $12,399,590 for the years ended June 30, 2014 and 2013, respectively. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Greenleaf Insurance Company, Ltd., is based solely on the report of the other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of 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 auditors' 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 consolidated financial statements.

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

Opinion

In our opinion based on our audit and the report of the other auditors, the 2014 consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Mercy Health Services, Inc. and Subsidiaries as of June 30, 2014, and the consolidated 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.

Prior Period Financial Statements

The financial statements as of June 30, 2013, were audited by Cohen, Rutherford, + Knight, P.C., certain of whose shareholders joined Dixon Hughes Goodman LLP as of June 1, 2014, and whose report dated October 10, 2013, expressed an unmodified opinion on those statements.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the 2014 consolidated financial statements as a whole. The 2014 consolidating information on pages 66 – 69 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The 2014 information has been subjected to the auditing procedures applied in the audit of the 2014 consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the 2014 information is fairly stated in all material respects in relation to the 2014 financial statements as a whole. The 2013 consolidating information on pages 66 – 69 was subjected to the auditing procedures applied in the 2013 audit of the financial statements by Cohen, Rutherford, + Knight, P.C., whose report on such information stated that it was fairly stated in all material respects in relation to the 2013 financial statements as a whole.

Dixon Hughes Goodman LLP

Tysons, Virginia
September 8, 2014

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets
(Dollars in thousands)

	June 30, 2014	June 30, 2013
ASSETS		
CURRENT ASSETS		
Cash, cash equivalents and short-term investments	$ 87,189	$ 81,451
Current portion of funds held by trustee or authority -- *Note E*	11,634	12,949
Resident prepayment deposits	496	637
Patient accounts receivable, net -- *Note B*	43,217	43,660
Other amounts receivable, net	6,937	3,319
Current pledges receivable, net -- *Note C*	4,181	4,907
Inventory	7,808	7,527
Other current assets	5,157	4,548
TOTAL CURRENT ASSETS	166,619	158,998
PROPERTY AND EQUIPMENT, net -- *Note D*	546,087	548,626
INVESTMENTS AND OTHER ASSETS		
Funds held by trustee or authority, less current portion -- *Note E*	23,130	23,201
Board designated and donor restricted investments -- *Note F*	141,941	130,506
Restricted cash, cash equivalents and investments	64,138	62,048
Long-term investments	10,981	15,976
Long-term pledges receivable, net -- *Note C*	8,462	10,175
Investments in and advances to affiliates -- *Note G*	920	329
Reinsurance balances receivable or recoverable -- *Note I*	4,150	10,018
Other assets -- *Note H*	20,536	16,433
TOTAL ASSETS	$ 986,963	$ 976,311

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Balance Sheets - Continued
(Dollars in thousands)

	June 30, 2014	June 30, 2013
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Current maturities of long-term debt -- *Note J*	$ 9,267	$ 8,597
Accounts payable and accrued expenses	83,223	75,915
Resident prepayment deposits	495	636
Construction retainage	0	2,042
Line of credit	8,000	8,000
TOTAL CURRENT LIABILITIES	100,985	95,190
Long-term debt -- *Note J*	431,799	441,523
Provision for outstanding losses -- *Note I*	51,599	58,205
Post-retirement obligation -- *Note M*	6,221	5,575
Interest rate swap liabilities -- *Note J*	29,804	28,843
Other long-term liabilities -- *Note W*	13,264	11,442
TOTAL LIABILITIES	633,673	640,779
NET ASSETS		
Unrestricted	322,805	303,625
Temporarily restricted -- *Note P*	28,307	29,729
Permanently restricted -- *Notes P and V*	2,178	2,178
TOTAL NET ASSETS	353,290	335,532
COMMITMENTS AND CONTINGENCIES -- *Notes I, J, L, M, N, R and U*		
TOTAL LIABILITIES AND NET ASSETS	$ 986,963	$ 976,311

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See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Dollars in thousands)

	Year Ended June 30, 2014	2013
REVENUE		
Patient service revenue		
(net of allowances and discounts) -- *Notes B and S*	$ 608,042	$ 603,249
Provision for bad debts	(22,719)	(30,285)
Net patient service revenue	585,324	572,964
Other operating revenue	32,529	25,990
Net assets released from restriction used for operations	3,860	3,394
TOTAL REVENUE	621,712	602,348
EXPENSES -- *Note Q*		
Salaries and benefits	338,090	330,572
Medical and surgical supplies	55,979	54,336
Pharmacy supplies	34,769	32,848
Other expendable supplies	27,364	26,627
Professional fees	16,208	15,324
Insurance	24,812	25,397
Other purchased services	49,804	53,392
Interest expense	19,729	19,617
Repairs	12,340	10,976
Depreciation and amortization	40,087	37,545
TOTAL EXPENSES	619,181	606,633
OPERATING INCOME (LOSS)	2,531	(4,285)
OTHER INCOME (EXPENSE)		
Investment income -- *Note F*	5,456	4,010
Net unrealized gains on trading securities -- *Note F*	10,155	1,334
Gain (loss) on early extinguishment of debt	(365)	2,649
Unrealized gain (loss) on interest rate swaps	(961)	13,497
Equity in joint ventures -- *Note G*	588	546
Loss on asset disposal	(16)	(17)
Asset abandonment -- *Note X*	(612)	(7,826)
Other	(407)	(652)
NET OTHER INCOME	13,839	13,540
EXCESS OF REVENUE OVER EXPENSES	16,370	9,255
Changes to post retirement plans obligations -- *Notes M and N*	(34)	2,939
Net assets released from restrictions for the purchase of property and equipment	2,845	3,444
INCREASE IN UNRESTRICTED NET ASSETS	$ 19,180	$ 15,638

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Changes in Net Assets
(Dollars in thousands)

	Unrestricted	Temporarily restricted	Permanently restricted	Total
Net assets, June 30, 2012	$ 287,987	$ 31,369	$ 2,178	$ 321,534
Excess of revenue over expenses	9,255	0	0	9,255
Net assets released from restrictions for the purchase of property and equipment	3,444	(3,444)	0	0
Restricted gifts, bequests, and contributions	0	5,198	0	5,198
Changes to post retirement plans obligations -- *Notes M and N*	2,939	0	0	2,939
Net assets released from restrictions used for operations	0	(3,394)	0	(3,394)
Change in net assets	15,638	(1,640)	0	13,998
Net assets, June 30, 2013	$ 303,625	$ 29,729	$ 2,178	$ 335,532
Excess of revenue over expenses	16,370	0	0	16,370
Net assets released from restrictions for the purchase of property and equipment	2,845	(2,845)	0	0
Restricted gifts, bequests, and contributions	0	5,282	0	5,282
Changes to post retirement plans obligations -- *Notes M and N*	(34)	0	0	(34)
Net assets released from restrictions used for operations	0	(3,860)	0	(3,860)
Change in net assets	19,180	(1,422)	0	17,758
Net assets, June 30, 2014	$ 322,805	$ 28,307	$ 2,178	$ 353,290

See notes to the consolidated financial statements

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Year Ended June 30, 2014	2013
OPERATING ACTIVITIES		
Change in net assets	$ 17,758	$ 13,998
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities		
Depreciation and amortization	40,087	37,545
Loss (gain) on interest rate swaps	961	(13,497)
Loss on asset disposal	16	17
Gain in equity of joint ventures	(588)	(546)
Realized and unrealized gains on board designated and donor restricted investments	(13,447)	(3,983)
Restricted gifts, bequests, contributions, and restricted investment income	(7,722)	(8,181)
Loss (gain) on early extinguishment of debt	365	(2,649)
Provision for bad debts	22,719	30,285
Decrease (increase) in:		
Patient accounts receivable, net	(22,275)	(38,262)
Other amounts receivable and investments in and advances to affiliates	1,659	(6,953)
Pledges receivable	2,439	2,984
Inventory	(280)	(175)
Other current assets	(609)	643
Increase (decrease) in:		
Accounts payable and accrued expenses	7,308	(2,223)
Provision for outstanding losses	(6,606)	20,947
Post-retirement obligation	646	(1,934)
Other long-term liabilities	1,822	(1,015)
NET CASH AND CASH EQUIVALENTS PROVIDED BY OPERATING ACTIVITIES	44,251	27,001
INVESTING ACTIVITIES		
Net decrease (increase) in short-term investments	1,025	(197)
Purchases of property and equipment	(38,553)	(30,712)
Net increase in restricted cash, cash equivalents and investments	(2,090)	(13,357)
Net decrease (increase) in funds held by trustee or authority	1,386	(241)
Net decrease (increase) in board designated and donor restricted investments	2,012	(7,126)
Net decrease in long term investments	4,995	11,338
Decrease (increase) in other assets	(4,777)	1,379
NET CASH AND CASH EQUIVALENTS USED IN INVESTING ACTIVITIES	(36,002)	(38,917)

(continued)

Mercy Health Services, Inc. and Subsidiaries
Consolidated Statements of Cash Flows - Continued
(Dollars in thousands)

	Year Ended June 30, 2014	2013
FINANCING ACTIVITIES		
Proceeds from restricted gifts, bequests, contributions, and restricted investment income	$ 7,722	$ 8,181
Net borrowing under line of credit agreement	0	8,000
Debt retirement	(18,195)	(55,036)
Proceeds from issuance of long term debt	18,065	55,412
Repayment of long term debt	(8,924)	(8,347)
Deferred financing cost	(155)	(431)
NET CASH AND CASH EQUIVALENTS PROVIDED BY (USED IN) FINANCING ACTIVITIES	(1,487)	7,779
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,762	(4,137)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	78,793	82,930
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 85,555	$ 78,793

See notes to the consolidated financial statements

Note A - Organization and Summary of Significant Accounting Policies

Organization, Basis of Presentation and Principles of Consolidation

Mercy Health Services, Inc. (MHS) was formed for the purpose of supporting, benefiting, or carrying out some or all of the purposes of Mercy Medical Center, Inc. (Medical Center or MMC), Stella Maris, Inc. (SMI), the physician practice groups comprising the Physician Enterprise (as further described below) and Mercy Health Foundation (MHF). MHS is the sole member of the Medical Center, SMI, the Physician Enterprise and MHF. MHS prepares its consolidated financial statements on the accrual basis of accounting. The accompanying consolidated financial statements include MMC, SMI, the Physician Enterprise and MHF. All material intercompany balances and transactions have been eliminated.

1. **Mercy Medical Center, Inc.**

   The Medical Center, a subsidiary of MHS, provides inpatient, outpatient, and emergency care services primarily for the citizens of the Baltimore metropolitan area. In addition, the following entities are wholly owned subsidiaries of the Medical Center:

Name of Subsidiary	Tax Status
Mercy Transitional Care Services, Inc (MTC) *Provider of subacute services*	Tax exempt
Greenleaf Insurance Company, Ltd. (GIC) *Provider of self-insured general and malpractice coverage to MHS*	Foreign subsidiary

2. **Stella Maris, Inc.**

   SMI, a subsidiary of MHS, is the sole member of the Stella Maris Operating Corporation, as well as the Cardinal Sheehan Center, Incorporated (CSC). SMI provides sub-acute, hospice, long-term care and adult day care to patients in the central Maryland service area, within its 412-bed long-term care facility.

   CSC is engaged in maintaining and providing care and housing of aged and infirmed persons. CSC owns St. Elizabeth Hall, a 200-unit apartment complex for the elderly.

Note A - Organization and Summary of Significant Accounting Policies - Continued

3. Physician Enterprise

The Physician Enterprise includes Maryland Family Care, Inc. (MFC), St. Paul Place Specialists, Inc. (SPPS), and Maryland Specialty Services, LLC (MSS). MSS is the sole member of Lutherville Hematology and Oncology, LLC and is the sole stockholder of Vascular Specialty Services, Inc. These entities provide primary care and specialty services within the Baltimore area. MFC, SPPS and MSS are wholly owned/controlled subsidiaries of MHS.

4. Mercy Health Foundation, Inc.

MHF, a subsidiary of MHS, was formed to coordinate and strengthen the fundraising function on behalf of MHS.

Income Taxes

MHS, MMC, SMI, MFC, SPPS, MHF, and MSS are not-for-profit organizations exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code, and are therefore not subject to federal income tax under current income tax regulations. MHS subsidiaries otherwise exempt from federal and state taxation are nonetheless subject to taxation at corporate tax rates at both the federal and state level on their unrelated business income.

Current accounting standards define the threshold for recognizing uncertain income tax return positions in the financial statements as "more likely than not" that the position is sustainable, based on its technical merits, and also provide guidance on the measurement, classification and disclosure of tax return positions in the financial statements. Management believes there is no impact on MHS' accompanying consolidated financial statements related to uncertain income tax positions.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Unrestricted, Temporarily Restricted, and Permanently Restricted Net Assets

Unrestricted net assets represent contributions, gifts, and grants which have no donor-imposed restrictions or which arise as a result of operations. Temporarily restricted net assets are subject to donor-imposed stipulations that may or will be met either by satisfying a specific purpose and/or the passage of time. Permanently restricted net assets are subject to donor-imposed stipulations that they be maintained in perpetuity. Generally, the donors of these assets permit the use of all or part of the income earned on related investments for specific purposes (see *Notes P and V*).

Cash Equivalents and Short-Term Investments

MHS and certain of its subsidiaries invest in money market funds and U.S. Treasury Bills, which are highly liquid and have an original maturity of ninety days or less. These financial instruments are considered cash and cash equivalents and are recorded at cost, which approximates fair value. Short-term investments are highly liquid assets that have an original maturity between three months and one year.

Restricted Cash, Cash Equivalents, and Investments

Restricted cash, cash equivalents and investments represent funds required for interest rate swap collateral, funds that have been set aside to cover a portion of GIC's estimated outstanding claims, and donor restricted funds from permanently and temporarily restricted net assets. Collateral posting requirements for interest rate swaps are based on credit ratings and the net liability position of the interest rate swap agreements outstanding. At June 30, 2014, restricted cash, cash equivalents and investments of $10,636 was set aside for interest rate swap collateral and $53,502 was set aside to cover estimated outstanding claims and donor restricted funds. At June 30, 2013, restricted cash, cash equivalents and investments of $11,682 was set aside for interest rate swap collateral and $50,366 was set aside to cover estimated outstanding claims and donor restricted funds.

Investments

Investments include marketable securities with readily determinable fair values based on quoted market prices. Unrestricted investment income or losses are reported in the consolidated statements of operations as part of excess of revenues over expenses unless the income is restricted by donor or law. Investments received by gift or bequest are reported at fair value at the date of the donation. Investment income and changes in the fair value of temporarily restricted and permanently restricted investments are recorded as increases or decreases in unrestricted, temporarily restricted or permanently restricted net assets in accordance with the terms of the donor's original gift or bequest.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Investments - Continued

Investments also include investments in limited partnerships and other alternative investments, which are made in accordance with the investment policies of MHS and are monitored through quarterly performance reviews. The limited partnerships acquire, hold, invest, manage, dispose of, and otherwise deal in and with securities of all kinds and descriptions. Publicly traded securities are valued using generally accepted pricing services selected by the fund managers of the limited partnerships. Securities not valued by such pricing services are valued upon bid quotations obtained from independent dealers in the securities. In the absence of any independent quotations, securities are valued by the fund managers on the basis of data obtained from the best available sources.

Although the various fund managers use their best judgment at estimating the fair value of the alternative investments, there are inherent limitations in any valuation technique. Therefore, the value is not necessarily indicative of the amount that could be realized in a current transaction. Future events will also affect the estimates of fair value, and the effect of such events on the estimates of the fair value could be material (see *Note K*).

Donor-Restricted Gifts

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. The gifts are reported as either temporarily or permanently restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the accompanying statements of operations as net assets released from restrictions.

Inventories

Inventories are stated at the lower of cost, determined by the first-in, first-out method, or market.

Deferred Financing Costs

Costs incurred in obtaining and issuing the Maryland Health and Higher Educational Facilities Authority bonds have been capitalized. These expenses are being amortized over the term of the bonds using the straight-line method. Accumulated amortization amounted to $2,367 and $2,273 at June 30, 2014 and 2013, respectively.

Note A - Organization and Summary of Significant Accounting Policies – Continued

Net Patient Service Revenue and Allowances

Net patient service revenue are reported at the estimated net realizable amounts from patients, third-party payers, and others for services rendered. MMC charges are based on rates established by the State of Maryland Health Services Cost Review Commission; accordingly, revenue reflects actual charges to patients based on rates in effect during the period in which the services are rendered (see *Note S*). SMI and Physician Enterprise are paid for services based on negotiated contracts with commercial payers and fee schedules with Medicare and Medicaid.

Contractual adjustments represent the difference between amounts billed as patient service revenue and amounts allowed by third-party payers, and are accrued in the period in which the related services are rendered.

The provision for bad debts is based upon management's assessment of historical and expected net collections. This estimate considers business and general economic conditions, trends in healthcare coverage and other collection indicators. Throughout the year, management assesses the adequacy of the allowance for uncollectible accounts based upon its review of accounts receivable and collections to date. Other factors, such as payer mix, account aging, approved discounts, denial rates, and payment cycles are considered when estimating the allowances. The results of these assessments are used to determine the provision for bad debts and to estimate an appropriate allowance for uncollectible accounts. MHS follows established guidelines for placing its self-pay patient accounts with an outside collection agency. After collection efforts are exhausted, the uncollected balances are returned to the appropriate MHS entities to be written off to bad debts. MHS does not maintain a material allowance for uncollectible accounts from third-party payers, nor did it have significant write offs from third-party payers.

(Dollars in thousands)

Note A - Organization and Summary of Significant Accounting Policies - Continued

Net Patient Service Revenue and Allowances - Continued

Medicare reimburses MTC and SMI under a prospective payment system (PPS) for skilled nursing facility services, under which facilities are paid a fixed fee for virtually all covered services. Under PPS, each patient's clinical status is evaluated and placed into a payment category. The patient's payment category dictates the amount that the provider will receive to care for the patient on a daily basis. The per diem rate covers (i) all routine inpatient costs currently paid under Medicare Part A; (ii) certain ancillary and other items and services previously covered separately under Medicare Part B on a "pass-through" basis; and (iii) certain capital costs.

The composition of patient service revenue (net of contractual allowances and discounts) as of June 30 is as follows:

	2014	2013
Federal programs (Medicare/Medicaid)	$ 321,138	$ 297,894
Other third party payers	262,870	280,737
Self pay	24,034	24,618
	$ 608,042	$ 603,249

Charity Care

The Medical Center provides medically necessary services without charge, or at amounts less than its established rates, to patients who qualify for charity care under its financial assistance policy. Because the Medical Center does not pursue collection of those amounts determined to qualify as charity care, they are not reported as a component of net patient service revenue or patient accounts receivable (see *Note B*).

The criteria for qualifying for charity care applied by the Medical Center include family income, net assets, and the size of the patient's bill relative to the patient's ability to pay. Discounts are provided to patients who are unable to pay based on a sliding scale that is applied for family incomes up to approximately 400% above the U.S. Department of Health and Human Services (HHS) Poverty Guidelines. Free care is provided to patients with family incomes up to approximately 200% above the HHS Poverty Guidelines.

Charity care will be provided to patients who qualify under the Medical Center's financial assistance policy at any time. Once the Medical Center determines that the patient qualifies for charity care, the Medical Center makes no further attempt to collect on the amount qualifying for charity care.

Certain other controlled subsidiaries of MHS also provide services without charge, or at amounts less than their established rates, to patients who qualify for charity care under their respective financial assistance policies.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Impairment of Long-Lived Assets

MHS accounts for long-lived assets in accordance with applicable guidance on accounting for impairment or disposal of long-lived assets. Such guidance requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. Management believes that no asset impairment existed at June 30, 2014 and 2013.

Property and Equipment

Property and equipment are recorded at cost. Donated property and equipment are recorded at fair value at the date of the donation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, which is forty years for buildings and the parking center and ranges from three to ten years for machinery and equipment.

The cost of software is capitalized provided the cost of the project is at least $5 and the expected life is at least 3 years. Costs include payment to vendors for the purchase and assistance in its installation, payroll costs of employees directly involved in the software installation, and interest costs of the software project if financed by debt. Preliminary costs to document system requirements, vendor selection, and any costs before software purchase are expensed. Capitalization of costs will generally end when the project is completed and the software is ready to be used. Where implementation of the project is in phases, only those costs incurred which further the development of the project will be capitalized. Costs incurred to maintain the system are expensed.

Resident Prepayment Deposits

SMI's private pay residents are required to make a non-interest bearing prepayment of two months' room and board at the time of admission. At the time of discharge or acceptance by Medical Assistance or similar government assistance programs, any prepayment remaining after application to the resident's outstanding bill will be refunded. At June 30, 2014 and 2013, resident prepayment deposits of approximately $495 and $636, respectively, were invested in short-term investments.

Note A - Organization and Summary of Significant Accounting Policies - Continued

Derivative Instruments

Current accounting standards require that an entity recognize all derivative instruments as either assets or liabilities in the statement of financial position and measure those instruments at fair value. MHS has entered into interest rate swap agreements to manage its interest rate risk (see *Notes J and K*). The interest rate swaps do not qualify for hedge accounting under current accounting standards; therefore, management accounts for the derivative instruments as speculative derivative instruments with the change in the fair value reflected in the accompanying consolidated statements of operations as a component of other non-operating income. Net settlement payments are reported as a component of interest cost, with the exception of the payments associated with construction activities that are capitalized. Entering into interest rate swap agreements involves to varying degrees elements of credit, default, prepayment, market and documentation risk in excess of the amounts recognized on the consolidated balance sheets. Such risks involve the possibility that there will be no liquid market for these agreements, the counterparty to these agreements may default on its obligation to perform, and there may be unfavorable changes in interest rates.

Accounting 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. Accordingly, actual results could differ from those estimates.

Meaningful Use Incentives

Under certain provisions of the American Recovery and Reinvestment Act of 2009 (ARRA), federal incentive payments are available to hospitals, physicians and certain other professionals when they adopt, implement or upgrade certified electronic health record (EHR) technology or become “meaningful users,” as defined under ARRA, of EHR technology in ways that demonstrate improved quality, safety and effectiveness of care. Incentive payments will be paid out over varying transitional schedules depending on the type of incentive (Medicare and Medicaid) and recipient (hospital or eligible provider). Eligible hospitals can attest for both Medicare and Medicaid incentives, while physicians must select to attest for either Medicare or Medicaid incentives. For Medicare incentives, eligible hospitals receive payments over four years while eligible physicians receive payments over five years. For Medicaid incentives, eligible hospitals receive payments based on the relevant State adopted payment structure and physicians receive payments over six years.

Note A - Organization and Summary of Significant Accounting Policies – Continued

Meaningful Use Incentives - Continued

MHS recognizes EHR incentives when it is reasonably assured that MHS will successfully demonstrate compliance with the meaningful use criteria. During the year ended June 30, 2014, certain hospitals and physicians of MHS satisfied the meaningful use criteria. As a result, MHS recognized $5,596 and $0 of EHR incentives during fiscal year 2014 and 2013, respectively, in other operating revenue.

Excess of Revenue Over Expenses (Expenses over Revenue)

The consolidated statements of operations include excess of revenue over expenses (expenses over revenue). Changes in unrestricted net assets which are excluded from excess of revenue over expenses (expenses over revenue), consistent with industry practice, include 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 purposes of acquiring such assets).

Activities that result in gains or losses unrelated to the primary operations of MHS are considered to be nonoperating.

(Dollars in thousands)

Note B – Patient Accounts Receivable, Allowances, and Charity Care

Patient accounts receivable consist of the following at June 30:

	2014	2013
Gross patient accounts receivable	$ 152,287	$ 150,537
Less:		
Allowance for doubtful accounts and contractual adjustments	(79,782)	(75,705)
Third party advances	(29,288)	(31,172)
	$ 43,217	$ 43,660

Approximately 40% and 30% of gross patient accounts receivable were due from Medicare and Medicaid at both June 30, 2014 and 2013, respectively.

The net cost of charity care provided by MHS totaled $19,942 and $14,944 for the years ended June 30, 2014 and 2013, respectively. The cost of charity care was calculated by applying the cost-to-charge ratio to the total amount of charges foregone for each of the controlled subsidiaries of MHS that provide charity care. The net cost of charity care was determined net of any patient-related revenue due to sliding scale payments or other patient-specific sources, and includes both direct and indirect cost of rendering care. The net cost of charity care is not reported net of the uncompensated care fund net receipts (see *Note S*).

Additionally, MHS and certain of its controlled subsidiaries provide structured repayment plans to patients without collateral.

(Dollars in thousands)

Note C - Pledges Receivable, Net

At June 30, 2014 and 2013, pledges receivable were $13,625 and $16,530, respectively, less an allowance for uncollectible pledges of $333 and $529, respectively, and a discount of $649 and $919, respectively. The expected payment of the pledges receivable less the uncollectible pledges at June 30, 2014 are as follows:

2015	$ 4,181
2016	2,792
2017	4,031
2018	425
2019	839
Thereafter	375
	12,643
Less current portion	4,181
Long-term portion	$ 8,462

Note D - Property and Equipment

Property and equipment, at cost, consists of the following at June 30:

	2014	2013
Buildings and improvements	$ 575,697	$ 555,096
Machinery and equipment	193,394	222,073
Parking center	41,234	41,221
Construction-in-progress	4,206	28,538
Land	18,976	11,181
	833,507	858,109
Accumulated depreciation	(287,420)	(309,483)
	$ 546,087	$ 548,626

(Dollars in thousands)

Note E - Funds Held by Trustee or Authority

Funds held by trustee or authority, which consist primarily of cash and government obligations (at fair value), are limited as to use as follows at June 30:

	2014	2013
Debt service reserve	$ 22,095	$ 21,917
Debt service fund	11,634	12,949
Reserve for replacements and residual receipts	1,035	1,284
	34,764	36,150
Less current portion	11,634	12,949
Long-term portion	$ 23,130	$ 23,201

Note F - Board Designated and Donor Restricted Investments

Board designated investments are set aside by the board of trustees for costs relating to replacement or improvement of existing assets, or to cover the cost of services rendered as charity care and other programs. All board designated investments are unrestricted, as the board at its discretion may undesignate the use of such funds. Donor restricted investments have been limited by donors to a specific purpose.

Board designated and donor restricted investments consist of the following at June 30:

	2014	2013
Equity	$ 73,810	$ 57,540
Fixed maturity	35,840	34,715
Cash	25,322	31,217
Alternatives	6,969	7,034
	$ 141,941	$ 130,506

Each of the alternative investments owned by MHS represents less than three-quarters of one percent of each respective alternative investment fund as of June 30, 2014 and 2013.

(Dollars in thousands)

Note F - Board Designated and Donor Restricted Investments - Continued

The investments above have been allocated, by source, as follows at June 30:

	2014	2013
Board designated	$ 126,277	$ 115,860
Donor restricted (temporary)	15,664	14,646
	$ 141,941	$ 130,506

Permanently restricted donor investments at June 30, 2014 and 2013 of $2,178 are reported as restricted cash.

Earnings on investments are as follows for the years ended June 30:

	2014	2013
Unrestricted:		
Interest and dividends	$ 2,164	$ 1,361
Net realized gains	3,292	2,649
Unrealized gains on trading securities	10,155	1,334
	$ 15,611	$ 5,344

Note G - Investments In and Advances to Affiliates

Investments in and advances to affiliates include a joint venture in which the Medical Center has an ownership interest of 50%. Investments in which the ownership interest is less than 20% are carried at cost, and investments in which the ownership interest is at least 20% and less than 51% are generally carried on the equity method.

(Dollars in thousands)

Note G - Investments In and Advances to Affiliates - Continued

MHS has investments totaling $920 and 329 at June 30, 2014 and 2013, respectively, in the following joint ventures:

		Percentage of ownership		Investment	
Joint venture	**Business purpose**	**2014**	**2013**	**2014**	**2013**
Premier Purchasing Partners, Inc.	Capital balance in group purchasing organization	n/a	n/a	$ 920	$ 329
Mercy Ridge, Inc.	Continuing care retirement community	50%	50%	0	0
				$ 920	$ 329

MHS recorded non-operating income of $588 and $546 related to the operations of the investments in joint ventures for the years ended June 30, 2014 and 2013, respectively. MHS receives rebates from Premier Purchasing Partners, Inc. which are netted with associated supplies expense.

Note H - Other Assets

Other assets consist of the following at June 30:

	2014	2013
Amortizable assets, net	$ 12,205	$ 8,926
Deferred compensation plan assets (see *Note L*)	6,184	5,738
Health insurance prepayment	1,118	944
Other investments	583	657
Notes receivable	446	168
	$ 20,536	$ 16,433

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses

GIC management based the provision for losses at June 30, 2014 on a report dated July 2014 prepared by GIC's independent actuaries, Complete Actuarial Solutions Co. of Bethesda, Maryland. In their report, the actuaries estimate outstanding losses at an expected confidence level, on an undiscounted basis, to be $45,560 and $47,126 net of reinsurance as of June 30, 2014 and 2013, respectively. As of June 30, 2014 and 2013, GIC's provision for outstanding losses was $51,599 and $58,205, respectively, and the reinsurance receivable for such losses was $4,150 and $10,018 respectively, after factoring in actual losses paid to June 30th. The estimates provided by the actuaries are based on the historical data of the program blended together with relevant insurance industry loss development statistics.

Note I - Reinsurance Receivable/Recoverable and Provision for Outstanding Losses - Continued

In the opinion of the GIC management, the provision for outstanding losses relating to losses reported and losses incurred but not reported at the consolidated balance sheet dates is adequate to cover the expected ultimate liability of GIC. However, due to the nature of the insurance risks assumed, these provisions are necessarily estimates, and could vary from the amounts ultimately paid.

Consistent with most companies with similar insurance operations, GIC's provision for outstanding losses is ultimately based on management's reasonable expectations of future events. It is reasonably possible that the expectations associated with these amounts could change in the near term (i.e., within one year) and that the effect of such changes could be material to the consolidated financial statements.

GIC's estimated provision for outstanding losses exceeds GIC's retention limits by $4,150 and $10,018 for the years ended June 30, 2014 and 2013, respectively. These losses are reinsured with reinsurers as described in *Note R,* Self Insurance Program section, and accordingly are recorded as reinsurance balances recoverable in the consolidated balance sheets.

In the event that GIC's reinsurers are unable to meet their obligations under the reinsurance agreements, GIC would still be liable to pay all losses under the insurance policies it issues, but would only receive reimbursement to the extent the reinsurers could meet their above mentioned obligations. GIC considers that all amounts included in reinsurance balances receivable and recoverable in the accompanying consolidated balance sheets will be collected in full from the reinsurers.

(Dollars in thousands)

Note J-Long - Term Debt

Long-term debt consists of the following at June 30:

	2014	2013
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series A 2007, interest rate ranging from 4.25% to 5.50%, due July 1, 2042	$ 148,290	$ 149,755
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2013, variable interest rate ranging from 1.21% to 1.24%, due July 1, 2042	50,210	50,210
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2012, interest rate ranging from 4% to 5%, due July 1, 2031	49,995	49,995
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2011, interest rate ranging from 3.00% to 6.25%, due July 1, 2031	38,970	39,870
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2011B, variable interest rate (1.59% and 1.62% at June 30, 2014 and 2013, respectively), due July 1, 2037	34,890	34,890
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2006; interest rate 5.69%; due July 1, 2036	32,020	32,685
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2007 B and C (converted); interest rate 3.87%; due July 1, 2024	28,000	29,000
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2008 (converted); interest rate 3.99%; due July 1, 2022	25,235	27,570
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 1996; interest rate ranging from 4.55% to 6.50%; due July 1, 2026	0	19,195
MHHEFA Revenue Bonds, Mercy Medical Center Issue, Series 2013B; variable interest rate (1.50% at June 30, 2014); due July 1, 2026	17,610	0
MHHEFA Revenue Bonds, Stella Maris Issue, Series 1997; variable interest rate (0.08% and 0.11% at June 30, 2014 and 2013, respectively); due 2021	11,095	12,200
HUD mortgage loan; interest rate 2.64%; due 2046	5,059	5,160
Other	140	169
Total long-term debt	441,514	450,699
Less:		
Net unamortized discount	448	579
Current portion	9,267	8,597
Long -term portion	$ 431,799	$ 441,523

(Dollars in thousands)

Note J - Long-Term Debt - Continued

Principal payments on long-term debt are as follows for the years ended June 30:

2015	$	9,267
2016		9,434
2017		9,675
2018		8,948
2019		11,601
Thereafter		392,589
	$	441,514

Pursuant to an amended and restated Master Loan Agreement, as supplemented (the "Loan Agreement"), the Obligated Group members have issued debt through Maryland Health and Higher Educational Facilities Authority ("MHHEFA"). Currently the Medical Center, MHS and MHF comprise the Obligated Group. Each Obligated Group member is jointly and severally liable for the repayments under the obligations of the loan agreement. As security for the performance of the obligations of the Obligated Group members under the Loan Agreement, the Obligated Group members have granted to MHHEFA a security interest in their receipts, subject to certain permitted encumbrances. In addition, the Medical Center has mortgaged to MHHEFA certain real and personal property of the Medical Center under a Mortgage from the Medical Center to MHHEFA, as amended and supplemented. The Loan Agreement contains certain restrictive, financial and nonfinancial covenants. Under the terms of the Loan Agreement and other loan agreements, certain funds are required to be maintained on deposit with the trustee or MHHEFA to provide for repayment of the obligations of the Obligated Group (see *Note E*).

Note J - Long-Term Debt - Continued

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted)

In October 2007, MHHEFA authorized the issuance, sale and delivery of its $305,000 Revenue Bonds, Mercy Medical Center Issue, Series 2007 (A, B, C and D). The proceeds were loaned by MHHEFA to MMC to finance the construction of a new replacement hospital facility. The proceeds were also used to refinance the MHHEFA Pooled Loan Revenue Bond.

On April 1, 2010, $30,000 of the Revenue Bonds Series 2007 B and C was converted to Bank Qualified Revenue Bonds held by a commercial bank. The 2007 B and C (converted) Bonds refinanced $18,080 of the $50,000 2007 Series B and $11,920 of the $50,000 2007 Series C. Principal repayment on the converted bonds series began July 1, 2012 and is paid annually through the termination date. The termination date is July 1, 2024. The converted bonds will be subject to mandatory purchase by MMC on April 1, 2020 at their par value, unless the bank and MMC agree to an extension. Interest accrues at a fixed rate of 3.87%. The monthly interest payments are made directly to the bank. During 2011, the remaining $70,000 of the Series 2007 B and C Revenue Bonds were refunded with proceeds from two separate Revenue Bond issues; MMC Issue, Series 2011 and MMC Issue Series 2011B.

Principal repayment of the MMC issue Series 2007 Bonds began July 1, 2008 and is scheduled to be paid annually through July 1, 2042. On the Series 2007 A Bonds ($155,000 Revenue Bonds), interest accrues at a fixed rate ranging from 4.0% to 5.50%. The Series 2007 A Bonds are net of an original issue discount of $875, which is being amortized over the life of the bonds using the straight line method. The Series 2007A Bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2014 and 2013 was $12,579 and $12,520, respectively (see *Note E*). Interest is payable semi-annually on January 1st and July 1st. Prior to redemption the $50,000 Series 2007 D Bonds accrued interest at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2007 (A, B, C, and D) Bonds and Series 2007 B, C (Converted) - Continued

During 2013 the Series 2007D Bonds were refunded with proceeds from the 2013 Bond issue. The variable rate of interest was set to be the lower of the Maximum Rate as defined by the Indenture and the minimum rate that would enable the Remarketing Agent to sell all of the bonds. The Series 2007 D Bonds were issued net of an original issue discount of $225, which was being amortized over the life of the bonds using the straight line method. Payment on the Series 2007 D Bonds was secured by a $50,000 irrevocable letter of credit from Wells Fargo Bank. An annual letter of credit fee equal to 0.38% was payable quarterly by MMC. The letter of credit was terminated when the Series 2007D Bonds were refunded.

To lower the cost of capital of the hospital replacement project, MMC entered into two interest rate swap agreements. In August 2007, a fixed spread basis swap was entered into with a notional amount of $210,000. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of the USD-LIBOR-BBA and 0.54%. The interest rate swap agreement terminates on August 20, 2037. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2014 and 2013, the fair value of the interest rate swap was ($6,765) and ($6,779), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. For the years ended June 30, 2014 and 2013, an unrealized gain (loss) on interest rate swap totaling $14 and ($1,271), respectively, is reflected in the accompanying consolidated statements of operations.

During October 2007, MMC entered into a fixed payer swap with a notional amount of $65,000. Pursuant to the swap agreement, MMC pays the counter party a fixed rate of 4.093% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on July 1, 2042. At June 30, 2014 and 2013, the fair value of the interest rate swap was ($13,462) and ($12,292), respectively, and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling ($1,170) and $10,329 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2014 and 2013, respectively. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2013 Bonds

In January, 2013, MHHEFA authorized the issuance, sale and delivery of its $50,210 Revenue Bonds, Mercy Medical Center, Series 2013. The proceeds were loaned by MHHEFA to MMC to refund the $50,000 Series 2007D Bonds. The bonds were issued as non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on January 16, 2020 at which time the bonds will be subject to a mandatory purchase at their par value by Mercy Medical Center unless the bank and Mercy Medical Center agree to an extension.

The bonds bear interest at a variable rate equal to 30 day LIBOR times 70%, plus 1.10%. Interest is paid monthly. Principal repayment of the Series 2013 Bonds begins July 1, 2014 and is scheduled to be paid annually through July 1, 2042.

Mercy Medical Center Issue, Series 2012 Bonds

In April 2012, MHHEFA authorized the issuance, sale and delivery of its $49,995 Revenue Bonds, Mercy Medical Center Issue, Series 2012. The proceeds were loaned by MHHEFA to MMC to refund $49,480 aggregate principal amount of the Mercy Medical Center Issue, Series 2001 Bonds. The bonds include an original issue premium of $1,742, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2014 and 2013 was $5,488 and $5,467, respectively (see *Note E*).

Principal repayment of the MMC Issue, Series 2012 begins July 1, 2023 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 4.0% to 5.0%. The interest is paid semi-annually on January 1st and July 1st.

On December 1, 2004, the Medical Center entered into a fixed spread basis swap agreement in order to reduce the cost of capital with respect to the Series 2001 Bonds by removing the tax risk to bond holders and transferring the risk to the Medical Center. The fixed spread basis swap matures on December 1, 2024 and the exchanges of cash flows with the counter party began March 1, 2005. The notional amount of the swap is $50,000. Pursuant to the swap agreement, the Medical Center pays the counter party a variable rate equal to the USD-SIFMA Municipal Swap Index and receives interest at a variable rate equal to the sum of 67% of USD-LIBOR-BBA and 0.60%. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles.

At June 30, 2014 and 2013, the fair value of the interest rate swap was $839 and $781, respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling $58 and ($214) is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2014 and 2013, respectively.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2011 Bonds

In February 2011, MHHEFA authorized the issuance, sale and delivery of its $40,770 Revenue Bonds, Mercy Medical Center Issue, Series 2011. The proceeds were loaned by MHHEFA to MMC to refund $35,110 aggregate principal amount of the MMC Issue, Series 2007 B and C Bonds. The bonds were issued net of an original issue discount of $881, which is being amortized over the life of the bonds using the straight line method. The bonds require a debt service reserve fund. The balance of the debt service reserve fund at June 30, 2014 and 2013 was $4,029 and $3,930, respectively (see *Note E*).

Principal repayment of the MMC Issue, Series 2011 Bonds began July 1, 2012 and is scheduled to be paid annually through July 1, 2031. Interest accrues at a rate varying from 3.0% to 6.25%. The interest is payable semi-annually on January 1st and July 1st.

Mercy Medical Center Issue Series 2011B Bonds

In June 2011, MHHEFA authorized the issuance, sale and delivery of its $34,890 Revenue Bonds, Mercy Medical Center Issue, Series 2011B. The proceeds were loaned by MHHEFA to MMC to refund $34,890 aggregate principal amount of the MMC Issue, Series 2007 B and C Bonds. The bonds were issued as non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on June 9, 2021 at which time the bonds will be subject to a mandatory purchase at their par value by MMC unless the bank and MMC agree to an extension.

The bonds bear interest at a variable rate equal to 30 day LIBOR plus 1.5% times 69%, plus 0.45%. Interest is paid monthly. Principal repayment of the Series 2011B Bonds begins July 1, 2032 and is scheduled to be paid annually through July 1, 2037.

Mercy Medical Center Issue, Series 2006 Bonds

In August 2006, MHHEFA authorized the issuance, sale and delivery of $35,000 of Mercy Medical Center Series 2006 Revenue Bonds. The proceeds were loaned by MHHEFA to MMC in order to finance the construction of a new parking garage as well as the financing of certain routine capital expenditures.

Principal repayment of these bonds began on July 1, 2009 and is paid annually through July 1, 2036. Interest is paid semiannually on January 1st and July 1st. Interest accrues at a fixed rate of 5.69%.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2006 Bonds - Continued

Simultaneously with the issuance of the bonds, MMC entered into an interest rate swap agreement with a counter party with a notional amount of $35,000 to convert the fixed rate structure to a variable rate. Under this agreement, MMC will receive a fixed interest rate of 5.14% and pay to the counter party the USD-SIFMA Municipal Swap Index. The interest rate swap agreement terminates on August 3, 2016. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. The value of this contract is based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value is equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%). The bonds are currently callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2014 and 2013, the fair value of the swap was zero.

In anticipation of the transaction, MMC entered into a forward interest rate swap agreement on June 28, 2006 with a notional amount of $35,000 in order to convert the variable swap rate to a fixed rate. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 3.976% and receives a variable rate equal to 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2036. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2014 and 2013, the fair value of the interest rate swap was ($7,332) and ($7,238), respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain (loss) on interest rate swap totaling ($94) and $3,381 is reflected in the accompanying statements of operations for the fiscal years ended June 30, 2014 and 2013, respectively.

Mercy Medical Center Issue, Series 2008 (Converted)

In July 2008, MHHEFA authorized the issuance, sale and delivery of its $35,325 Revenue Bonds, Mercy Medical Center Issue, Series 2008, the proceeds of which were loaned by MHHEFA to MMC in order to refund the MMC Series 2003 Bonds. On December 16, 2009, $30,000 of the Series 2008 Bonds was converted to Bank Qualified Revenue Bonds with a fixed interest rate period of approximately twelve years. The bank at its discretion has the right to call the converted bonds at the seventh and tenth year anniversary. Principal repayment of the converted bonds began July 1, 2011 and is paid annually through July 1, 2022. Interest accrues at a fixed rate of 3.9932%.

Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2008 (Converted) - Continued

The monthly interest payments on the Series 2008 Bonds were made directly to the bank. Principal repayment of the Series 2008 Bonds began on July 1, 2009, and the portion of those bonds that were not converted to Bank Qualified Bonds were fully paid on July 1, 2011.

Mercy Medical Center Issues, Series 1996

In May 1996, MHHEFA authorized the issuance, sale and delivery of its $30,000 Revenue Bonds, Mercy Medical Center Issue, Series 1996, the proceeds of which were loaned by MHHEFA to MMC in order to finance and refinance the costs of the 1996 project. The 1996 project consisted of the construction, acquisition, renovation, and equipping of certain hospital facilities including certain inpatient upgrades, ambulatory care facilities, operating rooms, building infrastructure, and administrative and support service facilities.

The Series 1996 Bonds were issued net of original issue discounts of $302, which are being amortized over the life of the bonds using the straight line method. Interest is payable semi-annually on January 1st and July 1st. Principal repayment of these bonds began on July 1, 2004 and is paid annually through July 1, 2022.

In 2006, MMC entered into an agreement with a third party to run a tender process for the entire balance of the callable Series 1996 Bonds that totaled $19,700. MMC gave investors the choice of accepting a 1% incremental premium over the existing call premium in exchange for tendering their bonds. Any investor not tendering their bonds had their bonds redeemed at the applicable redemption price. Through the execution of a traditional bond agreement, the third party agreed to purchase the bonds from those investors who tendered their bonds.

To convert the underlying fixed rate structure to a variable rate, simultaneously with the purchase of the bonds, MMC entered into two interest rate swap agreements with a counter party with notional amounts of $13,840 and $4,355. The two interest rate swap agreements with the counterparty were amended on July 25, 2011. Pursuant to the amended swap agreements, the counter party pays to MMC a fixed interest rate of 5.75% and 5.625% and receives a variable rate equal to the USD-SIFMA Municipal Swap Index and 1.55%. The interest rate swap agreements were scheduled to terminate on July 25, 2014. The interest rate swaps did not qualify for hedge accounting under generally accepted accounting principles. The value of this contract was based on two components: (i) the accrued but unpaid periodic cash flows and (ii) the termination value as defined in the agreement. By definition, the termination value was equal to the bond amount multiplied by the difference between highest price in the marketplace and the bonds base price (100%).

Note J - Long-Term Debt – Continued

Mercy Medical Center Issues, Series 1996 - Continued

During October 2013 MMC refunded the Series 1996 bonds with proceeds from the Series 2013B bonds (see next page). In conjunction with the refunding of the Series 1996 bonds, two interest rate swap agreements that effectively converted the fixed rate structure to a variable structure, with the notional amounts of $13,840 and $4,355 were terminated. These interest rate swap agreements were set to terminate on July 25, 2014 and were no longer needed with the now variable rate structure of the Series 2013B bonds.

The bonds were callable at par (100%) and the call price would be the highest price in the marketplace on the valuation date. This is due to the fact that MHS would be economically inclined to call the bonds at par versus paying any termination payment on the swap and the bonds are carried on MHS' books at par. With MHS prepared to call the bonds at par, the market price should immediately converge on the call price. Additionally, MHS has the right to optionally terminate the contract. The counter party does not have the right to optionally terminate the agreement. The counter party can only terminate the agreement prior to its stated maturity if an event of default or an additional termination event exists. Therefore, as of June 30, 2013, the fair value of the swap was zero.

On June 28, 2006, to convert the structure back to a fixed rate, MMC entered into a forward rate swap agreement with a notional amount of $18,741. Pursuant to the swap agreement, MMC pays the counter party a fixed interest rate of 4.031% and receives a variable rate of 67% of the USD-LIBOR-BBA. The interest rate swap agreement terminates on July 1, 2026. The interest rate swap does not qualify for hedge accounting under generally accepted accounting principles. At June 30, 2014 and 2013, the fair value of the interest rate swap was ($3,084) and ($3,315) respectively and is included in other long-term liabilities in the accompanying consolidated balance sheets. An unrealized gain on interest rate swap totaling $231 and $1,272 is reflected in the accompanying consolidated statements of operations for the fiscal years ended June 30, 2014 and 2013, respectively.

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Note J - Long-Term Debt – Continued

Mercy Medical Center Issue, Series 2013B Bonds

In October, 2013, MHHEFA authorized the issuance, sale and delivery of its $18,065 Revenue Bonds, Mercy Medical Center, Series 2013B. The proceeds were loaned by MHHEFA to MMC to refund the $18,195 Series 1996 bonds. The bonds were issued as a non-bank qualified revenue bonds and directly purchased by a commercial bank. The direct bank purchase terminates on October 22, 2023, at which time the bonds will be subject to a mandatory purchase at their par value by MMC unless the bank and MMC agree to an extension. The bonds bear interest at a variable rate equal to 1.35% plus 78% of one-month LIBOR. Interest and principal is paid monthly. Principal repayment of Series 2013B bonds began on December 1, 2013 and the final payment will be on July 1, 2026.

Stella Maris Issue, Series 1997 Bonds

The Series 1997 Bonds were issued to finance the acquisition by SMI of Stella Maris Operating Corporation and CSC; to advance refund certain nursing home revenue bonds previously issued by MHHEFA, Stella Maris Issue, Series 1991; and to refinance certain outstanding indebtedness of the acquired corporations.

Principal repayment of these bonds began on July 1, 2001 and is paid annually through July 1, 2021. All bonds are subject to redemption prior to maturity beginning March 1, 2001. Interest is accrued at a variable rate based on the prevailing interest rate in effect as determined by the Remarketing Agent on each Calculation Date. Interest on the bonds is payable monthly.

Under the provisions of the bond agreement, SMI has granted to MHHEFA a security interest in all of its real property and the assignment of its leases. In addition, payments on the bonds are secured by an irrevocable letter of credit provided by M&T Bank. An annual letter of credit fee, equal to 1.29% of the letter of credit amount, is payable quarterly by SMI. The letter of credit expires July 1, 2020.

Note J - Long-Term Debt - Continued

Stella Maris Issue, Series 1997 Bonds - Continued

Under the terms of the bond indenture, SMI is required to maintain certain deposits with a trustee. The bond indenture agreement also requires SMI to satisfy certain measures of financial performance as long as the bonds are outstanding. As of June 30, 2014 and 2013, SMI was in compliance with the financial covenant requirements of the bond indenture.

HUD Mortgage Loan

The mortgage loan from the U.S. Department of Housing and Urban Development (HUD) was used by CSC to construct St. Elizabeth Hall. This original note was refinanced during the year ended June 30, 2013. The original terms of the note reflected an interest rate of 6.875% per annum with monthly installments of $43, including interest, with the final payment due November 1, 2020.

From July 1997 through December 2005, CSC received authorization from HUD to suspend its monthly principal and interest payments of $43. The unpaid interest during this deferral period was accrued. On December 21, 2012 the original outstanding debt was refinanced with a new outstanding face amount of $5,202 and the unpaid interest accrued during the deferral period was forgiven, resulting in a gain on extinguishment of debt of $2,649. The current note reflects an interest rate of 2.64% per annum with monthly installments of $20, including interest, with the final payment due January 1, 2046. The current note requires mortgage insurance of 0.45% of the average annual outstanding principal balance determined annually for the duration of the note. Concurrent with these monthly mortgage payments, St. Elizabeth Hall is required to make monthly payments of $23 derived from the savings of the new note to a Debt Service Savings Reserve Fund through May 2029 for purposes stipulated by a Debt Service Savings Agreement. Also concurrent with these monthly payments, St. Elizabeth Hall is required to make monthly payments of $8 to a reserve fund for the replacement of property and equipment. These payments are required until the mortgage matures and are included in Board designated and donor restricted investments. All disbursements from this fund are contingent upon HUD's prior approval.

The liability of CSC under the mortgage note is limited to the underlying value of the real estate collateral plus other amounts deposited with the lender.

Note J - Long-Term Debt - Continued

Line-of-Credit

The Medical Center has a $20,000 operating line of credit and an additional $1,000 operating line of credit (for leases) with M&T Bank, and a $15,000 line of credit for equipment and construction with PNC Bank which terminated January 2013 and was replaced by a $15,000 line of credit agreement with Wells Fargo Bank during December 2013. At June 30, 2014, the $20,000, $15,000 and $1,000 operating lines of credit had $8,000, $0 and $0 outstanding, respectively. At June 30, 2013, the $20,000 and $1,000 operating lines of credit had $8,000 and $0 outstanding, respectively. As of June 30, 2014 and 2013, the interest rate on the outstanding $8,000 line of credit draw was 2.34% and was based on two hundred and fifteen basis points above the greater of one-month LIBOR, with an interest period duration of one day. The $15,000 line of credit bears interest at 0.85% above the daily one month LIBOR on the outstanding principal balance. The $20,000 operating line of credit agreement is scheduled to remain in effect until all obligations are paid in full or terminated by the Bank.

Note K - Fair Value of Financial Instruments

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

> *Cash and cash equivalents, patient accounts receivable, other amounts receivable, accounts payable and accrued expenses, due to third party payers and construction retainage:* The carrying amounts reported in the consolidated balance sheets approximate fair value.
>
> *Short-term investments, funds held by trustee or authority and board designated and donor restricted investments:* Fair values, which are the amounts reported in the consolidated balance sheets, are based on quoted market prices, if available, or estimated using quoted market prices for similar securities.
>
> *Long-term debt:* Fair values of revenue bonds and other debt are based on current traded values. At June 30, 2014 and 2013, the fair value of long-term debt was approximately $450,635 and $456,290, respectively.

Note K - Fair Value of Financial Instruments - Continued

Current accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establish a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels of inputs that may be used to measure fair value are:

> Level 1: Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities that are traded in an active exchange market, as well as U.S. Treasury securities.
>
> Level 2: Observable input other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted market prices that are traded less frequently than exchange-traded instruments. This category generally includes certain U.S. government and agency mortgage-backed debt securities, corporate-debt securities, and alternative investments.
>
> Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private debt and equity instruments and alternative investments.

The following discussion describes the valuation methodologies used for financial assets and liabilities measured at fair value. The techniques utilized in estimating the fair values are affected by the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about the business, value, or financial position of MHS based on the fair value information of financial assets and liabilities presented below.

Note K - Fair Value of Financial Instruments - Continued

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial asset or liability, including estimates of the timing, amount of expected future cash flows, and the credit standing of the issuer. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial asset or liability. Furthermore, the disclosed fair values do not reflect any premium or discount that could result from offering for sale at one time an entire holding of a particular financial asset or liability. Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in the amounts disclosed.

MHS uses techniques consistent with the market approach for measuring fair value of its Level 2 and Level 3 assets and liabilities. The market approach is a valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Fair values of equity securities and fixed maturity securities have been determined by MHS from observable market quotations, when available. Private placement securities and other equity securities where a public quotation is not available are valued by using broker quotes. Cash equivalents comprise short-term fixed maturity securities and carrying amounts approximate fair values, which have been determined from public quotations, when available. Money markets and certificates of deposit comprise short-term fixed maturity securities. The carrying amounts approximate fair values, which have been determined from public quotations, when available.

MHS holds alternative investments that are not traded on national exchanges or over-the-counter markets. MHS is provided information on a net asset value per share for these investments that has been calculated by the funds of funds' managers (who are investment advisors registered with the Securities and Exchange Commission) based on information provided by the managers of underlying funds. These investments are accounted for under the equity method which approximates fair value.

Fair value of the interest rate swaps represent, or are derived from, mid-market values. Mid-market prices and inputs may not be observable, and instead valuations may be derived from proprietary or other pricing models based on certain assumptions regarding past, present and future market conditions. Some inputs may be theoretical, not empirical, and require subjective assumptions and judgments. Valuations may be based on assumptions as to the volatility of the underlying security, basket or index, interest rates, exchange rates, dividend yields, correlations between these or other factors, the impact of these factors upon the value of the security (including any embedded options), as well as issuer funding rates and credit spreads (actual or approximated) or additional relevant factors.

(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2014.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Cash and cash equivalents				
Cash	$ 168	$ 0	$ 0	$ 168
Money market funds	0	6,191	0	6,191
Commercial paper	0	125	0	125
Equity securities				
Mutual funds				
International large cap core	9,653	0	0	9,653
Emerging markets	15,137	0	0	15,137
Domestic mutual fund	9,116	0	0	9,116
Common stocks				
Healthcare	4,505	0	0	4,505
Utilities	282	0	0	282
Financials	5,634	0	0	5,634
Consumer staples	2,185	0	0	2,185
Consumer discretionary	3,873	0	0	3,873
Materials	1,204	0	0	1,204
Energy	1,835	0	0	1,835
Information technology	8,390	0	0	8,390
Industrials	5,965	0	0	5,965
Miscellaneous	35	0	0	35
Foreign stocks/American deposit receipt	4,582	0	0	4,582
Fixed maturity				
US treasury notes	21,350	0	0	21,350
US government and agencies				
U.S. treasury bonds	0	1,219	0	1,219
Government agency bonds	0	45	0	45
Government agency mortgage backed securities	0	642	0	642
Government agency pools	0	4,981	0	4,981
Corporate bonds				
Strip and zero coupon	0	17	0	17
Asset backed securities	0	2,107	0	2,107
Banking	0	826	0	826
Financial	0	2,309	0	2,309
Industrial	0	7,743	0	7,743
International (other global corp bonds)	0	1,881	0	1,881
Asset backed securities		1,238		1,238
Collaterized mortgage backed	0	95	0	95
Fixed maturity loan fund	0	7,589	0	7,589
Bond fund	1,858	0	0	1,858
Municipal bonds	0	2,190	0	2,190
Fixed income alternative	0	0	6,971	6,971
Total board designated and donor restricted investments	95,772	39,198	6,971	141,941

(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted funds				
Cash	$ 2,384	$ 0	$ 0	$ 2,384
Money market fund	0	1,761	0	1,761
Certificate of deposit	0	1,567	0	1,567
Equity				
Mutual fund				
Exchange traded	6,775	0	0	6,775
Emerging markets	5,204	0	0	5,204
Mortgage securities fund	9,041	0	0	9,041
Equity income fund	1,989	0	0	1,989
European equity fund	364	0	0	364
Fixed maturity				
U.S. treasury notes	24,777	0	0	24,777
U.S. government and agencies				
Mortgage backed securities	0	428	0	428
Corporate and foreign bonds				
Financial	0	3,140	0	3,140
Industrial	0	1,768	0	1,768
Other	0	378	0	378
Asset backed	0	0	0	0
Municipal bonds	0	4,562	0	4,562
Total restricted funds	50,534	13,604	0	64,138
Cash and cash equivalents				
Cash	62,070	0	0	62,070
Money market fund	0	17,285	0	17,285
Certificate of deposit		5,737		5,737
Fixed income mutual funds	285	0	0	285
Exchange traded fund	74	0	0	74
Domestic mutual equity funds	104	0	0	104
Total cash and cash equivalents	62,533	23,022	0	85,555
Short term investments				
Money market fund	0	369	0	369
Certificate of deposit	0	1,264	0	1,264
Total short term investments	0	1,634	0	1,634
Total cash, cash equivalents and short term investments	62,533	24,656	0	87,189
Long term investments				
Cash				
Foreign currency	0	140	0	140
Fixed maturity				
U.S. treasury notes	3,267	0	0	3,267
U.S. government and agencies				
Government agency mortgage backed securities	0	495	0	495
Government agency pools	0	66	0	66
Corporate Bonds				
Financial	0	1,841	0	1,841
Industrial	0	2,835	0	2,835
International (other global corp bonds)	0	638	0	638
Bond fund	556	0	0	556
Municipal bonds	0	1,143	0	1,143
Total long term investments	3,823	7,158	0	10,981

(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Funds held by trustee (current)				
Money market	$ 0	$ 10,039	$ 0	$ 10,039
Fixed maturity				
Government agency notes	0	1,595	0	1,595
Total funds held by trustee (current)	0	11,634	0	11,634
Funds held by trustee (non-current)				
Cash	1,035	0	0	1,035
Money market	0	190	0	190
Fixed maturity				
U.S. government and agencies	0	21,905	0	21,905
Certificate of deposit	0	0	0	0
Funds held by trustee (non-current)	1,035	22,095	0	23,130
Total funds held by trustee	1,035	33,729	0	34,764
Total assets fair value	$ 213,697	$ 118,345	$ 6,971	$ 339,013
Liabilities				
Interest rate swaps	$ 0	$ 0	$ 29,804	$ 29,804
Total liabilities at fair value	$ 0	$ 0	$ 29,804	$ 29,804

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table presents MHS' fair value hierarchy for financial instruments measured at fair value on a recurring basis as of June 30, 2013.

Assets	Level 1	Level 2	Level 3	Total Fair Value
Board designated and donor restricted investments:				
Cash and cash equivalents				
Cash	$ 194	$ 0	$ 0	$ 194
Money market funds	0	27,173	0	27,173
Commercial paper	0	300	0	300
Long term investments				
Certififcate of deposit	0	245	0	245
Equity securities				
Mutual funds				
International large cap core	8,050	0	0	8,050
International emerging markets	9,016	0	0	9,016
Domestic mutual fund-equity income	7,874	0	0	7,874
Common stocks				
Healthcare	3,477	0	0	3,477
Utilities	172	0	0	172
Financials	4,554	0	0	4,554
Consumer staples	1,794	0	0	1,794
Consumer discretionary	3,703	0	0	3,703
Materials	1,071	0	0	1,071
Energy	1,655	0	0	1,655
Information technology	7,065	0	0	7,065
Industrials	5,217	0	0	5,217
Miscellaneous	56	0	0	56
Foreign stocks/American deposit receipt	2,793	0	0	2,793
Fixed maturity				
US treasury notes	7,224	0	0	7,224
US government and agencies				
U.S. treasury bonds	0	810	0	810
Government agency bonds	0	3,028	0	3,028
Government agency mortgage backed securities	0	1,611	0	1,611
Government agency pools	0	5,098	0	5,098
Corporate bonds				
Strip and zero coupon	0	19	0	19
Banking	0	351	0	351
Financial	0	2,134	0	2,134
Industrial	0	4,979	0	4,979
International (other global corp bonds)	0	1,259	0	1,259
Asset backed securities	0	1,172	0	1,172
Collaterized mortgage backed securities	0	155	0	155
Fixed maturity loan fund	0	7,265	0	7,265
Bond fund	548	0	0	548
Municipal bonds	0	3,410	0	3,410
Alternative	0	0	7,034	7,034
Total board designated and donor restricted investments	64,463	59,009	7,034	130,506

Mercy Health Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - Continued
(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Restricted funds				
Cash	$ 6,915	$ 0	$ 0	$ 6,915
Certififcate of deposit	0	5,397	0	$ 5,397
Equity				
Mutual fund				
Exchange traded	7,131	0	0	7,131
Emerging markets	4,847	0	0	4,847
Domestic mutual fund	1,735	0	0	1,735
Fixed maturity				
U.S. treasury notes	15,391	0	0	15,391
U.S. government and agencies				
Mortgage backed securities	0	10,242	0	10,242
Corporate and foreign bonds				
Financial	0	1,958	0	1,958
Industrial	0	1,949	0	1,949
Other	0	589	0	589
Municipal bonds	0	5,894	0	5,894
Total restricted funds	36,019	26,029	0	62,048
Cash and cash equivalents				
Cash	63,011	0	0	63,011
Money market fund	0	14,075	0	14,075
Certificate of deposit	0	1,342	0	1,342
Fixed maturity-mutual funds	221	0	0	221
Equities-exchage traded	77	0	0	77
Equities-domestic mutual equity funds	67	0	0	67
Total cash and cash equivalents	63,376	15,417	0	78,793
Short term investments				
Money market	0	1,014	0	1,014
Money market fund	0	383	0	383
Certificate of deposit	0	1,261	0	1,261
Total short term investments	0	2,658	0	2,658
Total cash, cash equivalents and short term investments	63,376	18,075	0	81,451
Long term investments				
Foreign currency	0	381	0	381
Fixed maturity				
U.S. treasury notes	5,542	0	0	5,542
U.S. government and agencies				
U.S. treasury bonds	0	0	0	0
Government agency bonds	0	880	0	880
Government agency mortgage backed securities	0	662	0	662
Government agency pools	0	1,157	0	1,157
Corporate Bonds				
Financial	0	1,545	0	1,545
Industrial	0	4,168	0	4,168
International (other global corp bonds)	0	494	0	494
Mortgage backed securities	0	124	0	124
Municipal bonds	0	1,023	0	1,023
Total long term investments	5,542	10,434	0	15,976

(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

Assets	Level 1	Level 2	Level 3	Total Fair Value
Funds held by trustee (current)				
Money market	$ 0	$ 8,067	$ 0	$ 8,067
Fixed maturity				
Government agency notes	0	3,982	0	3,982
Total funds held by trustee (current)	0	12,049	0	12,049
Funds held by trustee (non-current)				
Money market	0	1,438	0	1,438
Fixed maturity				
U.S. government and agencies	0	22,531	0	22,531
Certificate of deposit	0	132	0	132
Funds held by trustee (non-current)	0	24,101	0	24,101
Total funds held by trustee	0	36,150	0	36,150
Total assets fair value	$ 169,400	$ 149,697	$ 7,034	$ 326,131
Liabilities				
Interest rate swaps	$ 0	$ 0	$ 28,843	$ 28,843
Total liabilities at fair value	$ 0	$ 0	$ 28,843	$ 28,843

During fiscal year 2014, MHS transferred $3,300 from level 2 securities to level 1 securities in accordance with MHS investment committee decision to reallocate the portfolio. During fiscal year 2013, MHS transferred $7,000 from level 1 fixed maturity and money market fund securities to level 2 fixed maturity securities, and transferred $5,000 from level 1 securities money market fund securities to level 3 securities in accordance with MHS investment committee decision to reallocate the portfolio.

Included in alternative investments as of June 30, 2014 are three classes of hedge funds of funds with fair values of $891 (Fund A), $364 (Fund B) and $5,751 (Fund C). Fund A and B are in liquidation and redemptions are suspended until the fund can liquidate its underlying holding. Fund C is redeemable calendar quarterly with 65 days advance notice. Included in alternative investments as of June 30, 2013 are three classes of hedge funds of funds with fair values of $1,249 (Fund A), $480 (Fund B) and $5,304 (Fund C). Fund A and B are in liquidation and redemptions are suspended until the fund can liquidate its underlying holding. Fund C is redeemable calendar quarterly with 65 days advance notice. There are no unfunded commitments for any of the hedge fund of funds for either 2014 or 2013.

(Dollars in thousands)

Note K - Fair Value of Financial Instruments - Continued

The following table is a rollforward of the consolidated statements of financial position amounts for financial instruments classified by MHS within level 3 of the valuation hierarchy defined above:

	Investments	Interest rate swaps
Fair value June 30, 2012	$ 2,363	$ (42,340)
Unrealized gains, net	356	13,497
Purchases	5,000	0
Redemptions	(685)	0
Fair value June 30, 2013	7,034	(28,843)
Unrealized gains (losses), net	501	(961)
Purchases	0	0
Redemptions	(564)	0
Fair value June 30, 2014	$ 6,971	$ (29,804)

Note L - Pension and Profit Sharing Plans

MHS has a qualified 401(k) plan covering substantially all employees of the Medical Center and SMI who have completed at least one year of service and are at least twenty-one years of age. MHS makes an annual contribution on behalf of all eligible employees based on either the employee's contributions to the 401(k) plan or their annual compensation. MHS will match, on a dollar for dollar basis (based on age and years of service thresholds) the amount contributed by the employee, not to exceed 6% of the employee's salary. MHS' contributions to the 401(k) plan for all participants employed prior to April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees, vest at a rate of 25% annually and completely vested on April 1, 2001 for Medical Center employees and July 1, 2001 for SMI employees. MHS' contributions for all participants employed on or after April 1, 1997 for Medical Center employees or July 1, 1997 for SMI employees vest after four years of service, with no vesting prior to four years of service. Contributions under this plan totaled approximately $4,461 and $4,292 for the years ended June 30, 2014 and 2013, respectively.

The Medical Center has a nonqualified deferred compensation plan for certain executives and physicians. The deferred compensation plan provides for severance and supplemental retirement benefits as defined in the plan. Compensation expense related to the deferred compensation plan was $1,221 and $954 for the years ended June 30, 2014 and 2013, respectively. Total deferred compensation obligations of $6,184 and $5,738 are included in other long-term liabilities in the accompanying consolidated balance sheets at June 30, 2014 and 2013, respectively (see *Note W*).

(Dollars in thousands)

Note L - Pension and Profit Sharing Plans – Continued

The fair values of deferred compensation plan assets fair value on a recurring basis as of June 30, 2014 by asset category are as follows (see *Notes H and K*):

Assets	Level 1	Level 2	Level 3	Total Fair Value
Equity				
Mutual funds				
International large cap core	$ 474	$ 0	$ 0	$ 474
Emerging markets	45	0	0	45
Domestic mutual fund-equity income	4,110	0	0	4,110
Fixed maturity				
Bond fund	0	1,555	0	1,555
Total assets fair value	$ 4,629	$ 1,555	$ 0	$ 6,184

The fair values of deferred compensation plan assets on a recurring basis as of June 30, 2013 by asset category are as follows (see *Notes H and K*):

Assets	Level 1	Level 2	Level 3	Total Fair Value
Equity				
Mutual funds				
International large cap core	$ 388	$ 0	$ 0	$ 388
Emerging markets	37	0	0	37
Domestic mutual fund-equity income	3,358	0	0	3,358
Fixed maturity				
Bond fund	0	1,955	0	1,955
Total assets fair value	$ 3,783	$ 1,955	$ 0	$ 5,738

There were no significant transfers between level 1 and level 2 fair value investments for the years ended June 30, 2014 and 2013.

(Dollars in thousands)

Note M - Post-Retirement Benefit Plan

MHS has an unfunded contributory health and medical post-retirement benefit plan available to all eligible employees who meet certain age and length of service requirements. The plan provides for health and medical benefits including primary care physician and specialist visits, hospitalization and emergency care, prescription drugs, vision care, and Medicare supplemental coverage.

The following table sets forth the components of the MHS obligation at June 30:

	2014	2013
Change in Benefit Obligation		
Benefit obligation at beginning of year	$ 5,755	$ 7,741
Service cost	98	95
Interest cost	262	240
Actuarial (gain) loss	433	(2,066)
Employer portion of benefits paid	(163)	(255)
Benefit obligation at end of year	6,385	5,755
Change in Plan Assets		
Employer contribution	163	255
Plan participants' contribution	401	381
Medicare Part D reimbursement	82	70
Benefits paid	(646)	(706)
Fair value of plan assets at end of year	0	0
Fund status	(6,385)	(5,755)
Accrued post-retirement benefit cost	(6,385)	(5,755)
Less current portion, included in accounts payable and accrued expenses	(164)	(180)
Total accrued post-retirement benefit cost, long-term portion	$ (6,221)	$ (5,575)

(Dollars in thousands)

Note M - Post-Retirement Benefit Plan – Continued

Net periodic post-retirement benefit cost included the following for the years ended June 30:

	2014	2013
Service cost - benefits attributed to service during the period	$ 98	$ 95
Interest cost on accumulated post-retirement benefit obligation	262	240
Net amortization	(126)	(128)
Net post-retirement benefit cost	$ 234	$ 207

The weighted average discount rate used in determining the accumulated post-retirement benefit obligation (APBO) for the plan was 4.25% and 4.5% for the years ended June 30, 2014 and 2013, respectively. For measurement purposes, the health care cost trend rates used in determining the APBO for the plan were 7.0% and 7.5% in 2014 and 2013, respectively. Increasing the health care cost trend rates by 1% would increase the APBO by $1,176 and aggregate service and interest cost by $84 at June 30, 2014.

Note N - Retirement Annuity Plan

MHS had a pension plan that was terminated on April 1, 1997 and established a retirement annuity plan under which certain participants of the terminated plan were entitled to annuity payments. Participants in the plan include (a) the retirees and beneficiaries entitled to benefits from the terminated plan on April 1, 1997 and (b) other participants with benefits worth more than $4 that elected an annuity. All benefits are vested and based on the frozen accrued benefits at April 1, 1997.

(Dollars in thousands)

Note N - Retirement Annuity Plan – Continued

The measurement dates for fiscal years 2014 and 2013 were June 30, 2014 and June 30, 2013, respectively. The following table sets forth the funded status of the retirement annuity plan and amounts recognized in accompanying consolidated financial statements:

	2014	2013
Change in Benefit Obligation		
Benefit obligation at beginning of year	$ 8,877	$ 10,119
Interest cost	371	375
Actuarial loss (gain)	33	(407)
Benefits paid	(1,136)	(1,210)
Benefit obligation at end of year	8,145	8,877
Change in Plan Assets		
Fair value of plan assets at beginning of year	4,701	5,434
Actuarial return on plan assets	464	477
Benefits paid	(1,136)	(1,210)
Fair value of plan assets at end of year	4,029	4,701
Funded status/accrued benefit cost	$ (4,115)	$ (4,176)

The discount rate was 4.25% and 4.50% for 2014 and 2013, respectively. The expected rate of return on plan assets was 6.50% for 2014 and 2013. The accompanying consolidated net pension cost was $338 in 2014 and $364 in 2013.

MHS' expected rate of return is evaluated annually and is based on the current interest rate environment, rate of inflation, allocation of the plan assets among various investment options and other market conditions.

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The weighted-average asset allocations in the plan as of June 30, 2014 and 2013, by asset category were as follows:

	June 30,	
	2014	2013
Asset Category		
Equity securities	38%	45%
Fixed income bond fund	34%	29%
Fixed income alternatives	11%	13%
Cash and cash equivalents	14%	10%
Equity alternatives	3%	3%
Total	100%	100%

MHS' asset allocation guidelines at June 30, 2014 are as follows:

	Ranges	Target Allocation
Total equity	30-65%	50%
Domestic equity	30-65%	40%
International equity	0-15%	10%
Equity alternatives	0-50%	0%
Fixed maturity alternatives	0-40%	35%
Cash	5-25%	15%

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair values of plan assets on a recurring basis as of June 30, 2014 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents				
Cash	$ 0	$ 1	$ 0	$ 1
Money market funds	0	578	0	578
Equity alternative	0	0	110	110
Fixed maturity alternative	0	0	438	438
Fixed maturity				
Bond fund	0	1,063	0	1,063
International mutual fund	0	305	0	305
Equity securities				
Mutual funds				
International mutual funds				
International large cap core	352	0	0	352
Emerging markets	99	0	0	99
Global	204	0	0	204
Domestic mutual fund	879	0	0	879
Total assets fair value	$ 1,534	$ 1,947	$ 548	$ 4,029

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

The fair values of plan assets on a recurring basis as of June 30, 2013 by asset category are as follows:

Assets	Level 1	Level 2	Level 3	Total Fair Value
Cash and cash equivalents				
Cash	$ 0	$ 1	$ 0	$ 1
Money market funds	0	477	0	477
Equity alternative	0	0	151	151
Fixed maturity alternative	0	0	603	603
Fixed maturity				
Bond fund	0	1,060	0	1,060
International mutual fund	0	298	0	298
Equity securities				
Mutual funds				
International mutual funds				
Large cap core	322	0	0	322
Emerging markets	275	0	0	275
Global	92	0	0	92
Domestic mutual funds	1,042	0	0	1,042
Common stocks				
Healthcare	29	0	0	29
Utilities	12	0	0	12
Financials	95	0	0	95
Consumer staples	8	0	0	8
Consumer discretionary	55	0	0	55
Materials	19	0	0	19
Energy	13	0	0	13
Information technology	40	0	0	40
Industrials	83	0	0	83
Foreign stocks/American deposit receipt	26	0	0	26
Total assets fair value	$ 2,111	$ 1,836	$ 754	$ 4,701

There were no significant transfers between level 1 and level 2 fair value investments for the years ended June 30, 2014 and 2013.

(Dollars in thousands)

Note N - Retirement Annuity Plan - Continued

Included in alternative investments as of June 30, 2014 and 2013 are hedge funds of funds with fair values of $548 and $754, respectively. The funds are redeemable semiannually with no prior required redemption notice. There are no unfunded commitments for any of the hedge fund of funds for either 2014 or 2013.

The following table is a rollforward of the fair value amounts for financial instruments classified by the plan within level 3 of the valuation hierarchy above:

	Alternative Investments
Fair value June 30, 2012	$ 899
Unrealized gains, net	49
Redemptions	(194)
Fair value June 30, 2013	754
Unrealized gains, net	51
Redemptions	(257)
Fair value June 30, 2014	$ 548

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Benefit Payments
2015	$ 1,086
2016	1,020
2017	953
2018	884
2019	814
Next 5 years	3,053

Note O - Supplemental Cash Flow Information

Cash payments for interest, net of amounts capitalized and swap payments, were $19,629 in 2014 and $19,513 in 2013. Capitalized interest related to construction activities includes interest payments to creditors on bonds, net payments/receipts to counterparties on interest rate swap arrangements, and income received on trustee-held funds.

(Dollars in thousands)

Note P - Temporarily and Permanently Restricted Net Assets

Temporarily restricted net assets are available for the following health care services at June 30:

	2014	2013
Capital improvements	$ 11,598	$ 14,737
Departmental expenses	9,505	7,442
Pastoral care	4,516	5,008
Research programs	1,256	1,187
Indigent care	1,139	1,117
Education programs	202	187
Other	91	51
	$ 28,307	$ 29,729

Permanently restricted net assets consist of the following at June 30:

	2014	2013
SMI Hospice Endowment	$ 1,055	$ 1,055
Weinberg Endowment	1,000	1,000
Dr. Goodman Endowment	123	123
	$ 2,178	$ 2,178

Note Q - Functional Expenses

MHS and its subsidiaries provide general health care services to patients within their geographic location. Expenses related to providing these services are as follows for the years ended June 30:

	2014	2013
Health care services	$ 456,982	$ 455,250
Administrative and support services	162,199	151,383
	$ 619,181	$ 606,633

Note R - Commitments and Contingent Liabilities

Litigation

MHS has outstanding litigation involving claims brought against it in the normal course of business. Litigation in the normal course of business, as well as responses to claims and investigations described below, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings and government investigations are difficult to predict. Attorneys for MHS are representing MHS in all of these matters. Management is currently unable to estimate, with reasonable certainty, the possible loss, or range of loss, if any, for such lawsuits and investigations. Management of MHS is unable to determine the amount of any possible settlements for such lawsuits and investigations, but is of the opinion that all of the lawsuits are covered by applicable MHS insurance.

MHS is subject to asserted and unasserted claims (in addition to litigation) encountered in the ordinary course of business. As a result of the current level of governmental and public concerns with health care fraud and abuse, management recognizes that additional investigative activity could occur in the future. In the opinion of management and after consultation with legal counsel, management believes it has established adequate accrued reserves related to all known matters. The outcome of any potential investigative, regulatory or prosecutorial activity that may occur in the future cannot be predicted with certainty, however, and any associated potential future losses resulting from such activity could have a material adverse effect on the future financial position, results of operations and liquidity of MHS.

Self-Insurance Programs

As discussed in *Notes A* and *I*, GIC provides general and professional liability coverage to MHS and its subsidiaries. GIC's policies provide primary and certain excess liability coverage. GIC retains the risk related to the primary policy and reinsures the whole of the excess policies. While insurance policy limits vary by year, management believes the amounts are appropriate.

(Dollars in thousands)

Note R - Commitments and Contingent Liabilities – Continued

GIC's primary coverage limits for the periods ending June 30 are:

	2014	2013
Healthcare Professional Liability (HPL) and Managed Care Organization Liability (MCO)	$5,000 per related loss event $20,000 aggregate	$5,000 per related loss event $16,500 aggregate
Commercial General Liability (CGL)	$5,000 per occurrence $20,000 aggregate	$5,000 per occurrence $16,500 aggregate

GIC's primary coverage for HPL is $5,000 per loss event. GIC provides excess coverage for HPL and MCO in the aggregate amount of $75,000 in excess of $5,000 for related loss events and in excess of $20,000 and $16,500 aggregate for fiscal year 2014 and fiscal year 2013, respectively. GIC provides excess coverage for CGL in the aggregate amount of $75,000 in excess of $5,000 per occurrence and in excess of $20,000 and $16,500 aggregate for fiscal year 2014 and fiscal year 2013, respectively. All excess coverage is reinsured by commercial insurance companies.

In management's opinion, the assets of GIC are sufficient to meet its obligations as of June 30, 2014. If the financial condition of GIC were to materially deteriorate in the future, and GIC were unable to pay its claim obligations, the responsibility to pay those claims would return to MHS.

MHS and certain of its subsidiaries are self-insured against employee medical claims. Plan expenses include claims incurred and provisions for unreported claims. However, the program has an annual aggregate stop loss provision per employee.

MHS and certain of its subsidiaries are self-insured in the State of Maryland for the use and benefit of all employees of MHS. The State of Maryland requires any self-insurer employer to provide a workers' compensation surety bond issued by a corporate surety company that meets the State's financial rating under A.M. Best. MHS has had a surety bond in place since 1997 currently written by Fidelity and Deposit Company of Maryland in the amount of $2,200. All past, present, existing and potential liability under this bond shall remain in effect and to the benefit of the State of Maryland.

MHS and certain of its subsidiaries are self-insured against unemployment claims and have surety bonds of $1,893 for the Medical Center and $339 for SMI. The amounts change each October 1st as dictated by the Maryland Department of Licensing and Regulation.

(Dollars in thousands)

Note R - Commitments and Contingent Liabilities - Continued

Lease Commitments

The Medical Center and MFC have entered into separate long term leases for commercial space. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2015	$	2,726
2016		2,727
2017		1,945
2018		1,722
2019		1,694
Thereafter		57,933
	$	68,747

MHS and certain of its subsidiaries have other office space leases. Rent expense for the years ended June 30, 2014 and 2013 was $3,056 and $5,047, respectively.

The Medical Center and MFC have entered into separate long term operating leases for equipment. The leases contain escalation clauses and charges for other costs related to the leased space. Future minimum payments for these leases for each of the years ended June 30 are as follows:

2015	$	4,180
2016		3,796
2017		1,961
2018		1,329
2019		1,232
Thereafter		1,086
	$	13,584

MHS and certain of its subsidiaries have other operating leases for equipment. Equipment lease expense for the years ended June 30, 2014 and 2013 was $4,632 and $3,779, respectively.

Note S - Maryland Health Services Cost Review Commission

The Medical Center's charges are subject to review and approval by the State of Maryland Health Services Cost Review Commission (the Commission). Management has made the required filings with the Commission and believes the Medical Center to be in compliance with the Commission's requirements. The Commission has jurisdiction over hospital reimbursement in Maryland by agreement with the Centers for Medicare and Medicaid Services (CMS). This agreement is based on a waiver from the Medicare Prospective Payment System reimbursement principles granted under Section 1814(b) of the Social Security Act. On January 10, 2014 Maryland's All-Payer Hospital System Modernization was approved by CMS. This is a five year demonstration where Maryland agreed to permanently shift away from its current statutory waiver, which is based on Medicare payment per inpatient admission, in exchange for the new CMS model based on Medicare per capita total hospital cost growth.

The Commission established an uncompensated care fund whereby all hospitals are required to contribute 0.75% of revenues to this fund to help provide for the cost associated with uncompensated care for certain Maryland hospitals above the State average. In December 2008, the Commission modified this mechanism to finance uncompensated care statewide. The policy implemented 100% pooling and all Maryland hospitals have the same percentage of uncompensated care in rates. High uncompensated care hospitals receive funds and low uncompensated care hospitals pay into the fund. The Medical Center had net receipts of $245 and $210 for 2014 and 2013, respectively, related to its participation in the uncompensated care fund mechanism.

The Commission's rate-setting methodology for service centers that provide both inpatient and outpatient services or only outpatient services consists of establishing an acceptable unit rate for these centers within the applicable facility. The actual average unit charge for each service center is compared to the approved rate on a monthly basis. The rate variances, plus penalties where applicable, are applied to decrease (in the case of overcharges) or increase (in the case of undercharges) future approved rates on an annual basis. The timing of the Commission's rate adjustments for the Medical Center could result in an increase or reduction due to the variances and penalties described above in a year subsequent to the year in which such items occur. MHS' policy is to accrue revenue based on actual charges for services to patients in the year in which the services are performed and billed.

Note T - Housing Assistance Payment Contract

The U.S. Federal Housing Administration (FHA) has contracted with CSC under Section 8 of Title II of the Housing and Community Development Act of 1974 to make housing assistance payments to CSC on behalf of certified tenants. For fiscal year 2014 and 2013, the maximum contract commitment was $1,122 and $1,117 per year, respectively. During the years ended June 30, 2014 and 2013, CSC received housing assistance payments of $608 and $600, respectively, which are included in patient service revenue in the accompanying consolidated statements of operations. The effective date of the contract is retroactive to April 1, 2013 and expired on March 31, 2014. The overall contract expiration date is March 31, 2033.

Note U - Certain Risks and Uncertainties

Regulation and Reimbursement

MHS provides health care services primarily through an acute care hospital in Baltimore City and a long-term care facility in Baltimore County, Maryland.

MHS and other healthcare providers in Maryland are subject to certain inherent risks, including the following:

- Dependence on revenues derived from reimbursement by the federal Medicare and State Medicaid programs;
- Regulation of hospital rates by the State of Maryland Health Services Cost Review Commission;
- Government regulation, government budgetary constraints and proposed legislative and regulatory changes; and
- Lawsuits alleging malpractice and related claims.

Such inherent risks require the use of certain management estimates in the preparation of MHS' consolidated financial statements and it is reasonably possible that a change in such estimates may occur.

The Medicare and state Medicaid reimbursement programs represent a substantial portion of MHS' revenues and MHS' operations are subject to a variety of other federal, state and local regulatory requirements. Failure to maintain required regulatory approvals and licenses and/or changes in such regulatory requirements could have a significant adverse effect on MHS. Changes in federal and state reimbursement funding mechanisms and related government budgetary constraints could have a significant adverse effect on MHS.

Note U - Certain Risks and Uncertainties - Continued

Regulation and Reimbursement - Continued

The federal government and many states have aggressively increased enforcement under Medicare and Medicaid anti-fraud and abuse laws and physician self-referral laws. Recent federal initiatives have prompted a national review of federally funded health care programs. In addition, the federal government and many states have implemented programs to audit and recover potential overpayments to providers from the Medicare and Medicaid programs. MHS has implemented a compliance program to monitor conformance with applicable laws and regulations, but the possibility of future governmental review and enforcement action exists.

As a result of recently enacted and pending federal health care reform legislation, substantial changes are anticipated in the U.S. health care delivery system. Such legislation includes numerous provisions affecting the delivery of health care services, the financing of health care costs, reimbursement of health care providers, and the legal obligations of health insurers, providers and employers. These provisions are currently slated to take effect at specified times over the next decade. This federal health care reform legislation does not affect the consolidated financial statements for the year ended June 30, 2014.

Investments

MHS and certain of its subsidiaries have funds on deposit with financial institutions in excess of amounts insured by the Federal Deposit Insurance Corporation.

Certain alternative investments held in the MHS portfolio are exposed to potential risks in excess of the risks associated with the other investments in the MHS portfolio. These include, but are not limited to, the following potential risks:

- limited or no liquidity (including "side pocket" arrangements),
- derivative financial instruments that expose the investment funds to market risk (if the market value of the contract is higher or lower than the contract price at the maturity date) and credit risk (arising from the potential inability of counterparties to perform under the terms of the contracts),
- investment in non-marketable securities that are valued without the benefit of an active secondary market,
- substantially less regulation, and
- no current income production.

Note V – Endowment

Current accounting standards provide guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of the Uniform Prudent Management of Institutional Act of 2006 (UPMIFA) and additional disclosures about an organization's endowment funds. In 2008, the State of Maryland adopted UPMIFA.

The MHS endowments consist of three individual funds established for a variety of purposes. The endowments include both donor-restricted endowment funds and funds designated by the board of trustees to function as endowments. As required by generally accepted accounting principles, net assets associated with endowment funds, including funds designated by the board of trustees to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

The board of trustees of MHS has interpreted the Maryland State Prudent Management of Institutional Funds Act (SPMIFA) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds absent explicit donor stipulations to the contrary. As a result of this interpretation, MHS classifies as permanently restricted net assets (a) the original value of gifts donated to the permanent endowment, (b) the original value of subsequent gifts donated to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund. The remaining portion of the donor-restricted endowment fund that is not classified in permanently restricted net assets is classified as temporarily restricted net assets until those amounts are appropriated for expenditure by the organization in a manner consistent with the standard of prudence prescribed by SPMIFA. In accordance with SPMIFA, MHS considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

(1) The duration and preservation of the 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

(Dollars in thousands)

Note V – Endowment - Continued

MHS has adopted an investment policy for endowment assets that attempts to provide a predictable stream of funding to programs supported by its endowments while seeking to maintain the purchasing power of the endowment assets. Endowment assets include those assets of donor-restricted funds that must be held in perpetuity.

To satisfy its long term rate-of-return objectives, MHS relies on a total return strategy in which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). MHS targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

At June 30, 2014, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ 155	$ 2,178	$ 2,333
Total funds	$ 0	$ 155	$ 2,178	$ 2,333

At June 30, 2013, the endowment net asset composition by type of fund consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Donor-restricted funds	$ 0	$ (19)	$ 2,178	$ 2,159
Total funds	$ 0	$ (19)	$ 2,178	$ 2,159

(Dollars in thousands)

Note V – Endowment - Continued

Changes in endowment net assets for the fiscal year ended June 30, 2014, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ (19)	$ 2,178	$ 2,159
Investment return:				
Investment income	0	265	0	265
Total investment loss	0	265	0	265
Appropriation of endowment asset for expenditure	0	(91)	0	(91)
Endowment net assets, end of year	$ 0	$ 155	$ 2,178	$ 2,333

Changes in endowment net assets for the fiscal year ended June 30, 2013, consisted of the following:

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Endowment net assets, beginning of year	$ 0	$ (131)	$ 2,178	$ 2,047
Investment return:				
Investment income	0	186	0	186
Total investment income	0	186	0	186
Appropriation of endowment asset for expenditure	0	(74)	0	(74)
Endowment net assets, end of year	$ 0	$ (19)	$ 2,178	$ 2,159

(Dollars in thousands)

Note W – Other Long-Term Liabilities

Other long-term liabilities consist of the following at June 30:

	2014	2013
Deferred compensation plan	$ 6,184	$ 5,737
Retirement annuity plan	4,115	4,176
GIC claims estimated tail	2,374	1,000
Other	591	529
	$ 13,264	$ 11,442

Note X – Asset Abandonment

During fiscal year 2014, MHS abandoned several property projects. During fiscal year 2013, MHS decided to abandon its investment in the partially-completed upgrade of the Meditech hospital information system. Although management already had plans to replace the existing physician electronic health record (EHR) computer system with EPIC, significant performance issues with the previous EHR computer system accelerated its replacement. Management decided that EPIC was a better solution to achieving an integrated EHR (hospital and physician), and therefore abandoned efforts to complete the Meditech project. The first phase of the EPIC install (EPIC ambulatory for physicians) went live August 1, 2013.

Note Y - Subsequent Events

Management evaluated all events and transactions that occurred after June 30, 2014 and through September 8, 2014, the date the consolidated financial statements were available to be issued. MHS did not have any material recognizable subsequent events during the period.

OTHER FINANCIAL INFORMATION

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information
June 30, 2014
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
ASSETS							
CURRENT ASSETS							
Cash, cash equivalents and short term investments	$ 127	$ 2,875	$ 75,692	$ 8,152	$ 342	$ 0	$ 87,189
Current portion of funds held by trustee or authority	0	0	10,474	1,160	0	0	11,634
Resident prepayment deposits	0	0	0	496	0	0	496
Patient receivables, net	0	0	21,997	6,586	14,634	0	43,217
Other receivables, net	579	0	7,957	(590)	268	(1,276)	6,937
Current pledges receivable, net	0	4,181	0	0	0	0	4,181
Inventory	0	0	6,969	274	565	0	7,808
Other current assets	0	0	4,904	133	120	0	5,157
TOTAL CURRENT ASSETS	706	7,056	127,993	16,211	15,929	(1,276)	166,619
PROPERTY AND EQUIPMENT	0	0	515,428	23,607	7,052	0	546,087
INVESTMENTS AND OTHER ASSETS							
Funds held by trustee or authority, less current portion	0	0	22,095	1,035	0	0	23,130
Long-term investments	6,874	0	4,108	0	0	0	10,981
Board designated and donor restricted investments	10,886	12,406	100,915	17,735	0	0	141,941
Restricted cash	0	2,055	62,083	0	0	0	64,138
Interest in net assets of MHF	0	0	19,965	5,398	0	(25,363)	0
Long-term pledges receivable, net	0	8,462	0	0	0	0	8,462
Investments in and advances to affiliates	13,050	(3,483)	(5,080)	(173)	(393)	(3,001)	920
Reinsurance balances receivable	0	0	4,150	0	0	0	4,150
Other assets	138	0	16,833	524	3,041	0	20,535
TOTAL ASSETS	$ 31,653	$ 26,495	$ 868,489	$ 64,337	$ 25,629	$ (29,640)	$ 986,963

See independent auditors' report

Mercy Health Services, Inc. and Subsidiaries
Consolidating Balance Sheet Information-Continued
June 30, 2014
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
LIABILITIES AND NET ASSETS							
CURRENT LIABILITIES							
Current maturities of long-term debt	$ 26	$ 0	7,980	$ 1,261	$ 0	$ 0	$ 9,267
Accounts payable and accrued expenses	189	0	66,859	6,044	11,521	(1,390)	83,223
Resident prepayment deposits	0	0	0	495	0	0	495
Construction retainage	0	0	0	0	0	0	0
Line of credit	0	0	8,000	0	0	0	8,000
TOTAL CURRENT LIABILITIES	215	0	82,839	7,800	11,521	(1,390)	100,985
Long-term debt	114	0	416,792	14,893	0	0	431,799
Provision for outstanding losses	0	0	51,599	0	0	0	51,599
Post-retirement obligation	0	0	6,221	0	0	0	6,221
Interest rate swap liabilities	0	0	29,804	0	0	0	29,804
Other long-term liabilities	0	248	13,001	16	0	0	13,264
TOTAL LIABILITIES	329	248	600,256	22,709	11,521	(1,390)	633,673
NET ASSETS							
Unrestricted	31,324	884	247,151	32,954	13,380	(2,887)	322,805
Temporarily restricted	0	23,308	19,959	7,619	729	(23,308)	28,307
Permanently restricted	0	2,055	1,123	1,055	0	(2,055)	2,178
TOTAL NET ASSETS	31,324	26,247	268,233	41,628	14,108	(28,250)	353,290
TOTAL LIABILITIES AND NET ASSETS	$ 31,653	$ 26,495	$ 868,489	$ 64,337	$ 25,629	$ (29,640)	$ 986,963

See independent auditors' report

Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information
Year ended June 30, 2014
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
REVENUES							
Patient service revenues (net of allowances and discounts)	$ 0	$ 0	$ 426,358	$ 49,750	$ 131,934	$ 0	$ 608,042
Provisions for bad debt	0	0	(14,580)	(579)	(7,560)	0	(22,719)
Net patient service revenues	0	0	411,778	49,171	$ 124,375	0	585,324
Other operating revenues	1,481	877	23,742	7,364	10,297	(11,234)	32,529
Net assets released from restrictions used for operations	0	0	2,403	1,290	167	0	3,860
TOTAL REVENUES	1,481	877	437,923	57,825	134,839	(11,234)	621,712
EXPENSES							
Salaries and benefits	1,324	1,151	193,682	37,471	109,105	(4,643)	338,090
Medical and surgical supplies	0	0	54,249	879	851	0	55,979
Pharmacy supplies	0	0	25,354	1,064	8,351	0	34,769
Other expendable supplies	0	150	21,068	4,380	1,766	0	27,364
Professional fees	0	0	8,664	2,914	5,773	(1,142)	16,208
Insurance	0	0	18,742	932	5,106	32	24,812
Other purchased services	41	235	48,343	3,455	3,896	(6,166)	49,804
Interest expense	0	0	18,850	879	0	0	19,729
Repairs	0	27	10,757	879	677	0	12,340
Depreciation and amortization	0	0	35,345	2,220	2,522	0	40,087
TOTAL EXPENSES	1,365	1,563	435,054	55,073	138,046	(11,919)	619,181
OPERATING INCOME (LOSS)	116	(686)	2,869	2,752	(3,207)	686	2,531

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Mercy Health Services, Inc. and Subsidiaries
Consolidating Statement of Operations Information - Continued
Year ended June 30, 2014
(Dollars in thousands)

	Mercy Health Services, Inc.	Mercy Health Foundation, Inc.	Mercy Medical Center, Inc.	Stella Maris, Inc.	Physician Enterprise	Eliminations	Consolidated
OTHER INCOME (EXPENSES)							
Investment income	$ 1,514	$ 233	$ 3,283	$ 659	$ 0	($233)	$ 5,456
Equity in gains of affiliates	588	0	0	0	0	0	588
Net unrealized gain(loss) on trading securities	936	452	7,950	1,269	0	(452)	10,155
Unrealized loss on interest rate swap	0	0	(961)	0	0	0	(961)
Gain on early extinguishment of debt	0	0	(365)	0	0	0	(365)
Gain (loss) on asset disposal	0	0	(16)	0	0	0	(16)
Asset abandonment	0	0	(494)	0	(118)	0	(612)
Other	0	0	(110)	(65)	(232)	0	(407)
NET OTHER INCOME (EXPENSES)	3,039	686	9,287	1,863	(350)	(686)	13,839
EXCESS (DEFICIT) OF REVENUES OVER EXPENSES	3,155	0	12,156	4,615	(3,557)	0	16,370
Changes to post retirement plans obligations	0	0	(34)	0	0	0	(34)
Transfers of net assets	0	0	(3,887)	0	3,887	0	0
Net assets released from restrictions for the purchase of property and equipment	0	0	2,887	(42)	0	0	2,845
INCREASE (DECREASE) IN UNRESTRICTED NET ASSETS	$ 3,155	$ 0	$ 11,122	$ 4,573	$ 330	$ 0	$ 19,180

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